# OOCUR
# 10th ANNUAL CONFERENCE

## Credit Ratings and Caribbean Utilities

## Assessing the potential impact of utilizing the services of a credit rating agency

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- Credit Ratings can be applied to state owned utilities.
- After Revenue Determination Credit ratings can be used to test and assess financial viability.
- Credit Ratings have the potential to enhance ratio analysis and improve comparisons with best practice.

**PURPOSE**

- What is a Credit Rating?
- Rating Agencies Available
- Drawbacks of Credit Ratings
- Benefits of Credit Ratings
- A case study of LUCELEC
- Conclusion



## What is a Credit Rating?

- Credit ratings are opinions about credit risk.
- The ability and willingness of an entity to meet its financial obligations.
- Expressed as letter grades, for instance AAA to D.
- Evaluation of historical data and are designed to be forward looking.
- Ratings can change over time.
- A corporate credit rating will normally be the same as or below a sovereign credit rating.

| Country | International Sovereign Rating |
|---|---|
| Cayman Islands | Aa3/Stable |
| The Bahamas | A3/Stable |
| Barbados | Baa3/Stable |
| Trinidad and Tobago | Baa1/Stable |
| Dominican Republic | B1/Stable |
| St. Vincent and the Grenadines | B1/Stable |
| Jamaica | B3/Stable |

*Source: Moody’s investor service Latin America and Caribbean Sovereign Outlook 2011*



STANDARD &POOR'S — MOODY'S — FitchRatings

**International**

CariCRIS — Caribbean Information & Credit Rating Services Limited

**Regional**

- A global scale rating may be unnecessary and a regional scale comparison may be more useful
- Region's economies tend to be similar in economic, political and demographic structure.
- A regional credit rating will include more locally and regionally related issues.
- Credit ratings produced will be comparable across the region.

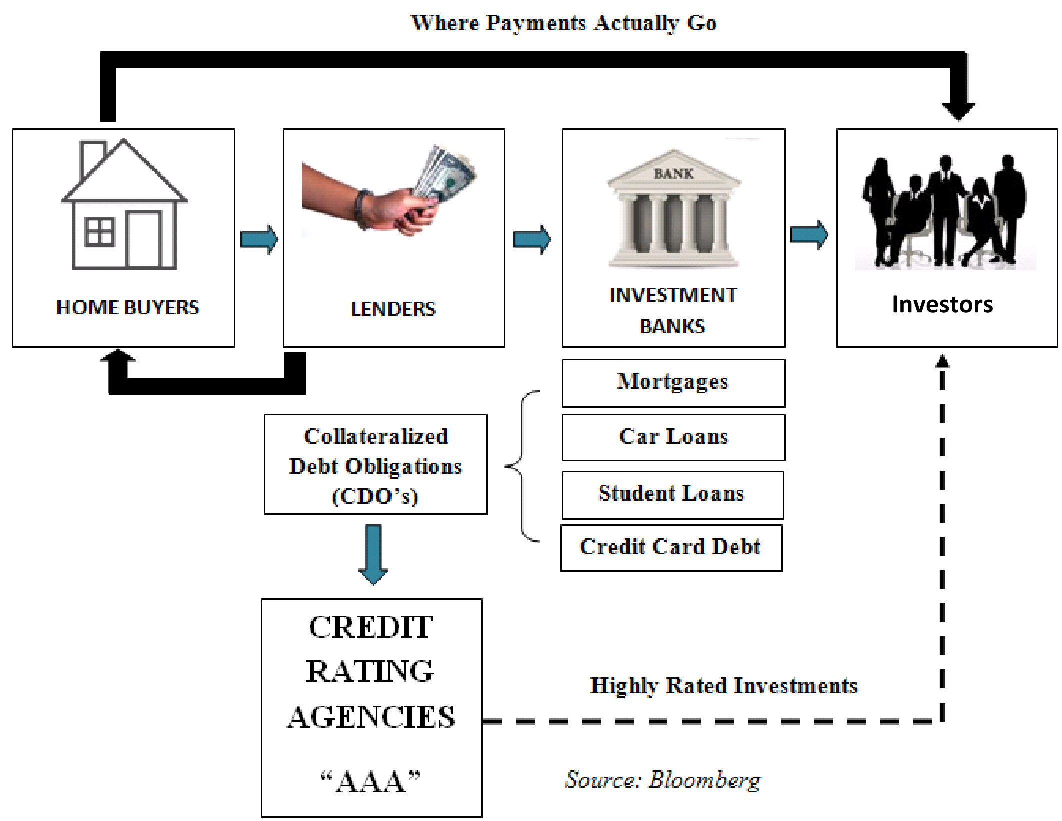
| S&P | Moody's | Fitch | CariCRIS | Description | Quality |
|---|---|---|---|---|---|
| AAA | Aaa | AAA | | Highest | Investment Grade |
| AA | Aa | AA | | | |
| A | A | A | CariAAA | | |
| BBB | Baa | BBB | CariAA | High | |
| BB | Ba | BB | CariA | Above Average | |
| B | B | B | CariBBB | Average | |
| CCC | Caa | CCC | CariBB | Below Average | Junk |
| CC | Ca | CC | CariB | Weak | |
| C | C | C | CariC | Poor | |
| D | | D | CariD | Default | |

