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Ratings

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**Research Update:**

## **FirstEnergy Solutions Corp. Downgraded To 'CCC-' On Creditor Discussions**

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## Research Update:

# FirstEnergy Solutions Corp. Downgraded To 'CCC-' On Creditor Discussions

## Overview

- Recently, FirstEnergy Solutions Corp. (FES) announced that it was initiating discussions with its creditors on a possible exchange in advance of 2018 maturities.
- We are lowering our issuer credit rating on FirstEnergy Solutions to 'CCC-' from 'CCC'. The outlook is negative.
- At the same time, we are lowering our rating on the company's secured debt to 'CCC+' from 'B-'. We are also lowering our rating on the company's senior unsecured debt to 'CCC-' from 'CCC'. The recovery ratings on the debt remain '1' and '4', respectively.
- The negative outlook reflects our expectation that the issuer could potentially file for bankruptcy or enter into a distressed exchange within the next six months.

## Rating Action

On Aug. 14, 2017, S&P Global Ratings lowered its issuer credit rating on FirstEnergy Solutions Corp. to 'CCC-' from 'CCC'. The outlook is negative. We also lowered the rating on the company's secured debt to 'CCC+' from 'B-' and on its unsecured debt to 'CCC-' from 'CCC'. The recovery ratings of '1' and '4' on secured and unsecured debt, respectively, are unchanged.

## Rationale

The rating action stems from the recent announcement by FirstEnergy Solutions that it was pursuing exchange discussions with its creditors. This announcement appears to potentially accelerate the timeframe to default, which we had previously believed would immediately precede 2018 maturities. An exchange that provides less than full compensation would be considered an event of default under our criteria; given our current low recovery expectations for this portfolio, as well as bond spreads indicating severe distress, we expect that any exchange would be for less than full compensation. It's not clear, currently, how long it will take for these events to transpire, but, even absent an agreement with the creditors, we expect that the company will file for bankruptcy in advance of its 2018 maturities. While uplift for nuclear assets via either a state subsidy or the Department of Energy study is possible, we consider neither in our base case, and believe that even these would not forestall bankruptcy indefinitely.

## **Outlook**

The negative outlook reflects our expectation that the issuer could potentially file for bankruptcy or enter into a distressed exchange within the next six months.

### **Downside scenario**

We could lower the ratings if the timeline of a possible restructuring accelerates or if the issuer makes an announcement to this effect.

### **Upside scenario**

We could revise the outlook to stable if leverage decreased sharply or if liquidity improved intermittently.

## **Recovery Analysis**

FES and affiliates own or lease and operate power plants in the U.S. with a combined capacity of about 13,000 megawatts (MW), but for purposes of this analysis we exclude Allegheny Energy Supply. Parent FirstEnergy Corp. and its other regulated subsidiaries do not guarantee any of FES' debt or lease liabilities and it is unlikely that there would be a compelling economic reason to provide additional support to the entities if it comes under stress.

We no longer attribute any support from FirstEnergy in our corporate credit rating on the competitive entities, and we evaluate their recovery prospects on a stand-alone basis. That said, FirstEnergy does have about \$200 million in guarantees and other obligations (about \$1 billion underfunded pension) that it is obliged to support.

The companies have a moderately complex capital structure, with secured debt at FirstEnergy Nuclear Generation LLC (FENG) and FirstEnergy Generation LLC (FEG) backed by the underlying assets at these entities, which generate about 4,100 MW and 5,200 MW of power, respectively. While parent FirstEnergy Corp. has taken a credit exposure to FES, the secured revolver is also guaranteed by FEG and FENG and secured primarily by a value lien of substantially all of those entities' generation assets. Also, senior unsecured debt at FES, FEG, and FENG is pari passu and cross collateralized by the assets.

### **Simulated default scenario**

S&P Global Ratings' simulated default scenario assumes that a default results from continued low commodity prices and evolving environmental legislation that lead to the shuttering of additional plants. More specifically, our simulated default scenario assumes that by 2018, through a combination of the open generation position and a continuation of depressed power prices, the cash flow generation continues to erode as the high value legacy hedges roll

off. We project negative free cash flow in 2018, which we assume becomes larger as energy margins do not rebound.

### **Valuation and outcome**

We performed our valuation using debt-per-kilowatt (kW) values for each plant, with valuations ranging generally by asset type, location, and level of emissions control. Baseload coal plant valuations were revised downward--to as low as \$200/kW to \$225/kW. All values for plants (\$ per kW) are based on recent comparable transactions as well as our expectation of asset sale proceeds. We assumed lower valuations for assets like Beaver Valley 2, which have steam generator upgrade requirements. Nuclear assets are trading at about 7x current cash flows under the prevailing commodity environment. This gives nuclear assets that are not in discounted hubs (i.e. unduly affected by renewables, or distressed natural gas) a value of about \$300-\$350 per kW.

These valuations were based on our discussions with market participants and also recent public and private transactions.

On the other hand, natural gas assets are currently trading at about 10x EBITDA on a going-concern basis. We assigned values of up to \$200/kW to peakers that had the ability to ramp up quickly.

### **Related Criteria**

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Corporates - General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - Industrials: Key Credit Factors For The Unregulated Power And Gas Industry, March 28, 2014
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings, Oct. 1, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

## Ratings List

### Downgraded

	To	From
FirstEnergy Solutions Corp.		
Corporate Credit Rating	CCC-/Negative/--	CCC/Negative/--
Senior Secured	CCC+	B-
Recovery Rating	1 (95%)	1 (95%)
Senior Unsecured	CCC-	CCC
Recovery Rating	4 (30%)	4 (30%)
FirstEnergy Generation LLC		
Senior Secured	CCC+	B-
Recovery Rating	1 (95%)	1 (95%)
Senior Unsecured	CCC-	CCC
Recovery Rating	4 (30%)	4 (30%)
FirstEnergy Nuclear Generation LLC		
Senior Secured	CCC+	B-
Recovery Rating	1 (95%)	1 (95%)
Senior Unsecured	CCC-	CCC
Recovery Rating	4 (30%)	4 (30%)

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.globalcreditportal.com](http://www.globalcreditportal.com) and at [www.spcapitaliq.com](http://www.spcapitaliq.com). All ratings affected by this rating action can be found on the S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column.

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