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Although Commodity Costs Are A Pass Through For Utilities, They Still Affect Credit Quality

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Sector **Utilities & Power, Oil & Gas, Infrastructure & Utilities, Utilities & Power**

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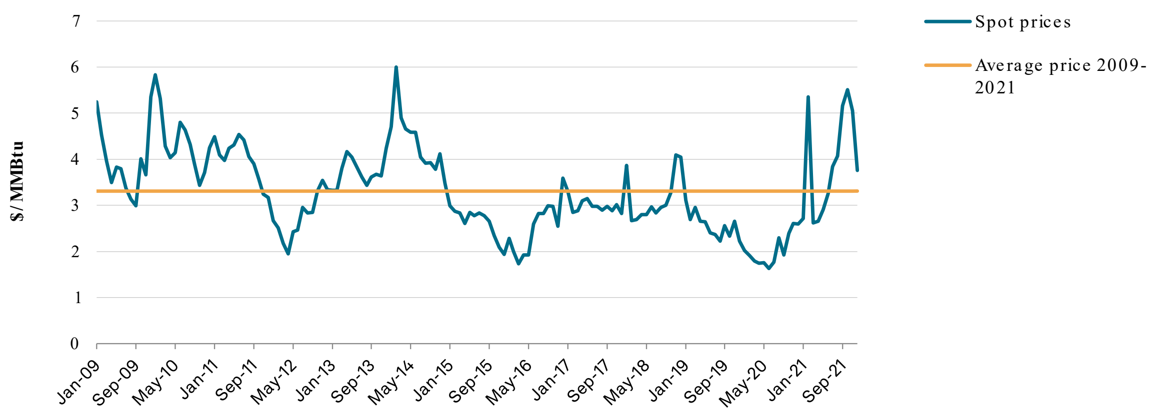
As natural gas prices start to come down again in North America we cannot help but remember lyrics from the Grateful Dead's song, Uncle John's Band: "when life looks like easy street there is danger at your door". We believe these wise words by the late Jerry Garcia reflect the negative impact that rising commodity prices had on North America's regulated utility industry in 2022. Although prices have subsequently retreated, the 2022 experience highlights the industry's susceptibility and credit exposure to rising commodity prices.

How Rising Commodity Costs Affect Working Capital Needs--And The Balance Sheet

The vast majority of North America's regulated investor-owned utilities are able to directly recover commodity costs--such as those related to fuel purchases for electricity generation or natural gas supply--from ratepayers in a timely manner. From 2009 to 2021, natural gas costs were generally very stable, with minimal volatility. About 95% of the time, the monthly Henry Hub natural gas spot price was less than $5/MMbtu and under $3/MMbtu nearly 50% of the time. The average price during this timeframe was $3.30/MMbtu, reflecting consistently low and stable commodity prices. Because utilities usually recovered these commodity costs on a monthly basis, natural gas prices had only a minimal effect on the overall customer bill during these 13 years, making life look like "easy street" for the sector.

Chart 1

Henry Hub natural gas spot prices
Henry Hub spot prices 2009-2021



Source: S&P Global Ratings.

"...there is danger at your door"