*Source: CariCRIS*



## Credit Ratings and the 2008 Financial Crisis

- Highly criticized for understating the risk involved with new, complex securities that fueled the US housing bubble.
- Key enablers of the financial meltdown.
- Regulators of Public utilities within the Caribbean must keep in mind that ratings are only an opinion when considering the amount of reliance to be placed.





## Drawbacks

**Possibility of Bias**
- information collected by the rating agency may be subject to personal bias of the rating team.

**Data Inaccuracy**
- Non disclosure of certain material facts to the investigating team of the rating agency.

**Changing Environment**
- Difficult to predict the future financial position of a public utility.

**Downgrading**
- Can possibly affect the image of the utility.

**The Opinion**
- Ratings are not certificate of financial soundness



## Major Benefits of a Credit Rating can be categorized in the following areas:

1. Assessing Financeability
2. Debt Financing
3. Gearing
4. Monitoring
5. Benchmarking
6. Regulatory Governance



# Assessing Financeability

- The revelations associated with credit ratings can assist the utility regulator when assessing Financeability.
- Caribbean utilities can use this information as independent third party evidence, in their submission for tariff adjustments where necessary.
- A poor performing utility will obtain a low credit rating along with negative comments pertaining to financial and operating performance.

**Within the UK if financeability test is failed due to poor credit rating**

Adjust Cash flows

Neutral manner

Positive manner

Implications such as Intergenerational Equity



# Debt Financing

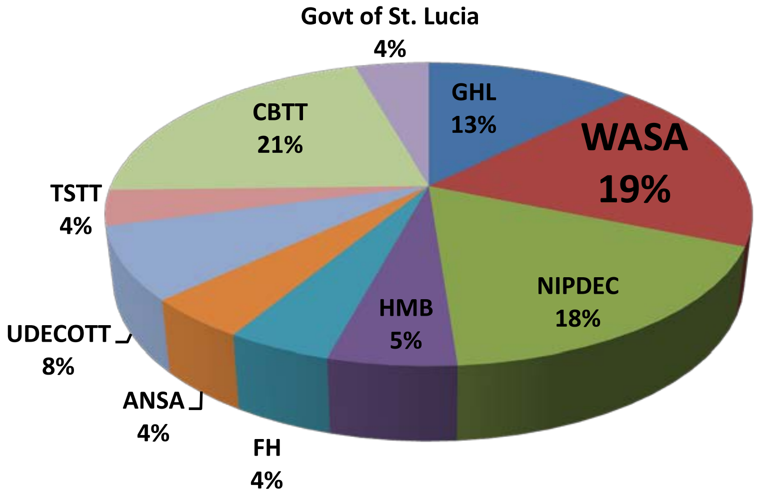
- The culture of maintaining a credit rating must be embedded into utility companies if there is indeed a desire to move towards self reliance/sufficiency.
- Those seeking reduced government involvement in the provision of utility services may attempt to remove or reduce the heavy subsidization of basic utility needs, It can be expected, that some state owned utilities will want to reduce its dependence on government assistance and therefore seek its own financing.
- Credit ratings may facilitate the process of issuing and purchasing bonds and other debt issues by providing an efficient, widely recognized, and long standing measure of relative credit risk.
- Investors may check to see whether a bonds’ credit rating is in keeping with the level of credit risk the investor is willing to assume. An investment grade rating means that securities issued can be bought by a wide range of institutions whose mandates are restricted to bonds with such ratings.



