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SPECIAL REPORT

Environmental Regulation Starts To Squeeze Utilities' Credit Quality (p. 12)

**Renewable Energy And
Japan's Power Sector** (p. 16)

**Europe's Emission Rules
Add Costs For Utilities** (p. 20)

**New Standards And
U.S. Electric Utilities** (p. 26)

**Treating Australia's
Carbon Tax Regime** (p. 30)



SPECIAL REPORT | Renewable Energy

12 Environmental Regulation Starts To Squeeze Utilities' Credit Quality

By Michael Wilkins, London

The upcoming U.N. Climate Change Conference in Qatar will once again seek to find a global consensus to curb rising emissions of greenhouse gases. With the devastating impact of Hurricane Sandy fresh in U.S. policymakers' minds, and a newly re-elected President Barack Obama declaring climate change to be one of the top three priorities in his second term of office, we could be heading for a "perfect storm" as far as environmental regulation is concerned.

16 Japan's New Rules For Renewable Energy Spark An Investment Boom—And A Challenge To Ensure A Sustainable Market

By Hiroki Shibata, Tokyo

Renewable energy in Japan got a shot in the arm on July 1, 2012, when a law went into force directing electric power utilities to purchase clean energy at mandated, above-market rates. The new law and regulations increase investment certainty and help mitigate the risk of construction overruns.

20 Europe's Tightening CO2 Emission Rules Add Costs And Uncertainties For Utilities

By Michael Wilkins, London

Europe's strict limits on carbon emissions are about to become even tougher for utility companies to deal with. Under the third phase of the EU Emissions Trading System, utilities will no longer receive EU carbon emission allowances for free, but will have to bid for them at auction. We believe this will increase carbon liabilities for all Western European power generators.



CREDIT FAQ

26 What Renewable Energy Standards Mean For U.S. Electric Utilities' Future

By Michael T. Ferguson, CFA, CPA, New York

Since the late 1990s, most U.S. regulated electric utilities have grappled with renewable portfolio standards. Many states are compelling investor-owned utilities to buy or build renewable energy, although each state's approach differs. While efforts to set national carbon standards have stalled, states appear to have taken the lead in establishing renewable standards.

CREDIT FAQ

30 How Standard & Poor's Treats The Carbon Tax Compensation For Australia's Electricity Sector

By Thomas Jacquot, Sydney

On July 1, 2012, the Clean Energy Act 2011 came into effect in Australia. This put a price on carbon and established transitional assistance measures designed to lessen the financial impact on the heaviest polluters. We've analyzed the implications for qualifying electricity generators of the cash compensation and free permit allocation on their adjusted metrics and ratios. Here, we explain our treatment of the carbon tax compensation in our rating analysis.



35 Taking It To The MAT(S)—The U.S. Merchant Power Sector Wrestles With Emissions Rules

By Aneesh Prabhu, CFA, FRM, New York

Regulating power plant emissions has never been easy, and recent events affecting the U.S. merchant (i.e., unregulated) power sector bear that out. Reeling from low power prices, merchant generators were awaiting a U.S. Court of Appeals ruling on challenges to the Cross-State Air Pollution Rules. After hearing the court's decision, the stakes for litigation have increased against another set of rules—the Mercury And Air Toxin Standards (MATS).



Q&A

40 In The Wake Of The Election, A Divided Washington Braces For The Fiscal Cliff

By Beth Ann Bovino, New York



Even with President Obama's decisive victory, Washington remains largely divided.

Democrats strengthened their majority in the Senate, while Republicans retained control of the House of Representatives. This potential for continued gridlock could have profound effects for the U.S. economy, as well as for many borrowers that we rate, as the country heads toward the "fiscal cliff" of simultaneous tax-cut expirations and across-the-board spending cuts.

49 Voters Continue To Show Support For State Bond Measures

By Chris Morgan, San Francisco

On Nov. 6, voters in 38 states decided 176 ballot measures. Two of the most significant measures from a credit perspective were in California and Michigan, states where the Great Recession's effects were strongly felt. California's passage of Proposition 30 provides school district financial managers relief from "trigger cuts."

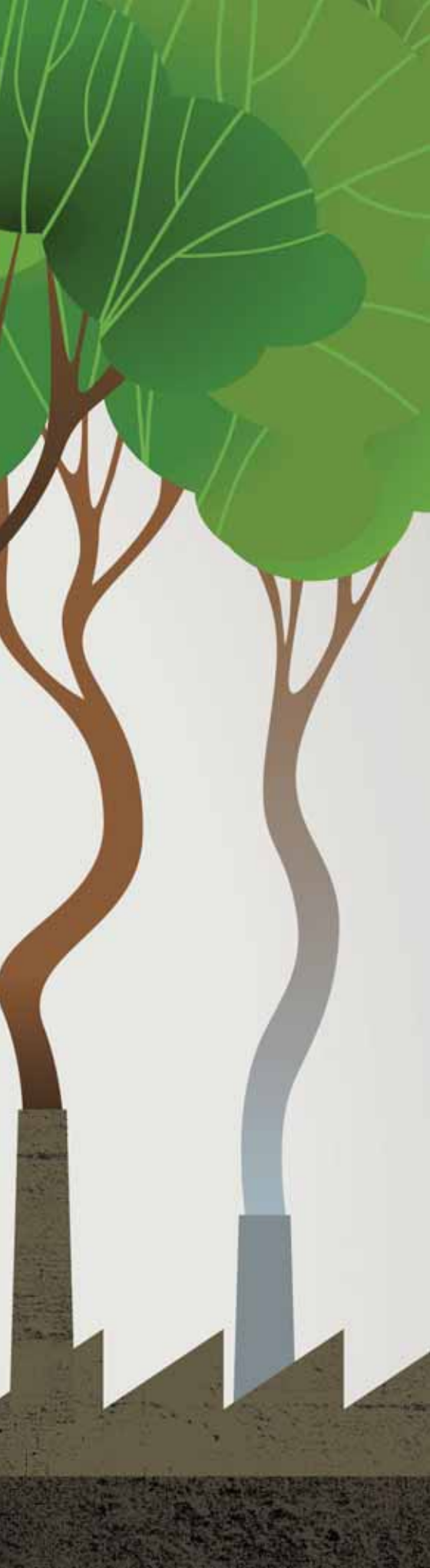
Michigan voters rescinded a law that gave the state more powers to intervene in local government financial management.



57 California Credit Quality Looks To Improve With Passage Of Proposition 30

59 Election Outcome Could Prove Critical To Puerto Rico's Credit Quality





Environmental Regulation Starts To Squeeze Utilities' Credit Quality

Overview

- The U.N. Climate Change Conference in Doha aims to reach agreement on an extension of the Kyoto Protocol that sets binding targets for reducing greenhouse gas emissions, to clarify climate finance flows from 2013, and to map out a path to reach a global climate agreement by 2015.
- Meanwhile, utility companies face increasing carbon liabilities as regulators tighten up their standards for the big CO2 polluters.
- The regulators are also pushing power generators to utilize renewable energy sources, such as wind and solar power, for a greater proportion of their output.
- The risk of retrospective changes to feed-in tariffs for renewable energy projects is creating investor anxiety and industry uncertainty.

The U.N. Climate Change Conference set to take place in Doha, Qatar, between Nov. 26 and Dec. 7, will once again seek to find a global consensus to curb rising emissions of greenhouse gases (GHGs) in a bid to halt what many scientists believe could be catastrophic climate change over the next 50 years.

With the devastating impact of Hurricane Sandy fresh in U.S. policy-makers' minds, and a newly re-elected President Barack Obama declaring climate change to be one of the top three priorities in his second term of office, Standard & Poor's Ratings Services believes we could be heading for a "perfect storm" as far as environmental regulation is concerned. President Obama's victory in the Nov. 6, elections should enable the U.S. administration to press ahead with its regulation of carbon dioxide (CO₂) and other pollutants; however, it seems unlikely in our view that a divided Congress would sanction major climate or energy legislation.

Meanwhile, the world leaders meeting in Doha will focus on three crucial issues (*see note*). First, and probably the most critical, is to agree to a second commitment period to the Kyoto Protocol, since the first period expires on Dec. 31. Under this protocol, 37 countries committed to reduce their GHG emissions by 5% against 1990 levels. The second issue is to give clarity on how finance commitments pledged by industrialized countries of up to \$100 billion per year until 2020 will flow to developing countries from 2013. And the third issue is to lay out a road map to obtain a global climate agreement by 2015, the year in which scientists believe GHGs need to peak to hold global warming to two degrees Celsius—the point above which scientists predict catastrophic climate change.

The Big Polluters Face Rising Carbon Liabilities

Yet despite the urgency to reach agreement in Doha, the negotiations are already taking place against a backdrop of ever more stringent environmental regulation related to climate change, especially in the utilities sector that's responsible for around one-half of all industrial GHG emissions worldwide. In Western Europe, for instance, utility companies will shortly be operating under the third phase of the EU Emissions Trading System (EU ETS) that takes effect on Jan. 1, 2013. From that point, utilities will no longer

receive EU carbon emission allowances (EUAs) for free. Instead, they'll have to bid for them at auction (*see "Europe's Tightening CO₂ Emission Rules Add Costs And Uncertainties For Utilities," on p. 20*).

We believe this move will increase carbon liabilities for all Western European power generators. Although they've cut their carbon costs as a percentage of EBITDA significantly over the past year, we predict that they'll still have to purchase EUAs beginning next year. What's more, we've commissioned a study of nine European utilities we rate that, assuming a carbon trading price of €14 per tonne, finds carbon liabilities could cost these companies up to €2.5 billion per year extra in 2014 and 2016, compared with 2011. Even assuming that companies will, on average, be able to pass on 80% of this cost to customers, their carbon payments could cost up to 20% of EBITDA in 2016 for some companies, and between 0.3% and 5% for others, depending on the amount of CO₂ they emit. We believe this financial exposure could increase even further depending on the outcome of policy changes currently being considered by the European Commission to increase the price of allowances.

Although the U.S. has not yet adopted a countrywide cap-and-trade scheme to curb CO₂ emissions, it has nonetheless espoused ever-tightening regulation to cut other forms of polluting gases from power plants. For instance, the U.S. merchant (that is, unregulated) power sector faces increasing regulatory uncertainty in light of recent judicial decisions on pollution rules (*see "Taking It To The MAT(S)—The U.S. Merchant Power Sector Wrestles With Emissions Rules," on p. 35*).

It's also getting tougher for fossil fuel power generators in Australia, where the Clean Energy Act came into force on July 1. The new legislation put a price on carbon and also established a series of transitional assistance measures designed to lessen the immediate financial impact on the heaviest polluters (*see "How*

Standard & Poor's Treats The Carbon Tax Compensation For Australia's Electricity Sector," on p. 30). Although similar in concept to the EU ETS, the Australian emissions trading scheme differs from the European model through shorter transitional arrangements and more restrictive criteria on firms' eligibility for assistance.

Renewable Energy Generation Gets A Regulatory Push

But it's not just CO₂ restrictions that are affecting utilities. Another consequence of climate change regulation is an increased emphasis on renewable energy generation. Since the late 1990s, most U.S. regulated electric utilities have grappled with renewable portfolio standards (RPS)—regulations that require utilities to derive an increasing amount of energy from renewable sources (*see "What Renewable Energy Standards Mean For U.S. Electric Utilities' Future," on p. 26*). Many states are compelling investor-owned utilities to buy or build renewable energy installations, although each state's time to compliance, measurement of renewable output, and definition of renewable technology differs. So while efforts to set national carbon standards have stalled, states appear to have taken the lead in establishing renewable standards.

Critics of CO₂ reduction standards often cite the higher cost of deriving energy from renewable sources, especially when natural gas prices are low. Some question the economics of funding renewable energy at a time when unemployment is high and economic recovery is lackluster. In addition, most renewable projects, whether wind, solar, or hydroelectric power, depend heavily on weather patterns to perform and their reliability can vary significantly.

Electric utilities are attempting to find some middle ground. They're complying with requirements, while trying to keep consumers' bills low and regulators and policymakers satisfied. We've looked at how electric utilities are integrating renewable standards into their supply portfolios, and how these changes may affect their credit quality. Following the U.S. elections,

...the negotiations are already taking place against a backdrop of ever more stringent environmental regulation...

we expect renewed efforts from environmental groups to pressure President Obama to regulate GHG emissions from new and existing power plants and industrial facilities. It remains to be seen if this will lead to the adoption of a new clean energy standard, which would require 80% of U.S. electricity to come from clean energy sources by 2035.

Meanwhile in Japan, renewable energy received an important boost on July 1, 2012, when the government kick-started its feed-in tariff (FIT) mechanism forcing regulated electric utilities to purchase clean energy at fixed prices and during fixed periods. We take the view that the effect of this requirement on regulated electric utility companies will be very low because of the supportive regulatory framework in which utilities can fully pass on costs to customers.

The new Renewable Energy Law and other associated regulations—covering 20-year power procurement prices that are set between July 1, 2012, and March 31, 2013—should give confidence to new power generators investing in the solar, wind, geothermal, hydro, and biomass energy sectors. The new law and regulations have effectively fixed prices in advance of power purchase agreements (PPAs), with Japanese regulated utilities signing off on renewable projects. We believe this gives greater certainty to investments and reduces the risks typically associated with construction delays.

Retrospective Adjustments Of Feed-In Tariffs Undermine Confidence

However, the Japanese government has also declared that it will retain the

right to retrospectively change the applicable tariff and procurement period if prices and other economic conditions change materially. We consider the ability to make such a retroactive change as highly questionable (see “Japan’s New Rules For Renewable Energy Spark An Investment Boom—And A Challenge To Ensure A Sustainable Market,” Nov. 13, 2012). We’ve seen such retroactive changes in FITs and other incentive mechanisms implemented in Europe, causing investor anxiety and hampering confidence (see “Why Regulatory Risk Hinders Renewable Energy Projects In Europe,” published July 5, 2011). Should the same occur in Japan, it could significantly dampen the fledgling renewables sector.

While the Doha talks aim to reach a deeper global consensus on reducing the effects of climate change post 2013, the utility sector is shouldering tougher environmental regulation due to its CO2 intensity, which in turn weighs on credit quality. This may lead to new opportunities for the renewable energy sector, although the regulatory environment for clean energy has its own uncertainties due to the amount of public subsidies still required to make this form of energy economically viable.

NOTE

Source: “How to avoid the climate cliff: Doha climate conference preview,” HSBC Global Research, Oct. 24, 2012. **CW**

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Japan's New Rules For Renewable Energy Spark An Investment Boom—And A Challenge To Ensure A Sustainable Market

Overview

- Fixed prices and procurement periods for renewable energy in Japan are likely to be favorable to private investors for at least the next two to three years, in our opinion, despite a potential for the government to change terms for agreements signed after March 31, 2013.
- We expect the government to set a target to raise renewable energy production to 15% to 25% of Japan's power generation mix from 1% to 2% within 20 years, but we predict the market to expand to only about 5% before running into obstacles.
- The central government has the task of managing a boom in renewable energy so that it does not need to sharply cut the terms of mandated agreements between producers and electricity utilities to rein in a bubble over the next two to three years.

Renewable energy in Japan got a shot in the arm on July 1, 2012, when a law went into force directing electric power utilities to purchase clean energy at mandated, above-market rates. The new Renewable Energy Act and associated regulations governing the feed-in tariff (FIT) system guarantee prices for 15 to 20 years for investors in solar, wind, geothermal, hydropower, and biomass energy projects launched between July 1, 2012, and March 31, 2013. The new law and regulations fix prices in power purchase agreements (PPAs) between renewable power producers and regulated utilities in Japan, increasing investment certainty and helping mitigate the risk of construction overruns.

The fixed prices and guaranteed periods contained in PPAs support new investors in renewable energy, in our view. The central government is yet to fix prices for projects after March 31, 2013, and it may choose to alter pricing and procurement periods in response to material changes in either electricity prices for end users or other economic conditions. But while we may see some incremental changes to such terms in the next couple of years, we expect PPAs to remain favorable to investors as the government encourages expansion of this new energy market during this time. Furthermore, at present, we do not expect the government to change the agreed terms of the FIT or other incentive mechanisms retroactively, as has occurred to the detriment of investor confidence in some European nations (see *"Credit FAQ: Why Regulatory Risk Hinders Renewable Energy Projects In Europe," published July 5, 2011, on RatingsDirect on the Global Credit Portal*). Japan's fledgling renewable energy sector would be hard hit if the same were to happen here, in our view.

We see a boom occurring in investor interest in the renewable energy sector in Japan. However, we don't expect utilities to encourage more PPAs than they are obliged to under the law. We also predict some overinvestment will occur in Japan's renewable market, as was the case in Spain and Germany,

which could force the government to make significant changes to its FIT in the future, especially if the market continues to expand rapidly in the next two to three years. Avoiding abrupt policy changes may be a challenge for the government.

Specifics Of A New Energy Strategy And Its Implementation Remain Unclear

Since the March 2011 disaster at the Fukushima No.1 nuclear power plant in Japan's Tohoku region, the government has tried to formulate a new energy policy and set targets for a new energy mix by 2030, including future proportions of nuclear and renewable energy production. It announced a goal in September to phase out nuclear power by 2040, but failed to formally endorse it and instead made a general promise to develop an energy policy following exhaustive examination. It is yet to unveil a specific process or timeframe. Progress has stalled because of division between local governments and citizens who oppose nuclear power, and industry and foreign nations, including the U.S. and France, who support it, partly owing to its close links to national security, in our view. Accordingly, we wait for the government to settle on a plan.

