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Credit Opinion: Commonwealth Edison Company

Global Credit Research - 09 Sep 2013

Chicago, Illinois, United States

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	Baa2
First Mortgage Bonds	A3
Senior Unsecured	Baa2
Pref. Shelf	(P)Ba1
Commercial Paper	P-2
Parent: Exelon Corporation	
Outlook	Stable
Issuer Rating	Baa2
Senior Unsecured	Baa2
Subordinate Shelf	(P)Baa3
Pref. Shelf	(P)Ba1
Commercial Paper	P-2
ComEd Financing III	
Outlook	Stable
BACKED Pref. Stock	Baa3

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Key Indicators

[1]Commonwealth Edison Company

	LTM06/2013	2012	2011	2010
(CFO Pre-W/C + Interest) / Interest Expense	2.3x	4.3x	5.2x	4.1x
(CFO Pre-W/C) / Debt	12%	13%	25%	21%
(CFO Pre-W/C - Dividends) / Debt	10%	12%	21%	16%
Debt / Book Capitalization	39%	44%	38%	39%

[1] All ratios calculated in accordance with the Global Regulated Electric Utilities Rating Methodology using Moody's standard adjustments.

Note: For definitions of Moody's most common ratio terms please see the accompanying [User's Guide](#).

Opinion

Rating Drivers

Regulatory environment remains less predictable despite credit supportive legislation

Sizeable capital program

Good credit metrics for the rating category

Parent's dividend reduction enhances CWE's internal cash flow

Dispute with IRS remains an overhang credit issue

Corporate Profile

Commonwealth Edison Company (CWE) is a regulated electric transmission and distribution company and a subsidiary of Exelon Corporation (Exelon: Baa2 stable). CWE provides energy delivery services to retail and wholesale customers in northern Illinois, including the city of Chicago. CWE is regulated by the Illinois Commerce Commission (ICC) and the Federal Energy Regulatory Commission (FERC). At June 30, 2013, CWE had total assets of \$23.35 billion.

SUMMARY RATING RATIONALE

CWE's Baa2 senior unsecured rating primarily reflects an improving but still unpredictable state regulatory environment in which the company operates. While the ICC implementation of the 2011 EIMA legislation created challenges for Illinois electric utilities, passage of SB9 in May 2013 should address the implementation issues allowing for an improvement in the cost recovery framework. The rating factors in good credit metrics for its rating category, good liquidity management, a sizeable capital spending program, and a diverse regional economy which helps mitigate the financial impact from the still weak economic recovery. The rating further recognizes the expected enhancement to CWE's internal cash flow following Exelon's decision to reduce its annual common dividend by 40%. A longer-term credit overhang is CWE's ongoing exposure to litigation with the IRS.

DETAILED RATING CONSIDERATIONS

-Somewhat improved but still challenging regulatory environment

CWE continues to operate in a somewhat improved, but still challenging regulatory environment for electric utilities in Illinois resulting in lingering concerns about the framework's predictability. Since 2011, CWE's distribution rates have been established through a performance-based formula rate plan (FRP) pursuant to the Energy Infrastructure Modernization Act (EIMA), which provides a structure for substantial capital investment by utilities over a ten-year period to modernize Illinois' electric utility infrastructure. While passage of EIMA was viewed favorably, the law has not been implemented by the ICC as anticipated which reduced CWE's expected financial results and planned capital investment amounts under the program. During March 2013, the Illinois House and Senate each passed Senate Bill (SB) 9 with supermajority votes to clarify the intent of EIMA on three major issues: the use of year-end rather than average rate base and capital structure in the annual update, the use of CWE's weighted average cost of capital interest rate to apply to the annual update and an allowed return on CWE's pension assets. On May 22, 2013, the Illinois General Assembly overrode the Governor's May 5th veto of SB9 which resulted in the legislation becoming effective immediately.

On May 30, 2013, CWE updated the distribution formula structure to reflect the impacts of SB9 with the ICC approving the filing (\$14 million revenue reduction) effective July 1, 2013. In addition, on May 31st, CWE updated its April 29, 2013 distribution formula rate filing to reflect the impacts of SB 9. The May 31st filing established the revenue requirement used to set the rates that will take effect in January 2014. Including the impact of SB9, CWE has requested a total increase to its revenue requirements of \$359 million, reflecting an increase of \$165 million for the initial revenue requirement for 2013 and an increase of \$194 million for the annual reconciliation for 2012.

