OCC FAQ: Explaining the Impact and Drivers of S&P Downgrades of Connecticut Utilities' Credit Ratings

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<u>What do utility company credit downgrades mean for utility customers</u>?

Q. How do Connecticut utilities' new credit ratings compare to other utilities?

A. Standard and Poor's (S&P) recently downgraded their credit ratings for several utilities. Connecticut Light and Power (CL&P) is now rated A. Connecticut Natural Gas (CNG), Southern Connecticut Gas (SCG) and Eversource Energy are now rated BBB+. Yankee Gas Services is now rated BBB. Aquarion Water is now rated BBB-. All have stable outlooks. These ratings changes only impact Eversource Energy and its subsidiaries, as well as CNG and SCG, which are subsidiaries of Avangrid. Notably, S&P has not adjusted its credit ratings for the other investor-owned Connecticut utilities or their corporate parents. United Illuminating and its parent, Avangrid, remain at A- and BBB+, respectively. Connecticut Water and SJW Group its parent, both remain at an A- rating.

According to the electric utility industry group Edison Electric Institute (**EEI**), "[t]he industry's average parent company credit rating in 2023 remained at BBB+ for the tenth straight year." At the end of 2023, "68% of parent company outlooks were "stable", 16% were "positive" or "watch positive", 16% were "negative" or "watch-negative"."

Despite these downgrades, Connecticut utilities are therefore still rated higher than many utilities across the country – See **EEI** update – and hold investment grade ratings signifying a relatively low risk as a stable companies with adequate capacity to meet financial commitments. Understanding Credit Ratings | S&P Global Ratings.

Q: Is it true that credit downgrades can increase costs for utility companies that are passed on to customers?

A: Yes – it is true that lower credit ratings tend to result in higher debt costs. Just like when a consumer's credit score is low, the consumer will generally not be able to access lower interest rates for borrowing. It is also true that when a utility company pays interest on debt, those costs are generally recovered in customer rates. However, as discussed further below, when; how much; and whether an increased debt cost will result in higher overall rates are all dependent upon many other factors. Because of this unknowable scope of rate impact, we believe the level of harm projected by Eversource and Avangrid to both their companies from these credit downgrades is overstated.

Q: Are my rates going to increase because of the credit downgrade?

A: There is no immediate or automatic impact to rates from these credit downgrades. Rates can only be changed by PURA. PURA recently decreased rates for both CNG and SCG. CNG/SCG's

downgrades, which resulted from their rate case decisions, cannot change those rate decisions. Yankee Gas, which is owned by Eversource, recently filed a rate increase application and we expect that PURA will rule on it next year. There is no pending application from Eversource's Connecticut electric company, Connecticut Light and Power ("CL&P"), to increase electric rates. Unless and until a rate application is reviewed at a future point, we cannot be certain whether a credit downgrade will result in an overall rate increase. The cost of debt is also only one component of rates, and its effect upon overall rates can greatly vary depending on all the other rate components under consideration.

Q: Do these credit downgrades mean that all my utility's debt costs are going up?

A: Not necessarily. The downgrade does not impact existing debt (e.g. loans/borrowing) unless they are subject to variable interest rates. When a regular consumer obtains a mortgage, that person's credit score at the time of the transaction has a direct impact upon the interest rate applied to the mortgage – but if the person's credit score goes up or down after the transaction closes, it typically does not impact the actual mortgage payment unless the person refinances the mortgage at a new rate. The same is true for utility companies – a credit downgrade, like a lowered credit score, primarily impacts the interest rates they will be able to obtain on new debt in the future, and generally does not negatively impact the debt already issued.

Q: How long will the credit downgrade increase the interest rates a utility is able to obtain?

A: When a utility company's credit rating changes will depend upon many factors – including a parent company's financial condition. This includes metrics like the Funds From Operations ("FFO") to debt ratio, which measures a company's ability to pay off its debt using its operating income, and which S&P commonly identifies as a credit rating driver. For example, S&P has noted that if Eversource can increase its FFO to debt ratio above 15%, and there are no increased business risks, their credit rating can improve. Eversource has indicated that it expects this metric to improve in 2025 when the full revenues associated with the sales of its offshore wind interests are realized, and when it is able to recover outstanding deferred costs – including some costs for storm response by CL&P in Connecticut. However, again, those costs can only be recovered through a rate adjustment authorized by PURA, and no rate adjustment application by CL&P has yet been filed. Because electric and gas rate applications are reviewed and decided in a 350-day timeline, even if CL&P immediately filed a rate adjustment application, any resulting rate changes would be a year away.

