DOCKET NO. ________

APPLICATION OF SOUTHWESTERN PUBLIC SERVICE COMPANY FOR AUTHORITY TO CHANGE RATES	**§ § §**	**PUBLIC UTILITY COMMISSION OF TEXAS**

DIRECT TESTIMONY
of
PATRICIA L. MARTIN

on behalf of

SOUTHWESTERN PUBLIC SERVICE COMPANY

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Table of Contents

GLOSSARY OF ACRONYMS AND DEFINED TERMS

Acronym/Defined Term	**Meaning**
CFO	Cash from Operations
Commission	Public Utility Commission of Texas
EBITDA	Earnings Before Interest, Taxes, Depreciation and Amortization
FFO	Funds from Operations
Fitch	Fitch Ratings
Moody's	Moody's Investors Service
RFP	Rate Filing Package
ROE	Return on Equity
S&P	Standard & Poor's
SPS	Southwestern Public Service Company, a New Mexico corporation
Test Year	October 1, 2019 through September 30, 2020
Update Period	October 1, 2020 through December 31, 2020
WACC	weighted average cost of capital
W/C	Working Capital
Xcel Energy	Xcel Energy Inc.

LIST OF ATTACHMENTS

Attachment	Description
PLM-RR-1	Moody's October 19, 2018: Rating Action: Moody's Changes Xcel Energy's outlook to negative; downgrades Southwestern Public Service ratings to Baa2 with stable outlook (*Non-native format*)
PLM-RR-2	Moody's December 31, 2020: Credit Opinion Southwestern Public Service; Update to credit analysis (*Non-native format*)
PLM-RR-3	S&P Global Ratings November 6, 2018: Ratings Direct: Southwestern Public Service Co. (*Non-native format*)

DIRECT TESTIMONY
OF
PATRICIA L. MARTIN

I. <u>WITNESS IDENTIFICATION AND QUALIFICATIONS</u>

Q. Please state your name and business address.

A. My name is Patricia L. Martin. My business address is 401 Nicollet Mall, Minneapolis, Minnesota 55401.

Q. On whose behalf are you testifying in this proceeding?

A. I am filing testimony on behalf of Southwestern Public Service Company, a New Mexico corporation ("SPS") and wholly-owned electric utility subsidiary of Xcel Energy Inc. ("Xcel Energy").

Q. By whom are you employed and in what position?

A. I am employed by Xcel Energy Services Inc. as Assistant Treasurer.

Q. Please briefly outline your responsibilities as Assistant Treasurer.

A. As Assistant Treasurer, I am responsible for providing leadership, direction, and technical expertise related to Treasury and finance processes and functions. I lead a professional team to provide financial analysis and recommendations on valuations of new investments, financial objectives, and policies. I am also responsible for development and implementation of financial plans for regulated operating companies, execution of long-term debt and equity financings, establishing and maintaining banking relationships, and providing written testimony for capital structure and cost of capital.

Q. Please describe your educational and professional background.

A. I have a Bachelor of Science degree in Business Administration from University of Wisconsin-Stevens Point and a Master of Business Administration from Edgewood College in Madison, Wisconsin. I have been employed by Xcel Energy since 2016, and have been in my current role as Assistant Treasurer since October 2019. From 2016 to September 2019, I was the Director of Treasury Forecasting at Xcel Energy with responsibilities for cash forecasting and long-term financial modeling. From 2012 to 2016, I was employed at Pacific Gas and Electric Company as Corporate Finance Manager in the Treasury Department (2012 – 2014) and as a Business Finance Manager supporting Gas Operations (2014 – 2016). From 2007 to 2012, I was employed by several start-up companies in Denver, Colorado including Mobile Accord (VP Finance and Chief Administrative Officer, 2010 – 2012), Local Matters (Director Financial Planning and Analysis, 2008 – 2010) and Pendum Inc. (Manager Financial Planning and Analysis/Treasurer, 2007 – 2008). From 2006 to 2007, I was employed by GE Healthcare as a Financial Planning and Analysis Manager. I was also employed by CUNA Mutual Group from 2004 to 2006 as the Manager of Forecasting, Planning and Analysis. And lastly, I was employed by Alliant Energy Corporation from 1998 to 2004 in several roles with progressively more responsibility including, Manager – Performance Consulting, Senior Financial Analyst, and Senior Treasury Analyst.

Q. Have you previously provided testimony to any regulatory commission?

A. Yes. I provided rebuttal testimony on financial integrity, cost of debt, and capital structure before the Public Utility Commission of Texas (“Commission”) in the previous SPS base rate case, *Application of Southwestern Public Service Company for Authority to Change Rates*, Docket No. 49831. I also provided direct testimony on financial integrity, cost of debt, and capital structure before the New Mexico Public Regulation Commission ("NMPRC") in *Application for: (1) Revision of its Retail Rates under Advice Notice No. 292; (2) Authorization and Approval to Abandon its Plant X Unit 3 Generating Station; and (3) Other Associated Relief*, Case No. 20-00238-UT, and on security issuances (e.g., first mortgage bonds and unsecured debt) in a recent NMPRC proceeding, Case No. 20-00052-UT. Further, I submitted the 2020 and 2021 capital structure petitions on behalf of Northern States Power Company to the Minnesota Public Utilities Commission, Docket Nos. E,G002/S-19-662 and E,G002/S-20-768.

II. ASSIGNMENT AND SUMMARY OF TESTIMONY AND RECOMMENDATIONS

Q. What is the purpose of your testimony in this proceeding?

A. My testimony supports SPS's weighted average cost of capital ("WACC") during the Test Year[1] and for the Update Period[2] at 7.56%. I further demonstrate that a reasonable capital structure for SPS consists of 54.60% equity and 45.40% debt, including the proposed return on equity ("ROE") of 10.35% as supported by SPS witness Mr. Dylan D'Ascendis in this proceeding. In addition, my testimony will:

- discuss financial integrity, its importance to SPS and its stakeholders, and the need for SPS to demonstrate stable overall financial health in order to access the market in varied market conditions and raise debt capital for utility expenditures at low costs;
- provide a current assessment of SPS's financial integrity and describe the impact that regulatory decisions, changes in cash flow, and the timely recovery of prudent utility costs have on SPS's financial integrity;
- present and support the use of SPS's actual capital structure, which consists of 54.60% equity and 45.40% long-term debt, as of the end of the Historical Test Year and the Update Period; and
- present and support SPS's Test Year and Update Period cost of long-term debt, which is 4.20%.

Q. Are you sponsoring any attachments as part of your direct testimony?

A. Yes, I am sponsoring the following attachments:

- Attachment PLM-RR-1, which is a Moody's publication titled Moody's changes Xcel Energy's outlook to negative; downgrades Southwestern Public Service ratings to Baa2 with stable outlook, dated October 19, 2018;

[1] The "Test Year" is the Historical Test Year Period consisting of October 1, 2019 through September 30, 2020.

[2] The "Update Period" is October 1, 2020 through December 31, 2020.

- Attachment PLM-RR-2, which is a Moody's publication titled Credit Opinion, Southwest Public's Service, update to credit analysis, dated December 31, 2020; and

- Attachment PLM-RR-3, which is an S&P Global Ratings publication titled Southwestern Public Service Co., dated November 6, 2018.

In addition, I sponsor or co-sponsor the Rate Filing Package ("RFP") Schedules set forth below:

- Schedule K-1 provides SPS's overall rate of return as a weighted average of each class of capital based upon SPS's capitalization at the end of the Test Year, including Update Period items as well as SPS's proposed capital structure and cost of capital. The cost of debt capital, the return on stockholder's equity, and the component amounts of each class of capital are presented and agree with supporting Schedules K-2 and K-3. In addition, this schedule presents the overall rate of return on the original cost of rate base and the resulting total return (capital cost) expressed in dollars. That portion of the schedule is sponsored by SPS witness Stephanie N. Niemi.

- Schedule K-2 is intended to provide the weighted average cost of preferred stock capital. Because SPS has no preferred stock, the schedule is not applicable.

- Schedule K-3 contains a schedule of the weighted average cost of long-term debt capital and lists each debt issue for each class and series of long-term debt outstanding, according to the balance sheet as of the end of the Test Year and Update Period.

- Schedule K-4 provides information pertaining to SPS's notes payable, although notes payable are not included in the capital structures provided in Schedule K-1. The schedule also includes a description of any significant changes anticipated in the balance of notes payable during the twelve-month period following the Test Year.

- Schedule K-5 provides a description and calculation of the most restrictive financial tests pertaining to the issuance of securities or the maintenance of banking lines of credit.

- Schedule K-6 provides historical financial ratios for the Test Year and the five fiscal years preceding the Test Year, as well as forecast data through 2023. In addition, Schedule K-6 provides the definition of the ratios.

- Schedule K-7 provides estimates of the requirements for and sources of future capital for three fiscal years following the Test Year, with explanations of all assumptions and estimates used.

- Schedule K-8 provides historical financial information necessary to calculate earnings per share, dividends per share, and book value per share over the previous 15 fiscal years, with the weighted average number of shares adjusted for stock splits. Compound growth rates and average values for ROE and earnings retention are provided for these measures over the most recent five-, ten-, and fifteen-year periods. The amount of any non-recurring gains or losses is provided for each year along with a book description of the non-recurring event, if appropriate. Finally, a calculation of the year-end market-to-book ratio is provided for each year.

- Schedule K-9 contains copies of all credit rating analyses or investment reports on SPS and Xcel Energy published during the most recent 12-month period and in the possession of SPS, including but not limited to reports by Standard & Poor's ("S&P"), Moody's Investors Service ("Moody's"), and Fitch Ratings ("Fitch").

Q. Please summarize the recommendations in your testimony.

A. I recommend that the Commission approve SPS's proposed WACC as shown in Table PLM-RR-1, which as summarized above, is the same for both the Test Period and the Update Period.

Table PLM-RR-1: Proposed Cost of Capital

Update Period		**Forecast December 31, 2020**	
	Ratio	**Rate**	**Wtd Cost**
Long-Term Debt	45.40%	4.20%	1.91%
Equity	54.60%	10.35%	5.65%
Total Cost			**7.56%**

Q. Are the attachments to your testimony true and correct copies of the documents you represent them to be?

A. Yes.

Q. Were the portions of the RFP schedules that you sponsor or co-sponsor prepared by you or under your direct supervision and control?

A. Yes.

Q. Do you incorporate the RFP schedules sponsored or co-sponsored by you into your testimony?

A. Yes.

III. FINANCIAL INTEGRITY, RATING AGENCY CONSIDERATIONS, AND SOUTHWESTERN PUBLIC SERVICE COMPANY

Q. What topics do you discuss in this section of your testimony?

A. In this section of my testimony, I will:

- discuss financial integrity and the importance of this case in supporting SPS's future financial integrity;
- provide a current assessment of SPS's financial integrity and its impact to SPS's customers;
- identify both how SPS is working to maintain its financial integrity and how its financial integrity could be strengthened through a supportive regulatory decision in this case; and
- present and support the recommended Test Year and Update Period WACC of 7.56%.

A. Financial Integrity

Q. What is financial integrity?

A. As used in my testimony, "financial integrity" refers to a company's financial strength and its ability to attract capital to support operations and infrastructure investment during periods of both economic growth and economic decline. The ability to attract capital at a reasonable cost in all market conditions is essential for a utility to fulfill its obligation to provide safe and reliable utility service to customers. Financial integrity ensures that the utility will have the flexibility to withstand unanticipated macroeconomic events outside of its control, such as the COVID-19 pandemic.