# Debt Financing

At the end to 2011, WASA was the second largest issuer of bonds next to the Central Bank within Trinidad and Tobago.

**Trinidad and Tobago Bonds Issued 2011**




*Source: CBTT Economic Bulletin January 2012*

- Public utilities are heavy issuers of debt, this can be expected since utilities require massive outlays of capital to build and maintain infrastructure.
- Credit ratings will allow a public utility to determine an accurate measure attached to the cost of borrowing. Public Utilities that have higher credit ratings will obtain lower borrowing rates while lower credit ratings will demand higher interest rate payments.
- This further supports the need for public utilities to obtain and maintain credit ratings which will greatly assist the debt issuance process.



# Gearing

- ❑ Rising debt levels raise the issue of "financeability" and whether the projected revenues and cash flows are sufficient to maintain financial viability.
- ❑ A strong credit rating has increasingly become a focus of attention with international utility regulators.
- ❑ During a price review, regulators will establish a revenue requirement for the regulated utility.
- ❑ The next step is to conduct financeability tests, where emphasis is placed on prospective financial ratios such as various versions of interest coverage, cash flow to debt ratios, and gearing ratios.
- ❑ These financial indicators are utilized to determine the credit ratings that are expected to be retained throughout the price control period.
- ❑ Even operating licenses have been amended in some cases to require companies to maintain investment grade credit ratings.



# Gearing

various ratings and their respective gearing levels, along with interest coverage ratios for rated electric utilities in the Americas.

| | 3 Yr Average (2003-2005) | | Moody's Expected Financial Ratios | |
|---|---|---|---|---|
| **Moody's Rating** | **FFO interest coverage (Times)** | **Debt/Total Capital (%)** | **FFO interest coverage (Times)** | **Debt/Total Capital (%)** |
| Aa2 | - | - | 6.0 | < 40 |
| Aa3 | - | - | 5.0 - 6.0 | < 50 |
| A1 | 4.1 | 51.7 | - | - |
| A2 | 4.2 | 51.7 | 3.5 - 6.0 | 40 - 60 |
| A3 | 4.2 | 52.1 | 3.0 - 5.7 | 50 - 75 |
| Baa1 | 3.8 | 54.4 | - | - |
| Baa2 | 3.5 | 53.6 | 2.75 - 5.0 | 50 - 70 |
| Baa3 | 3.3 | 59.4 | 2.0 - 4.0 | 60 - 75 |
| Ba1 | 2.4 | 60.9 | < 2.5 | > 60 |
| Ba2 | 2.6 | 64.8 | < 2.0 | > 70 |

*Source: The Electricity Journal Volume 22*



# Gearing

- ❑ Regulators will need to carry out proper financial modeling to confirm that proposed price limits will allow companies to maintain credit ratings.
- ❑ OFWAT's final determinations for the period 2010 to 2015, achieved appropriate levels of financeability at targeted financial ratios under a notional gearing structure that is consistent with an A-/A3 credit rating, this allows a gearing with a range of 55% - 65%. OFWAT ensures that service providers meet the criteria for a strong BBB+/Baa1 credit rating as a minimum requirement.
- ❑ Regional utility regulators can work together with agencies to determine credit ratings and hence set a benchmark rating, from which annual reviews will be done to ensure the service provider, is operating at an optimal gearing level to maintain the ideal credit rating.



# Monitoring

- Credit ratings are mainly indicators of organizations credit worthiness
- This indicator can provide a means of monitoring the performance of a public utility (possible KPI).
- This can provide an easily readable scale from which utilities within the Caribbean can compare and monitor performance.
- From the following list of ratios regulators will now have more information to facilitate further monitoring of regulated utilities



# Monitoring

- ❑ Return on capital/RAB (%)
- ❑ EBIT (Earnings before interest and tax) / Interest Coverage (x)
- ❑ Free Operating Cash Flow (FOCF)
- ❑ EBITDA (Earnings before interest, tax, depreciation and amortization) / Interest Coverage
- ❑ Free Operating Cash Flow / Total Debt (%)
- ❑ Operating income / Revenue (%)
- ❑ Operating Cash Flow (OCF)

- ❑ Discretionary Cash Flow (DCF)
- ❑ FFO / Total Debt (%)
- ❑ Total Debt / EBITDA

In accordance with this year’s conference th **“Harmonization”** n” we can agree to use these ratios and compare across the Caribbean region.