When the government does unveil a roadmap, we predict it will include targets to increase renewable energy to

15% to 25% of Japan's power generation mix within about 20 years. Renewables (excluding hydropower) accounted for just 1% to 2% of the total in 2010. Prior to the Fukushima crisis, the government had targets of 11% for renewables (excluding hydropower) and 45% for nuclear energy by 2030. However, we forecast that Japan's path toward either existing or higher targets for renewable energy will not be smooth. Unfettered growth of Japan's renewable energy market will last only until it reaches about 5% of the nation's total energy mix, in our view. At this level, we see a risk of two issues constraining further growth: higher overall electricity prices due to the added cost of renewable energy; and the need to enhance existing transmission and distribution (T&D) infrastructure to cope with the greater volatility of renewable energy production.

In the meantime, cost and time constraints make mega-solar photovoltaic (PV) power and wind power projects the sources of renewable energy most likely to win government support. Mega-solar PV is the most promising of the two because of shorter construction periods, more reliable operating conditions, and higher guaranteed purchase prices. We understand that the government, electricity regulator, and utilities are also examining the following factors:

Business Expansion Plan For Renewable Energy By Resource

	Existing capacity (maximum output)	New projects planned for the next 2-3 years	Estimated average operating rates (%)	Comments	Guaranteed prices	Period of guaranteed fixed prices
Mega-solar photovoltaic	0.8 mil. kW	1.3 mil. kW (more than 110 projects planned)	around 12-15	Highest fixed, guaranteed purchase price	¥42kWh (for projects larger than 10kW, except for households)	20 years
Wind	2.5 mil. kW	0.75 mil. kW (more than 20 projects planned)	around 20	Falling construction costs, proven technology and track record, but limited suitable locations	¥23.1kWh (for projects larger than 20kW)	20 years
Geothermal			around 70	Abundant natural resources, higher operating rates, but high technological hurdles and costs		15 years

kW—Kilowatt.
Source: Standard & Poor's.

The government's encouragement of renewables will have little impact on the credit quality of Japan's regulated utilities...

- Opposition to nuclear energy;
- Electricity costs;
- Volatility of renewable energy generation systems; and
- Lower carbon dioxide emissions from renewables.

Investor Interest Increases Expectations About Renewables

The government's new FIT not only fixes costs under PPAs but also makes Japan's vertically integrated and regional monopoly electric utilities purchase all the renewable energy that producers generate. These utilities also operate T&D lines across the country. To encourage new developers to build out renewable energy, the government has set initial prices of ¥23.1 per kilowatt-hour (kWh) for wind projects with capacity that exceeds 20kW and ¥42 per kWh for solar projects larger than 10kW. The high price for solar energy surprised most investors in the energy sector. We consider the government's fixed prices sufficiently attractive to lure many investors into the market, similar to the rush of investment into renewables in the U.S. and Europe in the early 2000s.

A number of countries have implemented policies to encourage investment in renewable energy technologies only to run into strong consumer opposition to the higher electricity rates that follow. Greater reliance on renewables in Japan may see the business' record of heavy dependence on government price-setting mechanisms and regulation pressure the credit quality of renewable energy producers. And changing the structure of the government's price-setting mechanism or regulatory framework would put greater credit pressure on the nation's entire energy system, in our view.

Still, while the government has the ability to revise prices and procurement periods after March 31, 2013, we think it is unlikely to dilute them significantly for at least the next two to three years, because the government aims to expand the renewable energy market following the Fukushima crisis. Therefore, we expect investors in new renewable energy projects in Japan to benefit from the government's FIT system during this period. Beyond March 31, 2015, however, we think FIT prices for renewables have the potential to take a bigger dive if an investment bubble forms and the government takes sudden action to deflate it.

Regulated Utilities Likely To Feel Only A Limited Effect On Ratings

We believe the government's encouragement of renewables will have little impact on the credit quality of Japan's regulated utilities in the next two to three years, for the following reasons:

- Just 1% to 2% of total power generation in Japan is from renewables, and even if this were to triple to around 5% on the way to a higher government target, it would be unlikely to dampen demand for electricity, in our view;
- The current supportive pricing mechanism, allowing utilities to pass on higher costs to customers, will remain, in our view; and
- Lacking the necessary cash flows, regulated utilities have planned few specific capital expenditures to strengthen T&D facilities, including smart grid and meters, over the next two to three years. New renewable projects themselves hold the primary responsibility for connecting them to existing key trunk lines. Existing T&D facilities can handle new renewable production in the short term, but a failure to upgrade infrastructure over the long term may constrain

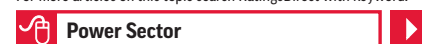
expansion of the renewable business and limit growth of renewable markets.

Because renewables comprise only 1% to 2% of total power generation in Japan, changes in government policy will not affect the credit quality of the domestic utility sector significantly. It is too early to incorporate the risks we have seen in Europe into our credit analysis of Japan's electric utility sector, in our view. Much to do with Japan's renewable sector will depend on government policy, so it needs to develop a record of handling the sector's regulatory framework before we can draw further conclusions.

Sustaining An Expansion In Renewables Requires Active Management

The spike in new renewable projects in Japan since the new FIT took effect, and other potential developments, will require active management on the part of government. Otherwise, overinvestment in renewables, particularly in the short term, risks forcing the government down the same troublesome route of a dramatic policy reversal as Spain and Germany. Furthermore, even if it avoids this possibility, a rise in the proportion of renewables in Japan's total energy mix to more than 5% from 1% to 2% now may begin to push up the cost of electricity, sparking protests from households and industries. While it is inevitable that the cost of power in Japan will rise, at that level consumers could really begin to feel the pain of higher electricity prices and start demanding policy changes. This may force the government to revise its targets for renewables and cause investors to shun further funding of renewables in Japan. **CW**

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Europe's Tightening CO2 Emission Rules Add Costs And Uncertainties For Utilities

Overview

- European utilities face rising costs and profit pressures from the third phase of the EU emissions trading system, which starts on Jan. 1, 2013.
- Companies whose carbon liabilities form a greater share of EBITDA will be hardest hit.
- Yet, lower carbon emission prices due to the economic downturn, and utilities' ability to pass on large parts of the costs to customers, should mute the effects on credit quality for now.

Europe's strict limits on carbon emissions are about to become even tougher for utility companies to deal with. Under the third phase of the EU Emissions Trading System (EU ETS) that takes effect on Jan. 1, 2013, Western European utilities will no longer receive EU carbon emission allowances (EUAs) for free. Instead, they'll have to bid for them at auction. We believe this will increase carbon liabilities for all Western European power generators. Although they have cut their carbon costs as a percentage of EBITDA significantly over the past year, we predict that they'll still have to purchase allowances beginning next year.

A study of nine rated European utilities commissioned by Standard & Poor's Ratings Services has found that, assuming a carbon trading price of €14 per tonne, carbon liabilities could cost these companies up to €2.5 billion per year extra in 2014 and 2016. Even assuming that companies will be able to pass on an average 80% of this cost to customers, their carbon payments could cost up to 20% of EBITDA in 2016 for the most-affected companies, and between 0.3% and 5% for others, depending on the amount of carbon dioxide (CO₂) they emit. We believe this financial exposure could increase even further depending on the outcome of policy changes currently being considered by the European Commission (EC) aimed at driving up the price of allowances.

We nevertheless expect that the effect of the new carbon auctions on power company ratings will be muted, at first. Partly, that's because the price of carbon-emission allowances on the open market that utilities purchase through exchanges has fallen dramatically in the past year, mainly thanks to an oversupply of allowances as a result of lower power demand in a recession. It also reflects the fact that the long phase-in of carbon emission costs and the price discovery available through the forward markets have let us factor the projected effects of the stepped-up Phase III regu-

lations into our ratings on utilities. We also believe electricity prices in Europe already largely reflect the carbon costs associated with the fuels utilities use to generate power—and that demand plus the fiscal and regulatory environment are likely to continue to influence electricity prices more than the EU ETS will.

Utilities may well, however, face further intervention by the EC to restrict the supply of carbon allowances to provide incentives to replace thermal, high-emission generators. And while the EC allows regulated companies to use international carbon-offset credits, they are rapidly approaching the caps imposed by the EC on usage.

As well as dealing with EU changes, power companies face additional climate-protection programs by individual countries. In some cases, a country's emissions-reduction and energy-efficiency standards supplement these broader targets. What's more, the availability or lack of natural resources for renewable energy generators—which varies by country—could significantly influence a power generator's costs. Meanwhile, Phase III of the ETS will limit the carbon offset credits utilities can buy from outside the EU to no more than 50% of the reductions they're required to make under the EC's carbon regulations, which are linked to the Kyoto Protocol. If Kyoto isn't extended beyond this year,

Table 1 | Potential Effect Of EU ETS Carbon Liabilities On The EBITDA Of Rated European Utilities*

Company name	—EU ETS CO ₂ emissions (mt)—			—Carbon cost per year (mil. €)—			—Liability as % of EBITDA (incl. 80% carbon pass-through rate)—		
	2010	2014f	2016f	At €14.5/tonne	At €14/tonne	At €14/tonne	2010	2014f	2016f
Centrica	7.39	6.69	6.57	107.22	93.6	92.05	0.53	0.35	0.33
Endesa	30.12	28.37	29.59	436.8	397.16	414.23	0.53	0.47	0.46
Iberdrola	25.07	26.2	25.83	363.49	366.75	361.61	0.97	0.88	0.82
EDF	65.91	58.96	60.82	955.72	825.46	851.53	1.2	0.94	0.92
SSE PLC	24.5	21.73	22.16	355.25	304.26	310.24	2.58	2.02	1.84
E.ON	85.4	87.96	90.93	1,238.30	1,231.42	1,273.06	1.85	2.05	2.02
Vattenfall	91.5	87.06	88.42	1,326.75	1,218.89	1,237.88	3.79	3.09	2.99
RWE	164.9	174.92	179.53	2,391.05	2,448.94	2,513.41	4.86	5.29	5.17
Drax Power Ltd	23.09	20.87	21.29	334.85	292.23	298.1	16.06	20.22	19.64

*Based on aggregate EBITDA growth of 9.6% per year for all companies. Data are illustrative and don't necessarily represent Standard & Poor's view of future EBITDA or carbon liabilities for any of the companies listed. f—Forecast.

some bilateral agreements between the EU and other countries may afford offsets to EU-regulated companies.

Study Reveals Increased Carbon Exposure Liabilities For Utility Companies

The utility sector will be the hardest hit, in our opinion, among carbon-intensive industries that are subject to Phase III of the EU ETS system, also known as cap-and-trade. We base this view on the results of an updated study of a sample of utilities we rate that RepuTex, an independent carbon data and analytics firm, did on our behalf. Moreover, we think the effect on credit quality associated with carbon exposure under Phase III will vary markedly between high and low emitters of CO₂. Where utilities fall along this continuum will depend on, among other things:

- The auction price of EUAs;
- Worldwide developments affecting the energy sector that could constrict fuel supplies for power generators, such as the nuclear crisis in Japan and social unrest in the Middle East and North Africa;
- The availability of international carbon offset allowances; and
- Possible further revisions of the EU ETS, such as setting aside or permanently cancelling EUAs from the reserve of new EU member states.

Individual country factors that could affect utilities include:

- Local emissions reduction and energy efficiency regulations that supplement EU ETS targets, such as those in the U.K.;
- The local marginal fuel price at a particular time;
- The availability of natural resources for renewable energy generators to offset carbon-producing power; and
- National policy decisions on nuclear capacity, such as the German government's 2012 decision to speed up the country's exit from nuclear power.

For individual companies, factors affecting carbon liabilities are likely to be:

- A company's current energy mix and its dependence on different fuels; and
- Short- to medium-term plans for decarbonizing its energy fleet.

To calculate the effect of carbon liabilities on the profitability of a sample of

nine large utilities over the next four years, the RepuTex research study assumed a carbon trading price €14 per tonne (about twice the current price) in the years 2014 and 2016. This price assumption is based on a composite of forecasts from respected carbon market traders and analysts. It also factored in companies' historical and forecast EBITDA and likely future emissions (*for details of the RepuTex study methodology and assumptions see the Appendix*). Based on these assumptions, the study estimated that in 2016 carbon emission liabilities could cost these companies between €92 million (for U.K.-based Centrica PLC; A-/Stable/A-2) and €2.5 billion for Germany-based RWE AG (BBB+/Stable/A-2). Even assuming that companies will be able to pass on 80% of this cost to customers, their liabilities could cost nearly 20% of EBITDA in 2016 for the U.K.'s Drax Power Ltd. (BBB+/Stable/—), 5% for RWE, nearly 3% for Sweden's Vattenfall AB (A-/Stable/A-2), and 2% for Germany's E.ON AG (A-/Stable/A-2; *see table 2*).

Among our portfolio of rated utilities, the results of the RepuTex study therefore indicate that carbon liabilities are likely to have the most significant effect on the EBITDA of Drax Power, RWE, Vattenfall, and E.ON.

Prices Face An Uncertain Future As Political Intervention Looms

Although we expect next year's tougher regulations to eventually put pressure on utility profits, currently low carbon prices may delay that reckoning for a while, in our view. In fact, carbon emission prices have fallen from about €25 per tonne before the financial crisis to about €7 to €8 per tonne currently.

Various factors explain this decline. Since the financial downturn, economic activity has contracted alongside carbon emissions. Companies have also reverted to buying cheaper carbon offsets. Capacity of renewables generation has also increased significantly, especially in Germany, reducing the demand for EU ETS.

In part, that's because the EC hasn't adjusted the number of allowances

within the EU ETS market. This has fed the oversupply of allowances, which many believe will last until 2020.

Nevertheless, the EU ETS is a politically sensitive market and is unlikely to be left to its own devices, in our opinion. We believe that EU officials have held initial discussions on how to reduce the oversupply of carbon certificates. We think that a quick decision is unlikely because countries with a carbon-intensive electricity generation profile will likely oppose any move that could lift costs. Yet, we could see proposals emerge before the end of year. Such a structural reform could permanently cancel allowances of up to 1.2 gigatonnes of CO₂ to reduce oversupply and support a higher price. We believe it's more likely, however, that the EC will use a different tactic: limiting the number of allowances coming to auction during the first three years of Phase III to support a higher price, then increasing the number in the final years (2018 to 2020)—so-called backloading. According to Deutsche Bank, the backloading of 1.2 gigatonnes should be enough to push prices back toward €15 per tonne over the 12 to 18 months following such a decision.

Price support for the ETS could, however, also come from other directions. Australia and the EU announced on Aug. 28 that their emission trading systems will be linked. This will enable businesses in Australia to start using the ETS beginning in 2015, and aims for com-

plete integration of the European and Australian systems by July 2018. In the long term, this could provide an opportunity to reduce some of the current oversupply by selling some of the excess EUAs to Australian businesses.

On the other hand, we think regulators would intervene to prevent excessive spikes in power prices. This would be especially so during the current recession, when affordability of power is a higher priority than reducing emissions.

Consumers Will Likely Continue To Pick Up The Cost Of Carbon

Still, a factor offsetting the effect of tougher climate regulation is power generators' ability in liberalized energy markets to pass through costs. Utilities in heavily-regulated markets, by contrast, have to negotiate with regulators to pass on costs.

To date, European utilities' credit quality has held up well because they can recoup costs. What's more, lower CO₂ emitters such as utilities that generate power from nuclear, hydro, and renewable sources have benefited from rising power prices without incurring pollution-related costs.

Generating plant construction and closure decisions are highly sensitive to the long-term projections of the carbon price, in our opinion. In Europe, the introduction of cap-and-trade has led to reluctance to build new fossil-fuel power stations, particularly coal-fired plants. Large utilities such as RWE, E.ON, and Enel SpA (BBB+/Negative/A-2) still build such plants occasionally, as a backup for renewables. However, we believe that coal-fired generation by independent power producers will become increasingly uneconomic in Europe with the onset of EU ETS Phase III.

Moreover, the anticipation of higher carbon costs and policy incentives have led to a rapid increase in renewable capacity. In Germany, for example, renewable energy production gains subsidies and priority access to the electricity grid. Even gas-fired power producers have considered temporarily idling or closing plants. To ensure system stability, Germany has proposed

Table 2 | Rated European Utility Companies Covered By RepuTex Carbon Liabilities Study

Company	Country of domicile	Corporate credit rating*
Centrica PLC	U.K.	A-/Stable/A-2
Drax Power Ltd.	U.K.	BBB+/Stable/—
E.ON AG	Germany	A-/Stable/A-2
Electricite de France S.A.	France	A+/Stable/A-1
Endesa S.A.	Spain	BBB+/Negative/A-2
Iberdrola S.A.	Spain	BBB+/Watch Neg/A-2
RWE AG	Germany	BBB+/Stable/A-2
SSE PLC	U.K.	A-/Negative/A-2
Vattenfall AB	Sweden	A-/Stable/A-2

*As of Oct. 25, 2012.

a new law that will pay power generators not to close plants. This cost will likely be passed through to consumers as well.

Whatever happens in the next year or two, as Europe crawls out of its recession, the long-term trend seems clear. The rules governing utility carbon emissions are tightening. And sooner or later, utilities or consumers—or perhaps both—will end up paying the price.

The authors would like to acknowledge the contribution of RepuTex in providing some of the background data for this article.

Appendix: Our Study's Methodology For Assessing The Effect Of Carbon Liabilities On EBITDA

RepuTex, an independent carbon data and analytics firm, conducted an illustrative study on our behalf to help assess the effect of carbon liabilities on the EBITDA of a sample of our rated European electric utility companies (see table 2).