Q. How does maintaining financial integrity benefit SPS's customers?

A. A utility's financial integrity directly affects both SPS's ability to access capital to fund necessary investments on behalf of customers, and the cost of that capital, which is ultimately included in the utility's overall rates. Attracting reasonably priced capital in all market conditions, including following unexpected macroeconomic events outside SPS's control, is also critical to being able to invest in the infrastructure necessary for SPS to provide safe and reliable utility service.

It is important to note that the question of a utility's financial integrity is not necessarily binary (i.e., does a utility have financial integrity or not?); rather, the degree of financial integrity and therefore the cost of capital available to a utility lies on a spectrum. Weaker financial integrity at a utility increases the issued cost of debt and the implied cost of equity, which increases the overall WACC and the ultimate financing costs paid by customers. Stronger financial integrity produces the opposite effects, which in turn benefits customers.

B. <u>Factors Impacting Financial Integrity</u>

Q. What factors contribute to a utility's financial integrity?

A. The financial integrity of a regulated utility is largely a function of its capital structure, ROE, and cash flow, but other factors can also affect a utility's financial integrity. To maintain a strong financial profile, a utility needs to have the opportunity to recover all prudently-incurred utility costs in a timely manner, which includes not only the costs for operations and maintenance, but also the costs of servicing debt and providing a fair return for equity investors.

Q. How do regulatory outcomes impact rating agency perceptions and influence investor decisions?

A. As discussed further in Mr. Shipman's direct testimony, credit rating agencies determine credit ratings, which investors may rely on for investment decisions. The rating agencies have emphasized that balanced, constructive outcomes in utility rate proceedings are indicative of a supportive, stable regulatory environment and underpin a utility's financial integrity.

Q. How do a utility's credit ratings affect its ability to access capital on reasonable terms?

A. As Mr. Shipman discusses in his direct testimony, a credit rating measures credit risk, which is the ability and willingness of an issuer to fulfill its financial obligations in full and on time. Credit ratings summarize the relative probability that an issuer or an issue will default (i.e., the failure to pay either the required periodic payment or the principal when it matures).[3] Credit ratings help debt investors differentiate between utilities – all of whom are competing (with companies within and outside the utility sector) for the same investment dollars. The credit ratings assigned by rating agencies indicate their opinions of a company's ability to meet its financial obligations. Rating agency opinions are considered valuable by potential investors because they represent independent, third-party opinions that are based upon a consistent approach to the evaluation of company risk over time. Ratings affect the number of potential investors and the cost of a company's debt and offer important insight into a company's investment risk in the past and future.

During the period 2014 to 2020, debt investors provided approximately $749 billion of capital investment to the U.S. utility sector. Capital provided from these investors allows utilities to fund a portion of their capital investment programs. See Chart PLM-RR-1 below.

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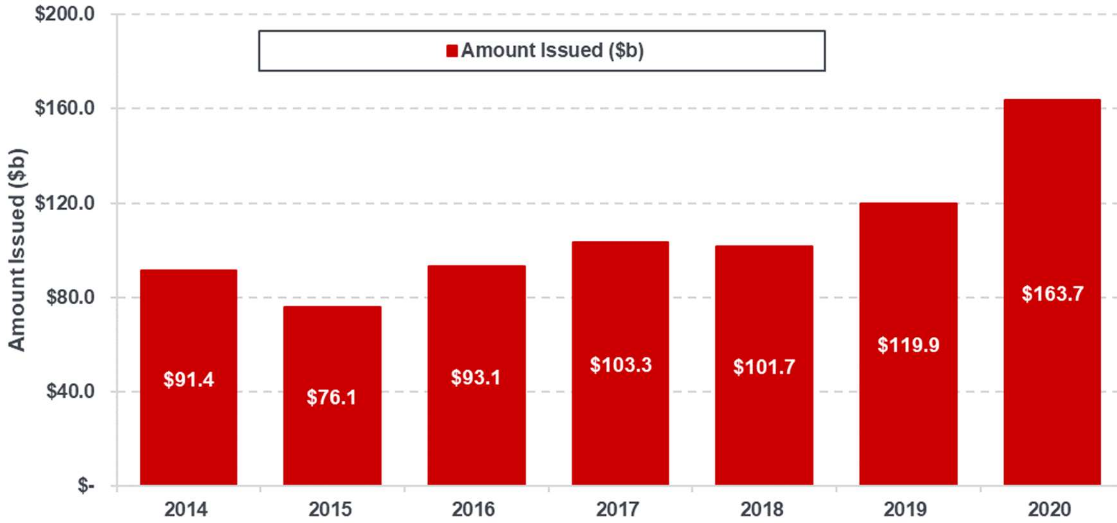
[3] Direct Testimony of Todd A. Shipman at 8.

Chart PLM-RR-1: 2014-2020 Debt Amount Issued to the U.S. Utility Sector[4]



In order to attract capital at favorable rates in a competitive environment, protecting SPS's credit ratings is critical. This becomes even more pertinent in a volatile market environment, such as the COVID-19 pandemic. Utilities with higher credit ratings are associated with reduced risk, which attracts investors willing to provide funds at a lower cost of debt and favorably position a utility relative to lower-rated comparable companies. The stronger the Company's credit ratings, the larger the pool of investors willing to consider investing in the Company's debt and the lower the coupon rate[5] the Company will need to pay in order to issue debt.[6] Investment-grade credit ratings are crucial because the cost of debt increases very rapidly – and the number of potential buyers decreases

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[4] Source: Bloomberg.

[5] The coupon rate is the rate of interest paid by bond issuers on the bond's face value. A bond is priced at the underlying Treasury rate plus a credit spread.

[6] Investors rely on credit ratings to assess the utility's ability to generate cash flows for repayment. Investors' confidence in that repayment is a primary driver of the pricing of capital. Brealy, Meyers & Allen, *Principles of Corporate Finance*, New York, McGraw-Hill Education, 2017.

substantially – for those companies rated near the bottom of or below investment grade. Credit ratings take on greater importance when economic conditions worsen, and credit becomes more difficult to obtain. As credit availability tightens, investors become increasingly selective in choosing the companies that qualify for their investment funds. Therefore, lower credit ratings can reduce access to capital markets and increase the expense of obtaining capital as compared to comparable utilities.

Equity investors also rely on credit ratings to differentiate between utilities. Because the income available to common equity holders is subordinate to debt obligations, the weakening of a company's creditworthiness may also increase the cost of equity. As Mr. D'Ascendis explains, the higher the proportion of debt and preferred stock in the capital structure, the higher the financial risk to common equity owners (i.e., failure to receive dividends due to default or other covenants). Consequently, as the degree of financial leverage increases, the risk of financial distress (i.e., financial risk) also increases. Therefore, consistent with the basic financial principle of risk and return, common equity investors require higher returns as compensation for bearing higher financial risk.[7] Mr. D'Ascendis further explains that bond and credit ratings are reflective of the types of risks faced by debt holders, and lower credit ratings generally correspond to higher required returns on equity to compensate for higher risk.[8]

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[7] See the Direct Testimony of Dylan D'Ascendis at 33-34. This concept is also discussed by Dr. Roger Morin, PhD in *New Regulatory Finance* at 455.

[8] Mr. D'Ascendis' recommended upward adjustment to SPS's requested return on equity illustrates this principle. See the Direct Testimony of Dylan D'Ascendis at 66-67.

Ultimately, customers of the higher-rated utility benefit from the lower capital costs as these costs are borne by customers.

Q. Do credit ratings affect SPS's cost of capital?

A. Yes. The price of long-term debt is based on the underlying Treasury rate plus a credit spread that is primarily based on SPS's credit rating. In general, the lower the credit rating, the higher the credit spread. Issuing debt at a higher rate will increase the long-term cost of debt for SPS and ultimately increase the cost of debt paid for by SPS's customers.

Q. Do credit spreads differ based on credit ratings?

A. Yes. As discussed above, lower credit ratings are seen as riskier and therefore investors demand a higher spread when investing in riskier companies. Chart PLM-RR-2 below[9] shows that the credit spreads of BBB rated utility companies are historically wider than those of A rated utility companies, especially in times of market volatility. This chart demonstrates that although in current market conditions the credit spread between A and BBB ratings is approximately 22 basis points, in periods of market volatility, such as June 2009, the credit spread increased dramatically, at an average spread of 100 basis points. More recently, in March 2020, due to the market volatility related to the COVID-19 pandemic, the credit spread increased at an average spread of 75 basis points. At an average spread of 75 basis points a BBB rated utility, such as SPS, would pay an additional $750,000 of interest annually above what an A rated utility would pay for every $100 million issued in debt. For a 30-year bond, this would equate to an additional $22.5 million of interest over the life of the bond.

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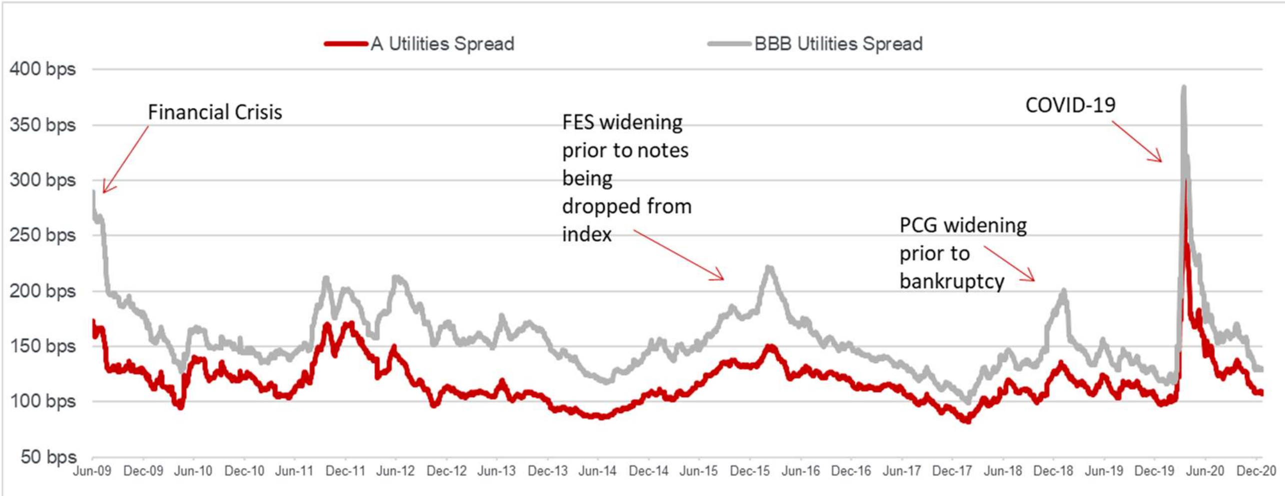
9 Source: Bloomberg.

Chart PLM-2: A vs. BBB Rated Utility Spreads



Q. Why is it important for SPS to maintain an investment grade credit rating?

A. Maintaining investment grade credit ratings is important because many institutional investors are not permitted to purchase non-investment grade securities (less than Baa3 for Moody's and BBB- for S&P and Fitch; also referred to as "junk bonds" or "junk"). Institutional investors include banks, insurance companies, pension funds, endowments, and mutual funds that invest money on behalf of individuals or other institutions.

Institutional investors own substantially all of SPS's outstanding bonds, and it is critically important for SPS and its customers that institutional investors be eligible to own its debt instruments. In times of capital scarcity, companies with "junk" ratings may not have access to capital at any cost. As described below, in times of market volatility the capital markets have effectively been closed except to those with higher credit ratings. Therefore, SPS's continued provision of safe and reliable electric delivery in all market conditions depends on not only maintaining its financial integrity but continuing to seek to strengthen it such that it will allow SPS to access cash on reasonable terms when it needs it most.