# Monitoring

Financial indicators will be further supplemented by the final credit rating issued to the public utility

| | |
|---|---|
| CariAAA | • Highest |
| CariAA | • High |
| CariA | • Above Average |
| CariBBB | • Average |
| CariBB | • Below Average |
| CariB | • Weak |
| CariC | • Poor |
| CariD | • Default |

**Acceptable Credit Ratings for Caribbean Utilities (Investment Grade)**

**Need for Improvement**

*Source: CariCRIS*



# Benchmarking

- ❑ Credit ratings can be used as a tool to further facilitate comparisons, hence improving benchmarking within the Caribbean.
- ❑ When determining efficient levels of expenditure, the utility maintaining an ideal credit rating can be used as a benchmark to determine efficient expenditure levels and also provide additional financial performance targets.

**The following must be considered when Benchmarking**

**Credibility:**
The information must be trust worthy

**Technical Credibility:**
- ☐ Sound Methodology
- ☐ Accurate data and analysis.
- ☐ Timely and periodic results

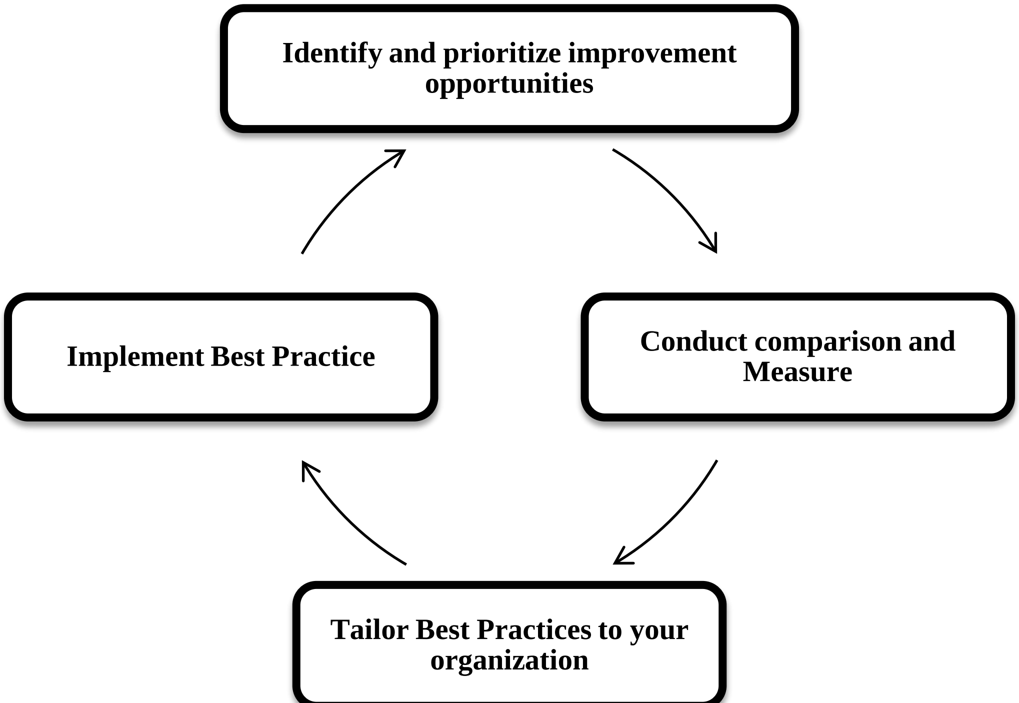
**Institutional Credibility:**
- ☐ Credible leadership
- ☐ Appropriate implementing agency
- ☐ Transparency
- ☐ Stakeholder involvement

*Source: The Institute for Public Private Partnerships*



# Benchmarking

- Benchmarking is a continuous process.
- Opportunities for improvement can be identified from examining the credit rating agency report of adequately rated public utilities.
- Comparative measurements can then be made with these best practice organizations, both inside and outside the Caribbean region to determine the performance gap between current practice and best practice.
- The cycle of improvement continues and evolves with changes in the industry.