EBITDA projections

To project the EBITDA of the nine companies in our study for the period 2012 to 2016, we extracted historical and forecast EBITDA figures from the Capital IQ database, which is based on companies' reported disclosure from 2006 to 2014.

We applied an annual EBITDA growth scenario of 2.5% for 2014 to 2016 to eight of the nine companies. For Vattenfall, we applied this scenario from 2012 to 2016 because EBITDA forecasts were only available up to 2012 (not 2013 and 2014).

Company level emissions projection

Our study created emissions forecasts for the power generation business of each company, which it developed in the following steps:

- It projected companies' market share of generation based on their historical generation patterns, the scheduled retirement and addition of fossil fuel plants, and their new renewable energy generation projects.
- It used this projected market share, as well as forecast electricity demand in

their countries of operation over the period 2012 to 2016, to calculate companies' projected generation.

- We forecast emissions factors based on companies' historical emissions trends and the retirement and addition (renewable) of generation assets.
- We then added to this the emissions of new fossil fuel plants. In cases where there is no specific date in a year for a new entry, the study allocated one-half of the full-year emissions to the first year.

Our study derived the data for the above projections from various sources, as follows:

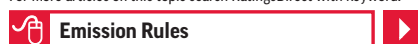
- It sourced electricity demand growth by country for 2012 to 2016 from the ENTSO-E 2011 System Adequacy Forecasting Report.
- It calculated the annual historical generation market shares from 2005 to 2011 for each of the nine companies from the historical generation of the countries in which each company has generation assets in and their disclosed generation.
- It sourced historical emissions factors or absolute CO2 emissions from companies' disclosure data.
- The phase-out of fossil fuel plants from the Large Combustion Plant Directives is sourced from a number of official documents.
- The entry time and parameters of new fossil fuel plants are based on RepuTex research.

EU carbon price trajectory

RepuTex applied the below carbon price trajectory for the EU ETS, derived from proprietary modeling:

- 2010: €14.5 (actual)
- 2014e: €14 (estimated)
- 2016e: €14 (estimated) **cw**

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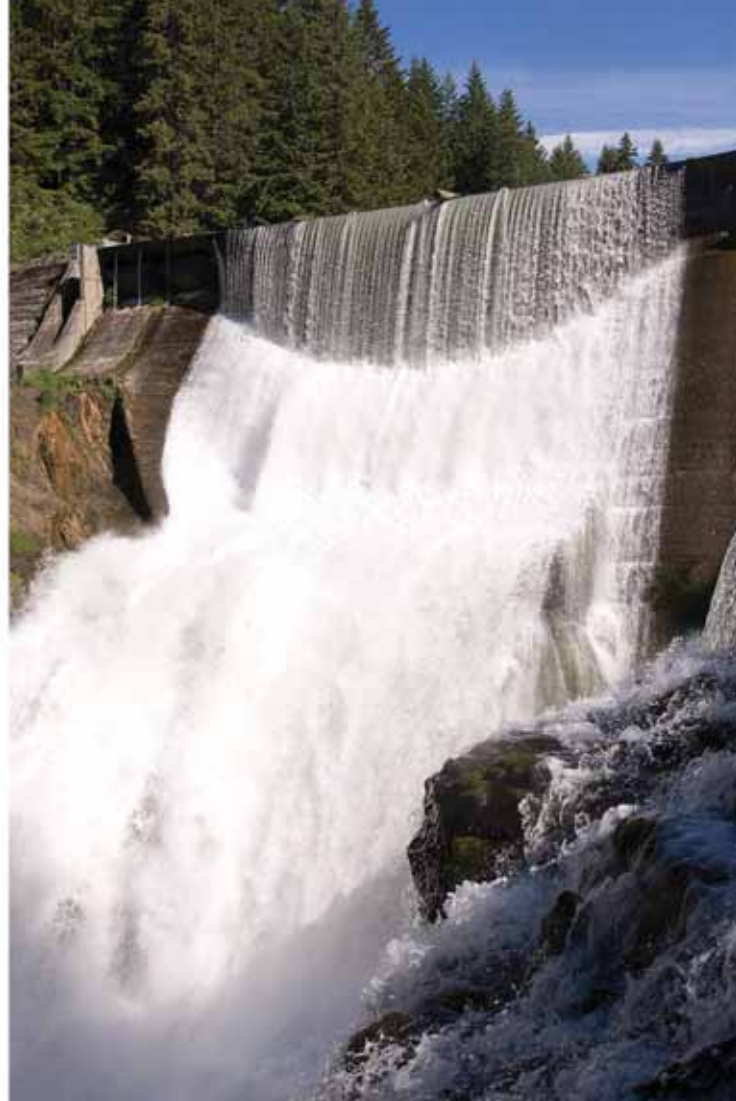
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Credit FAQ

What Renewable Energy Standards Mean For U.S. Electric Utilities' Future

Since the late 1990s, most U.S. regulated electric utilities have grappled with renewable portfolio standards (RPS), regulations that require utilities to derive an increasing amount of energy from renewable sources. Many states are compelling investor-owned utilities to buy or build renewable energy, although each state's time to compliance, measurement of renewable output, and definition of renewable technology differs.



While efforts to set national carbon standards have stalled, states appear to have taken the lead in establishing renewable standards. Critics of carbon standards often cite the higher cost of deriving energy from renewable sources, especially when natural gas prices are low. Some are questioning the economics of funding renewable energy at a time when unemployment is high and the recovery is lackluster. In addition, most renewable projects, whether wind, solar, or hydro, depend heavily on weather patterns to perform and their reliability can vary significantly.

Electric utilities are attempting to find some middle ground. They're complying with requirements, while trying to keep consumers' bills low and regulators and policymakers satisfied. We've looked at how electric utilities are integrating renewable standards into their supply portfolios, and how these changes may affect their credit quality.

Q. *Why are states setting these energy standards, rather than the federal government? How does the public perceive these mandates?*

A. The U.S. federal government has not established a renewable energy mandate. The federal government has used tax incentives to spur the growth of renewable projects, but it has not offered electricity off-takers stronger incentives. The Investment Tax Credit and Production Tax Credit and the bonus depreciation that Congress passed and extended in recent years to support the development of renewable projects were meant to combat climate change and economic woes. But given the high cost of these projects, these credits won't likely result in further development without additional incentives from the states. And the expiration of the federal tax credits in coming years could ultimately put more pressure on the states to provide adequate incentives.

In general, the public has had a positive view of RPS mandates. For example, a 2010 Pew/National Journal poll showed that 78% of Americans, with support across party affiliation, supported such standards. Many voters are willing to tolerate the incremental cost increases, especially when low natural gas prices have lowered the overall cost consumers have to pay. Some have even called for higher standards, although we think this is likely to be contingent on an accelerated economic recovery as well as decreased costs of renewable technology. But this positive sentiment is not uniform, and support has waned amid the weak economy.

Q. *How are utilities coping with renewable portfolio standards?*

A. The development of renewable projects is a relatively new industry, and, for smaller utilities, building their own

renewable projects is risky and can be outside their core capabilities. We typically view a pure transmission and distribution entity as more creditworthy than one that also is involved in generation because there are fewer construction and operational risks.

Many utilities have used power purchase agreements (PPAs) to meet their renewable quotas. These plans often force a utility to pay a higher price than it might effectively pay if it generated power internally, but they also protect the utility from some of the risks and help mitigate cash flow volatility.

Cost recovery—the extend and timeliness of a utility's ability to be compensated for the costs it incurs—is key to a utility's credit quality, in our view. Given the very high cost of building a renewable program, we look to see how quickly and completely the utility will be compensated, and determine whether there are any potential loopholes that may prevent

them from being remunerated. Utilities have generally been proactive in working with the regulatory commissions to ensure that cost recovery associated with renewable projects and their related transmission buildout is clear well in advance of procurement. Utilities that make use of PPAs often receive compensation through a “purchased power adjustment” or other comparable method that permits them recovery when the price they pay is not fixed. Nevada Power Co. and Idaho Power Co., for instance, have been able to pass such costs through to their customers. Utilities that generate renewable power themselves, such as Portland General Electric, are remunerated by modifications to their rate bases to reflect the higher costs associated with these capital expenditures. Some utilities are granted riders that allow them to be compensated between rate cases; Public Service Co. of New Mexico earned this outcome in August 2012.

Maintenance capital expenditure costs associated with renewable projects tend to be higher on a per kilowatt basis than those of conventional fossil fuel facilities, so diligent utilities will attempt to incorporate this into rate cases. Northwestern Corp., which has begun to add renewable assets to its generating portfolio, has been proactive in this regard. Obviously, regulators don't want to impose higher rates on its voting customers. But they do want utilities to recover these costs, because they want them to meet the renewable portfolio standards in their states.

From a credit perspective, we take into account lags in cost recovery for renewable projects. These lags sometimes occur with the use of historical test years in rate cases. Even if a utility will eventually receive compensation for renewable programs, delays in recovery because of slow prosecution of rate cases can harm a liquidity profile or add uncertainty to

Estimated Levelized Cost Of New Generation Resources, 2017*

—U.S. average levelized costs (2010 \$/megawatt hour) for plants entering service in 2017—						
Plant type	Capacity factor (%)	Levelized capital cost	Fixed O&M	Variable O&M (including fuel)	Transmission investment	Total system levelized cost
Dispatchable technologies						
Conventional coal	85	64.9	4.0	27.5	1.2	97.6
Advanced coal	85	74.1	6.6	29.1	1.2	111.0
Advanced coal with CCS	85	91.8	9.3	36.4	1.2	138.7
Natural gas-fired						
Conventional combined cycle	87	17.2	1.9	45.8	1.2	66.1
Advanced combined cycle	87	17.5	1.9	42.4	1.2	63.0
Advanced CC with CCS	87	34.3	4.0	50.6	1.2	90.1
Conventional combustion turbine	30	45.3	2.7	76.4	3.6	128.0
Advanced combustion turbine	30	31	2.6	64.7	3.6	101.9
Advanced nuclear	90	87.5	11.3	11.6	1.1	111.5
Geothermal	91	75.1	11.9	9.6	1.5	98.1
Biomass	83	56.0	13.8	44.3	1.3	115.4
Nondispatchable technologies						
Wind	33	82.5	9.8	0.0	3.8	96.1
Solar PV	25	140.7	0.7	0.0	4.3	145.7
Solar thermal	20	195.6	40.1	0.0	6.3	242.0
Hydro	53	76.9	4.0	6.0	2.1	89.0

*Total system levelized cost—the dollar cost per megawatt hour that must be charged over time to pay the total cost. Divide by 1,000 to get the cost per kilowatt hour (move the decimal point one place to the left to get the cost in cents/kWh).

Source: U.S. Energy Information Administration, Annual Energy Outlook 2012, June 2012.

forward-looking cash flow characteristics, at least in the short term. Companies that exceed authorized returns on equity (ROEs) demonstrate that they are not significantly affected by lagging, and that their expenditure forecasts are accurate. We would generally not consider a lower-than-average ROE to be as detrimental to credit quality if it accompanies stronger-than-average (and timely) recovery for RPS compliance measures.

While not all commissions include these provisions, decoupling mechanisms that separate the link between a utility's sales and revenues can be helpful in addressing conservation risk. If customers respond to inevitable rate increases by using less power, a decoupling mechanism partially protects the utility. Although it's not common, customers can choose to bypass, or self-generate, for part of their power needs rather than purchase power from a utility. Community choice aggregation plans allow customers to pool their resources and build generation assets to satisfy their power needs. However, the costs of doing this are still prohibitive in most places and only five states allow community choice aggregation, so bypassing is currently not a significant concern.

Q. Which states don't have renewable portfolio standards, and why don't they?

A. Could this change? Most states have some form of renewable mandate or voluntary goal. Only 13 states had neither as of Aug. 31, 2012: Alabama, Alaska, Arkansas, Florida, Georgia, Idaho, Kentucky, Louisiana, Mississippi, Nebraska, South Carolina, Tennessee, and Wyoming. But the reasons behind the absence of standards vary, and they can give us some insight into likely changes.

States like Wyoming and Idaho are awash in renewable resources (wind in Wyoming, hydro in Idaho), but they're surrounded by states with fairly strict renewable standards. These two outliers also have access to inexpensive fossil fuel, especially in Wyoming, which has generated about 93% of its power from low-sulfur Powder River coal. Thus, they can produce renewable power in-state (and bolster the local economy) and sell

Most states have some form of renewable mandate or voluntary goal. Only 13 states had neither as of Aug. 31, 2012...

this more expensive power to meet external renewable standards, while using inexpensive fossil fuel power to satisfy in-state load requirements.

Some states in the Southeast are in a different situation. Renewable resources aren't as abundant in the south. These states also tend to have lower income levels. Several are among the bottom 10 states in household income, putting consumers in a worse position to absorb rate increases. They also tend to have interests in other parts of the fossil fuel supply chain, such as mining or gas extraction, and disrupting these businesses would hurt employment numbers in the states like Kentucky.

Florida, however, may eventually be an exception. In March 2012, the state House of Representatives passed a renewable tax credit bill, which later went into law without Gov. Rick Scott's signature. A few years earlier, the Florida Public Service Commission had endorsed the development of a binding renewable standard, which had substantial popular support, but a 2009 bill seeking to impose a 20% standard was summarily rebuffed, citing potential cost increases. With a still-sputtering economic recovery in the state, as well as power prices that are conventionally quite high to begin with, fierce resistance to a 20% standard will likely persist. Florida obtains only 3% of its energy from renewable sources currently, so a bill that would up that number to 20% within eight years would eventually affect customers' bills.

Q. What is the role of the public service commissions?

A. In most instances, the regulatory commission doesn't develop the RPS standards exclusively, but along with

the state legislature, with gubernatorial approval. However, enforcement does typically fall onto the commission. The state service commissions often are able to impose penalties for noncompliance. For instance, the California Public Utilities Commission can fine a utility up to \$25 million per year, based on the deficiency between the actual renewable energy used and the amount implied by the 33% goal. But the commissions' most important role is to authorize the provisions that enable utilities to meet standards. Utilities can seek capital recovery and decoupling mechanisms as well as riders, but the commission must authorize these measures. A commission may also impose cost caps under certain circumstances.

Renewable Energy Standards Are Here To Stay

Supporters and critics of renewable energy mandates have been vocal in recent years, and the discord shows no signs of abating as the deadlines for compliance approach. We think these standards are unlikely to disappear any time soon, and that utilities that want to preserve their credit quality will need to be proactive about building supportive regulatory relationships. We will continue to assess the risks inherent in renewable development for utilities, and identify the utilities that have successfully put themselves on the path to compliance. **cw**

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Credit FAQ

How Standard & Poor's Treats The Carbon Tax Compensation For Australia's Electricity Sector

On July 1, 2012, the Clean Energy Act 2011 came into effect in Australia, putting a price on carbon and established a series of transitional assistance measures designed to lessen the immediate financial impact on the heaviest polluters.

In broad terms, generators eligible for the compensation are those with an emissions intensity of greater than 1.0 ton of carbon dioxide (CO₂) equivalent per megawatt hour. Effectively, the large brown coal generators in the Australian state of Victoria will receive most of the carbon tax assistance. For these electricity generators, an upfront cash compensation was paid in late fiscal year ended June 30, 2012, and free permits will be allocated annually to them over the fiscal 2014-2017 period. The Appendix provides a summary of the assistance provided to eligible electricity generators.

Standard & Poor's Ratings Services has analyzed the implications for qualifying electricity generators of the cash compensation and free permit allocation on their adjusted metrics and ratios. Here, we explain our treatment of the carbon tax compensation in our rating analysis.

Q. How will Standard & Poor's treat the initial carbon tax assistance payment received in late June 2012?

A. We consider the carbon tax assistance cash payment as a nonrecurring item that we will exclude from our funds from operations (FFO) measure, even though companies may elect to report this amount in its cash measures.

Our criteria state that nonrecurring items are to be excluded from financial measures in order to ensure that historical financial ratios are more indicative of future performance (see criteria article titled "2008 Corporate Criteria: Analytical Methodology," published April 15, 2008, on RatingsDirect, on the Global Credit Portal). Given the one-off

nature of this compensation payment, including it in the FFO would artificially inflate that measure for fiscal 2012 compared to prior or future years.

Q. Is your treatment of the cash compensation driven by the fact the payment was received in June 2012, even though it is supporting a fiscal 2013 obligation? If so, will you add back that amount in FFO for financial year ending 2013?

A. Our treatment of the cash compensation payment received by the qualifying generation entities in June 2012 is a function of its nonrecurring nature rather than a potential timing mismatch between its receipt and the obligations it covers. We therefore would not seek to reallocate that amount into fiscal 2013 when calculating our financial metrics for a company.

That said, we would expect this cash payment to have some short-term benefits for a company's financial risk profile, although not expressly recognized in our FFO calculation, for the following reasons:

- If the cash compensation is used to pay down debt, financial ratios metrics could improve due to less leverage and lower interest expense.
- If not, liquidity would strengthen thanks to higher cash balances (see criteria article "Methodology And Assumptions: Liquidity Descriptors for Global Corporate Issuers," published Sept. 28, 2011).

Those short-term benefits would obviously be negated if a company seeks to temporarily increase distributions to shareholders rather than pay down debt.

