Rating Action: Moody's lowers Edison Mission's CFR to B3; outlook negative

Global Credit Research - 29 Jun 2011

Approximately $5.3 Billion of debt securities affected

New York, June 29, 2011 -- Moody's Investors Service downgraded the long-term ratings of Edison Mission Energy (EME) and its subsidiary, Midwest Generation Company, LLC (MWG), including EME's senior unsecured notes to Caa1 from B3, and EME's Corporate Family Rating (CFR) and Probability of Default Rating to B3 from B2. Moody's changed EME's speculative grade liquidity rating to SGL-4 from SGL-3. The rating outlook for EME and MWG is negative.

Downgrades:

..Issuer: Edison Mission Energy

....Probability of Default Rating, Downgraded to B3 from B2

....Corporate Family Rating, Downgraded to B3 from B2

....Senior Secured Bank Credit Facility, Downgraded to B3 from B2

....Senior Unsecured Regular Bond/Debenture, Downgraded to Caa1 from B3

Speculative Grade Liquidity Rating, Downgraded to SGL-4 from SGL-3

..Issuer: Midwest Generation, LLC

....Senior Secured Bank Credit Facility, Downgraded to Ba3/ LGD1, 3% from Ba2/ LGD1, 2%

....Senior Secured Pass-Through, Downgraded to Ba3/ LGD2, 13% from Ba2 / LGD2, 12%

RATINGS RATIONALE

The downgrade reflects our belief that EME's cash flow credit metrics will decline appreciably from recent historical results in 2012 and remain in that range for the foreseeable future due to reduced operating margins driven principally by low energy and capacity prices. The downgrade also reflects the expected drop in operating cash flow over the intermediate-term due to the extension of bonus depreciation which is expected to result in delays in EME's receipt of future tax-allocation payments from its parent, Edison International (EIX: Baa2 senior unsecured). Moody's calculates that the ratio of EME's consolidated CFO pre-W/C (cash flow) to debt will decline to below 5% from the 11.1% ratio recorded at year-end 2010, and that EME cash flow coverage of interest expense will decline to below 1.7x from the 2.6x level that had existed for the past several years. Compounding the problem for EME is the fact that projected drop in credit metrics is expected to occur near the timeframe when the EME and MWG revolving credit facilities expire in June 2012 and when the company's $500 million of senior notes mature 12 months later in June 2013. While we believe that the company will be able to address the expiry of the bank facilities and the bond maturity in a satisfactory way, we observe that the delay in receipt of future tax-allocation payments adds another challenge to the company's credit and liquidity profile.

The downgrade recognizes the continuing, multi-year challenge that EME faces in satisfying state and federal environmental requirements across its generation fleet. While MWG has received permits to retrofit some units utilizing dry scrubbing with sodium based sorbents to comply with combined pollutant standard requirements for sulfur dioxide emissions, it appears that scrubbers will need to be installed at two of the three units at the Homer City plant in western PA. Complicating the installation are the terms of the existing financing agreements at EME Homer City Generation Generating LLC (EME Homer City), which places limits on EME Homer City, including an ability to incur additional indebtedness. In order to satisfy the Clean Air Transport Rule in 2014, we anticipate the company needing to reach decisions on the type, cost, and financing approach for the installations of scrubbers at Homer City 1 and 2 within the next several months.

The downgrade also acknowledges the relationship that EME has with its parent, EIX, including the parent's clear position of not providing any direct or indirect credit support for EME and its subsidiaries. That said, we believe that EIX views EME as an important holding that provides long-term option value to the corporation and, as such, we believe that EIX and EME will continue to work through the numerous issues facing EME and its merchant operations. To that end, Moody's recognizes the company's track record in managing a competitive generation business during difficult times. We also note that today's rating action results in a very wide (8-notch) rating differential between EIX's senior unsecured rating and EME's CFR, further substantiating the degree of separateness that we believe exists between EIX and EME.

Moody's downgrade at MWG is prompted by the close interrelationship that exists between EME and MWG through the Powerton and Joliet sale leaseback agreement and by MWG's dominant position as the primary source of earnings and cash flow for EME.

EME's speculative grade liquidity rating of SGL-4 reflects our concern about EME's internal sources of liquidity over the next four quarters given the generation of negative free cash flow compounded by the delay in receiving future tax-allocation payments from its parent. The SGL-4 recognizes that EME's external sources of liquidity currently in place ($564 million EME revolver and the $500 million MWG revolver) expire within 12 months and such extension may prove challenging given EME's fundamental credit profile coupled with the delay in receiving tax-allocation payments. At March 31, 2011, EME had substantial total liquidity that exceeded $2 billion including $1.183 billion of consolidated cash and availability of $981 million under the EME and MWG revolvers. Extension of these bank credit facilities remains an important milestone for EME, particularly, since EME has $500 million of senior notes maturing June 2013. Both credit facilities have financial covenants which EME and MWG should be able to maintain over the next twelve months. The EME revolver requires recourse debt to total capitalization not exceed 75% and requires interest coverage (as defined in the credit agreement) be greater than 1.20x. At March 31, 2011, EME's recourse debt to total capitalization was 52% and its interest coverage ratio was 2.13x. The MWG revolver requires debt to total capitalization not to exceed 60%. At March 31, 2011, MWG's total debt to total capitalization was 14%. Moody's observes that many of the company's assets are pledged to creditors which places limits on the company's ability to raise additional liquidity from asset sales.

The negative rating outlook for EME and MWG primarily reflects uncertainties surrounding the company's near-term liquidity prospects in light of anticipated weaker operating margins and cash flows, the delay in receiving tax-allocation payments, and the near-term expiration of the company's two credit facilities all of which precedes the senior note debt maturity in June 2013. The negative outlook also considers the uncertainty that remains about EME Homer City's requirement to install scrubbers at Unit 1 and 2 of the Homer City plant, along with the lingering overhang that persists for EME given its coal concentration.

In light of these challenges, limited prospects exist for the rating to be upgraded. However, the rating outlook could be stabilized if the near-term liquidity challenges at EME are adequately addressed and if a workable plan for installing the scrubbers at Homer City is outlined.

In light of the June 2012 expiry date for the EME and MWG revolvers and the June 2013 bond maturity, the rating could be downgraded should meaningful progress in addressing the company's liquidity needs does not occur by first quarter 2012. Additionally, the ratings could be downgraded if there are major extended outages at key MWG plants or at more than one of the Homer City units or if wholesale market prices decline further resulting in additional deterioration in the credit metrics such that cash flow to debt declined to 3% and cash flow interest coverage was under 1.5x.

The principal methodologies used in this rating action were Global Unregulated Utilities and Power Companies published in August 2009, and Loss Given Default for Speculative-Grade Non-Financial Companies in the U.S., Canada and EMEA published in June 2009.

Headquartered in Santa Ana, California, EME is an unregulated generation company and an indirect wholly-owned subsidiary of EIX. At December 31, 2010, EME had an ownership or leased interests of 9,852 megawatts (MW) of electric capacity, of which MWG owned or had a leasehold interest in 5,477 MW of base load and mid-merit coal-fired assets and oil/gas peaking assets in the Midwest and EME Homer City, had a leasehold interest in the Homer City Generation Station, a 1,884 MW coal-fired base load plant in Western PA.

REGULATORY DISCLOSURES

Information sources used to prepare the credit rating are the following: parties involved in the ratings, parties not involved in the ratings, public information, confidential and proprietary Moody's Investors Service information, and confidential and proprietary Moody's Analytics information.

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