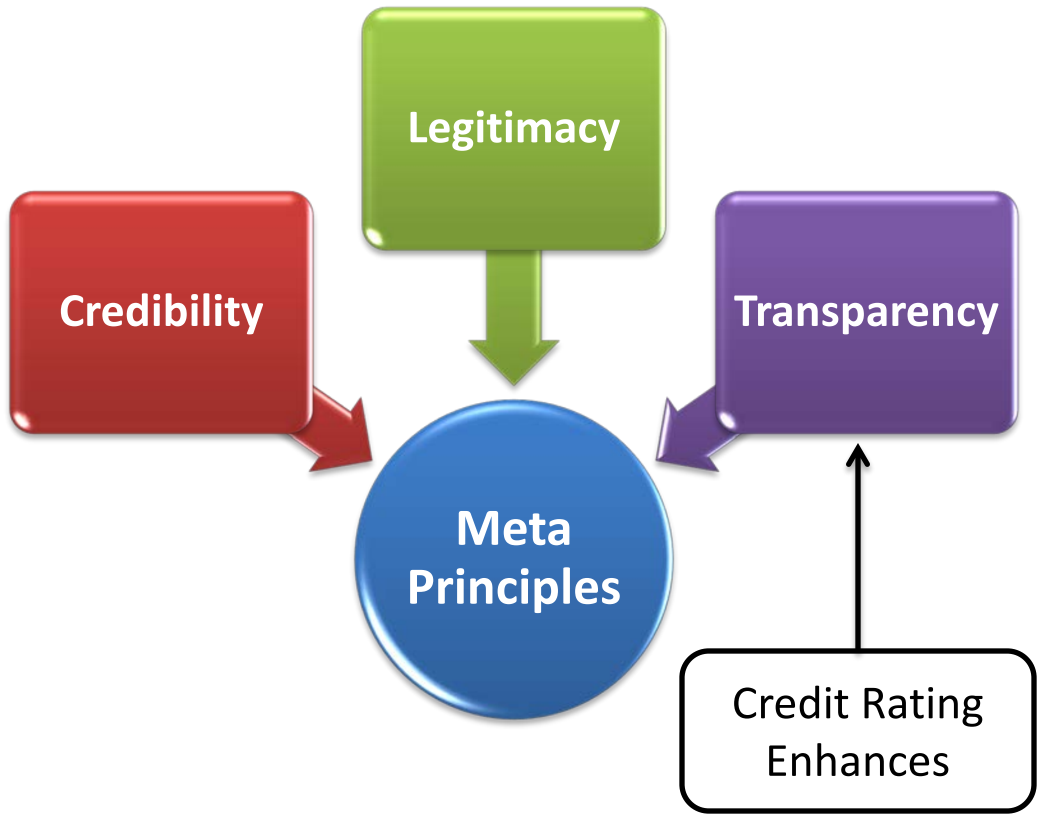

*Source: The Institute for Public Private Partnerships*



# Regulatory Governance

**Aim:**

- ❑ The supervision of the public services offered by the utility
- ❑ Periodic assessments of the balance between (public) costs and performance
- ❑ Assessments may be carried out by the regulator on behalf of the government and the stakeholders