Carbon Tax Compensation Paid As Of June 30, 2012

Generator	Location	Recipient	Amount (mil. A\$)
Alcoa Anglesea Power Station	Victoria	Alcoa of Australia Ltd.	14.9
Augusta Power Stations	South Australia	Flinders Operating Services Pty Ltd.	59.5
Collinsville Power Station	Queensland	RATCH Australia Corporation Ltd.	8.7
Energy Brix Australia Corporation Pty Ltd.	Victoria	Energy Brix Australia Corporation Pty Ltd.	27.7
Hazelwood Power Station	Victoria	National Power Australia Investments Ltd.	265.9
Loy Yang A Power Station	Victoria	Great Alliance Corporation Pty Ltd.	240.1
Loy Yang B Power Station	Victoria	IPM Australia Ltd. & Gippsland Power Pty Ltd.	116.9
Redbank Power Station	New South Wales	Redbank Project Pty Ltd.	8.8
Yallourn W Power Station	Victoria	TRUenergy Yallourn Pty Ltd.	257.5

We will assess, for each company, the amount of cash held that would be over and above the company's short-term...requirements.

Q. *In case a company has elected not to repay debt with the cash compensation, how would you treat this surplus cash?*

A. Our treatment of surplus cash, according to our criteria, is a function of our view of a company's near-term operating liquidity needs, medium- to long-term capital commitments, any upcoming debt refinancing, and/or appetite for enhancing shareholders returns.

Our approach will be to assess, for each company, the amount of cash held that would be over and above the company's short-term and aforementioned requirements. Generally, cash balances in excess of levels stated in policies and historical trends, or not indicative of future trends are seen as transitory and generally excluded from our metric calculation (*see criteria article "2008 Corporate Criteria: Ratios and Adjustments," published April 15, 2008*). However, if cash balances were used progressively, it could mean stable debt levels, and finances.

Q. *How will you treat the allocation of free permits in your projections?*

A. We also view the allocation of free permits as a nonrecurring item, albeit one that will be in place for the fiscal 2014 to 2017 period. The analysis aims to recognize the finite life of the assistance.

We will therefore exclude the financial benefit derived from the receipt of free permits from our FFO calculation. That is, when we calculate FFO, we will include the gross carbon tax liability instead of the actual carbon liability net of the free permits.

Taking this approach will enable us to look through the transition period and assess the cash flow measures for each company in the electricity generation

sector on a like-for-like basis without any distortion to FFO. An additional benefit is that such calculation will enable us to evaluate the financial metrics of the given company on a continuum, pre and post the free permit phase.

However, we would expect free permits to provide an indirect benefit to a company's financial profile, as the cash value of the free permits would be assumed to reduce debt, all else being equal. This is because the cash receipts of free permits could either be used to reduce the gross carbon tax liability stemming from the redemption of those permits or to on-sell them into the market. We would, however, exclude future benefits from the receipt of those permits should we have doubts about future allocation.

Ultimately, this approach focuses the analysis on long-term operating cash flow (i.e., beyond the end of the transitional arrangement), and comparability between companies in the electricity sector, as not all companies will be receiving assistance. Importantly, we are not seeking to entirely remove the financial benefits of the carbon tax assistance package, but merely recognizing its finite life.

Q. *Would you take a similar approach for project-financed transactions?*

A. Our treatment of an upfront cash compensation and receipt of free permits is likely to be analyzed on a case-by-case basis as circumstances may vary.

We calculate debt—service coverage ratio based on the structural features of each specific transaction and, in particular, the presence or not, of specific mechanisms aimed at reserving any compensation for the purpose of covering future carbon tax liability (*see criteria article titled "Updated Project Finance Summary*

Debt Rating Criteria," published Sept. 18, 2007). If the compensation can flow down to the bottom of the waterfall and be distributed, our financial analysis will reflect such a distribution.

Generally, if the upfront cash compensation were to be placed in a specific reserve account with drawdown only allowed to settle a carbon tax liability relating to fiscal 2013, we would treat the receipt as cash available to meet the carbon liability, which would be instantly offset by a transfer to that reserve—hence no immediate recognition. The drawdown would be recognized as a cash inflow for the purpose of calculating the cash flow available for debt service (CFADS). In that case, CFADS for fiscal 2013 would be calculated on the basis of the net carbon tax liability.

We would take a similar approach with the free permits, leading to CFADS being calculated on the basis of any net carbon tax liability.

Importantly though, the financial projections for project-financed transactions look at the ratio profile over the life of the project rather than at a two- to three-year horizon. If the ratios are marginally better in the short term but drops back at a later stage, we would discount that temporary benefit.

Q. *Do you believe the exclusion of free permits from your FFO measure could materially affect a company such that it breaches its downgrade trigger?*

A. Our ratings not only focus on specific financial metrics but, more importantly, we build our base case to assess cash flow volatility and robustness under a number of scenarios. Furthermore, our ratings are forward-looking opinions focusing on trends over an extended period, rather than simply a reflection of financial performance on a given date.

All else being equal, the continued receipt over the fiscal 2014 to 2017 period of free permits should ultimately translate into reduced leverage. We will look at the movement of financial metrics over the duration of the compensation period and assess their evolution. We would typically be more concerned about a future drop of a metric toward the final

years of the compensation period to below our expectations. This would indicate that, despite the deleveraging, the company's cash flows are materially adversely affected by the carbon tax. Conversely, an immediate departure of the metrics from our expectation followed by a relatively rapid recovery would indicate that the carbon tax assistance is allowing a company to transition smoothly toward a market environment where carbon has a price.

Ultimately, financial ratios are only one part of our analysis, and weaker metrics could be compensated by a stronger business risk profile or policies on liquidity to meet ongoing carbon liability that would sustain a rating at current levels.

Q. How do you factor in the potential uncertainty of the scheme in case of a change of government?

A. Our financial analysis is not driven by any potential change of government and what implications, if any, this may have. We view this as an event risk that would need to be factored in at the time. Our primary driver for this approach is to ensure that financial metrics are not distorted over the short term by a scheme which is, by definition, transitional.

Should a new government be elected and decide to legislate to amend/repeal the current carbon scheme, we would need to review how and when such legislative changes would be implemented and what carbon reduction scheme, if any, a new government may decide to substitute in its place.

Q. Does the federal government's scrapping of the floor price change Standard & Poor's view?

A. The recent abolition of the floor price in fact highlights how transitory assistance packages can be. The current weak outlook for carbon prices means, in our view, that the benefit of the free permits is eroded given there is no longer any floor to prop up the price of carbon. If carbon prices remain weak, this cessation of price support could re-balance the competitive

advantage somewhat back toward black coal generators, given the fact that they do not benefit from any free permits. Accordingly, we continue to believe a "look-through" approach remains the most appropriate way to analyze the credit impacts.

Q. How does your approach in Australia compare to that adopted for Europe for its carbon scheme?

A. In our view, the Australian model differs from the European because the transitional arrangements are shorter than those in Europe. In addition, the eligibility criteria for assistance in Australia are generally more restrictive than they are in Europe. Those two aspects drive our view that the transitional arrangements in Australia should be viewed as nonrecurring—unlike in Europe because of the initial uncertainty relating to the duration of the transitional arrangements and form of the final emissions trading scheme.

Appendix

Carbon tax transitional assistance for electricity generators

As part of its carbon tax legislation, the Australian government set up the Energy Security Fund, which comprises in particular:

- A\$1 billion cash assistance, paid in June 2012;
- A\$41.705 million of free carbon permits to be provided annually from 2013 to 2017 in proportion to the cash allocation as set out in the table.

The Energy Security Fund also includes provisions for payments to the most emission-intensive generators in exchange of a gradual closure of that capacity. To date, no agreement has been reached with the government to voluntarily close any capacity. **CW**

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Taking It To The MAT(S)

The U.S. Merchant Power Sector Wrestles With Emission Rules

Regulating power plant emissions has never been easy, and recent events affecting the U.S. merchant (i.e., unregulated) power sector bear that out.

Already reeling from low power prices, merchant generators were awaiting a ruling from the U.S. Court of Appeals for the District of Columbia Circuit on challenges to the Cross-State Air Pollution Rules (“Casper”). And after hearing the court’s decision, the stakes for future litigation efforts have increased against another set of rules—the Mercury And Air Toxin Standards (MATS).

On Aug. 21, 2012, the appeals court vacated Casper on the grounds that the rule required states to reduce emissions beyond what Section 110 of the Clean Air Act requires. The court also said that the U.S. Environmental Protection Agency (EPA) breached states' rights by failing to provide states with an initial opportunity to make reductions on their own through state implementation plans (SIP) before imposing its federal implementation plan (FIP).

The power markets took the news in stride, with nary a region reporting any significant power price dislocations. Given that Casper faced a series of challenges, a ruling in the EPA's favor would have been bigger news. But we think two questions are still relevant:

- Is Casper derailed, or just delayed (and does it matter)?
- And with the specter of Casper receding, and emboldened by their successful challenge, will interveners (state officials, generators, labor groups, etc.) next set their sights on the MATS?

Casper Recedes

The EPA finalized and issued Casper in July 2011, and Phase I was to begin on Jan. 1, 2012, less than six months later. While generators understood that environmental regulations were coming, they believed that they needed some relief because of insufficient time to ready plants, and also because the resulting idling of coal units could threaten the systems' reliability. We understand from industry experts that there were also many procedural issues with the implementation of Casper. While these are legal issues and outside the scope of a credit discussion, we believe they're noteworthy nonetheless because the court appears to have based its decisions on some of these arguments.

Broadly, the litigants challenged Casper on the following procedural aspects:

- The EPA cannot order reductions beyond what is actually needed to help downwind states meet current National Ambient Air Quality Standards.

- The EPA cannot order compliance with a FIP without first allowing upwind states to submit SIPs.
- The EPA cannot regulate states collectively without regard to an individual state's actual contribution to emissions. In other words, the EPA abandoned state-level analysis, and set the budget according to a regional assessment of cost-effective reductions.
- The EPA made substantial changes to the methodologies and modeling it used between its proposed and final rules.
- There were no distinctions between reductions needed to meet the standards and those needed to resolve nonattainment.

So, from a credit perspective, the question we need to consider is whether these challenges are significant enough to result in a rewrite of the rules, or whether the EPA can respond to the court quickly by simply tweaking them.

First, we understand that the EPA has 45 days from the date of the opinion (Oct. 5, 2012) to petition for a rehearing of the case by the three-judge panel or an appeal to the full D.C. Circuit Court. Typically, the threshold for obtaining full-bench hearings is high, and the court grants them only in limited cases. The EPA also could seek a Supreme Court review.

Intervenors and downwind states may also invoke Section 126 of the Clean Air Act, another statutory program (*see note 1*), which can impose the same level of reduction obligations on the same set of sources, but directly by the EPA and faster than Section 110 program (*see note 2*) of the Clean Air Act that deals with ambient air quality standards at issue with Casper. The Section 126 program, which deals with interstate pollution abatement, allows states to petition the EPA directly to require installation of pollution controls on power plants in upwind states.

Unless the EPA decides to challenge the D.C. Circuit Court's decision, industry experts we spoke to think that the entire process of revising or replacing Casper and then allowing time for comments and rulemaking (or

invoking other rules) could be lengthy. Specifically, the SIP submission requirement will likely give upwind states extra time to respond and eventually comply, pushing the effective date closer to 2015. We note that if implementation of the new rule runs into 2015, MATS' more exacting standards become the binding environmental constraint, at least as far as sulfur dioxide is concerned (*see sidebar*).

Take It To The MATS

We continue to believe the mercury rules have much greater bearing than Casper on coal generators. The mercury rules will continue to inform utility fuel choices and environmental-compliance equipment decisions through 2015. While the D.C. court's ruling on Casper may delay some of the marginal coal plant retirement decisions, future litigation efforts against MATS will become the dominant credit driver for the merchant power sector, in our opinion.

Although the two sets of rules are not directly related, the Casper decision adds some uncertainty to the timing of MATS in terms of potential litigation and plant-specific compliance extensions. Industry experts think that most of the procedural aspects that applied to Casper do not apply to MATS. Still, we note that comments have been filed against the MATS with the U.S. Court of Appeals for the D.C. Circuit. In a June 8, 2012, filing, state officials and industry and labor groups also petitioned the federal court to expedite its review of the finalized MATS (*see note 3*). No panel of judges has been appointed yet.

The Casper Ruling's Impact On The Power Market Has Been Subdued

Even if Casper had gone into effect as planned, we believe its impact would have been more moderate than we had anticipated last year. Most noncompliant companies were planning to change their dispatch load to burn more natural gas instead of coal to comply with the early deadline of Casper. Shale gas production's incessant onslaught on power prices in 2013 and 2014 and the

resulting sharp decline in natural gas prices since mid-2011 has overwhelmed any significant effect of Casper on emissions. Coal-to-gas switching has, at least in part, helped most upwind states reduce sulfur dioxide levels to levels closer to Casper's 2013-2014 regionwide targets, thus blunting the impact of the court's decision.

Forward power prices in the Pennsylvania-Jersey-Maryland (PJM) and Electric Reliability Council of Texas (ERCOT) regions rose by about \$2.25 per megawatt-hour in July 2011 compared

Table 1 | Top Companies By Retiring Capacity (2011 To 2015) (MW)

Company	—Retiring coal capacity*—					Total 2011 to 2015
	2011	2012	2013	2014	2015	
American Electric Power Co. Inc.	615	—	—	5,276	—	5,891
Duke Energy Corp.	—	477	—	1,234	1,223	2,934
Progress Energy Inc.	177	—	1,033	323	—	1,533
Tennessee Valley Authority	127	356	226	226	1,741	2,676
Southern Co.	252	251	850	—	—	1,353
Dominion Resources Inc.	160	515	—	227	222	1,124
Pinnacle West Capital Corp.	—	—	—	560	—	560
GenOn Energy Inc.	—	482	—	—	—	482
Dynegy Inc.	—	—	293	—	—	293
Exelon Corp.	—	311	—	—	—	311
Xcel Energy Inc.	106	107	44	—	—	257
Total	1,437	2,499	2,446	7,846	3,186	17,414

*As of Sept. 14, 2011.
Source: SNL Energy.

Table 2 | Top Companies By Retiring Capacity (2012 To 2016) (MW)

Company	—Retiring coal capacity*—					Total 2012 to 2016
	2012	2013	2014	2015	2016	
American Electric Power Co. Inc.	615	—	528	3,948	—	5,091
Duke Energy Corp.	1,478	616	710	1,375	—	4,179
GenOn Energy Inc.	698	—	460	2,310	—	3,468
FirstEnergy Corp.	2,467	—	—	885	—	3,352
Tennessee Valley Authority	356	—	—	678	—	1,034
Edison International	326	—	542	—	—	868
Dominion Resources Inc.	—	—	239	222	383	844
Southern Co.	251	591	—	—	—	842
PPL Corp.	—	—	—	809	—	809
The AES Corp.	—	—	—	807	—	807
Total	6,191	1,207	2,479	11,034	383	21,294

*As of March 26, 2012.
Source: SNL Energy.

with forward prices observed in June 2011 in response to the final Casper rule. However, prices then drifted down due to the combined effect of coal-to-gas switching and the declining prospects that the Court would approve Casper with every new challenge. Market heat rates in the PJM hardly moved the day Casper was vacated.

Generators have undertaken cost-benefit assessments across their fleets of coal plants. Companies have announced nearly 32 gigawatts (GW) of retirements between 2011 and 2021, although about 5 GW of these retirement decisions are already in abeyance following the judicial stay on Casper. Regulated utilities, which include some of the bigger coal-fired generators, announced the first wave of retirements (*see table 1*). However, the recent shale gas boom has merchant generators in retirement mode right now (*see table 2*). Economic factors, and not environmental considerations, are driving retirements.

Credit Implications For The Merchant Sector

In the short term, the credit impact of the Casper ruling is obvious: Because unregulated power generators don't have cost-recovery mechanisms and must rely on market pricing to recover environmental capital spending, they were at more risk from the Casper rule than integrated regulated utilities. Yet the credit implications on the merchant power sector are modest, in our opinion.

In fact, the ruling is better news for noncompliant generators than the compliant ("cleaner") ones because it gives noncompliant generators like Energy Future Holdings Corp., GenOn Energy Inc., NRG Energy Inc., and Edison Mission Energy a respite. Any delay in implementing environmental rules offers these companies more time for required capital spending, which will be especially important over the next two years, when languishing commodity prices are likely to hurt revenues.

A Brief Background: The EPA's Environmental Agenda Has Been A Busy One

The EPA established Casper as a cap-and-trade program for more than two dozen states, mostly in the eastern U.S., with the aim of curbing emissions of nitrogen oxide (NOx) and sulfur dioxide (SO₂) that impede downwind states from meeting clean air standards. The EPA drafted the rule because in July 2008, the U.S. Court of Appeals for the D.C. Circuit overturned the Clean Air Interstate Rule (CAIR)—a similar trading program designed to lower SO₂ and NOx emissions. Casper was the final form of the interim Clean Air Transport Rule, a draft agreement the EPA proposed in July 2010 to replace CAIR. The EPA finalized the rule on July 7, 2011. However, the appeals court later stayed Casper on Dec. 30, 2011, before vacating and remanding it to the EPA on Aug. 21, 2012.

The EPA also finalized the Mercury And Air Toxin Standards (MATS) in December 2011. MATS is designed to cut 68 types of air pollutants from coal- and oil-fired power plants via a mercury standard, a particulate matter standard for nonmercury metals, and an acid gas limit. Although MATS mainly focuses on mercury and acid gases, we expect it to become the constraining rulemaking for SO₂ beyond 2015 because its limits are more stringent than Casper's. With an April 2015 compliance deadline for those generators unable to get extensions, MATS is expected to supplant the effects of Casper on

plant retrofits and retirements in part through an acid gas limit, which would result in SO₂ reductions. Industry experts expect power plants that comply with the MATS acid gas limits to be in a position to comply with Casper's SO₂ standards, making MATS the binding constraint.