Q. Why should the Commission be concerned about SPS's financial integrity?

A. Financial integrity directly affects SPS's ability to access capital and the cost of that capital, which in turn, impacts the cost of debt and the cost of equity that must be paid by customers as well as SPS's ability to fund new projects. The ability to attract capital at a reasonable cost in all market conditions is also critical to satisfying SPS's obligation to provide safe and reliable utility service as it helps to ensure that a utility has the flexibility to withstand unanticipated macroeconomic events outside of its control, such as the deep economic downturn that occurred in 2008-2009 or more recently, the COVID-19 pandemic. In contrast, a company that lacks financial integrity will be limited in its ability to finance assets or undertake new projects, particularly during times of volatility in the capital markets. Weak financial integrity at a utility also increases the issued cost of debt and the implied cost of equity, which increases the overall WACC and the ultimate financing costs which are paid by customers.

Q. Is the outcome of this case important to how investors will view SPS's ongoing financial integrity?

A. Yes. This case is important for several reasons. First, this case provides an opportunity to build on the recent rate case settlement, which was a positive step in alleviating rating agency concerns regarding SPS's regulatory environment. Obtaining consistent, constructive regulatory outcomes is key to avoiding further ratings downgrades (such as occurred in 2018) and will position SPS to improve its current ratings. Second, SPS currently (and for the foreseeable future) has the need to raise outside capital (both equity and debt) to support investment necessary to (1) serve the economic expansion in SPS's service territory, (2) support required investment in SPS's generation resources and transmission and distribution system and (3) enable cost-reducing, customer-benefitting clean-energy resources.[10]

Moody's reinforces this point in its Credit Opinion concerning SPS dated December 31, 2020. Moody's states: "The utility has publicly disclosed its intention to file rate cases in Texas and New Mexico during the first quarter of 2021. The filings would be in accordance with 2018 multi-party settlement agreements pertaining to the Hale (completed in 2019) and Sagamore (completed in December 2020) wind projects." Moody's goes on to state, "the outcome of these rates cases will be another indication of both the utility's relationships with stakeholders, including the regulators, and the credit supportiveness of the regulatory environments."[11]

Q. Please address the credit rating downgrade of SPS in 2018.

A. In the fourth quarter 2018, Moody's, which rates SPS on a stand-alone basis (rather than as part of the Xcel Energy "family"), downgraded SPS's credit ratings as shown in Table PLM-RR-2 below.

Table PLM-RR-2

Moody's Ratings	Current Rating[12]	Prior Rating
Issuer Rating	Baa2	Baa1
Senior Secured-FMB	A3	A2
Commercial Paper	P-2	P-2

[10] See the Direct Testimony of David T. Hudson at 19-22, 29.

[11] Attachment PLM-RR-2 at 4.

[12] Attachment PLM-RR-1 at 1, 2.

This deterioration in SPS's credit ratings was partially due to investor concern with the regulatory environment and the lack of regulatory support that SPS was experiencing, more notably in New Mexico as compared to Texas.[13] As Mr. Shipman explains, the regulatory environment is the single most important factor in the assessment of a utility's business risk.[14]

The downgrade is concerning, as a one notch downgrade by Moody's or Fitch at SPS would result in a BBB- equivalent rating, just one notch away from "junk" bond status. Continuing to improve investor opinion is important to managing future funding costs to ensure that SPS's generation resources and transmission and distribution system can meet long-term growth requirements safely and reliably.

Q. Will the capital structure authorized in this proceeding impact SPS's ability to access capital at reasonable rates?

A. Yes. The level of earnings authorized by the Commission directly affects SPS's ability to fund its operations with internally generated funds. Because investors and credit rating agencies are concerned with the extent to which capital investments are funded with external capital (i.e., overall level of debt in the capital structure) as opposed to internally generated funds, both the capital structure and ROE established by the Commission in this proceeding will be of significant concern to the financial community.

It is also important to note that, because a utility's investment horizon is very long, investors require the assurance of a sufficiently high return to satisfy the

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[13] Attachment PLM-RR-1 at 1

[14] Direct Testimony of Todd A. Shipman at 10-11.

long-run financing requirements of the assets placed into service. Debt investors require assurance that they will receive scheduled interest payments over the life of their investment as well as the eventual return of principal. Those assurances, which often are measured by the relationship between internally generated cash flows and debt (or interest expense), depend heavily on the capital structure, as capital structure determines the amount of debt to be serviced and also influences the level of internal cash flow being generated. Consequently, both capital structure and ROE established in this proceeding will be significant factors affecting SPS's financial integrity and ability to raise capital at reasonable cost.

C. SPS's Financial Integrity and Credit Metrics

Q. What topics do you discuss in this section of your testimony?

A. I describe assessments of SPS's financial integrity, including as specified through its credit ratings, and explain how it has changed over time.

Q. What are SPS's current credit ratings?

A. Please see SPS's current credit ratings in Table PLM-RR-3 below.

Table PLM-RR-3

	S&P	Moody's	Fitch
Corporate Rating	A-	Baa2	BBB
Senior Secured	A	A3	A-
Stand Alone Credit Profile (SACP)[15]	BBB+	N/A	N/A
Commercial Paper	A-2	P-2	F2

* S&P is the only rating agency that publishes an SACP, as S&P's corporate rating is based on a "family style" assessment. Moody's and Fitch corporate ratings are based on a stand-alone assessment.

[15] S&P is the only rating agency that publishes an SACP, as S&P's corporate rating is based on a "family style" assessment. Moody's and Fitch corporate ratings are based on a stand-alone assessment.

As discussed above, Moody's downgraded SPS's credit ratings in 2018. S&P has not taken action on SPS's corporate credit ratings, in part because SPS benefits from "family style" ratings by S&P; meaning, the issuer credit rating for SPS is equal to Xcel Energy's group credit profile, and is therefore benefitted by SPS having sister utilities that operate in regulatory environments that investors view as relatively more supportive of the financial integrity of regulated utilities. S&P also assigns what is referred to as a SACP. As Mr. Shipman explains in his direct testimony, the SACP is an intermediate determination in S&P's ratings methodology that signifies what an issuer's rating would be absent extraordinary parental support.[16] The SACP for SPS was lowered in November 2018 to BBB+, around the same time as the Moody's downgrade,[17] and is one notch lower than the Corporate Rating of A-.

Q. Does a lower credit rating have impacts that extend beyond the long-term cost of debt?

A. Yes. A downgrade could also affect SPS's cost of daily business or access to its short-term liquidity. SPS's cost of daily business is comprised of ongoing credit facility fees, letters of credit to support utility operations, and commercial paper rates. If SPS were downgraded such that it lost its A2/P2/F2 commercial paper rating, SPS would need to borrow directly from its $500 million credit facility and pay up to approximately 120 basis points higher than SPS's current commercial paper rate,[18] which translates to approximately $1.2 million in additional annual debt expense for every $100 million borrowed directly from the revolver, given the

[16] Direct Testimony of Todd A. Shipman at 18 n.11.

[17] Attachment PLM-RR-3 at 4-5.

[18] SPS's 30-day commercial paper rate as of December 31, 2020 was approximately 0.32% vs. the drawn revolver pricing of 3-month LIBOR plus 1.25% (0.24% + 1.25% = 1.49%).

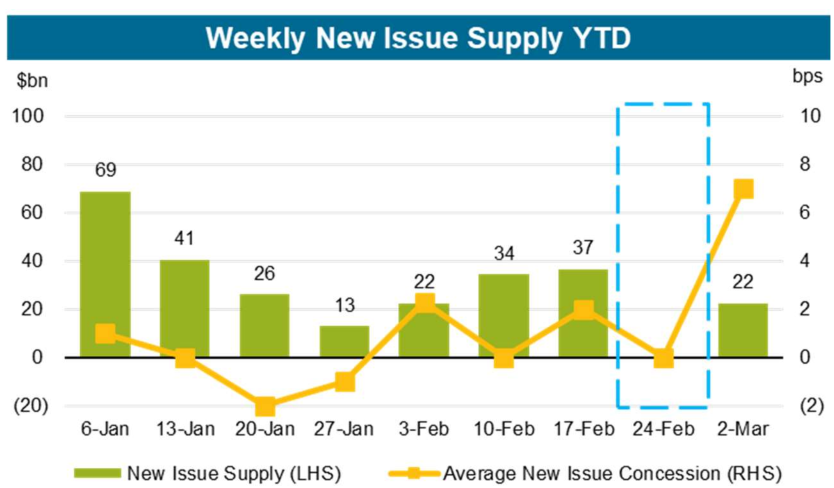
current rate environment. Credit enhancement products that SPS uses in the normal course of business, such as letters of credit, similarly become more expensive as the credit rating deteriorates.

During the Financial Crisis in 2007/2008, even though SPS had a A2/P2 commercial paper rating, SPS was forced to borrow against its credit facility rather than issue commercial paper due to extreme market volatility. SPS borrowed $125 million against its [then] $250 million credit facility at a cost of approximately 6%. The only companies that retained reasonably priced access to short-term commercial paper markets during October 2007 were companies with short-term ratings of A1/P1.

Q. Can you provide a recent example of volatility that impacted the capital markets?

A. Yes. Most recently, the COVID-19 pandemic introduced volatility into the market and made it challenging for companies to access capital, regardless of credit rating. Due to this market volatility, the investment grade markets were inaccessible the week of February 24, 2020, with no issuances coming to market as shown in Chart PLM-RR-3 below.

Chart PLM-RR-3: Weekly New Issue Supply YTD March 2, 2020



Investment Grade Issuers were not willing to issue given market volatility and pricing risk. The following week, while some issuers were able to access the markets and issue $22 billion of debt, the cost to issue that debt was elevated. This illustrates the importance of maintaining financial integrity in order to manage through all market conditions and that companies with higher credit ratings will have more financial flexibility to fund operations at lower costs.

D. Maintaining and Strengthening SPS's Financial Integrity

Q. Have you assessed SPS's financial metrics at the requested capital structure to determine if these metrics are sufficient to maintain the current credit ratings?

A. Yes. With a 54.60% regulated equity ratio, the FFO/Debt ratios continue to support the A- rating under S&P's methodology. The Debt/EBITDA ratios, however, increase as shown on Table PLM-RR-4 and are outside of the range for A- rating, reflecting continued pressure on the current credit ratings.

Table PLM-RR-4:

S&P Metrics at 54.60% Authorized Equity Ratio

A Corp. Rating Medial Volatility	S&P Guidelines	Actual 2018	Actual 2019	Forecast 2020	Forecast 2021	Forecast 2022
FFO/Debt*	no less than **15%**	18.3%	18.4%	***17.4%***	***17.6%***	***18.0%***
Debt/ EBITDA**	no more than **3.5-4.5**	4.4x	4.6x	***4.7x***	***4.8x***	***4.8x***
FFO/Interest * **	no less than **3.0-5.0**	5.4x	5.5x	***5.3x***	***5.3x***	***5.5x***
EBITDA/Interest ****	no less than **2.75-5.0**	5.4x	5.4x	***5.2x***	***5.1x***	***5.2x***

* Funds from Operations/Total Debt including adjustments
** Debt including adjustments/Earnings before interest taxes depreciation and amortization
*** Funds from Operations/total interest expense
**** Earnings before interest, depreciation and amortization/total interest expense

Q. What are the projected metrics under Moody's methodology?

A. Financial metrics account for 40% of Moody's methodology grid, with the CFO/Debt ratio being the most important financial measure. Assuming a 54.60% regulated equity ratio, the resulting credit metrics put SPS solidly on target to maintain its current Baa2 rating and supports progress toward regaining a higher credit rating. However, as Mr. Shipman discusses, regaining the former Baa1 rating will require sustained improvement in the metrics beyond what is achievable through this case.