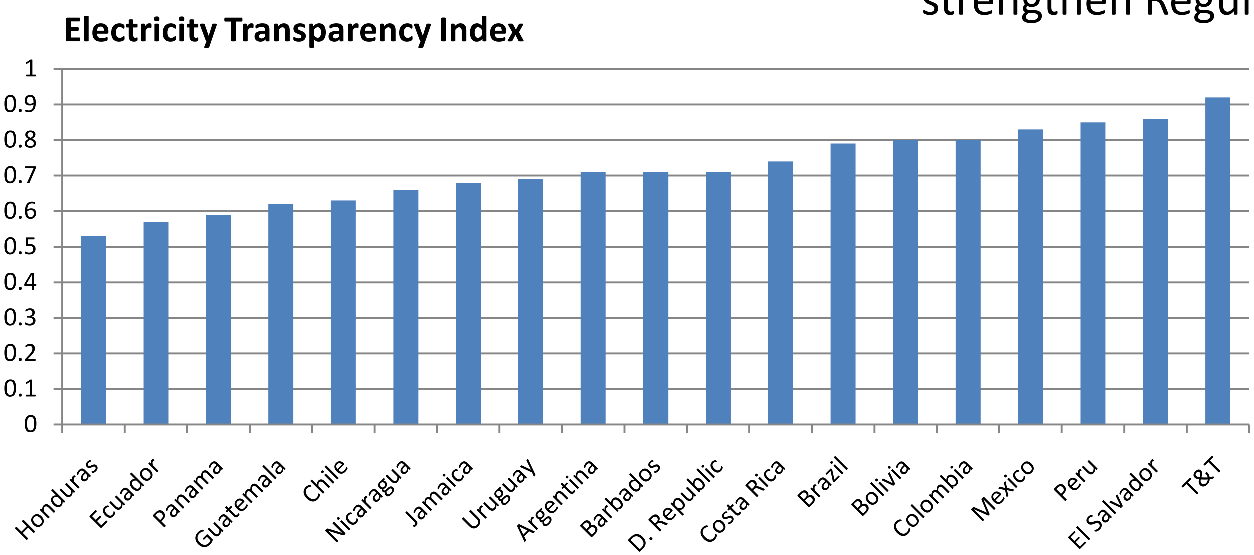




# Regulatory Governance

## Where we are with respect to transparency?

Countries with an index at 0.7 are meeting the bare minimum with respect to transparency compliance. Credit ratings can be used as an additional tool by utility regulators to strengthen Regulatory governance through Improved transparency, via additional analysis done by the credit rating agency and public display of credit ratings. International regulators such as OFWAT considers the disclosure of credit ratings to be a positive improvement in transparency.