Importantly, unlike a cap-and-trade program like Casper—which allows operating flexibility to environmentally uncontrolled generation units through market-based mechanisms such as allowance trading, controlling dispatch of power units, etc.—MATS has developed as a "command-and-control" environmental regulation. It will determine the future of inefficient coal units, which will have to either meet control standards, change fuels, or shut down if installing pollution-control equipment proves to be uneconomical. The unit-by-unit or facility-by-facility control requirements under MATS—as opposed to controls at the state or regional levels under Casper—may simply eliminate any flexibility that plants would have had in achieving reductions set by Casper. Consequently, MATS will likely result in more plant retirement announcements. Nearly 40% (or 130 gigawatts) of all U.S. coal plants are currently uncontrolled for SO₂ reductions (unscrubbed), although about 40 gigawatts are in various stages of construction and development.

On the flip side, the remanding of Casper to the EPA delays gratification for companies like PPL Corp., Public Service Enterprise Group Inc., and FirstEnergy Corp. that opted to comply with regulations ahead of time. The ruling is also unfavorable for nonpolluting (“clean”) generators like Exelon Corp. and Calpine Corp. Compliance with Casper would have resulted in higher marginal costs—and thus higher energy prices—for environmentally uncontrolled (“dirtier”) plants, to the benefit of cleaner generators. The potential delay or reversal of some coal-unit retirements, paired with the extended lifetime of some plants, will only slightly add to the downside risk to power prices, in our opinion.

We See Volatility In Power Forward Prices Until Rules Are Finalized

In the longer term, the credit implications of the Casper ruling are more nuanced, in our opinion. Unlike regulated utilities, which have to demonstrate to regulators that upgrades are necessary to comply with the environmental regulations in order to get approved into rate base, merchant plants must perceive that forward power prices will cover the upgrades. However, because environmental rules evolve over several years, plant owners are often reluctant to commit to emission-reduction plans that might not match with the final rules. As a result, many merchants stall when it comes to expensive commitments until the regulation becomes final.

We note that complying with regulations that are not final, while appropriate from an environmental perspective, is a directional bet from a credit perspective. Plant operators that have deferred environmental upgrades in recent years have generally benefited from postponed regulations or other changes in the market. For instance, a number of coal-fired generators deferred spending on scrubbers to reduce sulfur dioxide emissions because of uncertain carbon regulations. They perceived that if the carbon rules turned out to be more restrictive than anticipated, they would be investing in

coal-fired assets that may turn uneconomical. While carbon regulations were eventually postponed, the shale gas boom has rendered investments in scrubbers moot. To illustrate the stark implications, Constellation Energy Group Inc.’s Brandon Shores coal-fired unit invested nearly \$900 million to install scrubbers in 2009 and 2010. The unit sold in 2012 for less than half that cost (*see note 4*).

We expect some generators to adopt a similar approach to MATS. On one hand, waiting has often been the best strategy. Yet, if the mercury rules go into effect as currently proposed in April 2015, they may meet an industry that is not fully prepared.

Delaying action may increase volatility in power prices because adding emissions-control equipment or switching to alternative fuels can take time and some units may be unavailable. It may also result in significant contango conditions (when long-term prices are higher than near-term prices) for 2015 forward gas prices because of a sudden increase in gas demand.

NOTES

- (1) Section 126 of the Clean Air Act pertains to “Interstate Pollution Abatement” (*see*: <http://www.epa.gov/oar/caa/title1.html>).
- (2) Section 110 of the Clean Air Act pertains to “State implementation plans for national primary and secondary ambient air quality standards.”
- (3) White Stallion Energy Center et al versus U.S. EPA (No. 12-1100 et al).
- (4) The sale was arguably in a weak market and was mandated by the Federal Energy Regulatory Commission, ironically for mitigating market power. **CW**

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**FISCAL
CLIFF
AHEAD**



Q&A

In The Wake Of The Election, A Divided Washington Braces For The Fiscal Cliff

Even with President Barack Obama's decisive Electoral College victory giving him a second term in the White House, Washington remains largely divided. Democrats strengthened their majority in the Senate, while Republicans retained control of the House of Representatives. This potential for continued gridlock among legislators could have profound effects for the U.S. economy, as well as for many of the various borrowers that Standard & Poor's Ratings Services rates, as the country heads toward the "fiscal cliff" of simultaneous tax-cut expirations and across-the-board spending cuts under sequestration.

Health care providers, for example, clearly had much at stake in this election with regard to the fate of the Patient Protection & Affordable Care Act ("the ACA") and Republican avowals to repeal it. Banks and other financial institutions, meanwhile, seek greater clarity on what the Dodd-Frank Wall Street Reform And Consumer Protection Act Of 2010 will mean for them.

Here, in a series of questions and answers, we seek to provide some insight into the issues that borrowers currently face.

Q. What does the election result mean for the U.S. economy and, more specifically, the fiscal cliff?

A. Given that neither party has a majority with which to push through an agenda, we think the chance that political brinkmanship will push the U.S. economy over the fiscal cliff is increasing, though only to about 15%. While estimates vary regarding what going over the cliff will mean for GDP—with the Congressional Budget Office estimating a contraction of the federal budget by as much as 5% (or \$800 billion)—it's clear that things would degenerate sharply for an economy in a still very fragile recovery. Going over the fiscal cliff would almost undoubtedly sink the U.S. back into recession—and reverberate around the world. Export-led countries would suffer from lost revenue almost at once, while countries that rely on commodity exports would likely feel a hit a few quarters down the road as demand for these commodities, which drives industrial production, dries up.

Our base-case forecast has long been for Congress to resolve the fiscal cliff after the election and before the end of the year. We believe that lawmakers will finally come to realize that they must reach some compromise on tackling the long-term federal debt, phasing in spending cuts and tax increases over several years. But the detente that Congress reached earlier this year could easily become a stalemate, in which case automatic spending cuts would kick in on Jan. 1, just as the Bush-era and pay-

roll-tax cuts expire, along with emergency insurance benefits. This would, in our view, plunge the U.S. back into recession and push unemployment back above 9% by the end of next year.

Q. What signs do you see that there will be some compromise in Washington?

A. The most likely scenario, in our view, is that policymakers reach sufficient political compromise in time to avoid most, if not all, potential economic effects of the cliff. There are several reasons we hold this view. First, Democrats and Republicans seem to agree on delaying deficit reductions (i.e., "fiscal consolidation"), as the extension of the 2001 and 2003 tax cuts seems to indicate. We also believe that both parties tend to agree on the importance of avoiding noticeable action—or inaction—that the public might interpret as Washington hindering an economic recovery. Advocates in favor of allowing the fiscal cliff consolidation to happen are few, especially given that media attention raises the associated political costs.

Lastly, if most deadlines that make up the fiscal cliff arrived without previous, mitigating legislative action, we believe there would still be significant scope for administrative and legislative action to reduce the effects, after the fact. Examples would include back-loading sequestration-driven spending cuts and legislation to retroactively extend expiring tax relief measures.

Q. If fiscal-cliff consolidation is unlikely to occur, why does Standard & Poor's have a negative outlook on its 'AA+' sovereign credit rating for the U.S.?

A. Our sovereign credit ratings aren't economic forecasts; rather, they are forward-looking opinions about the likelihood a government will pay its market debt in full, on time, and unconditionally. This is informed by our assumptions regarding GDP growth (averaged over a 10-year period) and other economic, political, fiscal, monetary, and external factors. Our negative outlook (which we

assigned in August 2011) on the sovereign rating indicates that the likelihood of us lowering our long-term rating on the U.S. within two years is at least 33%.

The negative outlook reflects, among other factors, rising net general (total) government indebtedness (which we expect to surpass 80% of GDP this year) and the absence of policymakers' agreement on a credible, medium-term strategy of fiscal consolidation. Pressure on the rating could build if, in our view, elected officials remain unable to agree on a plan that represents significant, even if gradual, fiscal tightening beyond that envisaged in the Budget Control Act of 2011. Pressure could also increase if real interest rates rise and result in a projected general government (net) interest expenditure of more than 5% of general government revenue.

On the other hand, the rating could stabilize if lawmakers agree on a medium-term fiscal consolidation plan, or if the U.S. government makes faster progress toward reducing the general government deficit than we now presume.

Q. What are the prospects for Dodd-Frank and its effects on U.S. financial institutions?

A. The Dodd-Frank Act has what we consider to be several deficiencies that will have to be dealt with, regardless of the partisan mixture between the White House and Congress. For instance, the act doesn't address a resolution to the conservatorships of Fannie Mae and Freddie Mac. Also, we believe the Financial Stability Oversight Council, tasked with identifying and monitoring excessive risks to the U.S. financial system, has failed to deliver effectively on its mission because of lack of regulatory agreements. However, we believe the core and spirit of the legislation will remain intact.

Still, regulations affecting several components of Dodd-Frank have yet to be finalized—including those intended to curtail banks' proprietary trading. The likely outcome, in our view, is that the law's regulations will, over time, see revisions in some areas. These changes will

probably reflect, in part, the eventual resolution of partisan and ideological differences. Ideally, the Obama Administration would strive to strike a balance between appropriately safeguarding taxpayers and developing a regulatory environment that allows for banks to grow and support the economy.

Q. What effect would the fiscal cliff have on U.S. banks?

A. While Standard & Poor's considers it likely that falling off the fiscal cliff will be avoided, a lack of agreement on a resolution would likely push the economy back into recession. If such a scenario developed—and depending on how long it lasted—banks and other financial institutions would almost certainly suffer an erosion in credit quality, depressed revenues and profits, and, at weaker institutions, lower ratings. This would come at a time when regulation is calling for increased capital and improved liquidity for banks.

Q. What are the prospects for Fannie Mae and Freddie Mac?

A. Perhaps one of the most intractable problems facing a new Congress will be how to resolve the federal takeover of government-sponsored entities (GSEs) Fannie Mae and Freddie Mac. Both are insolvent and have already cost taxpayers \$170 billion. Yet the agencies are also critical to the functioning of the U.S. mortgage market now that non-agency issuance of residential mortgage-backed securities (RMBS) has shrunk to just 1% of the overall market.

The Federal Housing Finance Agency (FHFA) has set out a strategic plan outlining the next phase of the conservatorships of Fannie and Freddie, stating three goals: first, to build an infrastructure for the secondary mortgage market, second, to gradually reduce Fannie and Freddie's market dominance by simplifying and shrinking their operations, and third, to maintain foreclosure-prevention activities and credit availability for new and refinanced mortgages. We believe that the FHFA's proposal for building a new infrastructure will help ease

the transfer of credit risk to private investors, and its proposal for preventing foreclosures will likely support the stabilization of the housing market, at least initially. However, in our view, the credit-risk transfer from the GSEs to private investors will be a multiyear process so as not to create any material dislocations in the housing market. Furthermore, we anticipate that ultimate resolution is perhaps eight to ten years away, once housing stands on more solid footing and there are stronger economic prospects.

Perhaps one of the most intractable problems facing a new Congress will be how to resolve the federal takeover of government-sponsored entities Fannie Mae and Freddie Mac.

Q. How will the continued divide in Washington affect various corporate industries and sectors?

A. Health care: President Obama's reelection clearly obviates the outright repeal of the ACA that was a main plank of the Romney-Ryan campaign. While we expect continued implementation of the act (as it has already survived Supreme Court review), expected attempts by some Republicans to defund many provisions introduce additional uncertainty and potential delays around the path to reform, although the enhanced Democratic majority in the Senate makes changes unlikely. Either way, we expect a number of initiatives to continue to reduce the cost of health care—such as accountable care organizations and other managed care offerings—although comprehensive health care reform will remain elusive.

The extension of coverage to the uninsured under the ACA will likely benefit health care providers overall. However, individual providers' performance will vary depending on their locations, payor mix, and local employer

trends regarding health insurance for employees, among other factors. In addition, Medicare reimbursement is likely to decrease due to budget pressures.

Meanwhile, medical equipment, device, and supply companies are likely to bear a major portion of the federal government's cost reductions under the ACA as a result of the medical-device excise tax of 2.3%. We expect device companies to absorb the cost of the tax with a modest erosion to profitability. We do not expect any adverse rating actions due to the tax.

For the pharmaceutical industry, we see ACA as likely being neutral to credit quality. Increased drug sales under the individual mandate that requires everyone to have health care coverage will probably more than offset the \$85 billion in government fees that the ACA requires pharmaceutical companies to pay to help cover the costs of the legislation.

At the time of the March 2010 passage of the ACA, we said that the credit impact on health insurers would unfold slowly. The Supreme Court's decision in June to uphold the law removed a significant overhang for health insurers. The ACA, by itself, hasn't yet resulted in any rating actions, and we don't expect it to in the future.

In connection with President Obama's victory—combined with a split Congress—we expect no material changes to the law itself. Now, we may see some movement in implementation, given the relatively slow pace of development thus far, which was, in part, due to the election cycle and, in part, by the timetable embedded in the law itself. As of late September, only 19 states had begun setting up exchanges, or agreed to do so in partnership with the

federal government, according to an analysis by the Kaiser Family Foundation. We expect this number to accelerate in the weeks ahead.

We expect the Administration to now focus on developing final regulations, particularly regarding employer and exchange requirements. Also, we believe the White House will seek to work with states to advance nondisruptive payment reforms. We expect to see significant innovation to emerge from the private sector as well as health insurers seek to better integrate the coordination of care by means of enhanced collaboration (in some cases via merger and

mostly with federal money, to make up for dollars lost elsewhere in connection with other related ACA provisions. Also, employer groups may advocate for an opt-in to lower their exposure to tax penalties resulting from Medicaid-eligible employees receiving subsidized benefits through the exchanges.

We believe the sector focus has now squarely shifted to readiness and execution, and much will hinge on the ability of the Obama Administration to lead and work with the states and the private sector to tackle the challenges that will inevitably emerge in connection with this transformational undertaking.

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acquisition of insurers and medical groups), ongoing focus on cost transparency, and payment that is more aligned with performance and outcomes.

Open enrollment under the ACA begins in less than 12 months, and all states are required to report on the readiness of their exchange capability by the end of next week. We believe that many states are behind schedule and may need to resort to a partnership with Health and Human Services (HHS) or be reliant upon a federally facilitated exchange. It's possible the administration will allow for a staggered rollout and perhaps relax some regulatory provisions to provide additional flexibility regarding readiness and execution.

The states remain reasonably well positioned to influence how the law is carried out because the Supreme Court ruling gave them discretion about whether to move forward with the expansion of Medicaid, which had been expected to cover a majority of the estimated 30 million people gaining health insurance under the ACA. However, the hospital sector will likely lobby hard for the expansion, which is to be funded

Energy: An energy policy that forfeits some traditional energy sector interests for diversification as well as safety and environmental priorities could, in our view, slow growth in revenues and profitability in fossil fuel-based industries. While the production of natural gas and oil has increased under President Obama, it has been mostly on private land, and we believe it's unlikely there will be a wide opening of federal owned lands for drilling. Federal regulation (primarily through the Environmental Protection Agency [EPA]) and associated costs may also increase.

Although we consider the partial or full prohibition of hydraulic fracturing (fracking) due to environmental concerns unlikely, material government action in this regard could hurt industry profitability and growth, and could lead to spikes in fuel prices for consumers.

The Obama Administration has stated its intent to continue to promote renewable energy sources. Most likely, there could be an extension of tax credits for wind-energy providers, as well as incentives for nuclear, solar, and wind companies. In the case of oil and gas pipelines,

we believe the administration could be somewhat ambivalent toward major new projects as it weighs jobs against environmental issues.

We don't expect significant changes to the profitability dynamics for refiners with access to discounted mid-continent crude. In terms of refining-specific regulation, the Administration could attempt to expand greenhouse gas and CO2 legislation, and related costs, although states such as California have been leading this effort to date. This would likely pressure profit margins as refiners attempt to pass along such costs to consumers.

At the same time, the coal industry may continue to see increasing pressures from carbon and greenhouse-gas regulation. This would continue to benefit producers of natural gas, which is increasingly substituting for coal in electricity generation. In the wake of Superstorm Sandy and mounting concerns in many quarters about the effect of manmade global warming on climate change, both President Obama and Senate majority leader Reid have expressed interest in pursuing congressional legislation that would further limit carbon dioxide emissions. We believe this would have negative implications for coal-fired electric utility generators, coal miners, and refiners, if enacted.

However, in the end, the lack of a clean sweep for either party will likely limit further regulation and negative changes to incentives, which is positive for industry profitability overall.

Defense: The reelection of President Obama doesn't materially change our negative outlook for defense contractors' revenues and earnings. We continue to believe that sequestration, which calls for an additional \$500 billion of cuts in defense spending in the next 10 years, won't occur at the start of next year. However, we do expect that, as part of any agreement to delay or eliminate sequestration, defense spending cuts will be greater than the \$487 billion specified in the Budget Control Act of 2011.

Still, the split in Congress will likely limit the additional cuts to an amount that we believe the industry can handle.

We expect war spending to continue to decline as President Obama sticks to the plan of withdrawing all combat troops from Afghanistan by 2014. We also believe that a shift in strategic focus to Asia will result in a greater proportion of defense spending going to the Navy and Air Force, at the expense of the Army.