Table PLM-RR-5:
Moody's Debt Metrics at 54.60% Authorized Equity Ratio

Guidelines for Baa2 Corp. Rating	Moody's Guidelines	Moody's 2018	Actual 2019	Forecast 2020	Forecast 2021	Forecast 2022
CFO pre-WC /Debt*	**no less than 15%**	18.6%	18.1%	***18.2%***	***18.1%***	***18.5%***
CFO pre w/c /Interest**	**no less than 3.0-4.5**	5.8x	5.4x	***5.7x***	***5.6x***	***5.8x***
CFO pre w/c-Div/Debt***	**no less than 9 – 17%**	13.0%	5.1%	***11.6%***	***11.4%***	***12.0%***

* Cash from Operations before working capital/Debt. SPS threshold for downgrade is 15% per Moody's report

** Cash from Operations before working capital plus interest/Interest

*** Cash from Operations before working capital-Dividends/Debt

Q. Does SPS face business and financial risk that could negatively impact its current credit ratings and outlooks?

A. Yes. In addition to the risks described above, as well as the customer concentration and size risks, described by Mr. D'Ascendis, SPS faces business and financial risks that could jeopardize its current credit ratings and outlooks. For example, SPS will be making substantial capital investments over the next few years. In order to support these investments, SPS must meet the needs of its various stakeholders, including customers, bondholders and shareholders in order to ensure continued access to capital markets on reasonable terms.

Second, SPS has a number of off-balance sheet obligations such as purchased power agreements, operating leases, guarantees, asset retirement obligations, underfunded pension or other benefit plans, and other. After those off-balance sheet obligations are taken into account, the actual *economic* equity ratio considered by the rating agencies is far lower than the authorized regulated equity ratio.

Q. What is an economic capital structure and how does it impact credit metrics?

A. As Mr. Shipman discusses in his direct testimony, the credit rating agencies make certain adjustments for off-balance sheet items and impute these adjustments as additional debt when calculating credit metrics. Examples of these adjustments are discussed above. The "economic" capital structure includes these items in the debt-equity ratio calculation.

SPS has a number of off-balance sheet obligations that the rating agencies include in their analysis of credit metrics. During 2019, S&P identified $358.5 million of debt adjustments for off-balance sheet items for SPS, of which approximately 75% were for purchased power agreements and operating leases. After those off-balance sheet obligations are taken into account, the actual economic equity ratio considered by the rating agencies is far lower than the regulated equity ratio. For example, a regulated equity ratio of 54.60% translates to an economic equity ratio of 51.27% under S&P's methodology.[19] The regulated equity ratio thus understates true leverage because it excludes off balance sheet items as well as short-term debt.

Q. Why is it important for the Commission to consider the effect of agency considerations regarding SPS's economic capital structure in its decision in this case?

A. Because the rating agencies impute debt to SPS's balance sheet for the items mentioned above as well as short-term debt, the economic equity ratio is lower than the Commission's authorized regulated equity ratio, which does not include these items. The Commission should set an authorized equity ratio that will be sufficient to maintain credit ratings even after the rating agency adjustments have been made.

Q. What credit rating should the Commission target for SPS?

As Mr. Shipman's testimony explains, the Commission should target an 'A' rating for SPS. This is consistent with the analysis provided by Dr. Roger Morin, a noted expert on regulatory finance, regarding the optimal capital structure for utilities set forth in his book *New Regulatory Finance.* Based on that analysis, Dr. Morin concludes that an A rated utility is in the best interest of the customers and utilities:

> The message from the model is clear: over the long run, a strong A bond rating will minimize the pre-tax cost of capital to ratepayers. Long term achievement of at least an A rating is in the electric utility company's and ratepayers' best interests.
>
> . . . .
>
> The model results show that on an incremental cost basis, a strong A bond rating generally results in the lowest pre-tax cost of capital for electric utilities, especially under adverse economic conditions, which are far more relevant to the question of capital structure.[20]

---

[19] The credit metrics shown earlier in this direct testimony include the off-balance sheet items as identified by the rating agencies.

[20] Roger A. Morin, *New Regulatory Finance* at 515 (2006).

III. CAPITAL STRUCTURE

Q. What is SPS's recommended capital structure?

A. SPS recommends a capital structure consisting of 54.60% equity and 45.40% long-term debt.

Q. Does this capital structure reflect SPS's actual financing practices?

A. Yes. The capital structure on September 30, 2020 was 54.60% equity and 45.40% debt and is forecasted to be the same on December 31, 2020.

Q. Is it important that the Commission adopt a capital structure that reflects SPS's actual financing practices?

A. Yes. As noted earlier, it is important that the Commission adopt a capital structure that reflects SPS's actual financing practices. As Mr. D'Ascendis explains, the imposition of a hypothetical capital structure that understates SPS's actual capital structure will weaken the financial condition of its operations and adversely impact the Company's ability to address expenses and investments, to the detriment of customers and shareholders. This results from the fact that as more debt is introduced into the capital structure, the company becomes more financially risky, which in turn increases the equity returns demanded by investors.[21] Thus, an attempt to reduce the overall cost of capital by increasing the amount of debt in the capital structure can actually produce the opposite of the intended effect.

Q. Have you assessed the reasonableness of the requested equity ratio?

A. Yes. For the reasons explained in my testimony and in the Direct Testimony of Mr. D'Ascendis, SPS's requested 54.60% equity ratio will reasonably support the

[21] Roger A. Morin, *New Regulatory Finance* at 25 (2006).

Company's current credit rating and will provide flexibility in financing its operations and capital expenditures across all economic conditions.

IV. COST OF LONG-TERM DEBT

Q. What was SPS's embedded cost of long-term debt as of September 30, 2020?

A. SPS's embedded cost of long-term debt as of September 30, 2020 was 4.20%. The detailed calculation is shown in Schedule K-3 and is consistent with the method this Commission has approved in the past. The cost of debt is based on a yield-to-maturity calculation where the debt expenses include interest as well as fees associated with issuing the bond, such as legal, underwriting, rating agency, and other costs. These annualized costs are divided by the adjusted long-term debt balance to derive an overall cost of debt for SPS.

Q. Is SPS's embedded cost of long-term debt consistent with the Update Period?

A. Yes. During the three-month period between the Test Year and the Update Period, SPS did not forecast to issue any additional long-term debt, nor had any debt set to mature. As such, the forecasted cost of long-term debt has not materially changed.

V. COST OF CAPITAL

Q. What is SPS's requested WACC?

A. Based on SPS's capital structure, cost of debt, and requested ROE of 10.35%,[22] SPS's WACC is 7.56%, as reflected in Table PLM-RR-6. The detailed schedules supporting these amounts are included in Schedule K-1.

Table PLM-RR-6: SPS's Test Year WACC

		September 30, 2020	
	Ratio	**Rate**	**Wtd Cost**
Long-Term Debt	45.40%	4.20%	1.91%
Equity	54.60%	10.35%	5.65%
Total Cost			**7.56%**

Q. Does this conclude your direct testimony?

A. Yes, it does.

[22] See the Direct Testimony of Dylan D'Ascendis at 71.

AFFIDAVIT

STATE OF MINNESOTA)
)
COUNTY OF HENNEPIN)

PATRICIA L. MARTIN, first being sworn on her oath, states:

I am the witness identified in the preceding testimony. I have read the testimony and the accompanying attachment(s) and am familiar with the contents. Based upon my personal knowledge, the facts stated in the testimony are true. In addition, in my judgment and based upon my professional experience, the opinions and conclusions stated in the testimony are true, valid, and accurate.

Patricia L. Martin

PATRICIA L. MARTIN

Subscribed and sworn to before me this 28th day of January, 2021 by PATRICIA L. MARTIN.

JODY FOSTER
NOTARY PUBLIC - MINNESOTA
My Commission Expires
January 31, 2024

Notary Public, State of Minnesota

My Commission Expires: 1/31/24

MOODY'S
INVESTORS SERVICE

Rating Action: Moody's changes Xcel Energy's outlook to negative; downgrades Southwestern Public Service ratings to Baa2 with stable outlook

19 Oct 2018

Approximately $19 billion of debt securities affected

New York, October 19, 2018 -- Moody's Investors Service ("Moody's") changed the rating outlook of Xcel Energy Inc. (Xcel) to negative from stable and affirmed the A3 senior unsecured and Prime-2 short-term rating for commercial paper ratings.

At the same time, Moody's downgraded the long-term ratings of Southwestern Public Service Company (SPS) including the Issuer rating to Baa2 from Baa1 and affirmed SPS' P-2 short-term rating. The outlook for SPS was changed to stable from negative.

Moody's also affirmed the ratings and outlooks of the Xcel other rated subsidiaries: Northern States Power Company (Minnesota) (NSP-Minnesota, A2 stable), Public Service Company of Colorado (PSCO, A3 stable), and Northern States Power Company (Wisconsin) (NSP-Wisconsin, A2 stable).

RATINGS RATIONALE

"Xcel Energy's financial ratios will be lower for longer due to the cash flow leakage associated with tax reform and an elevated investment program primarily funded with debt" said Natividad Martel, Vice President - Senior Analyst. "The negative outlook reflects consolidated cash flow to debt ratios falling to the 16%-17% range over the next few years, down from around 20% over the last several years."

Xcel's A3 rating factors the group's fully regulated operations and its geographic and operational diversity benefits, as well as our view that the eight regulatory jurisdictions in which its four utility subsidiaries operate are overall credit supportive. The rating considers Xcel's improving carbon transition risk exposure, with an accelerating "steel for fuel" program where the company is replacing fossil-fired generation with renewable generation. The rating also factors in the $300 million equity issuance initiated September 2018 and the structurally subordinated position of the parent level debt vis-à-vis the debt outstanding at its utility subsidiaries, with holding company debt relative to total consolidated debt expected to remain below 25% (currently around 22%).

Southwestern Public Service Company (SPS)

The downgrade of SPS' ratings reflects a weakening in the utility's credit metrics, such that its ratio of CFO pre-W/C to debt is anticipated to drop to nearly 16% by next year, a material deterioration compared to the 22% ratio that SPS generated for the last twelve month period ended 30 June 2018. SPS' Baa2 rating and stable outlook incorporate the expectation that its CFO pre-W/C to debt ratio will remain in the 16%-17% range over the foreseeable future. The Baa2 rating considers our mixed view of the credit supportiveness of the regulatory environments under which SPS operates. Moody's sees more constructive recovery mechanisms available in Texas than in New Mexico, illustrated by the different regulators' responses to the utility's initiatives to offset the impact of the implementation of the TCJA. In Texas, the regulators approved the multi-party settlement that included authorization to earn a 9.5% rate on equity (ROE) on SPS' actual capital structure, which the utility anticipates will include an above average 57% equity layer. In contrast, the New Mexico Regulatory Commission approved, in September 2018, an increase in SPS' base rates ($8 million) based on a 51% equity ratio, a significant difference compared to SPS' requested 58% equity ratio. This request was updated post-tax reform, and could be indicating a less constructive relationship between the utility and the NMPRC. The combination of the utilities' investment program along with the exposure of its cash flows to regulatory lag, particularly due to the absence of any transmission and distribution riders in New Mexico, contribute to the extended deterioration in the utility's financial profile.

NSP-Minnesota, PSCO and NSP-Wisconsin

The affirmation of the ratings of NSP-Minnesota (A2, stable), NSP-Wisconsin (A2 stable) and PSCO (A3 stable) consider our view that all three utilities maintain a reasonably constructive relationship with their respective regulators. The rating affirmations incorporate the expectation that the outcomes of pending regulatory decisions, including the need to address tax reform cash flows, will be a net credit positive. In some states, these measures include the deferral of portions of the excess deferred tax liabilities (EDTL) to be refunded to end-users. In Colorado, PSCO was allowed to amortize prepaid pension assets as an offset of refunds in 2018 and 2019. PSCO has also requested an increase in its the equity ratio to 56% in the Colorado natural gas TCJA true-up proceeding with the decision expected later this year. The stable outlooks assume that these regulatory initiatives along with the reduction in the utilities' base case investments will help to partially mitigate the anticipated weakening in the credit metrics. Importantly, the stable outlooks also assume that each of these utilities will continue to generate CFO pre-W/C to debt in excess of 20%, on a sustained basis.