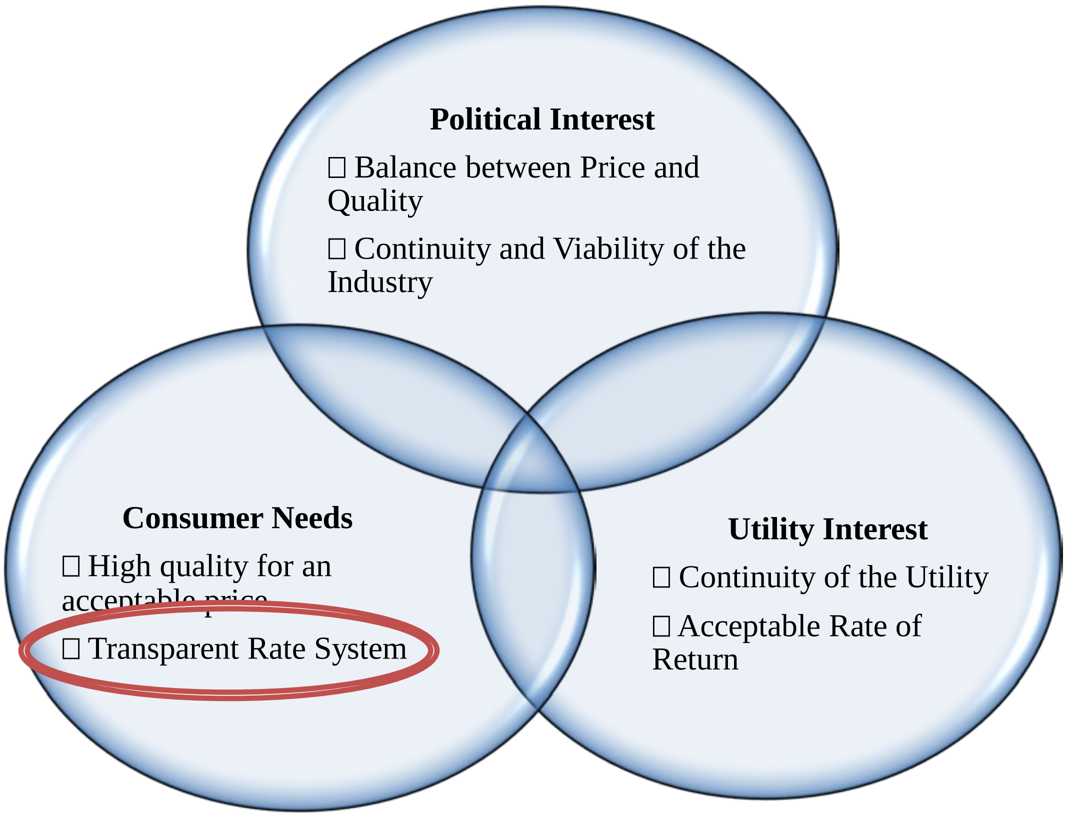

*Source: LAC Electricity Regulatory Governance Database, the World Bank 2007.*



# Regulatory Governance

## Satisfying Stakeholder Interest.

- Consumer needs in the area of ensuring a transparent rate system, will be enhanced with the use of credit ratings due to the independent review of financial performance
- Regulated utilities will not only be able to obtain an acceptable return, but also justify the return being proposed via the credit rating provided.
- Government will also have a system to further observe the financial viability of the regulated utility sector.




*Source: Reflections on a Utility Regulator for Electricity and Water on Curacao*



# Regulatory Governance

**Example of Financial Disclosure from a Credit Rating**

**Financial Performance of LUCELEC (2006 to 2010)**

| | 2010 | 2009 | 2008 | 2007 | 2006 |
|---|---|---|---|---|---|
| | EC $ Millions | | | | |
| Operating Revenue | 276.30 | 238.70 | 303.20 | 242.50 | 227.60 |
| Equity Share Capital | 80.20 | 80.20 | 80.20 | 80.20 | 80.20 |
| Net Worth | 162.20 | 154.50 | 149.00 | 142.20 | 134.10 |
| | % | | | | |
| EBITDA Margin | 29.80 | 32.50 | 24.10 | 29.30 | 28.90 |
| PAT Margin | 10.60 | 11.60 | 7.90 | 12.00 | 11.80 |
| ROCE | 17.50 | 16.60 | 15.90 | 17.70 | 17.70 |
| | Times | | | | |
| Interest Cover | 10.80 | 11.20 | 8.10 | 9.90 | 9.20 |
| Operating Cashflow/Debt Servicing Burden | 2.90 | 2.80 | 2.00 | 2.10 | 2.60 |
| Net Cash Accruals/Total Debt | 0.40 | 0.30 | 0.30 | 0.30 | 0.30 |
| Total Debt/Net Worth | 0.70 | 0.80 | 0.90 | 0.90 | 0.80 |
| Current Ratio | 1.40 | 1.30 | 1.30 | 1.10 | 0.90 |

*Source: CariCRIS*




# Regulatory Governance

**Additional analysis on the following was disclosed**

- ❑ Market position and Financial profile
- ❑ Operating efficiency
- ❑ Economic performance of the Saint Lucian economy
- ❑ Indirect exposure to fuel prices
- ❑ Single location and underinsurance
- ❑ Deteriorating accounts receivable aging profile