Technology: With Congress remaining divided, business and consumer confidence may remain subdued, undermining corporate and consumer investment in tech and IT products. The failure to prevent a fall off the fiscal cliff would mean budget cuts in the defense sector, which, in turn, could hurt IT contractors' performance. However, we believe that many of the government IT contractors that we rate provide essential services and would be less affected than they would under an overall decline in defense spending. Assuming Washington avoids the fiscal cliff and significant defense spending isn't profoundly affected, cuts could still be part of a subsequent budget deal under the Obama Administration—and this would have a negative effect on IT contractors' performance, in our view.

In any case, demand from corporate buyers may slow because fewer resources are available to make technology purchases. Consumer purchases and confidence may also remain restrained, which could weigh on sales of consumer electronics, handsets, and PCs. These products are key markets for semiconductor manufacturers, which could also suffer weakening demand. Software and services companies may feel fewer negative effects on revenue because of the significant amount of recurring revenues generated under long-term contracts and maintenance requirements. Nonetheless, new licenses and contracts in these sectors could be hurt as companies curb IT spending.

Despite the restrained IT spending environment that we anticipate over the near term, we expect a fairly balanced ratings trend in the technology sector to remain. Ratings on speculative-grade companies (rated 'BB+' or lower) are more susceptible to pressures resulting from this economic

environment, while many investment-grade companies (rated 'BBB-' or higher) have built up balance sheet strength and liquidity to bridge a period of weaker IT spending levels.

Telecom/Cable: Given the potential for continuing legislative gridlock, we expect a Federal Communications Commission (FCC) order that took effect late last year calling for so-called network neutrality—which prevents Internet service providers (ISPs) from blocking lawful Websites or otherwise engaging in unreasonable discrimination, and requires all broadband providers to disclose their network management practices, performance characteristics, and terms and conditions—to survive, with companies continuing the practices they've implemented to meet this.

Meanwhile, the FCC has adopted so-called intercarrier compensation (ICC) and universal service fund (USF) reforms, which are intended to reduce subsidies and fees that have benefited certain wireline telecom operators. We believe these are likely to survive. Also, both parties are publicly supportive of broadband initiatives to expand availability in rural and poor areas, and seem to support the elimination of access charges. Since Republicans and Democrats agree on many of the ICC and USF precepts, a divided Washington won't likely alter adoption of these reforms, but revisions to the contribution mechanism could conceivably take longer to adopt.

Lastly, both parties favor increasing spectrum availability, and political gridlock isn't likely to impede the auctioning of wireless spectrum, though the degree of restrictions on the process are less certain, in our view.

Overall, we don't expect the election to have any direct meaningful effect on sector credit ratings.

Utilities: Because local issues have more of an effect on utilities than the outcome of national elections, we expect President Obama's reelection to be credit neutral for corporate utility companies. Key credit factors for the industry include the recovery of costs

to meet mandated environmental regulations and policies toward renewable sources of energy. Reliability may come into play, especially in areas hit by extended outages, such as the Mid-Atlantic and Northeast after Hurricane Sandy. The pressure to retire more coal units may abate in a divided Washington, but regulated utilities have rate structures that pass along costs—or savings—to customers. A slowdown in federally mandated renewable energy sources, such as solar and wind power, would likely ease rising cost pressures on utility customers in a fragile economic environment.

Natural resources: The split in Washington fosters uncertainty regarding the regulatory environment, tax policy, and budget shortfalls—at least for a little while. This is reflected in our negative credit outlook on metals and mining firms. We see little impetus for improvement among coal producers and expect sluggish performance among manufacturers of steel and aluminum in the next year. However, we believe credit trends will be more favorable for gold and copper miners. We expect gold prices to remain high in the face of uncertainty, and we believe that copper, which has relatively favorable supply characteristics, will enjoy reasonably strong pricing over the next year. We expect credit conditions to continue to improve for building materials companies, albeit gradually, and for credit quality to remain mostly stable for forest products firms.

Homebuilders: Progress under a divided federal government depends on the parties' willingness to work together. Under a bipartisan scenario, in which the divisiveness and inaction that have dominated the U.S. political scene for the past two years subsides, substantial progress might be made on larger industry issues, including the reform of government-sponsored entities (GSEs) such as Fannie Mae and Freddie Mac. It's likely that monetary policy would be more restrictive, resulting in higher interest rates, but if this happens in a measured way and is supported by a growing economy, housing demand might not be materially affected.

Under this scenario, we would expect credit quality for rated homebuilders to improve as demand for new homes continues to grow from the very low levels experienced in 2011.

On the other hand, if the current stalemate between Democrats and Republicans continues, uncertainty will likely inhibit economic expansion. Weak job growth and high unemployment may limit the housing sector's ability to substantially recover. The prospects for extensive regulation and increased liability will likely keep most private lenders on the sidelines. With no viable private market alternative, reform of the GSEs is unlikely, resulting in little change in the moribund private lending market. In this case, ratings on U.S. homebuilders could come under pressure, particularly if builders have substantially depleted their substantial liquidity positions to fund growth that fails to materialize.

The various housing initiatives put forward under the Obama Administration to enable homeowners (particularly those that owe more than their homes are worth) to refinance may continue—although the effect of these programs has been relatively modest so far. However, if job growth remains lackluster and unemployment stays high over the next few years, the still-fragile recovery in housing could falter.

We expect regulatory oversight of mortgage lending to continue to grow during the second Obama term. Many of the more onerous regulations related to mortgage lending embedded in the Dodd-Frank legislation have yet to be written. Regulations could favor consumers over lenders, resulting in little change in the weak private-lending environment.

Autos: We do not see any immediate direct credit implications for the U.S. auto sector as a result of the outcomes of the elections for President and Congress earlier this week. Still, one risk worth watching is the potential negative economic impact from policy gridlock—and how that affects consumer and business purchase decisions for vehicles.

Unabated partisan strife in Washington could mean that business

and consumer confidence will remain weak, undermining the recovery in light-vehicle sales in the U.S. The most significant risk of gridlock could be to the economic recovery, which has supported this sales increase.

Generally, issues we consider with regard to Washington and the auto sector include fuel-efficiency rules, safety regulations, and consumer-related regulations, including consumer finance. The Transportation Department and Environmental Protection Agency recently finalized standards that aim to increase fuel economy to the equivalent of almost 55 miles per gallon for cars and light-duty trucks by model year 2025. Improved fuel economy technology has made all vehicles less susceptible, though not immune, to higher gas prices.

On the safety front, we assume that there will continue to be technology advancements, mainly inspired from within the industry rather than from outside. A less likely wildcard could be deficit-reduction actions, if such efforts resulted in a higher gas taxes or corporate taxes. The large U.S. automakers aren't currently U.S. taxpayers, but many suppliers are. Higher gas prices or individual taxes could lead to more small cars and fewer larger vehicles, which could hurt overall automaker profitability.

Capital goods: We don't expect the election outcome to have a major effect on ratings in the capital goods industry, as credit quality will continue to depend primarily on business confidence, the growth outlook for the U.S. and global economies, and manufacturing activity spurred by demand across a range of end-markets. Still, certain businesses or business lines could be affected more than others. Some equipment manufacturers with heavy exposure to sectors such as coal (mining and railcar manufacturing) or defense, for instance, could continue to face more difficult business conditions because of stated regulatory and/or budget priorities. Conversely, other manufacturers may benefit from policy initiatives that support infrastructure spending (construction equipment), alternative energy sources, and energy efficiency (electrical equipment).

Overall, we think a failure to address the U.S. economy's long-term fiscal challenges poses a higher risk for industry credit quality, because of the negative implications for business confidence, capital spending, financial market stability, and related credit availability.

Media/Entertainment: We believe that ad spending could suffer in the event of a reprise of 2011's 11th-hour standoff in Washington. Advertising is an inherently confidence-driven business. It relies on the assumption that consumers will spend to maintain their lifestyles. If businesses become concerned that consumers will pull back, or if they become worried about their own corporate bottom lines, they typically curb spending on marketing and advertising.

Additional scenarios that could result in a drop in ad spending are:

Overall, we think a failure to address the U.S. economy's long-term fiscal challenges poses a higher risk for industry credit quality, because of the negative implications for business confidence...

- Financial market shocks independent of the deficit reduction talks,
- A reversal of progress in European debt restructuring,
- Successive natural disasters close on the heels of Hurricane Sandy,
- Escalation of fuel prices, a reversal of positive signs in home prices, and a precipitous drop in stock prices (all elements of consumer wealth, which affects consumer spending), and
- Another spike in unemployment.

Any of these shocks could cause a sufficient drop in ad spending such that credit measures and financial flexibility could be adversely affected, even to the point of rating downgrades.

Q. What are the implications for the states that have yet to proceed with setting up the health care exchanges mandated under the ACA?

A. Before to the election, whether to establish an exchange remained an open question for many states. They now face a deadline and must submit, by Nov. 16, documentation showing how they meet, or will meet, all requirements of a state-based exchange or state partnership with the federal government. If they don't currently have an exchange that meets the requirements, the documentation must lay out how they will conform by 2014.

Although states have considerable latitude in the design of their exchanges, if they don't establish a state-based exchange, state partnership exchange, or show how they will have one by 2014, their residents will be eligible to obtain coverage through a federally facilitated exchange. With the election now behind us and because the federal government would step into the void, we anticipate

that at least some of the previously reticent states will move forward in an expedited fashion. Along these lines, some states have indicated a preference for establishing a state-based exchange, but that they do not expect to be prepared to do so by the Nov. 16 deadline. In other instances, states have indicated they may initially operate under a federally facilitated exchange with the intent to migrate to a state-based exchange at a later date.

Q. Medicaid is a significant, shared expense between the states and the federal government that was specifically exempted from cuts if the fiscal cliff becomes reality. Does this mean there is no risk to states' Medicaid budgets?

A. Not necessarily. It's true that the Budget Control Act (BCA) exempted Medicaid from sequestration cuts.

However, there appears to be bipartisan agreement that would adjust sequestration cuts and scheduled tax increases to avoid negative consequences to the U.S. economy. Assuming policymakers revisit the BCA, there is a wide range of possibilities for what could happen to Medicaid. At one end, the President's budget proposal preserves Medicaid and widens its scope under the ACA. On the other hand, House Republicans may seek to convert Medicaid to a block grant, which would likely reduce federal support for the program, particularly in future years. We note that despite their vast public policy differences, both the approach advocated by President Obama and the one supported by House Republicans would ask more of states' resources in future years.

Q. State and local issuers of Build America Bonds, issued as part of the federal American Recovery And Reinvestment Act Of 2009, receive a federal subsidy on this debt. Does Standard & Poor's believe these bonds could be in danger of default without the federal subsidy?

A. The Build American Bond (BAB) program authorized states and local governments to issue taxable bonds that were eligible for a federal subsidy payment equal to 35% of the interest cost of the debt. Under the program, states and local governments issued approximately \$180 billion in debt. The White House Office Of Management And Budget has estimated that approximately \$322 million of about \$4.2 billion in subsidy payments for BABs and some other federally subsidized bond programs could be at risk under sequestration. A majority of the BABs that Standard & Poor's rates included a gross debt-service security pledge without regard to the federal interest subsidy. However, a minority of the issued BABs included a net pledge whereby the repayment pledge for 35% of the interest cost was limited to the federal subsidy payment. If this subsidy were discontinued, these bonds could enter

default if the issuer didn't volunteer to fund the portion of debt service backed by a pledge of the federal subsidy payment. We believe that despite the added budgetary strain this scenario would present, the rated BAB issuers would fund the debt service as it comes due.

Q. What would the effect on municipal housing ratings be from a cut of 8.2% under sequestration?

A. The municipal housing sector has numerous links to the federal government:

- Public housing through the Department Of Housing And Urban Development (HUD);
- Military housing through the Department Of Defense;
- Mortgage insurance through the Federal Housing Administration, Veterans Administration, and the Department Of Agriculture; and
- Strong connections to Fannie Mae and Freddie Mac.

The ratings most directly affected would be those based on public housing authority capital grants. Sequestration would represent a reduction of \$154 million in capital fund grants. Of the 37 issues we rate, all are investment grade ('BBB-' or higher), with 21 at 'AA-', another 14 at either 'A+' or 'A', and two at 'BBB'. Seventeen of these ratings have negative outlooks, irrespective of the effects of possible sequestration. If sequestration takes effect, we would determine whether a transaction maintains sufficient debt-service coverage to support the rating, or if declining receipts would result in lower coverage, leading to a negative rating action.

Q. Which parts of the structured finance markets will the outcome of the election most affect?

A. President Obama's reelection, combined with a Democratic majority in the Senate and Republican control of the House, will have little effect on structured finance credit and issuance in the short run, in our view.

Tuesday's results aren't likely to affect the market for consumer asset-backed securities (ABS), such as credit-card ABS, the performance of collateral backing these securities, or the volume of securitization. However, borrowers of student debt continue to face relatively higher unemployment rates since the economic downturn and, as a result, the private student loan ABS market has been generally dormant in recent years.

We also expect the effect on the market for commercial mortgage-backed securities (CMBS) to be neutral given the modest role the government plays in that market outside of the multifamily area, and the role of the GSEs in that market. More relevant to CMBS is the government position regarding quantitative easing, through which the Federal Reserve buys financial assets to inject money into the economy. The Fed's third round of easing, known as QE3, is underway and has recently underpinned a surge in lending in the CMBS market. While quantitative easing has been a stimulant, the CMBS market was functioning before these measures, and we expect lending to continue, though at a more modest pace. **CW**

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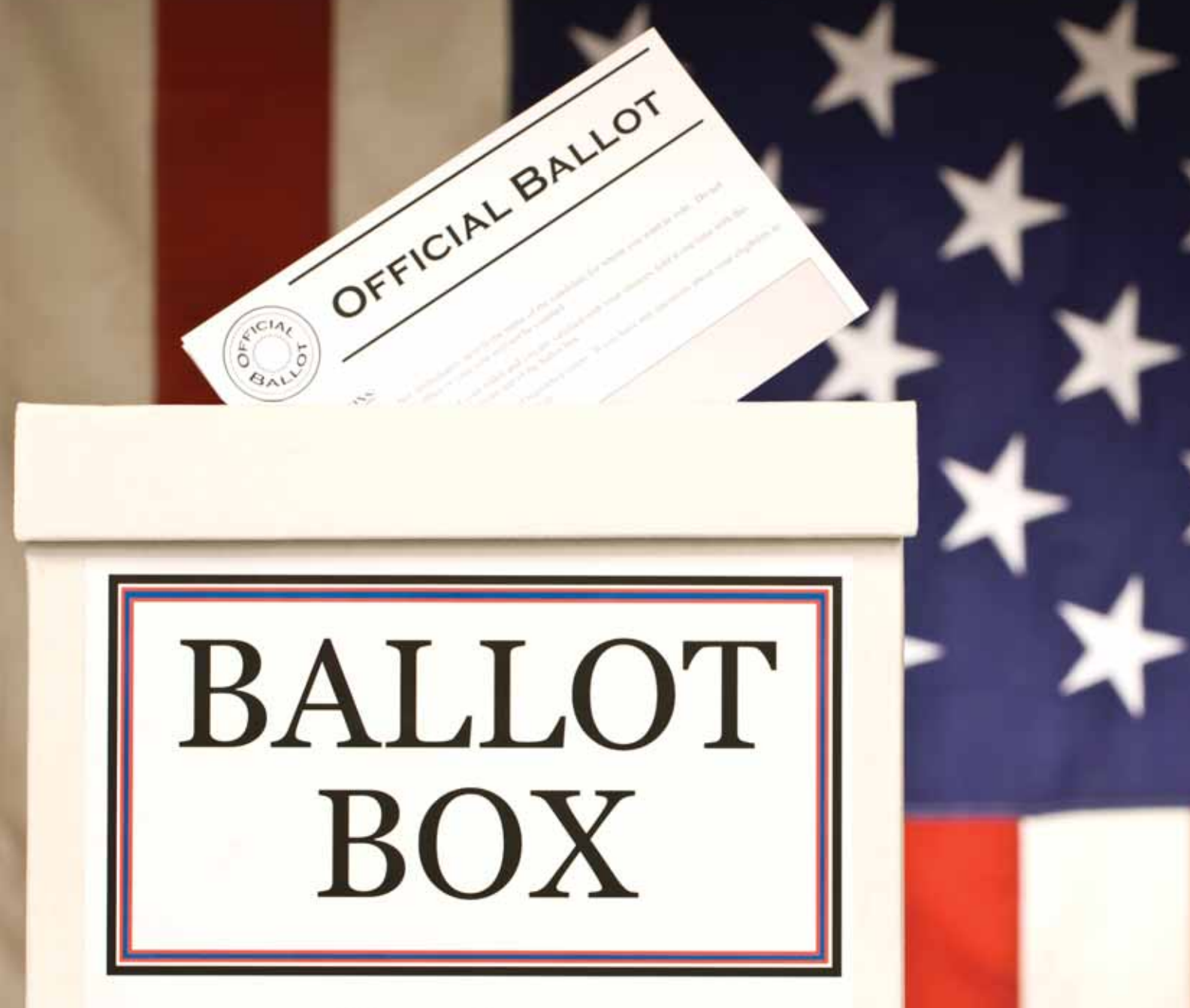
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Voters Continue To Show Support For State Bond Measures

On Nov. 6, voters in 38 states decided 176 ballot measures, according to the Initiative and Referendum Institute. This is the highest number since the 204 measures that appeared in 2006. Two of the most significant ballot measures from a credit perspective in our view were in California and Michigan, states where the Great Recession's effects were strongly felt.