Q: Is this the first time this has happened?

A: No. S&P downgraded Aquarion Water's credit in March of 2024 in light of Eversource's announced intention to sell Aquarion, where S&P believed "Aquarion would only receive extraordinary support from Eversource in some foreseeable circumstances." S&P also downgraded Eversource Energy, Yankee Gas, Aquarion Water, and NSTAR Gas (Eversource's Massachusetts-based gas company) in July of 2019 due to Eversource's "growth strategy towards more offshore wind development activities, which we view as higher risk than its traditional low-risk regulated transmission and distribution (T&D) utility operations."

Other credit rating agencies have also downgraded New England area utilities and their corporate parents in recent history. Fitch downgraded Eversource Energy in January of 2024 due to "continuing uncertainty around the sale of the three offshore wind projects under development." The ratings agency noted: "Fitch expects the sales will be executed at a lower price than previously expected due to the escalation in development costs and the rejection of

the increase in power price at Sunrise Wind. Eversource's credit profile has been weak over the last three years with FFO-leverage over 7.0x, as per Fitch's calculations. Sale proceeds was expected to be a key source of cash for parent level debt reduction, along with equity issuance. At this time, Fitch expects reduction in debt will be lower than expected resulting in leverage around 5.5x by 2025." Moody's also downgraded Eversource Energy and NSTAR Electric in October of 2023 because of the view that Eversource's financial profile would "remain weak and no longer supportive of the previous Baa1 rating. The downgrade also reflects heightened uncertainty as to whether the company's pending offshore wind project sale will be executed in part or as a whole and whether any additional balance sheet strengthening actions will be needed over the next year to offset the challenges associated with the transaction."

Q: How exactly does a credit downgrade impact rates?

A: Again, nothing can change rates unless or until PURA authorizes a rate change. Generally, the cost of debt is included in base distribution rates as a component of the overall weighted average cost of capital (WACC). A utility company's WACC is the blended cost of all its financing sources, including debt and equity, where each source is weighted based on its proportion in the company's capital structure; essentially, it represents the average cost a utility pays to raise capital for its operations. The utility's average cost of debt (i.e. the average interest rate it pays across all applicable borrowing (e.g. loans)) is multiplied by the proportion of its balance sheet (the financial statement that reports a company's assets and liabilities at a specific point in time) that is financed by debt. For example, if a company's capital structure is 52% equity and 48% debt, and its average cost of debt is 4.5%, the weighted average cost of debt would be 2.16% (i.e. 48% of 4.5%). The weighted average cost of debt can then be applied to the company's authorized rate base to determine the revenue necessary to be recovered in rates. Importantly, the debt market itself has as big if not bigger bearing on a utility's borrowing rates as its credit rating.

Q: How much is CL&P currently charging in rates for the cost of debt?

A: The cost of debt currently imputed in CL&P's base distribution rates is 4.64%. The authorized capital structure includes a 45.38% debt ratio. Therefore, the overall cost of debt imputed in base rates is 2.11% of the value of authorized rate base, which is $3.86 billion – meaning the revenue requirement in base rates for the cost of debt is $81,457,879. This is approximately 7% of CL&P's authorized $1.158 billion base distribution revenue requirement. The residential distribution rate is a fixed charge of $9.62 per month and a per-kWh charge of $0.05844, so a typical residential customer using 700 kWh per month pays $50.53 per month for distribution. Approximately 7% of that cost ($3.54) would be the monthly cost of debt recovered from the average residential customer.

Q: If the cost of debt goes up, does that mean rates go up?

A: Not necessarily – there are many components to rates. When overall rates are reduced for regulated utilities, as occurred for CNG and SCG, it is possible for a company's credit to be downgraded, which can ultimately increase the cost of capital (including debt). But it is important to note that the increased cost of debt can be offset by other adjustments to revenue. In other words, an increase to the cost of debt can be balanced by decreases to other costs, resulting in potentially stable or even reduced overall rates. For example, PURA decreased the authorized annual revenues for CNG and SCG by $25 million and $11 million, respectively. Both companies recently received credit downgrades as direct results of those rate decreases, but our

estimate is that any resulting increase to the cost of debt would be far less significant than those overall decreases to rates.