WHAT CAN CHANGE THE RATING - DOWN

Xcel's ratings could be downgraded if the consolidated ratio of CFO pre-W/C to debt remains below 18% for a sustained basis, or there is no transparent path to improve the ratio over the next few years. The ratings of NSP-Minnesota, NSP-Wisconsin, PSCO and SPS could be downgraded if we perceive a deterioration in the credit supportiveness of their regulatory environments, or if their credit metrics deteriorate more than currently anticipated. Specifically, downward pressure on the ratings of NSP-Minnesota and NSP-Wisconsin could result if their CFO pre-W/C to debt ratios fall to the low 20% range, for an extended period.

In the case of PSCO and SPS, producing CFO pre-W/C to debt below 20% and 16%, respectively, on a sustained basis, is also likely to result in a downgrade of their ratings.

WHAT CAN CHANGE THE RATING - UP

Given Xcel's negative outlook, there are limited prospects for a near term upgrade. However, the outlook could be stabilized if we see a clear path for Xcel to record again CFO pre-W/C to debt in excess of 18%, on a sustained basis.

Positive momentum on the ratings of NSP-Minnesota, NSP-Wisconsin, PSCO and SPS is also unlikely given our expectation that their weakening credit metrics will result in their credit profiles to be commensurate with their current ratings. Longer term, the utilities' ratings could experience positive momentum if higher than anticipated regulatory relief and/or cost savings allow them to record CFO pre-W/C to debt in the high 20% in the case of NSP-Minnesota and NSP-Wisconsin, 25% in the case of PSCO, and 18% in the case of SPS.

Downgrades:

..Issuer: Southwestern Public Service Company

.... Issuer Rating, Downgraded to Baa2 from Baa1

....Senior Secured Shelf, Downgraded to (P)A3 from (P)A2

....Senior Unsecured Shelf, Downgraded to (P)Baa2 from (P)Baa1

....Senior Secured First Mortgage Bonds, Downgraded to A3 from A2

....Senior Unsecured Bank Credit Facility, Downgraded to Baa2 from Baa1

....Senior Unsecured Regular Bond/Debenture, Downgraded to Baa2 from Baa1

Outlook Actions:

..Issuer: Northern States Power Company (Minnesota)

....Outlook, Remains Stable

..Issuer: Northern States Power Company (Wisconsin)

....Outlook, Remains Stable

..Issuer: Public Service Company of Colorado

....Outlook, Remains Stable

..Issuer: Southwestern Public Service Company

....Outlook, Changed To Stable From Negative

..Issuer: Xcel Energy Inc.

....Outlook, Changed To Negative From Stable

Affirmations:

..Issuer: La Crosse (City of) WI

....Senior Unsecured Revenue Bonds, Affirmed A2

..Issuer: Northern States Power Company (Minnesota)

.... Issuer Rating, Affirmed A2

....Senior Unsecured Shelf, Affirmed (P)A2

....Senior Secured Shelf, Affirmed (P)Aa3

....Senior Secured First Mortgage Bonds, Affirmed Aa3

....Underlying Senior Secured First Mortgage Bonds, Affirmed Aa3

....Senior Unsecured Bank Credit Facility, Affirmed A2

....Senior Unsecured Commercial Paper, Affirmed P-1

..Issuer: Northern States Power Company (Wisconsin)

....Senior Unsecured Shelf, Affirmed (P)A2

....Senior Secured Shelf, Affirmed (P)Aa3

....Senior Secured First Mortgage Bonds, Affirmed Aa3

....Senior Unsecured Bank Credit Facility, Affirmed A2

....Senior Unsecured Commercial Paper, Affirmed P-1

..Issuer: Public Service Company of Colorado

.... Commercial Paper, Affirmed P-2

.... Issuer Rating, Affirmed A3

....Senior Secured Shelf, Affirmed (P)A1

....Senior Unsecured Shelf, Affirmed (P)A3

....Senior Secured First Mortgage Bonds, Affirmed A1

....Senior Unsecured Bank Credit Facility, Affirmed A3

..Issuer: Pueblo (County of) CO

....Senior Unsecured Revenue Bonds, Affirmed A3

....Underlying Senior Unsecured Revenue Bonds, Affirmed A3

..Issuer: Southwestern Public Service Company

....Senior Unsecured Commercial Paper, Affirmed P-2

..Issuer: Xcel Energy Inc.

.... Issuer Rating, Affirmed A3

....Senior Unsecured Shelf, Affirmed (P)A3

....Subordinate Shelf, Affirmed (P)Baa1

....Preferred Shelf, Affirmed (P)Baa2

....Junior Subordinate Shelf, Affirmed (P)Baa1

....Senior Unsecured Bank Credit Facility, Affirmed A3

....Senior Unsecured Commercial Paper, Affirmed P-2

....Senior Unsecured Regular Bond/Debenture, Affirmed A3

The principal methodology used in these ratings was Regulated Electric and Gas Utilities published in June 2017. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

Xcel Energy Inc. (Xcel) is a holding company for vertically integrated utility subsidiaries, namely Northern States Power Company (Minnesota) (NSP-Minnesota, A2 stable), Public Service Company of Colorado (PSCo, A3 stable), Southwestern Public Service Company (SPS, Baa2 stable), and Northern States Power Company (Wisconsin) (NSP-Wisconsin, A2 stable). These subsidiaries serve 3.6 million electric and 2.0 million natural gas customers in eight states, but mostly in Minnesota, Colorado, New Mexico, Texas, and Wisconsin.

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MOODY'S
INVESTORS SERVICE

CREDIT OPINION
31 December 2020

Update

Rate this Research

RATINGS

Southwestern Public Service Company

Domicile	Amarillo, Texas, United States
Long Term Rating	Baa2
Type	LT Issuer Rating
Outlook	Stable

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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Southwestern Public Service Company

Update to credit analysis

Summary

Southwestern Public Service Company's (SPS) credit profile reflects its regulated vertically integrated electric utility operations. It also considers some limited geographic and regulatory diversity benefits as well as our mixed view of the credit supportiveness of the company's regulatory environments. SPS operates in Texas (around 54% of SPS' total 2019 rate base) and in New Mexico (28% of the total rate base). The Federal Energy Regulatory Commission (FERC) also oversees SPS' electric rates for wholesale production and transmission operations (in 2019: 18% of rate base). The credit quality also considers that SPS' regulatory bodies indirectly restrict its dividend distributions by requiring the utility to maintain an equity-to-total capitalization ratio (excluding short-term debt) ranging between 45-55% and an investment grade rating.

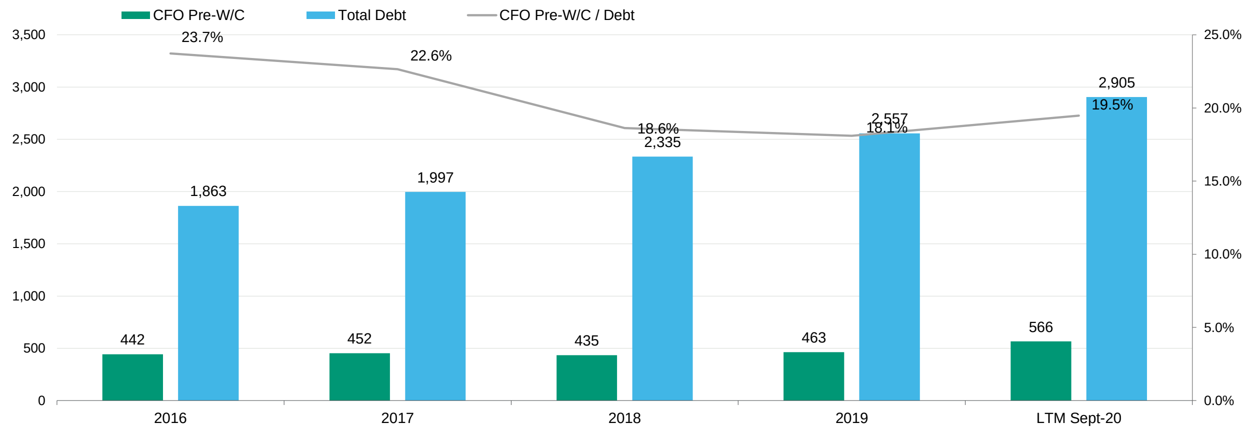
SPS' relatively modest size and its significant exposure to large industrial customers temper our view of the credit. SPS ranks as third largest subsidiary in the Xcel Energy Inc (Xcel, Baa1 stable) family in terms of rate base (2019 estimated: $4.9 billion) as well as contribution to consolidated earnings (10%-15%).

This year's credit metric improvement, despite a coronavirus driven power demand contraction, reflects the overall constructive outcome of SPS' 2019 electric rate cases (settled in 2020), some overcollection of fuel costs, and cost savings. Going forward, we assume that relatively credit supportive outcomes in SPS next rate cases in Texas and New Mexico (possibly filing during the 1Q2021) will allow the utility to maintain a ratio of cash flow from operations before changes in working capital (CFO pre-W/C) to debt ratio in the range of 17%-18%.

Recent Developments

Coronavirus - The rapid spread of the coronavirus outbreak, severe global economic shock, low oil prices, and asset price volatility are creating a severe and extensive credit shock across many sectors, regions and markets. The combined credit effects of these developments are unprecedented. We regard the coronavirus outbreak as a social risk under our ESG framework, given the substantial implications for public health and safety. However, we expect SPS to be relatively resilient to recessionary pressures because of its rate regulated business model and regulatory mechanisms.

Exhibit 1
Historical CFO Pre-W/C, Total Debt and CFO Pre-W/C to Debt
($ in millions



Source: Moody's Financial Metrics

Credit strengths

» Vertically integrated regulated utility with some geographic and regulatory diversity

» Dividend distributions are subject to the state commissions' indirectly imposed restrictions regarding capital structure

Credit challenges

» Generally, less predictable regulatory environments but outcomes of the 2019 electric rate cases were positive

» Significant exposure to large C&I industrial customers but their growing electricity demand helps SPS' cash flows

Rating outlook

SPS' stable outlook assumes that reasonable regulatory treatment in Texas and New Mexico (possible filings in 2021), along with the company's cost control efforts, will enable the utility to record a ratio of CFO pre-W/C to debt in the range of 17%-18%.

Factors that could lead to an upgrade

» The utility's rating could experience positive momentum if, through positive rate outcomes, cost control or deleveraging, we expect its ratio of CFO pre-W/C to debt to materially exceed 18%, on a sustained basis.

Factors that could lead to a downgrade

» A deterioration in regulatory relationships, or a weakening of SPS' financial profile that causes its ratio of CFO pre-W/C to debt to fall below 15% for an extended period, could put downward pressure on the rating.

