Inflation Could Weigh On U.S. Not-For-Profit Utilities' Credit Ratings

February 24, 2022

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Key Takeaways

- Inflation--which has reached levels not seen in decades--can adversely influence utilities' operating costs, add to the material and labor costs underlying capital projects, amplify borrowing needs, and expose utilities to higher borrowing costs.
- The effects of inflation are manifest in consumers' utility bills and expensive utility bills add to the other growing pressures on consumers' pocketbooks.
- Inflation can sap some of the benefits not-for-profit utilities derive from autonomous ratemaking authority if it is the catalyst for consumer and political resistance to utility retail rate adjustments needed to maintain a sound alignment among revenues, expenses, and debt service in the face higher operating and capital costs.

Most of the not-for-profit water, sewer, natural gas, public power, and electric cooperative utilities to which S&P Global Ratings assigns ratings have autonomous ratemaking authority. When assigning ratings to these utilities, a key positive consideration is the capacity of their ratemaking frameworks to help preserve sound financial margins by facilitating timely management responses to increasing operating, capital, and financing costs. Nevertheless, it is our view that if inflation creates a need for significant retail rate increases at a time when consumers are facing a panoply of other substantial cost increases that weigh on their wallets, those pressures can engender consumer and political resistance to proposals to increase utilities' retail rates. When utilities face opposition to rate increases needed to address rising costs, such barriers can erode financial performance and translate into negative rating actions if they weaken key financial credit metrics. In addition, inflation that drives rate increases that outpace wage growth can aggravate affordability, which could increase social risks from an ESG perspective and adversely influence credit ratings even if the rate increases shore up credit metrics.

Inflation Has Reached A Multi-Decade High

In its most recent monthly consumer price index (CPI) release covering a broad basket of commodities, products, and services, the U.S. Bureau of Labor Statistics (BLS) reported that the CPI for the 12 months through January 2022 rose 7.5%. This increase represented the largest

12-month increase since the period ending February 1982. Although average hourly earnings for most workers rose 6% year-over-year, inflation erodes some of the benefits of higher wages.

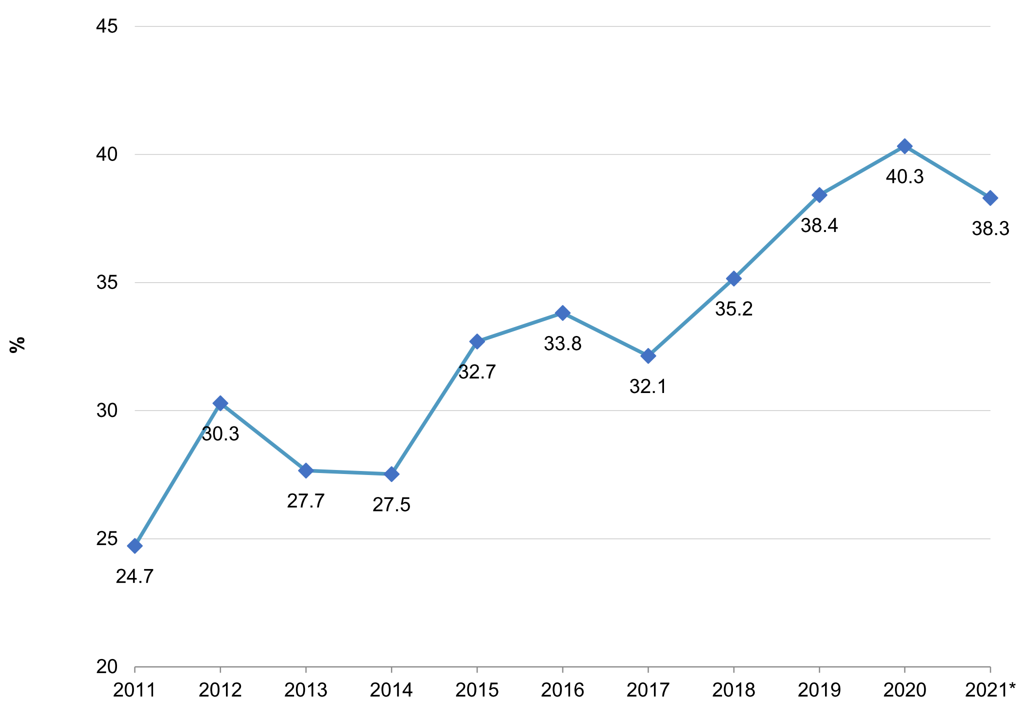
Notably, electricity and natural gas commodities exhibited significantly more pronounced inflation than the CPI basket's historically high 7.5% average. Through January 2022, the 12-month CPI for natural gas rose 23.9% and the index for electricity rose 10.7%. By comparison, water and sewer services exhibited a below average 4% increase. But, as discussed below, that average masks operational and cost differences across these utility systems.