Q: Where does the cost of debt show up on my electric bill?

A: The WACC is an element in several components of rates, such as the "local delivery" category on your CL&P bill, where the company collects both profits and the cost of debt on an annual basis. It is also a component in the "public benefits" category, where companies are currently recovering some deferred costs at the weighted average cost of capital (inclusive of both profit and interest costs). However, in both of these areas the rate applied to these sections of the bill is the company's WACC as determined in its last base distribution rate case. Unless and until PURA authorizes an adjustment to that authorized rate (within a base distribution rate case) or otherwise authorizes an adjustment to these items within an annual Rate Adjustment Mechanism proceeding, these bill components also cannot change.

Q: Is the credit downgrade a threat to Connecticut's economy or overall business environment?

A: As discussed above, when a regulated utility company's credit is downgraded, it increases the cost of borrowing. This increase in costs can have broader impacts, including acting as a potential disincentive to utilities to spend more money in Connecticut – which itself can impact businesses that contract with utilities to build or improve infrastructure or provide other services. However, as discussed above, a BBB+ is still an investment grade rating, so the cost of borrowing will not skyrocket. Additionally, this credit downgrade is partially the result of PURA's increased scrutiny of utility rates resulting in rate decreases for some companies. Because nearly every business in Connecticut is also a ratepayer, businesses also benefit from a regulatory environment that ensures that utility rates are no higher than necessary. Limiting or even lowering overhead costs for our local businesses can attract more investment and jobs into our state. Similarly, households with better regulated utility rates can devote more household income to local goods and services, which can have a net positive impact on the state's economy.

Why did S&P Downgrade Eversource's Credit Rating from "A-" to "BBB+"

Summary:

- On Monday, December 9, 2024 S&P issued a Report that announced a credit rating downgrade to Eversource Energy, the parent company to CL&P, Yankee Gas, and Aquarion Water. In the Report, S&P cited 2 reasons for the downgrade of Eversource: 1) "adverse regulatory developments for investor-owned utilities operating in Connecticut, which we believe has increased business risk for Eversource Energy and its Connecticut-based subsidiaries" and 2) "Eversource's financial measures have remained weak for the current rating, including funds from operations (FFO) to debt of 11.1% for the 12 months ended September 2024." This FFO to debt ratio is a measure for cashflow, which has been constrained for Eversource for several consecutive years. Several of Eversource's local distribution entities across multiple states – including but not limited to CL&P – were also impacted.

- This downgrade follows several notices by S&P that Eversource was at risk of a credit rating downgrade due to significant cash flow issues. S&P's stated concern – dating back to at least 2019 – has been that Eversource has been overleveraged at the corporate parent level and must generate more cash flow in order to balance its debt portfolio.

- There has been consistent messaging from S&P over the years that the company's FFO to debt ratio must improve to at least 14% or Eversource would be downgraded.
- Statements issued by Eversource related to Monday's downgrade do not acknowledge the long-standing warnings issued by the market analysts and instead have suggested that the regulatory environment in Connecticut is the sole cause of the downgrade. Detailed in the S&P reports and Eversource earnings presentations below, the Connecticut regulatory environment is a certainly a component factored into its recent credit downgrade, but the Company's consistent cash flow issues -- relating most materially to its offshore wind investments and losses, accrued deferrals and under-recovered expenditures -- have caused the company to remain below S&P's "downgrade threshold" for an extended period of time.
- Prior to the credit downgrade, Eversource also identified substantial under-recoveries and deferrals of costs in Connecticut as one of its cashflow concerns. When PURA increased rates for Connecticut electric customers on July 1, 2024, that rate increase provided Eversource with significant revenue to resolve some of these under-recoveries, for example for costs related to the Millstone Nuclear plant and uncollectible debt from unpaid bills that accrued during the COVID-19 pandemic. Eversource also successfully converted its regulatory deferral for the EV charging program to cash flow via PURA's second rate increase on September 1, 2024. Eversource is continuing to pursue cost recovery for its storm deferrals in Connecticut – which remains the only outstanding Connecticut-related item highlighted on its FFO to debt improvement plan. Therefore, Eversource's cash-flow related to under-recoveries have significantly improved, not worsened, over the last year. All other items identified by Eversource in their presentations pertain to financial planning at the parent company level.