**LUCELEC was given a – *CariBBB* rating This information is available to the public via CariCRIS's website.**

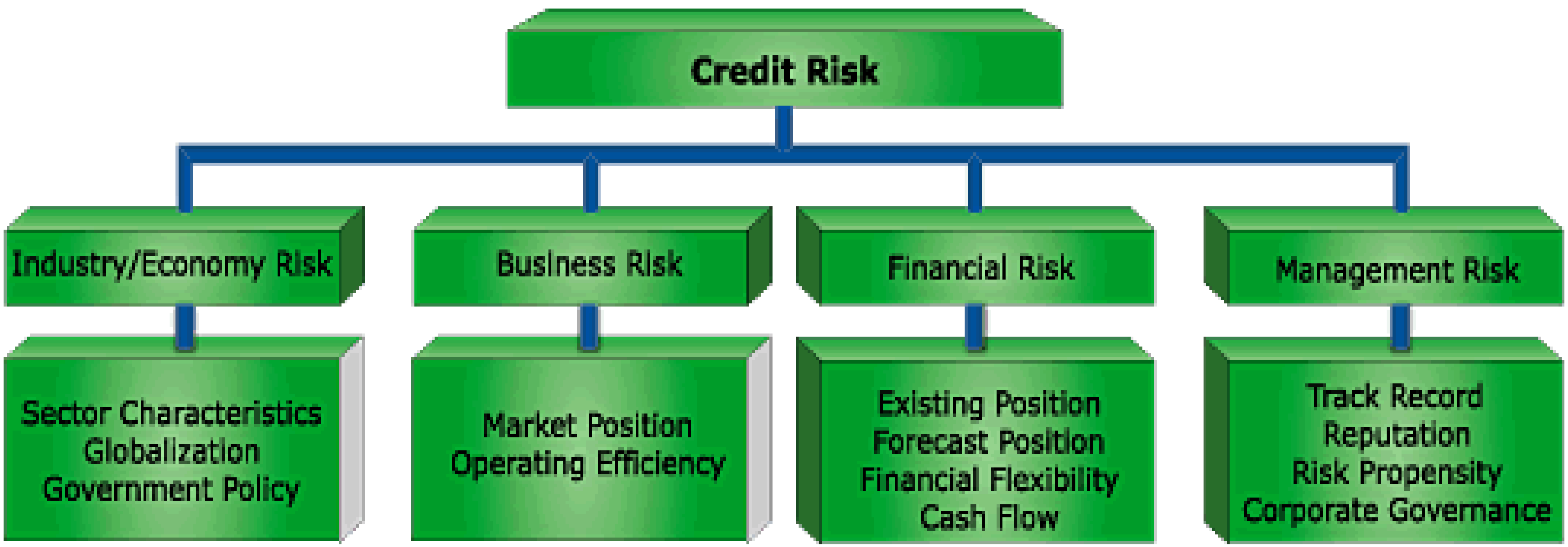
**Overall**

**Credit rating Disclosure**
↓
**Improved Transparency**
↓
**Improved Regulatory Governance**



**An Example of the Methodology used to determine LUCELEC's Credit Rating**

## Credit Rating Methodology for Corporate Entities




*Source: CariCRIS*



## The following areas are examined during a credit rating

**Business Risk**
- ❑ Competitive Position
- ❑ Management

**Industry Characteristics**
- ❑ Industry Structure
- ❑ Market size
- ❑ Growth Potential
- ❑ Basis of Competition
- ❑ Cyclicality
- ❑ Rate of technological change
- ❑ Operating Risk
- ❑ Regulatory environment
- ❑ Competitive Position

**Financial Risk**
- ❑ Financial policy
- ❑ Profitability and earnings protection measures
- ❑ Cash flow protection and adequacy
- ❑ Capital Structure / leverage and asset protection
- ❑ Financial flexibility / liquidity
- ❑ Management philosophies and policies provide the context in which to view financial performance
- ❑ Stated financial strategy / philosophy
- ❑ Level of financial risk vs. business risk
- ❑ Accounting practices and financial controls





**Liquidity Risk**

- ❑ Potential demands on liquidity such as long term debt maturities and short term debt usage.
- ❑ Operations related such as contractual commitments and working capital needs
- ❑ Pension and healthcare
- ❑ Off balance sheet obligations
- ❑ Internal sources of liquidity such as surplus cash / liquid assets.
- ❑ External sources of liquidity such as trade credit lines of credit e.g. from banks.

Thus far, Saint Lucia Electricity Services Limited (LUCELEC) is the only Caribbean utility to obtain a credit rating from CariCRIS. On average it is expected to cost Caribbean utilities approximately USD$20,000, for CariCRIS to carry out a rating review (on average less than 1% of Caribbean utility revenue).



1. Credit ratings can summarize the overall financial strength of a public utility while assisting the utility regulator in the price review process.

2. It provides a mechanism to improve the monitoring capabilities of regulators and has the potential to harmonize a tool used in utility regulation throughout the Caribbean.

3. Internationally it has become industry best practice, regulated utilities in a number of sectors and countries are required to maintain an investment grade credit rating as a condition of their operating license.

4. While there are problems associated with credit rating agencies, one cannot overlook the fact that this tool has the potential to facilitate self reliance via debt financing.

In this regard CariCRIS can be utilized as the rating agency for Caribbean utilities. This will provide information that can improve comparisons among utility providers within the Caribbean.

USEFUL TOOL

**OOCUR**

**Critical role in this exercise**

- Benchmarking
- Transparency
- Assessing Financeability



# Thank You

# Questions?