Not-For-Profit Utilities Are Facing Heightened Exposures

Natural gas is a key input for electricity production and heavily influences retail electricity prices. A decade of low natural gas prices and retirements of coal generation units led to a large increase in natural gas's contributions to electricity generation in the U.S. In 2021, natural gas accounted for 38% of U.S. utility-scale electricity production through November, up from 25% in 2011 (see chart 1). Electric utilities' increasing reliance on natural gas to produce electricity compounds the effects of the commodity's recent price increases in the second half of 2021.

Chart 1

Natural Gas As % Of U.S. Utility Scale Electric Generation



*11 months. Source: Energy Information Administration

Although the BLS report shows that in 2021, water and sewer ratepayers fared better than electric ratepayers with only a 4% nationwide average increase during the 12-month period, they and their utilities are not immune to the prevailing outsize inflationary pressures. Water and sewer ratepayers are also electric utility ratepayers and will feel the cumulative effect of inflation across all their utility bills, along with increased spending on food, housing, services, and more. Moreover, customers of those water and sewer systems whose operations have particularly energy intensive requirements for pumping, treatment, or processes such as desalination, will potentially be exposed to cost increases far greater than the 4% national average BLS cites. On average, electricity costs represent 25% to 30% of water and sewer utilities' operating and maintenance expenses and the Environmental Protection Agency (EPA) reports that electricity costs can represent as much as 40% of water utilities' operating costs.

Hedging Arrangements Are Helping Insulate Electric Utilities And Their Customers From Higher Costs

At many utilities, hedging arrangements that locked in gas and purchased power prices at more moderate pre-inflationary levels have helped shield utilities and their customers from commodities' pronounced price increases. Although hedging arrangements can help insulate exposure to upward pressure on market prices of natural gas and power purchases, the effects of inflation on other operating, capital, and borrowing costs remain. Moreover, hedging arrangements are typically short- to intermediate-term arrangements and of staggered durations. Therefore, we expect that as utilities renew these contracts at prevailing prices, they could need to raise retail rates to capture elevated operating costs in order to preserve financial metrics.

The Compounding Effects Of Capital Spending, Regulations, Drought, Extreme Weather, And Financing Needs

Water, sewer, gas, and electric utilities are highly capital-intensive enterprises. Sustaining operational reliability requires significant investments to maintain or replace aging infrastructure and respond to customer growth. Along with inflation, increasingly stringent emissions regulations in the electric sector and clean water regulations in the water sector add to cost pressures, as do projects that mitigate drought conditions and strengthen weather resilience, along with traditional capital spending needs. The confluence of these costs can contribute to upward pressure on customers' utility bills and create constraints on affordability and erode the ratemaking flexibility that is integral to credit quality.

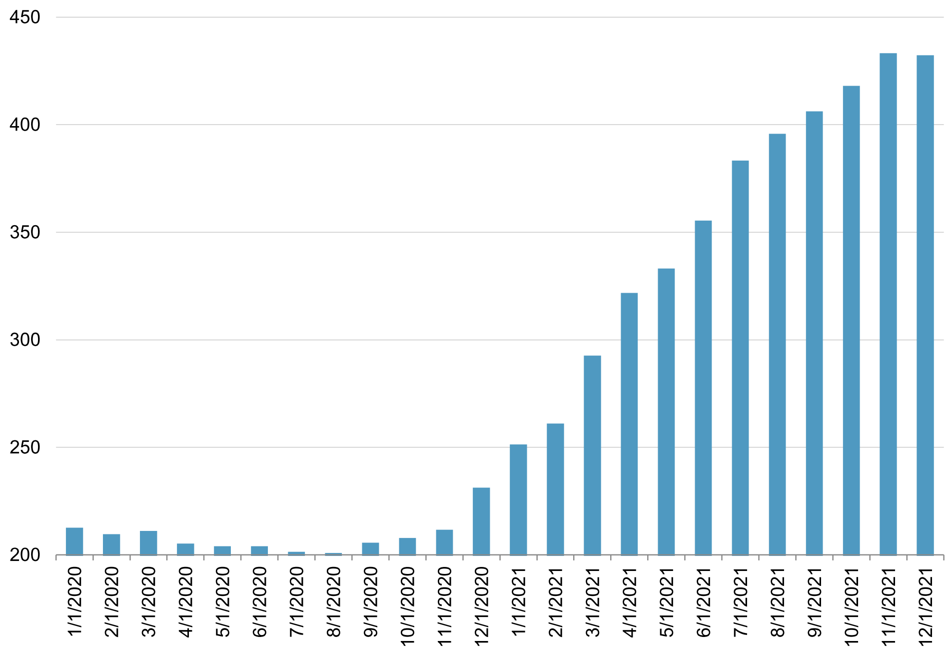
Both due to more rigorous regulations and the public's increasing focus on environmental issues, electric utilities are reducing reliance on generation that emits greenhouse gases. They are doing this by investing in clean generation and transmission that facilitates the transition. These investments add to the cost pressures electric utilities and their consumers face.