Detailed Timeline of Eversource's Credit Rating Activity:

As detailed in the S&P reports and Eversource (parent company) earnings presentations below, the Connecticut regulatory environment is a component in its recent credit downgrade, but the Company's consistent cash flow issues – relating most materially to its offshore wind investments and losses, accrued deferrals and under-recovered expenditures – have caused the company to remain below S&P's "downgrade threshold" for an extended duration:

1. On February 12, 2019 (significantly pre-dating any of the Connecticut regulatory activity Eversource has referenced as problematic), S&P revised Eversource's credit outlook to Negative because of the company's planned involvement in a joint offshore wind venture. The report noted: "The negative outlook on Eversource reflects the potential for a downgrade of one or more notches over the next 6-12 months due to the possible shift in the company's growth strategy toward higher-risk offshore wind generation. The negative outlook also incorporates our view that the company's FFO-to-debt ratio may weaken below our downgrade threshold of 15%."
2. On April 25, 2019, demonstrating that rating agencies consider their view of a parent when adjusting the credit rating of a subsidiary, S&P announced that it was affirming its negative outlook for Yankee Gas, and noted that " Our negative outlook on YGC reflects that we could downgrade its parent Eversource by one or more notches in the next six to 12 months due to a possible shift in its growth strategy toward higher-risk offshore wind generation. The negative outlook also incorporates our view that Eversource's FFO-to-debt ratio may weaken below our downgrade threshold of 15%."

3. On July 25, 2019, S&P downgraded Eversource's credit rating because of its perception of increased risk associated with offshore wind, noting: "Although unlikely, we could raise our ratings on Eversource and its subsidiaries over the next 12-24 months if the company's offshore wind generation investments remain limited and it maintains an FFO-to-debt ratio of consistently above 18% with no adverse changes in its management of regulatory risk."

4. On May 6, 2021, S&P affirmed its credit outlook for Eversource, noting: "We expect Eversource's FFO-to-debt ratio to be about 13%-14%, which indicates the company has minimal financial cushion."

5. On May 9, 2022, S&P revised its outlook to positive when Eversource announced the sale of its offshore wind interests. S&P again noting Eversource's rating could be raised if "it sells its entire offshore wind joint venture, consistently maintains FFO to debt of more than 13%, and continues to effectively manages its regulatory risk at a level significantly better than that of its peers in Connecticut and Massachusetts."

6. Then on October 26, 2023, S&P announced negative credit outlook for Eversource because the timing of its exit from the offshore wind business became uncertain. In that report, they noted: "*We could lower the ratings over the next 12-24 months should Eversource fail to maintain FFO to debt consistently above 13%****. This could occur if the company cannot sell its offshore wind assets at an attractive valuation, does not use proceeds from a sale in a credit-supportive manner, does not access the equity capital markets in a manner that at least consistently maintains financial measures above the downgrade threshold, or experiences further adverse regulatory outcomes beyond what we expect.*** *We could also lower the ratings if the company were unable to sell its offshore wind assets while its FFO to debt remains below 16%."*

7. On January 11, 2024 S&P placed Eversource on CreditWatch "Negative" following its announced offshore wind impairment. In that write-up, S&P highlighted the company's expected $2 billion loss on offshore wind, and noted the FFO to debt ratio in that context: "*The company expects to recognize an impairment charge between $800 million and $900 million for increased costs associated with its installation vessels and supply chain cost increases related to foundation fabrication. In addition, the company expects to recognize an additional impairment of $600 million-$700 million related to uncertainties regarding the JV's Sunrise Wind LLC project in New York. In total, we expect impairment charges between $1.4 billion and $1.6 billion, which is significantly higher than our previous base case and will likely weaken forward-looking financial measures. While the company is in advanced negotiations to sell its offshore wind assets, this impairment charge is a likely indication that the valuation of its offshore wind asset could be materially affected. Previously, our base case forecast did not assume an impairment, and we also assumed that Eversource would issue at least $1 billion of equity over the next few years. Given the negative development and the absence of other significant credit supportive measures,* ***we expect Eversource's financial measures to consistently remain below our downgrade threshold. For the 12 months ended September 2023, Eversource's FFO to debt was 9.7%, materially below our downgrade threshold."***