California's Proposition 30 passed, increasing sales and income taxes to bolster education funding after an extended period of state cutbacks. School districts and community college districts will feel its effects nearly immediately, as the state's fiscal year 2013 budget included "trigger" education funding reductions if the measure failed. The measure also sets the stage for a multiyear phase-out of education payment deferrals that often have strained school district and community college cash flows and, in some cases, the credit quality of tax and revenue anticipation notes.

While Michigan voters were not voting on potential tax increases, six ballot questions did address issues that included limiting the power of government. Most notably, Michigan voters rescinded Public Act 4, a new law that would have expanded the state's ability to appoint emergency managers and expand the power to suspend contracts and cut operating budgets. Voters did not, however, approve a constitutional amendment that would have required a two-thirds supermajority to increase taxes. It is Standard & Poor's opinion that the credit effect of both outcomes are likely to be limited for the state and for local governments.

There were numerous measures regarding state budgets, and overall these received a mixed reception.

- The **Washington** State legislature is again subject to a two-thirds supermajority requirement to increase taxes following the election. We believe that this restriction that will limit its budgeting flexibility although the state has lifted previous voter-imposed supermajority requirements under its constitutional ability to modify voter initiatives after two years.
- **Florida** voters declined to revise the state constitution's revenue growth formula, which we believe could have led to lower growth in discretionary revenues over time.
- A majority of voters in **New Hampshire** agreed to prohibit a personal income tax, which the state does not currently

impose, but this was insufficient to meet the supermajority needed to amend the constitution. We do not view the measure's failure as significantly affecting credit quality insofar as its passage or failure would not have affected the state's present taxing framework, but its passage would have reduced revenue flexibility by removing a potential revenue source common among other states.

- **Arizona's** local property tax framework changes following the election could create costs for the state, as we believe that the state could need to increase its share of contributions to education funding over time to keep such funding constant.

The following are other key themes and state voter responses of this election.

- There were numerous other states where tax increases were on the ballot, but unlike Proposition 30 in California, most of those proposals did not pass.
- Oklahoma voters approved and Florida voters rejected tightening property tax growth limits.
- **Idaho** voters reversed recently adopted education reform laws, and Washington approved the formation of charter schools.
- Voters in Alaska, Arkansas, Maine, New Jersey, New Mexico, Oklahoma, and Rhode Island approved debt authorizations totaling \$3.2 billion, with only one measure, one of four in Maine, failing.

To the extent that the consequences of these decisions are felt over time, we will monitor governments' ability and willingness to respond.

State-By-State Ballot Measures

Final results for most measures will not be known for several weeks. The following are based on unofficial results from the states or from other sources we believe are reliable, indicating the passage or failure of each measure.

Alabama (AA/Stable)

Amendment 1 (Forever Wild Land Trust). Amendment 1, which extends the Forever Wild Land Trust for another 20

years, has passed. The trust is funded from the 10% of investment interest proceeds on natural gas royalties paid into the Alabama Trust Fund. The trust uses the funds to purchase lands for recreational uses, natural preservation, and additions to state parks and wildlife management areas. We do not anticipate that this amendment's passage will significantly affect the state's credit quality as it does not change the current framework and caps contributions at \$15 million annually.

Amendment 2. Voters approved a change in the state's calculation of its \$750 million cap on general obligation (GO) debt so that the cap no longer includes refunding bonds. We do not believe this will have any immediate effect on the state's credit quality. We will, however, factor in any additional debt issued under this amendment into our analysis of the state's credit quality.

Amendment 9. Voters approved Amendment 9, which affirms the legislature's authority to regulate and impose a business privilege tax on corporations and other entities. This will give the authority powers to repeal various provisions regarding private corporations, railroads, and canals. We do not believe that passage of this amendment will have a significant effect on the state revenues.

Alaska (AAA/Stable)

Proposition A. Alaska voters approved \$454 million in GO bonds for transportation projects. We consider this debt authorization to be significant, at approximately 17% of the state's existing tax-supported debt at the end of fiscal 2011. But we believe the state will have sufficient flexibility to structure debt issuances to minimize the effect of a potential net increase in annual debt service into its budget. Absent other changes in the state's credit profile, we do not believe this measure would immediately affect the state's credit quality.

Ballot Measure No. 1. Voters turned down a decennial opportunity to convene a constitutional convention, echoing results in 2002.

Arizona (AA-/Stable issuer credit rating—ICR)

Proposition 116. Voters rejected Proposition 116, a proposed revision to taxes on business' capital spending, which would have provided a property tax exemption starting in the 2013 tax year for newly acquired business equipment used in agriculture or in a trade or business.

Proposition 117. Voters approved Proposition 117, which limits the annual growth in the limited property value of locally assessed properties to 5% beginning with the 2015 tax year. It revises the state's property tax system by moving to a single value to calculate taxes, from the state's current system, in which operating levies for school districts, cities, and counties are based on limited property value while levies to pay for bonded debt service, voter-approved budget overrides, and certain special purpose district obligations are based on full cash value. We believe that the passage of Proposition 117 will have little, if any, immediate effect on local government operating revenues. However, it likely will affect future bonded debt capacity, which the state will base on limited value rather than full cash value, and affect potential non-school revenue growth. In addition, we believe that the measure could result in a higher general fund cost to the state, particularly if future growth in the cash value far exceeds 5% annually, and the state keeps education funding constant because the state would likely have to contribute a larger share of education funding as the gap between the prior and new framework widens.

Proposition 118. Voters rejected Proposition 118, which would have revised the Permanent Fund annual distribution formula to 2.5% of the average monthly market value of the trust fund for the preceding five calendar years effective from fiscal year 2013 to 2021.

Proposition 204. Voters rejected Proposition 204, which would have reauthorized a one-cent sales tax that was originally enacted in 2010 for temporary state budget relief and is set to expire at the end of fiscal 2013. Passage of this

measure would have helped local school districts, in our view, by providing more aid but could have reduced state flexibility to make future cuts to education.

Arkansas (AA/Stable)

Issue 1. Voters approved Issue 1, which authorizes the state to levy a temporary 0.5% sales and use tax for maintenance and construction of the state's interstate highway system. The Arkansas State Highway Commission can use the incremental revenues to secure GO bonds of up to \$1.3 billion. The sales and use tax would terminate on repayment of the bonds, which would be in approximately 10 years. We do not believe that this

broad income tax increases and no sales tax increases.) The Legislative Analyst's Office (LAO) estimates that this will generate about \$6 billion annually in higher revenues through fiscal 2017 but less revenue in fiscal years 2013, 2018, and 2019. The measure also amends the constitution to permanently redirect a portion of the state's sales and use taxes and dedicates a portion of the state's vehicle license revenues to local governments under the state's initiative to transfer oversight and implementation of certain programs to local governments. These combined revenue redirections will equal an estimated \$5.9 billion, according to the state.

The passage of Proposition 30 will result in temporary increases in the income tax on higher earning individuals and couples and on the state sales tax.

measure would materially affect the state's credit quality due to its currently low debt levels, but we will monitor the effects of any new obligations on the state's overall debt burden.

Issue 2. Voters rejected this proposal to allow cities and counties to levy sales taxes and issue sales tax revenue anticipation bonds that they could use to retire the unfunded pension liabilities of local police and fire departments or to redevelop blighted areas.

California (A-/Positive)

Propositions 30 and 38. Voters approved Proposition 30 and rejected Proposition 38, both of which proposed to increase taxes with implications for education spending (see "California Credit Quality Looks To Improve With Passage Of Proposition 30," published Nov. 7, 2012, on Ratings Direct on the Global Credit Portal for more information about the credit implications for the state). The passage of Proposition 30 will result in temporary increases in the income tax on higher earning individuals and couples and on the state sales tax. (The competing measure, Proposition 38, proposed more

For kindergarten through grade 12 (K-12) schools and community college districts, Proposition 30 offers a short sigh of relief. We believe that such districts could still face revenue pressure from the state, but the immediate need to cut or draw on fund balances is alleviated for the current fiscal year. With the measure's passage, the state's enacted budget includes funding to reverse \$2.2 billion of the \$10.4 billion in inter-year deferrals for K-12 schools and community college districts. The state projects reversing all of the inter-year payment deferrals by the end of fiscal year 2016. Furthermore, the passage of the measure forestalls proposed "trigger cuts" to K-12 schools and community colleges in fiscal 2013. We believe that school districts' multiyear forecasts, which the state requires at least three times per year, will provide us with a clearer picture of where school districts' financial performance is likely to head in the next three years.

Proposition 31. Voters rejected a proposal to shift the state to a biennial from an annual budgeting system and

authorize the governor to make budget cuts unilaterally if the legislature fails to act during declared fiscal emergencies. Greater authority on the part of the governor to implement spending reductions could have allowed the state to respond more quickly to fiscal emergencies in our opinion, and other provisions could have provided local governments additional financial flexibility.

Proposition 34. Voters turned down Proposition 34, which would have eliminated the death penalty, which the LAO estimates would have saved at \$100 million to \$130 million annually after a one-time cost of \$100 million to pay local governments for implementation.

Proposition 36. Voters approved Proposition 36, which revises the state's "three strikes" law to impose a life sentence only when a new felony conviction is serious or violent. The LAO estimates state savings in the range of \$70 million to \$90 million annually. We do not believe the savings are significant enough relative to state expenditures to materially affect the state's credit quality.

would count toward the state's existing constitutional requirement to fund education, thereby increasing school funding by \$200 million to \$500 million through fiscal 2018 and \$500 million to \$1 billion beginning in fiscal 2019, according to the LAO. For fiscal year 2013, the Proposition 98 minimum funding guarantee is set at \$53.6 billion.

Colorado (AA/Stable ICR)

Amendment 64. Paralleling a Washington measure, Colorado voters approved the personal consumption of marijuana for persons aged 21 and older and the state's ability to authorize, regulate, and tax the drug, which is also currently legal for medical use under state law. In addition to state and local sales taxes, the measure directs the Colorado General Assembly to enact an excise tax of up to 15% on wholesale sales of nonmedical marijuana. The general assembly can increase the rate after 2017. The first \$40 million generated from the excise tax annually is to be directed to the state's Public School Capital Construction

binned statewide revenue loss of roughly \$18 million. We believe the revenue loss would make up an insignificant share of any individual local government's property tax revenues. Amendments 2 and 9 allow exemptions for "homestead" (owner-occupied) property held by disabled veterans who were not originally state residents or for surviving spouses of veterans. Amendment 11 includes an additional homestead exemption for poor elderly homeowners.

Voters turned down Amendment 3, which would have shifted the basis of the state constitution's limits on state government revenues to inflation and population growth from changes in income. The new framework, which would have taken effect in fiscal 2015, would have required the state to deposit amounts collected in excess of the revenue limitation into the state's budget stabilization fund (BSF) and, once the BSF reached 10% of the previous fiscal year's total budget, the state would use the excess amount to support public education by reducing the required local effort amounts that school districts fund through local property taxes. To the extent that required local effort amounts would be reduced, the state would have returned excess revenues to taxpayers.

Voters rejected Amendment 4, which would have tightened limits on the increase in property assessments. Per the state estimates, the aggregate revenue losses for local governments, such as counties, cities, special districts, and school districts, would have been about \$156 million in fiscal 2014, increasing to approximately \$565 million by fiscal 2016 and thereafter. Although the initial revenue loss would have represented approximately 3% of total property tax revenue, which we consider a small amount, we believe that the measure could have noticeably reduced local government revenue-raising flexibility in the longer term, considering that many tax bases have contracted in recent years. The voters also turned down Amendment 10, which would have provided exemptions ranging from \$25,000 to \$50,000 for taxes on tangible properties.

Colorado voters approved the personal consumption of marijuana for persons aged 21 and older and the state's ability to authorize, regulate, and tax the drug...

Proposition 39. The passage of Proposition 39 could provide additional revenues to the state, with implications for education spending, but we do not anticipate that the effect will be substantial enough to affect credit quality. The measure revises state law to require multistate businesses to calculate income tax liability based on the percentage of their sales in California. The LAO estimates that the measure will generate an additional \$500 million to the state for fiscal 2013 and at least \$1 billion annually thereafter. The measure would allocate 50% of revenues (subject to a maximum of \$550 million) to funding energy efficiency and alternative energy projects through 2018. Remaining revenues

Assistance Fund, which provides grants for school construction. After the passage of this measure, we believe that net new revenues accruing to the state and to local governments are unlikely to materialize at large enough sizes to significantly affect credit quality. Moreover, as we believe that the measure conflicts with federal drug laws, it presents uncertainty regarding the magnitude and timing of new revenues.

Florida (AAA/Stable)

Voters approved three amendments related to property tax exemptions (Amendments 2, 9, and 11), which, per Florida Revenue Estimating Conference (REC) estimates, will result in a com-

Hawaii (AA/Stable)

House Bill No. 2594. Hawaiian voters rejected this proposal to authorize the state to issue special purpose revenue bonds to finance improvements to make dam and reservoirs compliant with safety standards.

Idaho (AA+/Stable ICR)

Propositions 1, 2, and 3. Voters decided to repeal recently passed education reforms relating to teachers' collective bargaining agreements and to technology and online learning in Idaho. It is unclear how the rescission of these laws will affect the state funding framework, as recent state budget decisions were based, in part, on expected efficiencies related to online learning and other technologies. School districts in the state have relayed to us that the reforms, by themselves, have not significantly affected on their financial conditions to date.

Illinois (A/Negative)

House Joint Resolution Constitutional Amendment (HJRCA) 49. A measure which proposed to raise the minimum required Illinois General Assembly majority vote margin to increase public employee pension or retirement benefits to three-fifths from one-half failed to reach the 60% supermajority for passage, according to National Conference of State Legislatures data. The measure also would have required a three-fifths vote of the governing body of a local government or school district to provide pay increases to employees that result in increased pension benefits, although it would not have altered current pension benefits or contribution levels.

Maine (AA/Stable)

Questions 2, 3, 4, and 5. Mainers approved Questions 3, 4, and 5 and rejected Question 2. Questions 3, 4, and 5 will authorize the state to issue up to \$64.4 million in GO bonds for capital projects relating recreation and infrastructure while the failing measure would have authorized \$11.3 million for higher education facilities. We do not believe that the debt issued under these

measures would materially change the state's debt burden.

Maryland (AAA/Stable)

Question 7. Marylanders authorized the construction of an additional slot machine facility in Prince George County, an increase in the maximum number of slot machines that may be operated in the state to 16,500 from 15,000, and an increase in the maximum number of slot machine operating licenses that the state may award to six from five. The measure also will lower taxes on existing casinos. We do not believe that the revenue effects of this measure will be large enough to significantly affect the state's credit quality.

Michigan (AA-/Stable)

Proposal Number 12-1. Voters decided to rescind Public Act 4 of 2011, which was suspended after its passage last year. Public Act 4 would have allowed emergency managers greater powers than they have under its predecessor, Public Act 72 of 1990, which remains in effect. We believe that this will directly affect only the small group of local governments that are operating under an emergency manager, and, as such, would not have a major effect on the state's credit quality. Of the local governments that have emergency managers in Michigan, three have outstanding tax-supported debt on which we maintain unenhanced credit ratings. We will continue to monitor these case-by-case for any material impact on credit quality.

Proposal Number 12-2. Voters turned down this constitutional amendment, which would have granted public and private employees the constitutional right to organize and bargain collectively through labor unions. It also would have invalidated existing and precluded future state or local laws that limit the ability to join unions and bargain collectively or to negotiate and enforce collective bargaining agreements, including employees' financial support of their labor unions.

Proposal Number 12-3. Voters rejected a new requirement that electric utilities provide at least 25% of their annual retail sales of electricity from renewable

energy sources, such as wind, solar, biomass, or hydropower, by 2025. It also would have limited consumer rate increases tied to compliance with the renewable energy standard to not more than 1% per year with the potential for deadline extensions.

Proposal Number 12-5. Voters rejected this proposed constitutional amendment, which would have required a two-thirds majority vote in each chamber of the legislature or a simple majority of state voters for a new tax, a tax rate increase, or a tax base expansion. In our opinion, passage of this measure could have limited the state's ability to raise tax revenues and its budget flexibility in future downturns. This may have been particularly difficult for Michigan in view of its historically cyclical economy and tax revenue. The measure could also have limited the state's ability to make offsetting changes in the tax code such as, for example, replacing one type of tax with another. In addition, it may have been more difficult to obtain reauthorization for taxes that automatically sunset. While we do not believe that this measure's passage would have immediately affected credit quality, we believe that over time it could have made budgeting more difficult, particularly during revenue downturns.

Missouri (AAA/Stable)

Proposition B. Voters narrowly rejected Missouri's Proposition B, which would have increased taxes on a pack of cigarettes by 73 cents and would have translated into an additional \$283 million to \$423 million in revenue annually, according to state estimates. These additional funds would have been allocated to tobacco prevention programs and public education.

New Hampshire (AA/Stable)

Constitutional Amendment Concurrent Resolution (CACR) 13. Voters fell short of the two-thirds supermajority needed to amend the state constitution to ban on any new tax on a person's income, whether directly or indirectly, from whatever source it is derived. New Hampshire's two business taxes com-

bined are the largest revenue source for the state, and currently the state does not have a general sales tax or income tax. While we do not believe that the passage of this measure would have affected state finances directly, it could have precluded potential sources of new revenues in future years. The decision to maintain the status quo leaves the state's credit quality unchanged.

New Jersey (AA-/Negative)

Public Question 1. Voters approved a \$750 million authorization for financing buildings and upgrades at the state's colleges. This is the first higher education capital improvement bond bill in the state since 1988. On Sept. 18, 2012, we revised our outlook on the state to negative from stable to reflect our view of the risk of revenue assumptions we view as optimistic, continued reliance on one-time measures to offset revenue shortfalls, and longer-term growing expenditure pressures, including pension funding increases, Medicaid funding, and debt service. Our current rating and outlook already incorporate the state's debt burden. We do not expect that the state's annual debt service would change significantly under the measure.