U.S. water and sewer utilities also face significant investment needs as they address the sector's aging infrastructure, increasing regulatory requirements, and climate-related resiliency projects. For example, the EPA's 2021 revisions to its lead and copper rule is expected to trigger $30 billion in funding needs. Within the sector, we also expect increased spending on nationwide treatment upgrades in response to enacted and anticipated federal and state contaminant regulations. S&P Global Ratings believes that for these utilities, operational reliability and regulatory compliance require that they replace aging treatment plants and distribution and collection systems. There are an estimated $32 billion in consent decree related costs, which underscores the urgency and magnitude of the infrastructure needs in the sector. In addition, climate change considerations increase system exposure to physical and environmental risks which will require significant infrastructure hardening as well as supply redundancy to meet water scarcity considerations.

The costs of building materials, such as iron and steel, that are necessary for implementing capital programs that align with operational integrity and regulatory compliance have increased markedly over the past two years, as have labor costs (chart 2).

Chart 2

U.S. Producer Price Index: Iron and Steel
Jan. 1, 2020 - Dec. 1, 2021



Source: Federal Reserve Economic Data

Borrowing Costs Are About To Increase

As the Federal Reserve raises interest rates in an effort to control inflation, not-for-profit utilities that rely heavily on debt financing for capital projects--as their generally high debt to capitalization ratios indicate--will face financing costs that could be significantly higher than those in recent years. S&P Global's economists believe the Federal Reserve is poised to implement six rate hikes in 2022. Moreover, we see the potential for sizable rate increases, including the likelihood of a 50-basis-point increase. (See "Economic Research: U.S. Real-Time Data: Solid Job Gains, Surging Prices Fuel The Fed's Policy Rocket," Feb. 11, 2022).

Regulatory Compliance Costs Add To The Burden

To migrate electric generation fleets to cleaner resources, we anticipate that in addition to direct financing of new generation and transmission, many public power and electric cooperative utilities will rely extensively on power purchase agreements (PPA) to add wind, solar, and storage resources. We foresee a significant use of PPAs because these not-for-profit utilities need to partner with taxable entities to garner the monetary benefits of the federal investment tax credits and production tax benefits associated with renewable generation. Due to their not-for-profit status, public power and electric cooperative utilities would not be able to monetize the tax credits if they were to directly invest in renewable resources. Nevertheless, we believe that outsourcing the development of these resource additions will not shield public power or electric cooperative utilities from inflationary construction and financing costs. We expect any higher costs for materials and financing will be baked into developers' prices for power sales agreements with not-for-profit utilities.

Water and sewer utilities will continue to rely heavily on direct investment to meet infrastructure and regulatory requirements. Over the past five years, water and sewer debt has averaged $30 billion a year, with growth outpacing the municipal market. While federal investment may temper public debt issuance, we believe it will bolster infrastructure spending, given the nature of the mandates and the age of the infrastructure nationally.

What We Are Watching

There are many manifestations of inflationary impacts on public power utilities, electric cooperatives, gas distribution utilities, and water and sewer utilities. Persistent inflationary cost pressures can negatively influence ratings if they whittle financial metrics by eroding retail rate affordability and ratemaking flexibility in the face of increased operating, capital, and borrowing costs. Consequently, S&P Global Ratings continues to monitor the effects of inflation to identify utilities whose ratings could be vulnerable to the prevailing inflationary environment.

This report does not constitute a rating action.