Key indicators

Exhibit 2
Southwestern Public Service Company [1]

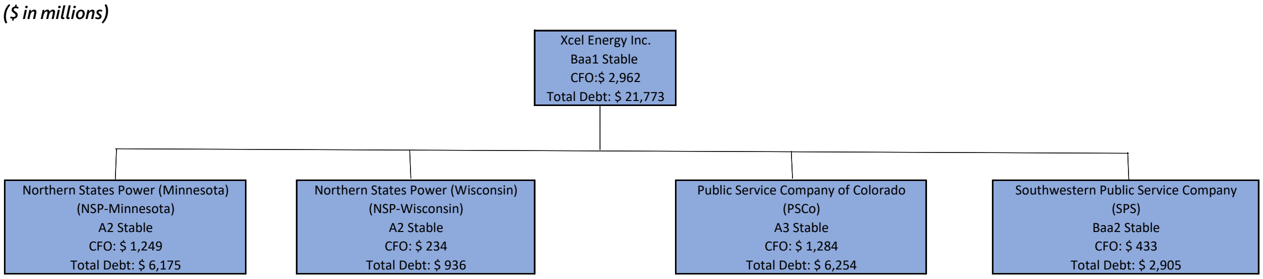
	Dec-16	Dec-17	Dec-18	Dec-19	LTM Sept-20
CFO Pre-W/C + Interest / Interest	5.7x	5.9x	5.8x	5.4x	5.9x
CFO Pre-W/C / Debt	23.7%	22.6%	18.6%	18.1%	19.5%
CFO Pre-W/C – Dividends / Debt	19.2%	17.2%	13.0%	5.1%	7.9%
Debt / Capitalization	39.1%	42.7%	42.8%	42.1%	42.2%

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.
Source: Moody's Financial Metrics

Profile

SPS is a vertically integrated electric utility with a customer base of about 396,000 retail customers in 93 communities. SPS' service territory (52,000-square-mile area) is located in eastern and southeastern New Mexico (around 30% of its retail customers and 14 communities) as well as in the panhandle and south plains regions of Texas (approximately 70% of the retail customers; 79 communities). The company also derives a significant amount of revenues from its wholesale business (2019: around 20% of its electric revenues). As depicted in Exhibit 3, SPS' parent company is Xcel Energy Inc. (Xcel, Baa1 stable), is a holding company with utility operations in eight states serving around 3.6 million electric and about 2 million natural gas customers. SPS (10%-15% of Xcel's consolidated earnings) is the third-largest of the four Xcel utility subsidiaries..

Exhibit 3
Xcel Energy Inc. Organizational Chart (LTM 3Q2020)
($ in millions)



Source: Xcel Energy Inc., Moody's Financial Metrics

Detailed credit considerations

Some geographic and regulatory diversity

SPS' credit quality reflects some diversification benefits from a geographic and regulatory perspective.

This considers SPS' exposure to FERC's oversight through its growing transmission rate base but also its declining wholesale rate base (2019: 20%; 2018: 25%). The latter results from the expiration of SPS' supply agreement with the Golden Spread Electric Cooperating. An additional decline is likely by mid-2021 following Lubbock Power & Light's (LP&L) planned transfer of 430 MW (out of its 600MW peak-load) to the Electric Reliability Council of Texas (ERCOT). We understand that the impact of these changes in wholesale customer load on SPS' cash flows are muted because the PUCT authorized SPS to allocate recovery of a large portion of SPS' costs associated with the cooperative's lost demand to its Texas retail jurisdictional load. In March 2018, the PUCT also approved a $24 million exit fee (Interconnection Switching Fee) agreed between SPS, LP&L and the PUCT staff to reduce the financial burden that the LP&L's loss (7% of SPS' load) would otherwise cause on SPS' remaining retail and wholesale transmission customers in Texas and New Mexico. However, LP&L has initiated discussions regarding the interpretation of the early termination fee in conjunction with the potential termination of its remaining 170 MW 25-year requirements contract. Resolution of the treatment of the remaining contract could be brought for arbitration creating some uncertainty.

Our view of SPS' credit quality also recognizes that SPS' operations in Texas benefit from more riders and surcharges compared to New Mexico (see Exhibit 3). These mechanisms that in Texas include transmission and distribution riders help to reduce regulatory lag in-between rate cases, particularly as base rates are established using historical test years. Our analysis also factors in our opinion that the utility's relationship with the NMPRC has demonstrated more signs of inconsistency and unpredictability as evidenced by the utility's track-record of appealing regulatory decisions in New Mexico.

Exhibit 4
Summary of key regulatory mechanisms available in SPS's state jurisdictions

	Forward Test Year	Interim Rates	Fuel Recovery Mechanism	Renewable Rider	Transmission Rider	Distribution Recovery Mechanism	Generation Rider	Pension Deferral Mechanism
SPS	√ NM Allowed	*	√	√ NM	√ TX	√NM & TX	√ TX	√

*Wind settlement in Texas reduced regulatory lag for wind projects
Source: Xcel Energy Inc.

That said, we acknowledge the overall credit supportive outcomes of SPS' last rate cases (filed in 2019) in both Texas and New Mexico. During 2020, the PUCT (August) and the NMPRC (May) approved the multi-party settlement agreements that the utility entered into in each jurisdiction. We calculate that the authorized base rate increase of $88 million in Texas and $31 million in New Mexico equaled over 65% of the utility's final requested step-up in rates as revised in September 2019 (Texas) and December 2019 (New Mexico), a credit positive. We also view the length of the regulatory proceedings positively. The NMPRC's authorization of the terms of the settlement agreement in May 2020 was less than one year from the utility's initial filing in July 2019. The PUCT approved a settlement agreement in August 2020, one year after the utility's initial filing. Although the Texas approval took slightly longer, in Texas, the utility was allowed to apply the new base rates retroactively to September 2019, and to make subsequent filings (4Q2020) to incorporate under-recovered revenues (estimated of around $70 million) since that date. However, the increase included amounts previously reflected in its transmission rider such that its Transmission Cost Recovery Factor, that allows for the recovery of transmission infrastructure improvement costs and changes in wholesale transmission charges, was reset to zero. SPS' separate request, also authorized in August 2020, to refund around $39 million in over-collected fuel and purchased power costs will further mitigate the impact of the rate increase on customer bills. This adjustment applies when the utility's annual fuel costs exceeds a +/-4%-threshold.

Importantly, the approved base rates in both jurisdictions incorporate accelerated depreciation associated with the early retirement of the Tolk coal-fired facility in 2037. In New Mexico, parties to the case also agreed not to oppose SPS' request, expected in its next base rate case, to further increase the depreciation rates associated with an even earlier retirement date of the pant in 2032. Base rates in Texas also incorporate the depreciation of the 478 MW Hale wind-farm (located in Texas) based on a useful life of 25 years.

In New Mexico, the terms of the settlement were premised on an authorized equity layer of 54.77%, the same ratio requested by SPS, a credit positive, and an allowed Return on Equity (RoE) of 9.45%. The latter ratio was lower than SPS' sought 10.1% RoE (as per revised filings), which contributed to the difference between the utility's requested and settled rate relief and is in line with recent regulatory decisions in other jurisdictions. In Texas, the underlying parameters remain undisclosed (blackbox) but we acknowledge the utility's ability to earn a RoE 9.45% on the allowance for funds used during construction (AFUDC) with a equity layer of 54.62%.

The utility has publicly disclosed its intention to file rate cases in Texas and New Mexico during the first quarter of 2021. The filings would be in accordance with 2018 multi-party settlement agreements pertaining to the Hale (competed in 2019) and Sagamore (completed in December 2020) wind projects. In New Mexico, SPS will seek authority to add the latter to its allowed rate base in New Mexico (see ESG section). The outcome of these rates cases will be another indication of both the utility's relationships with stakeholders, including the regulators, and the credit supportiveness of the regulatory environments.

Rate design and deferred accounting help to mitigate the impact of the coronavirus

Exhibit 5 illustrates last year's improvement in SPS' actual RoE in both New Mexico and Texas. The growing power demand in SPS' service territory, particularly during last year's severe summer given the absence of decoupling mechanisms, and Xcel's group-wide focus on managing the utilities' cost structure contributed to the gradual improvements.

Exhibit 5
Summary of key financial parameters including authorized and actual RoEs and applicable regulatory plans

		Authorized RoE	W/A Earned RoE (actual)			Regulatory Plan
			2017	2018	2019	
SPS	Electric - Tx	Blackbox	6.93%	7.98%	8.95%**	Rates effective/retroactive to Sept. 2019 (9.45% ROE for AFUDC)
	Electric - NM	9.56%	5.98%	8.45%	10.79%**	New rates implemented 2020 (9.45% ROE)
	Wholesale - SPS	***	***	***	***	

** Actual RoE, not weather-normalized
*** The transmission ROE = 10.50% and production formula ROE = 10.00%
Source: Xcel Energy Inc.

During the nine month period ended September 2020, SPS recorded a reduction in total retail sales of approximately 2% (weather-adjusted: around 3%). SPS' growing residential customer base (+0.5%) along with their higher customer usage during the pandemic explains the increase in the power demand of this customer class (actual:+5%; weather adjusted:+2%). However, the increase in the electric sales to the residential customers did not fully offset the contraction in the power demand of its commercial and industrial (C&I) customers in the aftermath of the economic disruptions caused by the coronavirus outbreak (actual:- 3.4%; weather-adjusted: around -4%). This highlights SPS' material C&I customer base, with oil and natural gas companies accounting for over 50% of SPS' total retail jurisdictional sales in New Mexico.

We acknowledge however, that the rate design of large C&I customers somewhat mitigates the impact of power demand volatility on SPS' cash flows. In New Mexico, SPS' revenues from large C&I users are based on the greater of actual monthly demand (kilowatts) or 60% of peak monthly fixed demand during the prior twelve months with the applicable threshold increasing to 70% in Texas. As a point of reference, we note that in 2019, the power supplied to C&I customers represented 54% of SPS' volumes sold but this customer class represented only 46% of its total revenues.

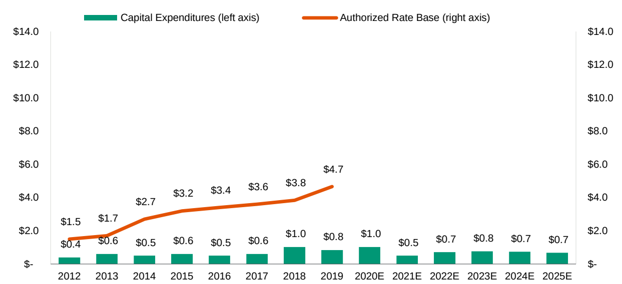
Earlier this year, the PUCT and the NMRC authorized the utilities to utilize deferral accounting treatment for incremental costs related to the coronavirus pandemic, including bad debt expenses. Recovery of the related regulatory assets and liabilities can be sought in future regulatory proceedings. However, we don't anticipate a meaningful impact on SPS' cash flows from an increase in these costs, particularly the bad debt expenses. As of September 2020, SPS reported allowance for doubtful accounts (AFDA) of $7.1 million compared to $5.3 million at year-end 2019. This increase is in line with Xcel's management expectations that the group's consolidated bad debt expenses (2019: about $55 million) will rise by around $25 million during 2020 which is an increase of around 50%. For SPS, a similar increase would result in a step-up of its reported allowance for doubtful accounts (AFDA) to around $8million. However, similar to other US utilities, SPS' base rates include recovery of historical write-offs, that is the annual amounts which were deemed ultimately uncollectible. This amount reduces the cash impact of its bad debt expense. As a point of reference, the utility's write-offs averaged around $5 million (or equal to around 1% of its funds from operations) during the 2015-2019 period. Utilities in New Mexico are currently subject to the annual winter moratorium of shutting off residential customer service for non-payment (until March 15) which does not apply in Texas where this year's disconnection bans put in place at the onset of the pandemic expire in September.

Credit metrics are expected to support credit quality

Operational and maintenance cost savings of nearly $10 million (or 4.5% year-to-date) along with the implementation of the aforementioned new rates have contributed to the improvement in SPS' financial metrics for the last twelve month period (LTM) ended September 2020. Despite this year's power demand contraction, SPS reported a ratio of CFO pre-W/C to debt of 19.5% for the LTM period ended September 2020 compared to 18.1% at year-end 2020.