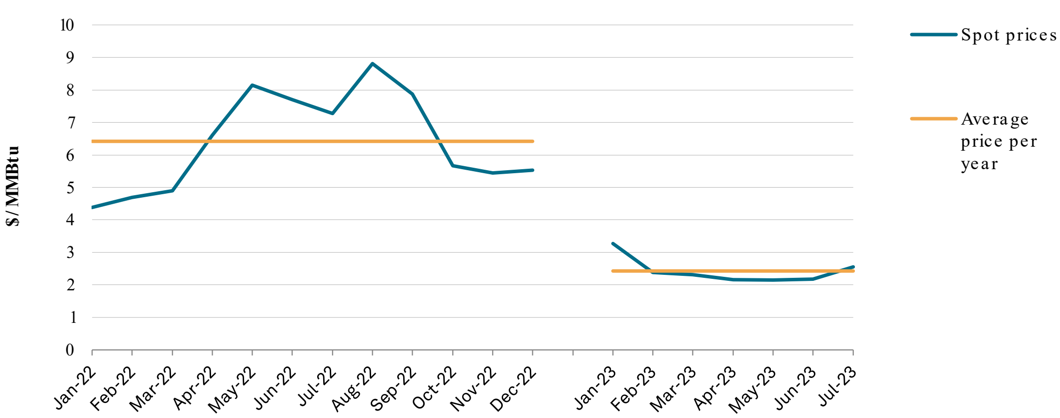
This all changed in 2022 when the price of natural gas sharply increased. During the year, commodity prices were above $5/MMbtu for 9 of the 12 months and nearly reached $9/MMbtu in August 2022, a price not seen since July of 2008. The average monthly price for 2022 was $6.40/MMbtu, nearly double the average price for the prior 13 years. Immediately passing these higher costs to the customer would have sharply increased the customer bill. To reduce this risk, many utilities and regulators determined to defer these higher costs for future recovery. Accordingly, regulatory lag, which is the timing difference between when costs are incurred and when utilities fully recover such costs from ratepayers, generally increased by 6 to 24 months. Utilities primarily funded these rising working capital costs with debt, leveraging their balance sheet, which weakened short-term credit metrics. The negative outlooks on Avista Corp., Essential Utilities Inc., and Wisconsin Power & Light Co., as well as our December 2022 downgrade of Central Hudson Gas & Electric Corp. all cite rising inflationary pressures, including higher commodity prices, that constrained credit quality.

Commodity Prices Declined In 2023

The 2022/2023 winter was mild in much of the Northeast and customers used less natural gas than anticipated. As such, natural gas storage levels increased and commodity prices fell. In January 2023, the Henry Hub natural gas spot price dropped to below $5/MMbtu for the first time since March of 2022. Additionally, since February 2023 natural gas prices have remained between $2-$3/Mmbtu, consistent with the historical commodity price for the prior decade.

Chart 2

Henry Hub natural gas spot prices
Henry Hub spot prices 2022-2023



Source: S&P Global Ratings.

Consistently low commodity prices support credit quality

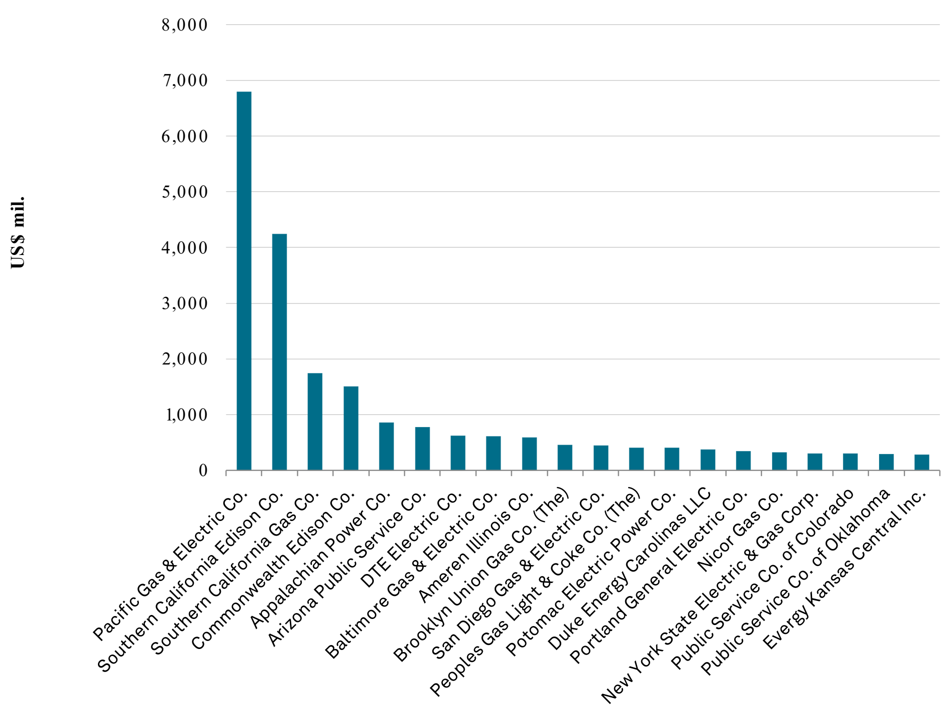
The 2023 drop in commodity prices has been important for the utility industry's credit quality. One of the key reasons that we revised the industry's outlook to stable from negative in May 2023 was the improving economic indicators, including the sharp decrease in natural gas prices. Also, lower commodity prices provided some cushion in the customer bill, allowing utilities to recover their previously deferred commodity costs without overwhelming customers. Absent a decline in commodity prices the industry's ability to consistently manage regulatory risk would have become more difficult.