On June 5, 2013, the ICC issued an interim order approving CWE's accelerated AMI deployment plan consistent with the provisions of SB 9. In September 2013, CWE have smarted grid deployment with 60,000 meters to be installed by the end of 2013.

-Material Capital Investment

CWE's capital expenditure program has increased in each of the last two years primarily to maintain and strengthen the transmission and distribution network in and around its service territory, and for infrastructure spending related to smart grid deployment. In 2011 and 2012, capital expenditures increased to \$1.0 billion and \$1.2 billion, respectively, as compared to the three year average of \$923 million over the 2008-2010 period. We anticipate that capital spending will approximate \$1.4 billion during 2013.

-Parent's dividend reduction enhances CWE's internal cash flow

On February 7, 2013, Exelon announced that it would reduce its common dividend by 40% which will enhance retained cash flow and free cash flow across the company by \$740 million annually. We view this action as being supportive of credit quality and highlights management's strong commitment to maintain an investment grade rating at all legal registrants. Exelon's revised dividend policy contemplates that the utilities, including CWE, pay out an average of 65-70% of their respective earnings.

-Overhang with IRS case

On January 9, 2013, the US Court of Appeals reached a decision for the government in a lawsuit involving Consolidated Edison's (ConEd's) participation in a lease-in, lease-out (LILLO) transaction that the IRS also has characterized as a tax shelter, and disallowed ConEd's deductions stemming from its participation in this investment.

CWE has deferred the \$1.2 billion of gain on the 1999 sale of its fossil generating facilities by acquiring like-kind property via a purchase leaseback transaction. The IRS has asserted that the Exelon purchase leaseback transaction is substantially similar to a leasing transaction known as a sale-in, lease-out transaction (SILO). Exelon believes that its like-kind exchange transaction is not the same as or substantially similar to a SILO. Exelon expects to initiate litigation to contest the IRS disallowance of the like-kind exchange position.

In light of the ConEd decision and Exelon's current determination that a settlement is unlikely, Exelon recorded in the first quarter of 2013 a non-cash charge to earnings of approximately \$265 million, which represents the full amount of interest expense (after-tax) and incremental state tax expense in the event that Exelon is unsuccessful in litigation. Approximately \$170 million of the amount was recorded at CWE.

Exelon expects to hold CWE harmless from any unfavorable impacts of the after-tax interest amounts on CWE's equity. As of June 30, 2013, in the event of a fully successful IRS challenge to Exelon's like-kind exchange position, the potential tax and after-tax interest, exclusive of penalties, that could become currently payable may be as much as \$860 million, of which approximately \$260 million would be attributable to CWE and the remainder to Exelon.

-Good Credit Metrics for the Current Rating

In recent times, CWE has produced strong credit metrics for the Baa rating category. Cash flow (CFO pre W/C) to debt has averaged around 21.2%, cash flow coverage of interest expense has averaged 4.6x while retained cash flow to debt has averaged 17.6% for the past three years, all of which are reflective of a higher Baa rating. Some of this financial performance can be attributed to the receipt of bonus depreciation, which is not a sustainable source of cash flow. During the twelve months ending 06/30/2013, CWE's financial results declined substantially reflecting the expiration of bonus depreciation that had enhanced historical results along with the one-time accounting implications associated with a \$170 million after-tax charge taken by CWE for the above referenced dispute with the IRS. A component of the accounting charge is the one-time accrual of interest expense associated with the potential loss related to the litigation. In that vein, quarterly interest expense increased by \$279 million during first quarter 2013 relative to the same period during 2012. As such, for the twelve months ending June 30, 2013, we calculate that cash flow to debt was 11.6%, cash flow coverage of interest expense was 2.3x, and retained cash flow to debt was 9.7%. In light of the one-time nature of the charge-off and the expected improvement in financial performance with the passage of SB9, this type of performance is not anticipated to persist. Moreover, with higher CWE capital spending during 2012 and 2013, we view the company's decision to reduce its dividend to the parent in 2012 (to \$105 million) and through the 12 months ended 06/30/2013 (to \$130 million) as credit supportive actions.

Liquidity

CWE's Prime-2 short-term rating for commercial paper reflects our view that the company will maintain adequate liquidity for the next 4 quarters. For 2012, we calculate that CWE produced a modest level of negative free cash flow of \$17 million. However, for the 12 months ending June 30, 2013, we calculate that negative free cash reached \$387 million based on cash from operations of \$1.115 billion, capital spending of \$1.372 billion and the payment of \$130 million in common dividends.

