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S&P: How Utilities Pay For Post-Sandy "Storm-Hardening" Infrastructure Investments Could Factor Into Credit Quality.

In October 2012, Superstorm Sandy knocked out electric service to 1.4 million of New York's Consolidated Edison Inc.'s approximately 3.3 million electric customers and about 920,000 of Long Island Power Authority's (LIPA) approximately 1.1. million customers. The lights also went out for about 1.7 million of New Jersey's Public Service Electric & Gas Co.'s (PSE&G) 2.2 million electric customers. For many, the outages lasted weeks, resulting in strong economic impacts that reverberated through the region as businesses closed and gasoline sales ground to a halt. Because the repercussions of the storm-related power outages were so wide, utility and government officials realized they needed strong utility responses to prevent this from happening again. Specifically, the utilities clearly needed to pursue investments in what the industry calls "storm hardening."

Although these utilities' solutions and their costs share common elements, the funding sources available reflect varying views among government officials as to where the financial responsibility for funding these investments lies. The availability of federal aid is also an important element of the funding solutions. Standard & Poor's believes that the means for funding and cost recovery can be important factors in determining credit quality.

Overview

- After incurring substantial power restoration costs, utilities affected by Superstorm Sandy are pursuing sizable storm-hardening investments.
- The extent to which government funds are available to defray these investments or, alternatively, the presence of regulatory approvals providing for cost recovery from customers could have credit implications.

The Storm-Hardening Programs' Common Attributes

Given the breadth of these utilities' service areas and their extensive coastal exposures, storm hardening costs will be substantial — about $1 billion per utility. Common elements of their storm hardening programs include raising key structures, such as substations, to heights that are better able to withstand storm surges. The utilities will also replace existing poles with stronger poles in those areas at risk for storm surges and they will step up activities to reduce the potential for trees and branches knocking down power lines.

FEMA Comes To LIPA's Aid

The long outages that LIPA's customers experienced triggered considerable ire among customers and politicians, leading to state legislation that imposed greater regulatory oversight. It whittled LIPA's capacity to set rates on its own, subjecting rate adjustments to hearings if rate increase proposals exceed prescribed thresholds. In addition, the legislation transformed the utility's

operations by transferring day-to-day operations to an affiliate of one of the region's investor-owned utilities and sets three days as the baseline for restoring service following a major power failure. If LIPA does not meet this target, the system operator must provide New York's Department of Public Service with an assessment of the utility's pre-event preparedness and post-event restoration efforts. The state also asked LIPA to freeze its base rates for at least one year, which it did, and the state is seeking a second year on that freeze. We believe these actions could reduce the utility's financial flexibility. We consider financial flexibility to be critical to responding to potentially volatile costs and preserving credit quality. Our negative outlook on LIPA reflects the constraints these conditions could impose on financial performance.

Against the backdrop of the state's response to the storm outages, the utility found a financing lifeline in the Federal Emergency Management Agency (FEMA). FEMA reimbursed LIPA for about 90% of its storm restoration costs. The agency reimburses these types of costs for not-for-profit utilities because they cannot take advantage of the federal tax benefits that investor-owned utilities can. Moreover, in an unusual move, the agency also agreed to finance much of LIPA's prospective storm hardening activities. This decision provides the utility with the capacity to buttress its system without incurring substantial infrastructure investment financing needs while its base rates remain frozen. The FEMA reimbursement plan helps shore up credit quality while enabling LIPA to invest in reliability as it faces ratemaking constraints.

Limits On Consolidated Edison's Options

Unlike LIPA, New York's Consolidated Edison, an investor-owned utility, will not have the benefit of FEMA resources to strengthen its system's storm resiliency. It also funded its storm recovery and restoration costs differently from LIPA, by capitalizing portions of its $363 million of spending. It recorded the uncapitalized balance as a regulatory asset for deferred recovery. In 2012, the company had no current federal income tax liability as a result of, among other things, deduction of costs incurred in connection with Sandy.

Consolidated Edison asked the state's rate regulator for cost recovery for about $1 billion of prospective storm hardening projects. The regulator approved the projects, albeit within a framework of stable rates. We believe that the company will need to effectively control costs and avoid cost overruns in its sizable capital program to mitigate the rate freeze's impact. The costs of storm hardening also need to be considered within the context of the recent East Harlem natural gas explosion. Although the explosion's cause has yet to be determined, and we believe Consolidated Edison carries insurance that should cover a portion of potential costs if it is found liable, it is our view that such a finding could lead to penalties and higher compliance costs for the utility's aging gas distribution system. Our outlook on the company is stable, but possible penalties and additional capital investment needs could harm its financial condition and might lead to modestly lower ratings.

PSE&G Benefits From Supportive State Regulation

By comparison, neighboring PSE&G appears to operate under more beneficial state regulation. On May 1, the New Jersey Board of Public Utilities' staff recommended that the regulator allow the utility to recover from customers $1.2 billion of the $2.6 billion of the multiyear storm hardening investments it had proposed. PSE&G ultimately plans to align its storm hardening spending with the amounts the regulator approves. Staff's recommendation includes a 9.75% return on equity on the first $1 billion of investment and a rate of return on the balance that this utility's next rate case will determine.

Vehicles For Recovering Investments Can Influence Credit Quality

Although very different avenues for funding storm hardening investments are available to these utilities, and some of the investments might weigh negatively on credit quality, the utilities and their regulators nevertheless are consistent in recognizing that investments that will help these systems better withstand storms are critical to enhancing operational predictability and improving customer satisfaction. Although we believe that these investments can contribute to greater operating stability and benefit utilities' enterprise and financial risk profiles, cost recovery — whether from customers or government reimbursements — remains an overarching consideration for credit quality.

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