SPS' robust equity ratios of around 54% (on a GAAP basis) as of end September 2020 and year-end 2019 also helped to mitigate the impact of SPS' material investments. According to Xcel's November 2020 investment program, SPS plans to invest total of $3.4 billion over the 2021-2025 period. Investments in SPS' transmission (nearly 50%) and distribution (approximately 30%) account for the majority of its planned capex. SPS has not earmarked any investments in renewable projects following the completion of the aforementioned Hale (2019) and Sagamore (2020) wind-farms. In absolute terms, the utility's capex program is comparable to the around $3.5 billion invested during the 2015-2019 period. However, we note some moderation in investments in relative terms as we calculate that on average, SPS' annual capital outlays will represent around 2.0x the utility's depreciation expense during the 2021-2025 period. As a point of reference, the ratio averaged 3.7x during the 2015-2019 period and spiked to around 4.0x for the LTM period ended September 2020 and year-end 2019 as SPS was completing the Hale and Sagamore wind-farms. We anticipate that this relative moderation in SPS' investment will help the utility to report a ratio of CFO pre-W/C to debt in the 17%-18% range over the next three years. That said, this will also depend on the outcome of future regulatory proceedings, particularly in New Mexico where SPs benefits from a lesser number of riders and surcharges than in Texas.

Exhibit 6
SPS' rate base and 2012-2025 historical and projected capital expenditure plan
($ in billions)



Source: Xcel Energy Inc.

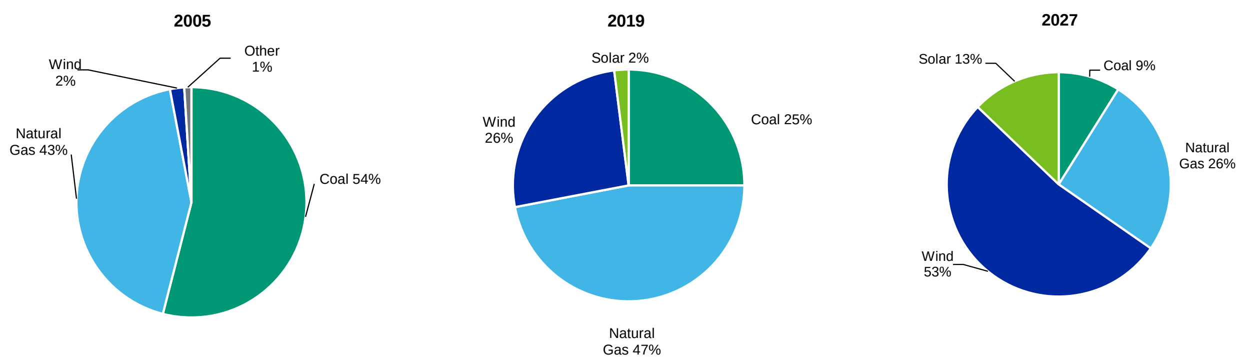
ESG considerations

Environmental considerations incorporated into our analysis of SPS are primarily related to carbon dioxide regulations. SPS' parent Xcel is strongly positioned for carbon transition in the regulated utility sector with strategies and plans in place that substantially mitigate its carbon transition exposure. Environmental considerations incorporated into our credit analysis of SOS factor in SPS's parent Xcel's goal of producing 100% carbon free energy by 2050.

In October 2020, the Texas Commission on Environmental Quality approved the Harrington Station Power Plant agreement to convert the coal-fired facility (1,018 MW) to a natural gas plant by Jan. 1, 2025. This conversion is necessary to attain Federal Clean Air Act standards for emissions of sulfur dioxide. This conversion explains the reduction in the contribution of coal-fired facilities to the utilities' energy-mix (2027: 9%). As per the current plan, the aforementioned Tolk plant will be its only operational coal-fired facility after 2025. The aforementioned early retirement in 2037 (possibly in 2032) will further help the group to meet its environmental goals. In its last rate case proceedings the utility sought to limit this plant's steam turbine generation (largely to peak summer months) to reduce the risks associated with the growing depletion of recoverable ground water to cool the Tolk facility steam cycles. The two plants' (Harrington and Tolk) location in Texas limits the possibility that SPS could benefit from the securitization provision embedded in the New Mexico Energy Transition Act (ETA). However, should the ETA remain in place (it is facing some regulatory challenges) it could foster additional changes to SPS' energy mix.

The majority of SPS' remaining fleet consists of natural gas facilities (total installed capacity at year-end 2019: nearly 2.3 GW), 1,000 MW wind assets (at the Hale and Sagamore projects) which drive SPS' intention to file an electric rate cases in 2021.

Exhibit 7
2005-2027 planned development of SPS' energy mix



Source: Xcel Energy Inc.Source: Moody's Financial Metrics

The Hale and Sagamore assets, and SPS' authority (as per a 2018 settlement agreement) to enter into a 230 MW wind Power Purchase Agreement (PPA), explain the growing contribution of wind resources to SPS' energy-mix. The combination of Production Tax Credits (PTC), which will flow through to customers under the fuel-clause after SPS' next rate cases, and the fuel-costs savings, allow the utility to limit the impact of its investments on the end-users' bills..

Under the terms of a 2018 settlement agreement, SPS will compensate its customers in New Mexico and Texas, through bill credits, should the wind-projects projects not record a net capacity factor of at least 48%. However, we acknowledge that this expected elevated net capacity factor is based on a probability of 90%-95%. In New Mexico, SPS agreed to operate the two wind-farms (Hale and Sagamore) on a merchant basis between their in-service dates, and the date of its next rate case outcomes. On a positive note, SPS was allowed also to keep the Production Tax Credits (PTCs) benefits and the margin from the two projects until the assets are added to its rate base. The PTC benefits enhance SPS' cash flow visibility and reduce the regulatory lag associated with the recovery of these material investments.

In its 2018 IRP, SPS estimated that it will be long on power by 2028 (excess: 383 MW) versus a reported capacity deficit (nearly 3 GW) in 2018. In July 2021, SPS will file its next integrated resource plan (IRP) in New Mexico (where it is required to file every three years), a key consideration in SPS' future investment plans and carbon transition risk.

Social risks are primarily related to demographic and societal trends as well as customer and regulatory relations. Corporate governance considerations include financial policy and we note that a strong financial position is an important characteristic for managing environmental and social risks amid the utility's elevated capital expenditure program. We also note that pursuant to SPS' 2020 settlement agreement in Texas, the utility is now subject to the ring-fencing requirements that are similar to other recent PUCT settlements, including maintain stand-alone credit facility and restrictions on pledging of assets and securing debt.

Liquidity analysis

Given its large capital program, SPS is reliant on external sources, including equity contribution from its parent, to maintain its liquidity profile. Similar to its sister companies, SPS has a separate $500 million credit facility that is scheduled to expire in June 2024 which back-stops a same sized commercial paper program. The credit facility provides for same day funding and SPS is not required to represent the lack of a material adverse change for future borrowings. We anticipate that the utility will remain comfortably in compliance with the one financial covenant embedded in the facility, namely a total debt to capitalization ratio below 65%. As of September 2020, we estimate the ratio to be approximately 46% (2019: 46%).

In addition to its own credit facility, SPS also participates in a regulated money pool with its sister companies (since October 2020, including NSP-Wisconsin) in which it has a $100 million borrowing limit. This money pool allows for short-term loans among those utility subsidiaries, and allows for short-term loans from Xcel to the utilities. However, it does not allow loans from the utilities to Xcel. As of September 30, 2020, SPS had $90 million availability under the money pool.

The utility's nearest debt maturities include $350 million in two series of first mortgage bonds (FMB) becoming due in June 2024. SPS issued $350 million first mortgage bonds in 2020 following the 30-year $300 million first mortgage green bonds issued in June 2019. These funds along with the utility's internally generated cash flows (LTM September 2020: $433 million) and short-term borrowings will help fund a material portion of its capital requirements next year. These requirements include planned investments of around $505 million. We also anticipate that Xcel will continue to manage its equity contributions to the utility (LTM September 2020: $461 million; 2019: $426 million) and SPS' dividend policy (LTM September 2020: $335 million; 2019: $333 million) so as to maintain its authorized regulatory capital structure in New Mexico and Texas. As mentioned earlier, SPS' ability to distribute dividends is subject to recording a regulatory equity-to-total capitalization ratio that ranges between 45%-55%.

Rating methodology and scorecard factors

Moody's evaluates SPS' financial performance relative to the standard business risk grid under the Regulated Electric and Gas Utilities rating methodology published in June 2017. As depicted in the grid below, the company's scorecard indicated outcome based on projected average key credit metrics is Baa1, one notch above its assigned Baa2 senior unsecured rating.

Exhibit 8
Southwestern Public Service Company

Regulated Electric and Gas Utilities Industry [1][2]	Current LTM 9/30/2020		Moody's 12-18 Month Forward View As of Date Published [3]	
Factor 1 : Regulatory Framework (25%)	**Measure**	**Score**	**Measure**	**Score**
a) Legislative and Judicial Underpinnings of the Regulatory Framework	A	A	A	A
b) Consistency and Predictability of Regulation	Baa	Baa	Baa	Baa
Factor 2 : Ability to Recover Costs and Earn Returns (25%)				
a) Timeliness of Recovery of Operating and Capital Costs	A	A	A	A
b) Sufficiency of Rates and Returns	Baa	Baa	Baa	Baa
Factor 3 : Diversification (10%)				
a) Market Position	Ba	Ba	Ba	Ba
b) Generation and Fuel Diversity	Baa	Baa	Baa	Baa
Factor 4 : Financial Strength (40%)				
a) CFO pre-WC + Interest / Interest (3 Year Avg)	5.7x	A	5x - 6x	A
b) CFO pre-WC / Debt (3 Year Avg)	19.0%	Baa	17% - 19%	Baa
c) CFO pre-WC – Dividends / Debt (3 Year Avg)	9.1%	Baa	9% - 11%	Baa
d) Debt / Capitalization (3 Year Avg)	41.9%	A	40% - 42%	A
Rating:				
Scorecard-Indicated Outcome Before Notching Adjustment		Baa1		Baa1
HoldCo Structural Subordination Notching	0	0	0	0
a) Scorecard-Indicated Outcome		Baa1		Baa1
b) Actual Rating Assigned		Baa2		Baa2

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.
[2] As of 9/30/2020(L)
[3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.
[4] Low Business risk grid for financial strength.
Source: Moody's Financial Metrics

Ratings

Exhibit 9

Category	Moody's Rating
SOUTHWESTERN PUBLIC SERVICE COMPANY	
Outlook	Stable
Issuer Rating	Baa2
First Mortgage Bonds	A3
Senior Secured Shelf	(P)A3
Sr Unsec Bank Credit Facility	Baa2
Senior Unsecured	Baa2
Commercial Paper	P-2
PARENT: XCEL ENERGY INC.	
Outlook	Stable
Issuer Rating	Baa1
Sr Unsec Bank Credit Facility	Baa1
Senior Unsecured	Baa1
Subordinate Shelf	(P)Baa2
Pref. Shelf	(P)Baa3
Commercial Paper	P-2

Source: Moody's Investors Service

Appendix

Exhibit 10

Peer Comparison [1]