Public Question 2. Voters approved the ability to take contributions from the salaries of state Supreme Court Justices and Superior Court Judges for their employee benefits, including their pension and health care coverage. This question is in response to a lawsuit filed after the state passed pension reform measures that increased the contributions taken from current and future justices' and judges' salaries for their benefits, starting in October 2011. In our view, the approval of this measure supports the state's pension reform measures and, over time, should reduce pension funding pressures for the state.

New Mexico (AA+/Stable)

Bond Questions A, B, and C. Voters approved all three bond measures, which collectively authorize the state to issue a combined \$140.2 million in GO bonds to fund specific capital improvement projects for higher education and special

schools (approximately 86% of the total), senior citizen facilities (7%), and public libraries (7%). We will factor in any additional debt issued under this proposition into our analysis of any current or future rating on New Mexico. We calculate that, if immediately issued, the new debt would result in incremental debt of only \$67 per capita and would represent a modest 4.4% of the state's overall tax-supported debt, including gas and severance tax debt.

Oklahoma (AA+/Stable)

State Question 758. Voters approved a lowering of a cap on increases in the fair cash value of certain property to 3% from 5% in any taxable year. The fair cash value is the value or price at which the willing buyer and seller would purchase and sell property, respectively, and is one of the factors that assessors use to determine ad valorem property taxes. The cap would be applicable mainly on owner-occupied property and agricultural land. While we believe this measure could reduce potential future property tax revenue growth, we do not anticipate that this measure would have immediate credit implications for local governments because its effects would likely appear gradually over time.

State Question 764. Voters appear to have approved a constitutional amendment that authorizes the Oklahoma Water Resources Board to issue GO bonds up to \$300 million to serve as a reserve fund for certain water and sewer programs. The board would only draw on the fund for the bonds' repayment after other money and sources are used. Oklahoma's debt levels are low, in our view, and we do not expect the additional issuance to significantly change the state's debt and liability profile.

State Question 766. Voters decided to exempt all intangible personal property, such as patents, licenses, and trademarks, from ad valorem property taxation starting in fiscal 2013. While we believe this change could reduce the property tax base for some local government obligors in the state, we anticipate that the decline would be relatively modest in most cases as intangible per-

sonal property tends to account for a small share of overall tax bases.

Oregon (AA+/Stable)

Measure 79. Oregon voters approved Measure 79, which amends the constitution to prohibit the state or local governments from imposing taxes, fees, or assessments on the transfer of an interest in real property. Although the state does not levy such taxes, and statutes prohibit local governments from imposing such taxes, Measure 79 makes the prohibition constitutional. The measure exempts from the prohibition any taxes, fees, or other assessments in effect and being levied as of Dec. 31, 2009.

Measures 82 and 83. Voters rejected Measures 82 and 83, which would have amended the constitution to permit the operation of privately owned casinos within the state and the development of a single casino in Multnomah County (AA/Stable GO rating).

Measure 84. Voters turned down Measure 84, which would have phased out estate or inheritance taxes, taxes on death-related property transfers, and taxes on property transfers between family members. The measure would have led to a gradual reduction of the estate tax and would have prohibited and phased out all taxes on transfers of property between family members.

Measure 85. Voters approved Measure 85, which amends the constitution to redirect the corporate income and excise tax "excess" refund to the state's general fund to provide additional funding for K-12 public education. Each biennium, as part of the budgeting process, the governor prepares an estimate of revenues the general fund expects to receive for the next biennium. Current law requires the state to refund any corporate income and excise tax revenue that exceeds 2% of the governor's projection. In the past 10 budget periods, the corporate excess was triggered five times. The legislature suspended it two of those times; refunds of \$101 million to \$203 million were made the other three times. In our opinion, this increased state funding will improve the credit quality of schools within the

state to the degree that higher revenues improve financial performance.

Rhode Island (AA/Stable)

Questions 1 and 2. Voters in Rhode Island approved “table games” at the Twin River casino in Lincoln (Question 1) and at the Newport Grand casino in Newport (Question 2), both of which were limited to a type of slot machine. We understand that its provisions were designed to reduce potential adverse effects on state revenues from competition that the state anticipates will come from new casinos in Massachusetts. A study commissioned by the Rhode Island Department of Revenue anticipates that competition from gambling facilities recently authorized in Massachusetts could lead to losses of \$100 million or more in annual revenues. We do not believe that either of these measures would significantly change the state’s credit quality; however, we will monitor how the state’s finances are affected if gambling revenues decline in the long term.

Questions 3, 4, 5, 6, and 7. Voters approved Questions 3 to 7, all concerning GO authorizations. These measures allow the state to borrow up to \$209 million for construction of veteran homes, higher education, recreation, affordable housing, and infrastructure projects. We do not believe that the debt issued under these measures will represent a material change to the state’s debt burden.

South Dakota (AA+/Stable ICR)

Constitutional Amendment O. Voters approved amending the state constitution to change the method of money transfer from South Dakota’s cement-plant trust fund to the state general fund each year. The constitution previously required a yearly transfer of \$12 million from the cement plant trust fund to the state’s general fund. The amendment changes this to a yearly transfer of 4% of the market value of the cement plant trust fund to the state general fund. In our view, given the small amount of the annual transfer compared with the state’s budget, the passage of this measure will not likely have a significant effect on the state’s credit quality.

Constitutional Amendment P. Voters approved a constitutional amendment to require the governor to propose a balanced budget and to prohibit legislative appropriations from exceeding anticipated revenues and existing available funds. We will consider the balanced budget requirement when evaluating the state’s government framework score.

Initiated Measure 15. Voters rejected Initiated Measure 15, which would have implemented a general sales and use tax rate increase to 5% from 4% starting in 2013, with the incremental revenues to be used equally for K-12 public education and state Medicaid reimbursements.

Amendment B...amends the constitution to exempt from property tax real property that is the primary residence owned by a member of the military or spouse on active duty...

Referred Law 14. Voters rejected Referred Law 14, which would have established a Large Project Development Fund and would have required that the state transfer 22% of contractors’ excise tax revenues to the fund from the state general fund, beginning Jan. 1, 2013. The state would have used this money to provide grants for the construction of large economic development projects.

Referred Law 16. South Dakota voters rejected Referred Law 16, which would have repealed a recently approved statute that mandated a uniform statewide rating system for evaluating teachers and principals, enabled bonuses for high performing math and science teachers, banned tenure, and established a scholarship program for eligible college students who committed to teach in South Dakota in critical need subject areas.

Utah (AAA/Stable)

Amendment A. Utah voters approved Amendment A, which requires the state to deposit a portion of its severance tax revenues into the permanent state trust fund beginning July 1, 2016, excluding

those designated for use by Native American tribes. The measure redirects 25% of the first \$50 million of annual severance tax revenue, 50% of the next \$50 million, and 75% of all severance tax revenue exceeding \$100 million to the permanent trust fund. The state estimates that \$36 million of severance tax revenue will be deposited annually into the permanent state trust fund beginning July 1, 2016, under the measure. This annual deposit also will result in an equal annual decrease in deposits to the state’s general fund. The state estimates lost severance tax revenues of 0.4% of the state’s combined fiscal 2011 general

fund and education fund revenues. We do not believe a loss of this magnitude will represent a material loss to the state’s budgetary flexibility.

Amendment B. This approved measure amends the constitution to exempt from property tax real property that is the primary residence owned by a member of the military or spouse when the military member is serving on federal active duty out of state for at least 200 days in a calendar year or 200 consecutive days. The legislative fiscal analyst estimates that local governments throughout the state could see a combined loss of about \$2 million in 2014 from these exemptions. We believe that it is unlikely that any single local government would experience large enough revenue effects associated with this measure that it would be unable to adjust its budget in response.

Washington (AA+/Stable)

Initiative 502. Similar to a measure in Colorado, this measure, approved by voters, authorized the state to license and regulate marijuana production and distri-

bution, tax marijuana sales, earmark marijuana-related revenues, and prohibit driving under the influence of the drug. Washington's Office of Financial Management (OFM) estimates that taxes and fees under the measure will total \$533 million in state revenues and \$33 million in local revenues in fiscal 2015, the first full year of its application. The measure will earmark revenues from a marijuana excise tax to a dedicated marijuana fund for specific uses, half of which (\$214 million in fiscal 2015, as estimated by the OFM) will flow to the state Basic Health Plan, a program the state operates to provide health insurance for eligible residents not covered by Medicaid. The OFM estimates that \$177.8 million (equivalent to 0.7% of fiscal 2011 state general fund expenditures) from the marijuana excise tax and general state taxes, such as sales and gross receipts taxes, will flow to the state's general fund in fiscal 2015. Estimated costs to the state will be much smaller, a total of \$14 million, according to the OFM, which did not estimate local costs. We do not expect the measure to have a significant effect on credit quality due to its small unrestricted revenue effects relative to the size of the state budget; in addition, we view the nature and timing of revenues under this measure to have significant uncertainty due to the measure's likely conflict with federal drug laws.

Initiative 1185. Voters approved this measure reinstating requirements that the legislature reach a two-thirds supermajority or voters reach a simple majority to raise state taxes, and new or increased state fees require majority legislative approval. This measure is similar to Initiative 1053, which voters approved in 2010 and is currently under legal challenge. The measure will, by requiring new legislative approval, end certain fees that the legislature imposed or increased during the 2011 and 2012. The OFM estimates that the measure will reduce net tolling operations associated with a major transportation project, the Alaskan Way Viaduct replacement in Seattle, by \$11.3 million to \$23 million during fiscal years 2013 through 2017 depending upon the timing of the opening of the project. We understand that the measure will also pre-

vent implementation of certain business and health care certifications, which the OFM estimates will decrease state revenue by \$2.7 million but will decrease state costs by a larger amount, \$3.6 million, during fiscal years 2013 through 2017.

Initiative 1240. Voters approved the establishment of 40 publicly funded charter schools in the state during the next five years. The measure limits the number of new charter schools to eight per year. It also will allow the creation of public charter schools through either the Washington Charter School Commission (a new state agency) or through local school district boards within their boundaries. We understand that approved, non-religious, nonprofit organizations will operate these schools, which will be open to all students without tuition, and that the schools will receive standard per-student public school funding. We believe the measure will indirectly affect the state aid revenues of existing public school districts but believe that the effects will be diffuse and occur gradually. The state has estimated a modest total state cost of \$3.1 million over the five-year period for authorization of the 40 public charter schools.

Senate Joint Resolution (SJR) No. 8221. Voters approved this constitutional amendment, which phases-down the debt limit percentage in three steps, to 8% from 9%, and modifies the calculation date, calculation period, and redefines the term "general state revenues." In addition, such calculations will now be based on the previous six-year average of general state revenues rather than the prior three years, as they were earlier. The measure will change the definition of general state revenues to include the state property tax starting July 2014. We believe that the measure will lead to a gradual reduction in the state's long-term debt burden and smooth the ability to borrow.

Senate Joint Resolution (SJR) No. 8223. Voters rejected this constitutional amendment to lift restrictions on the University of Washington and Washington State Universities to invest certain public funds in private stocks and bonds. The amendment had specified which and how universities could invest their funds.

Advisory Vote 1 (Engrossed Senate Bill 6635). Voters directed the state, by non-binding vote, to restore a deduction of the state's business gross receipts tax, known as the "business and occupation" tax that was available to certain financial institutions with interests in residential loans. The state OFM estimates that the elimination of the deduction (the current law) will increase fiscal 2013 revenues by \$15 million, or the equivalent of less than 0.1% of fiscal 2011 general fund expenditures. Due to its modest revenue implications, we do not view the measure as having significant credit implications if implemented by the legislature and signed by the governor.

Advisory Vote 2 (Substitute House Bill 2590). Voters also, by nonbinding vote, directed the state to rescind a recent extension and rate reduction of a tax on the possession of petroleum products. The OFM estimates that the change in state law prior to the measures' passage will net \$24 million during the next 10 years, with most realized in 2017. Due to its modest revenue implications, we do not view the measure as having significant credit implications if implemented by the legislature and signed by the governor. **CW**

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California Credit Quality Looks To Improve With Passage Of Proposition 30

Passage of Proposition 30 by California's voters in the Nov. 6, 2012, election finalizes the state's fiscal year 2012 to 2013 budget. According to California Department of Finance (DOF) estimates, the measure raises the state's revenue base by more than \$6 billion annually through fiscal year 2016 to 2017 and by smaller amounts for the two subsequent fiscal years. The additional revenue materially benefits the state's projected fiscal position and is consistent with Standard & Poor's Ratings Services' positive outlook on California's general obligation debt ratings ('A-'). Passage of the measure avoids triggering about \$6 billion in midyear cuts that otherwise would have fallen heavily on the state's public schools beginning in January. Also, passage of the measure averts incorporating the trigger cuts into future years' budgetary baseline.

Although its tax provisions are not permanent, we view Proposition 30 as part of the state's more structural approach to budgeting that began in 2011. The measure does more than temporarily increase operating revenues and, in our view, is the linchpin to the governor's broader, multiyear strategy for reversing the state's negative budget position. Weighed down by around \$34 billion in budgetary liabilities and payment deferrals, California's credit rating reflects about 10 years' worth of heavy reliance on one-time measures in response to a recurring structural budget deficit. Proposition 30 allows the state to forecast paying down 74% of these liabilities by the end of fiscal year 2015 to 2016, a reasonable projection in our view. We believe the beneficial effects from correcting its budget position to this extent could endure well beyond the time frame of the temporary taxes. However, our view of the state's degree of success in retiring the budget liabilities according to its schedule will be an



Even without additional fiscal reforms...we believe Proposition 30 is still beneficial to the state's credit quality, if to a lesser degree.

important factor in evaluating whether or how much its credit quality improves as a result of Proposition 30's passage. In either case, we are aware of no alternative approach to reduce anywhere near the amount of off-balance-sheet obligations than that projected under Proposition 30.

Proposition 30 also contains an important spending-side provision by constitutionally protecting the redirection of revenue to local governments for the state's realignment initiative. The \$5.9 billion revenue shift for realignment generates \$2.3 billion in general fund savings during the current fiscal year by removing it from the formula that determines the Proposition 98 funding guarantee for education. These savings permanently reduce the state's budgetary spending base and will increase in value as the realignment revenues grow in future years.

On the other hand, we acknowledge that Proposition 30 could exaggerate the state's tendency for revenue volatility. This is primarily because most of the new revenue (about 80%, according to DOF projections) will come from higher taxes on the state's high income tax filers. We have long viewed revenue volatility as a weakness in California's fiscal structure. But because the tax increases are temporary, Proposition 30 does not permanently alter the state's revenue composition—or its propensity for volatility. The only permanent provisions of Proposition 30 relate to the realignment funding mechanism, which generates a relatively stable source of general fund savings. Furthermore, given that the state faces a predictable budget gap when the temporary taxes expire, lawmakers will necessarily revisit the state's fiscal structure as it

transitions to a lower post-Proposition 30 revenue environment. We believe the interim situation, therefore, presents an opportunity for policymakers to pursue fundamental reforms to the state's fiscal problems—including revenue volatility—but in a less crisis-like budgetary environment.

There is potential, in our view, for material improvement of the state's credit quality if lawmakers reach agreement on reforms that help stabilize the state's fiscal performance while the temporary taxes are in effect. Conversely, assuming no fiscal reforms, the state could simply face a new structural budget gap when the temporary taxes expire. Under the latter scenario, we would be unlikely to view the state's credit quality as significantly improved.

Even without additional fiscal reforms, however, we believe Proposition 30 is still beneficial to the state's credit quality, if to a lesser degree. By providing a temporary but significant boost in tax revenues and permanently lowering its general fund spending baseline, we believe Proposition 30 helps alleviate the state's chronic fiscal strain. Projected revenue from the measure also allows the state to credibly plan for reversing the majority of its payment deferrals and budget liabilities. Potential for additional credit strengthening beyond this depends, in our view, on whether lawmakers can enact substantive fiscal reforms during this window of opportunity. **CW**

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Election Outcome Could Prove Critical To Puerto Rico's Credit Quality

Standard & Poor's Ratings Services said the election on Nov. 6, 2012, of Alejandro García Padilla as the Commonwealth of Puerto Rico's new governor has no immediate impact on its ratings on the commonwealth's general obligation (BBB/Negative) and appropriation (BBB-/Negative) debt ratings or other related obligors. However, we still believe that there is at least a one in three chance that we may lower these ratings later this year or in early 2013.

In the case of Puerto Rico, we will analyze the fiscal and economic policy choices over the next few months of both the current administration and the governor-elect, as well as the new legislature. Our current ratings are predicated on the assumption that commonwealth officials will remain committed not only to the maintenance of fiscal discipline, but also to the adoption of swift and comprehensive fiscal measures, particularly as it relates to the commonwealth's \$24 billion unfunded pension liability.

We believe that the governor-elect's electoral platform and public statements with regard to the commonwealth's unfunded pension liabilities could result in prolonged inaction on pension reform or the adoption of a diluted pension reform package that provides only temporary relief to the pension system. Either of these two potential outcomes (delayed or insufficient action to adopt a pension reform package) would result in a one-notch downgrade to our ratings in the next few months, with the potential for

additional deterioration within the next year, particularly if the economy continues to grow at a relatively slow pace, or the commonwealth's liquidity and market access is compromised. **CW**

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