   That report did go on to discuss the Connecticut regulatory environment as another concerning factor, but ultimately concluded: "*The CreditWatch placement with negative implications reflects the likelihood that we could lower the ratings on Eversource over the next 90 days if it does not take credit-supportive measures to consistently improve its financial measures.* ***We could lower Eversource's ratings if it sells its offshore wind investments but FFO to debt remains below***

14%. *Alternatively, we could also lower ratings if the company maintains its offshore wind assets but FFO to debt does not consistently improve to greater than 17%."*

8. On February 14, 2024, Eversource announced Q4 2023 results noting net losses in the full year attributable to their natural gas and water distribution businesses losses per share of $0.03 and $0.02, respectively) and – primarily – losses of $5.56 per share due to “wind impairment, transition/transaction and other costs”. *(see slide 11).* The 2023 after-tax wind impairment was reported to be $1.95 billion. *(see slide 12).* They announced a plan to improve their FFO to debt ratio by 2025 using:

    a. Offshore wind proceeds
    b. Planned rate increase
    c. Collection of deferrals
    d. Storm cost recovery
    e. Equity issuances
    f. Sale of Aquarion (see slide 20)

9. On March 5, 2024, S&P removed Eversource from CreditWatch because of the confirmatory announcement of the wind asset sale. However, it maintained a negative outlook for Eversource because: *"The negative outlook on Eversource reflects the company's minimal financial cushion for the current rating level coupled with the company's remaining offshore wind construction risk, execution risks related to its asset sales, and its ability to consistently and effectively manage regulatory risk in Connecticut.* ***We expect Eversource's funds from operations (FFO) to debt to be about 14% throughout our forecast period."***

    They specifically noted: *"Eversource's financial measures have minimal financial cushion from its downgrade trigger. Eversource's 2023 FFO to debt was 8.9%, significantly below our downgrade threshold of 14%. Under our base case of robust annual capital spending of more than $4 billion, annual dividends of about $1 billion, cash flow deficits of more than $1 billion, equity issuance of $1.3 billion through 2027, and the possibility that the company sells its water utility, we expect consolidated financial measures that more consistently reflect FFO to debt of about 14%. This is indicative of minimal financial cushion from the company's downgrade threshold and could lead to a downgrade if financial performance is not consistently improved to a level above our downgrade threshold."*

10. On May 2, 2024, Eversource announced Q1 2024 financial results noting positive earnings in all regulated utility business areas, with the only loss being in the “Parent & Other” category. *(See slide 9).* They noted their plan to resolve their FFO to debt results by pursuing “2023 under recovery of CT annual rate adjustment mechanism” and “2023 other under recoveries”. *(See slide 10).* Other elements of the plan included “GIP Sale Proceeds” (referring to the sale of South Fork and Revolution Wind projects); “South Fork Wind Tax Equity Investment”; “incremental storm cost recovery (2024 and 2025) and “total other enhancements”. *(see slide 10).* The same presentation showed that the expected revenues associated with the wind sales remained pending. *(see slide 15).*

11. On August 1, 2024, Eversource announced Q2 2024 results and noted the same plan to improve its FFO to debt ratio – still including the 2023 under recoveries of CT Annual Rate Adjustment Mechanism – which was the widely-publicized July 1 and September 1, 2024 rate increases authorized by PURA. By this time, the only remaining identified steps to enhance their FFO to debt ratio pertained to wind and storm cost recovery. *(see slide 12).*

12. On November 5, 2024, Eversource reported Q3 2024 results. They reported a loss in earnings per share of $1.30 due to "Losses on Offshore Wind and Other Charges." Note that every regulated utility business center was reported to be driving positive earnings. *(See slide 8).*

13. On December 9, 2024, as summarized above, S&P downgraded Eversource, citing **both** the Connecticut regulatory environment after the CNG/SCG rate case decision, as well as the message S&P had been consistently delivering for years: "*Eversource's financial measures have remained weak for the current rating, including funds from operations (FFO) to debt of 11.1% for the 12 months ended September 2024. Given these developments and, even after incorporating the potential sale of Aquarion Co. and its use of proceeds in a credit-supportive manner,* ***we do not expect Eversource's consolidated FFO to debt will consistently be greater than 14%***".