	Southwestern Public Service Company Baa2 (Stable)			El Paso Electric Company Baa2 (Stable)			Public Service Company of New Mexico Baa2 (Stable)			Southwestern Electric Power Company Baa2 (Stable)		
(In US millions)	FYE Dec-18	FYE Dec-19	LTM Sept-20	FYE Dec-18	FYE Dec-19	LTM Sept-20	FYE Dec-18	FYE Dec-19	LTM Sept-20	FYE Dec-19	FYE Dec-19	LTM Sept-20
Revenue	1,933	1,826	1,862	904	862	912	1,092	1,094	1,129	1,822	1,751	1,727
EBITDA	546	611	660	328	395	398	428	477	493	547	530	578
Total Debt	2,335	2,557	2,905	1,531	1,604	1,580	1,935	2,008	2,051	2,935	2,987	3,067
CFO Pre-W/C / Debt	18.6%	18.1%	19.5%	17.6%	15.7%	14.5%	18.5%	17.6%	19.0%	14.3%	13.7%	13.0%
CFO Pre-W/C – Dividends / Debt	13.0%	5.1%	7.9%	13.9%	11.9%	11.0%	14.5%	17.5%	17.0%	11.9%	12.3%	12.9%
Debt / Capitalization	42.8%	42.1%	42.2%	50.8%	50.8%	48.0%	49.6%	49.6%	48.5%	47.9%	47.1%	46.4%
Debt / EBITDA	4.3x	4.2x	4.4x	4.7x	4.1x	4.0x	4.5x	4.2x	4.2x	5.4x	5.6x	5.3x
EBITDA / Interest Expense	6.0x	5.9x	5.7x	3.4x	4.0x	4.1x	4.6x	5.6x	6.1x	4.1x	4.3x	4.7x

[1] All figures & ratios calculated using Moody's estimates & standard adjustments. FYE = Financial Year-End. LTM = Last Twelve Months.
Source: Moody's Financial Metrics

Exhibit 11

Cash flow and credit metrics [1]

CF Metrics	Dec-16	Dec-17	Dec-18	Dec-19	LTM Sept-20
As Adjusted					
EBITDA	**492**	**513**	**546**	**611**	**660**
FFO	**434**	**456**	**435**	**496**	**581**
- Div	85	109	131	333	335
RCF	**349**	**347**	**304**	**163**	**245**
FFO	434	456	435	496	581
+/- ΔWC	-48	31	8	8	-133
WC	394	483	443	471	433
WC	442	452	435	463	566
+/- Other	8	-4	0	-33	-15
CFO	**394**	**483**	**443**	**471**	**433**
- Div	85	109	131	333	335
- Capex	501	549	1,017	833	1,046
FCF	**-192**	**-175**	**-706**	**-695**	**-948**
Debt / EBITDA	3.8x	3.9x	4.3x	4.2x	4.4x
EBITDA / Interest	5.3x	5.6x	6.0x	5.9x	5.7x
FFO / Debt	23.3%	22.8%	18.6%	19.4%	20.0%
RCF / Debt	18.7%	17.4%	13.0%	6.4%	8.4%
Revenue	1,851	1,918	1,933	1,826	1,862
Interest Expense	94	92	91	104	116
Net Income	150	156	176	249	271
Total Assets	5,434	5,947	6,744	7,839	8,636
Total Liabilities	3,520	3,841	4,239	4,995	5,382
Total Equity	1,914	2,107	2,505	2,843	3,255

[1] All figures & ratios calculated using Moody's estimates & standard adjustments. FYE = Financial Year-End. LTM = Last Twelve Months.
Source: Moody's Financial Metrics

REPORT NUMBER 1252797

MOODY'S INVESTORS SERVICE

S&P Global
Ratings

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Summary:
Southwestern Public Service Co.

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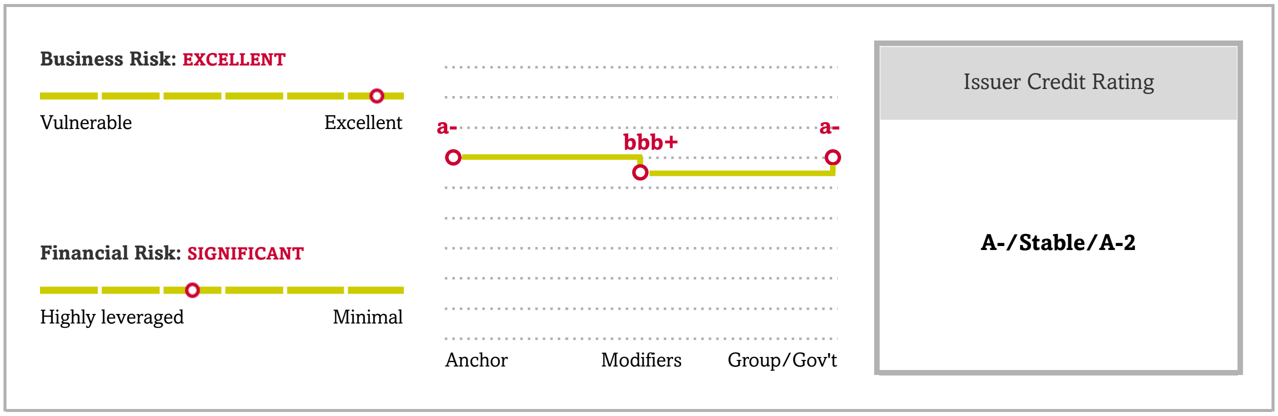
Table Of Contents

Summary:

Southwestern Public Service Co.



Rationale

Business Risk: Excellent	Financial Risk: Significant
• Low-risk, vertically integrated, fully rate-regulated electric utility; • Effective management of regulatory risk; • Relatively small, mostly residential customer base; and • Revenue concentration in Texas together with environmental risks associated with coal generation.	• Steady, regulated utility operating cash flow; • Financial measures consistent with the lower end of the range for its financial risk profile category; • Elevated capital spending; and • Negative discretionary cash flow, leading to external funding needs.

Outlook: Stable

The stable rating outlook on Southwestern Public Service Co. (SPS) reflects that of parent Xcel Energy Inc. Over the next two years, S&P Global Ratings' expects Xcel Energy's management to continue to reach constructive regulatory outcomes to avoid any significant rise in business risk for the regulated utilities. Specifically, our base case forecast includes adjusted funds from operations (FFO) to debt of about 16% and assumes the company will continue to fund its capital investments in a balanced manner to support its capital structure.

Downside scenario

We could lower the rating on Xcel Energy and its subsidiaries, including SPS, over the next 12 months if Xcel Energy's financial ratios weaken and consistently reflect adjusted FFO to debt at or below 15%. This would most likely occur if rate-case outcomes are weaker than expected and capital spending materially rises.

Upside scenario

We could raise the ratings over the next 12 months if Xcel Energy improves its collective ability to manage regulatory risk across its regulatory jurisdictions, resulting in a consistent improvement to its business risk. We could also raise the rating if the company's consolidated financial measures consistently exceed our baseline forecast, including adjusted FFO to debt of greater than 20%.

Our Base-Case Scenario

Assumptions

- Continued use of regulatory mechanisms
- Annual gross margin of about 45%
- Annual capital spending of about $1 billion through 2019
- Annual dividend payments averaging about $115 million
- Negative discretionary cash flow every year, indicating external funding needs
- All debt maturities refinanced

Key Metrics

	2017A	2018E	2019E
Adjusted FFO to debt (%)	22.1	15-17	13-15
Adjusted debt to EBITDA (x)	4.1	4.5-5.5	5.5-6.5
Adjusted FFO cash interest coverage (x)	7.3	4.7-6	4-5

A—Annual. E—Estimate. FFO-Funds from operations.

Company Description

SPS, a wholly owned subsidiary of Xcel Energy, operates as an electricity utility in Texas and New Mexico.

Business Risk: Excellent

SPS's stand-alone business risk profile incorporates its relatively low-risk rate-regulated electric utility serving about 390,000 mostly residential customers (about 80%) provide a level of revenue stability. The limited geographic and regulatory diversity and customer concentration mostly in Texas, marginally weaken SPS's business risk profile. Generation sources that about 40% coal-supplied, adds some environmental risk to the company.

Financial Risk: Significant

Our stand-alone financial risk profile for SPS incorporates a base-case scenario that includes adjusted FFO to debt averaging about 16%, below the midpoint of the benchmark range of the significant category. We expect the supplemental ratio of FFO cash interest coverage to be in the 5x-5.5x range, supporting the existing financial risk profile. In addition, operating cash flow after capital spending and dividends, or discretionary cash flow, to be mostly negative over the next several years. This indicates a need for external funding such as debt issuances and cash injections from within the Xcel Energy group. Over the next few years, we expect debt leverage to be relatively aggressive as indicated by debt to EBITDA averaging about 5.25x. Reflecting the company's steady cash flow and rate-regulated utility operations, we base our risk assessment on our medial table benchmarks. These are more relaxed benchmarks as compared to those used for a typical corporate issuer.

Liquidity: Adequate

We assess the company's stand-alone liquidity as adequate because we believe its liquidity sources are likely to cover uses by more than 1.1x over the next 12 months and meet cash outflows even with a 10% decline in EBITDA. The assessment also reflects our view of the company's generally prudent risk management, sound relationship with banks, and a generally satisfactory standing in credit markets.

Principal Liquidity Sources	Principal Liquidity Uses
• Estimated cash FFO of about $420 million; • Credit facility availability of $400 million; and • About $4 million cash and liquid investments.	• Debt maturities of about $10 million; • Capital spending of about $510 million; • Dividend payments of about $125 million; and • Working capital outflows of about $90 million.

Other Credit Considerations

The stand-alone credit profile on SPS incorporates a one-notch negative adjustment based on our expectation that the financial measures in our base-case scenario are trending toward the lower end of the range for its financial risk profile category.

Group Influence

Under our group rating methodology, we consider SPS as a core subsidiary of its parent Xcel Energy, reflecting our view that it is highly unlikely to be sold, is integral to the overall group strategy, possesses a strong long-term commitment from senior management, and is closely linked to the parent's name and reputation. We therefore assess SPS's issuer credit rating to be in line with Xcel Energy's group credit profile of 'a-'.

Ratings Score Snapshot

Issuer Credit Rating

A-/Stable/A-2

Business risk: Excellent

- **Country risk:** Very low
- **Industry risk:** Very low
- **Competitive position:** Strong

Financial risk: Significant

- **Cash flow/Leverage:** Significant

Anchor: a-

Modifiers

- **Diversification/Portfolio effect:** Neutral (no impact)
- **Capital structure:** Neutral (no impact)
- **Financial policy:** Neutral (no impact)
- **Liquidity:** Adequate (no impact)
- **Management and governance:** Strong (no impact)
- **Comparable rating analysis:** Negative (-1 notch)

Stand-alone credit profile : bbb+

- **Group credit profile:** a-
- **Entity status within group:** Core (+1 notch from SACP)

Issue Ratings

We base the short-term rating on SPS on the issuer credit rating on the company.

Issue Ratings--Subordination Risk Analysis

Capital structure

SPS's capital structure consists of about $1.5 billion of first-mortgage bonds and $300 million of senior unsecured notes.

Analytical conclusions

We rate SPS's senior unsecured debt the same as the issuer credit rating because it is the debt of a qualified investment-grade utility.

Issue Ratings--Recovery Analysis

SPS's first-mortgage bonds benefit from a first-priority lien on substantially all of the utility's real property owned or subsequently acquired. Collateral coverage of more than 1.5x supports a recovery rating of '1+' and an issue rating one notch above the issuer credit rating.

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- Criteria - Corporates - Utilities: Key Credit Factors For The Regulated Utilities Industry, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria - Corporates - Utilities: Collateral Coverage And Issue Notching Rules For '1+' And '1' Recovery Ratings On Senior Bonds Secured By Utility Real Property, Feb. 14, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Business And Financial Risk Matrix

	Financial Risk Profile					
Business Risk Profile	Minimal	Modest	Intermediate	**Significant**	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	**a-**	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-