Effective management of regulatory risk is critical

Currently, the industry has nearly $30 billion of rate case filings pending. Had commodity prices remained high, severely pressuring the customer bill, the industry's ability to successfully manage regulatory risk would have been even more difficult. Given utilities' record capital spending to fund necessary safety, reliability, and energy transition programs, their credit quality is dependent on constructive rate case orders. As such, persistently high commodity costs likely would erode the industry's credit quality.

Chart 3

Largest pending filed rate cases



As of Sept. 5, 2023. Source: Company reports.

Severe commodity price spikes have challenged the industry before

In February 2021, Winter Storm Uri's severe winter weather in the central U.S. drove electricity and natural gas prices in the southern U.S. to extraordinary levels. Natural gas supply constraints--in part, from frozen natural gas wells and pipelines--and surging demand over this six-day period pushed electricity and natural gas prices to record levels. For example, electricity prices in the Electricity Reliability Council Of Texas (ERCOT) reached ERCOT's market cap of $9,000/MWh and the Houston Ship Channel prices spiked to higher to $400/mmBtu, compared to gas prices of around $3/mmBtu before the storm.

Sustained soaring prices over several days saddled the sector with extraordinary electricity and gas costs. The investor-owned utilities deferred collecting these unusually high costs from their customers, and in the process increased their debt to pay for these costs, leveraged their balance sheets, and weakened their credit measures. As such, S&P Global Ratings downgraded Atmos Energy Corp. and ONE Gas Inc. and revised its outlook on OGE Energy Corp. to negative from stable.

Long-term solutions are hard to find

Physical and financial hedges, while expensive, can smooth short-term commodity cost spikes. Another credit-supportive tool is securitization, which allows for the issuance of debt that is secured by a non-bypassable charge to the customer's bill, allowing the utility to fully recover its costs at a lower interest rate for customers.

However, there is no practical solution to long-term rising commodity prices. Eventually utilities will have to recover these higher costs from customers on an ongoing basis, raising the customer bill, and pressuring the customer's affordability. This situation would decrease the industry's ability to effectively manage regulatory risk, making it challenging for utilities to consistently achieve constructive rate case orders.

For more than a decade, the utility industry benefited from consistently low natural gas prices. The industry remains very reliant on natural gas for electric generation with natural gas-fired generation accounting for about 40% of total electric generation. As such, rising natural gas prices affects virtually every customer across North America. The 2022 commodity price spike is another reminder that while natural gas costs are typically collected from customers with minimal regulatory lag, the industry's credit quality still relies on consistently low-cost commodity prices.

Related Research

- **Essential Utilities Inc. And Subsidiaries' Outlooks Revised To Negative On Weak Financial Measures, 'A' Ratings Affirmed**, July 12, 2023
- **Wisconsin Power & Light Co. Outlook Remains Negative On Weak Financial Metrics; Ratings Affirmed**, May 26, 2023
- **The Outlook For North American Regulated Utilities Turns Stable**, May 18, 2023
- **Central Hudson Gas & Electric Corp. Downgraded To 'BBB+' On Weakening Financial Measures, Outlook Stable**, Dec. 1, 2022
- **Avista Corp. Outlook Revised To Negative On Weaker Financial Measures; Ratings Affirmed**, Nov. 11, 2022
- **OGE Energy Corp. And Sub. OG&E Outlooks Revised To Negative On Unprecedented Winter Related Costs; Ratings Affirmed**, March 3, 2021
- **ONE Gas Inc. Downgraded To 'BBB+' From 'A' On Unprecedented Weather Conditions; Outlook Negative**, Feb. 23, 2021
- **Atmos Energy Corp. Downgraded To 'A-' On Weakening Credit Metrics; Ratings Placed On CreditWatch Negative**, Feb. 22, 2021

This report does not constitute a rating action.

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