In March 2013, CWE extended its \$1 billion unsecured revolver one additional year moving the expiry date to March 2018. This credit facility is used primarily to provide liquidity support for commercial paper and for the issuance of letters of credit. At June 30, 2013, CWE had \$374 million of commercial paper outstanding and had no letters of credit issued under the facility. While the credit agreement does not contain any rating triggers that would

affect borrowing access to the commitment and does not require any material adverse change (MAC) representation for borrowings, there is a requirement to maintain a ratio of net cash flow from operations to net interest expense at a minimum level of at least 2.0 times. At June 30, 2013, CWE's ratio of net cash flow from operations to net interest expense was 2.58x reflecting the above referenced charge taken in the first quarter for the like-kind exchange. On August 10, 2013, CWE amended the interest coverage ratio in their credit agreement to exclude any non-cash impacts related to the like-kind exchange. Cash on hand at June 30, 2013 was \$93 million.

In light of the ample capital investment program anticipated at the utility, we expect CWE being free cash flow negative for the next few years. That said, in light of the higher capital spending at CWE, we believe that the company will continue moderate its dividend to the parent to a level well below the targeted 65-70% range.

In August 2013, CWE issued \$350 million of 30-year 4.6% first mortgage bonds. During 2014, CWE has \$617 million of maturing debt. We anticipate the company seeking to access the capital markets to refinance a substantial portion of this debt given the capital requirements of the utility.

As of June 30, 2013, if CWE lost its investment grade credit rating, it could be required to provide \$18 million of collateral.

Rating Outlook

CWE's rating outlook is stable reflecting an expectation that financial results will strengthen, particularly with the passage of EIMA. Although the regulatory environment remains challenging and unpredictable, we believe that the latest credit supportive legislation will improve cost recovery under the FRP. CWE's stable outlook further incorporates our belief the company's dividend policy will continue to remain sensible in light of the utility's increased capital spending requirements.

What Could Change the Rating - Up

In light of our March 2012 one notch upgrade of CWE's ratings and the increased capital spending anticipated at CWE, prospects for an upgrade of the utility's ratings are not imminent. However, upward rating pressure can surface if we observe that the new regulatory framework is seamlessly implemented and accepted as a workable model by key constituents in the state, resulting in more predictable financial results for the state's utilities.

What Could Change the Rating - Down

The rating could be downgraded if EIMA ratemaking implementation is altered dramatically or terminated, if the company's cash flow to debt declines to below 16.0% or cash flow to interest expense falls below 3.5x for an extended period. Also, negative rating pressure could materialize if the outcome of a continuing IRS challenge concerning certain sale/leaseback transactions affecting Exelon and CWE leads to substantial payments for the utility.

Other Considerations

As depicted below, CWE's implied rating under the grid on a historical and projected basis is Baa2 on par with the current senior unsecured rating.

Rating Factors

Commonwealth Edison Company

Regulated Electric and Gas Utilities Industry [1][2]	LTM 06/30/2013		Moody's 12-18 month Forward View* As of September 2013	
Factor 1: Regulatory Framework (25%)	Measure	Score	Measure	Score
a) Regulatory Framework		Ba		Ba
Factor 2: Ability To Recover Costs And Earn Returns (25%)				

a) Ability To Recover Costs And Earn Returns		Baa		Baa
Factor 3: Diversification (10%)				
a) Market Position (10%)		Baa		Baa
b) Generation and Fuel Diversity (na)		na		na
Factor 4: Financial Strength, Liquidity And Key Financial Metrics (40%)				
a) Liquidity (10%)		Baa		Baa
b) CFO pre-WC + Interest/ Interest (3 Year Avg) (7.5%)	3.9x	Baa	3.8x - 4.3x	Baa
c) CFO pre-WC / Debt (3 Year Avg) (7.5%)	20.1%	Baa	15 - 18%	Baa
d) CFO pre-WC - Dividends / Debt (3 Year Avg) (7.5%)	16.8%	A	12 - 14%	Baa
e) Debt/Capitalization (3 Year Avg) (7.5%)	38.7%	A	35 - 38%	A
Rating:				
a) Indicated Rating from Grid		Baa2		Baa2
b) Actual Rating Assigned		Baa2		Baa2

* THIS REPRESENTS MOODY'S FORWARD VIEW; NOT THE VIEW OF THE ISSUER; AND UNLESS NOTED IN THE TEXT DOES NOT INCORPORATE SIGNIFICANT ACQUISITIONS OR DIVESTITURES

[1] All ratios are calculated using Moody's Standard Adjustments. [2] As of 06/30/2013(L); Source: Moody's Financial Metrics



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