COMMERCE DEPARTMENT

May 20, 2025
Will Seuffert
Minnesota Public Utilities Commission
121 7th Place East, Suite 350
St. Paul, Minnesota 55101-2147

RE: Comments of the Minnesota Department of Commerce
Docket No. E015/S-25-138

Dear Mr. Seuffert:

Attached are the comments of the Minnesota Department of Commerce (Department) in the following matter:

> *The Petition of Minnesota Power for Approval of Consolidated Capital Structure to Issue Securities for 2025.*

Minnesota Power filed the Petition on February 28, 2025.

The Department recommends **approval** and is available to answer any questions the Minnesota Public Utilities Commission may have.

Sincerely,

/s/ Dr. SYDNIE LIEB
Assistant Commissioner of Regulatory Analysis

JT & CA/ad
Attachment

Before the Minnesota Public Utilities Commission

Comments of the Minnesota Department of Commerce

Docket No. E015/S-25-138

I. INTRODUCTION

On February 28, 2025, Minnesota Power (the Company) petitioned the Minnesota Public Utilities Commission (Commission) for approval of ALLETE Inc.'s (ALLETE) consolidated 2025 proposed capital structure (Petition). Minnesota Power is seeking approval of:

- ALLETE's proposed capital structure, including an equity ratio of 63.21%;
- An equity ratio contingency range of +/- 15% of its proposed equity ratio (i.e., 53.73% to 72.69%);
- Total consolidated capitalization of $7,145 million, including a proposed contingency reserve of $652 million;
- Approval to issue short-term debt up to 15% of total capitalization;
- Continuation of the variance of Minn. R. 7825.1000, subp. 6 (2023) to allow ALLETE to treat borrowing under multi-year credit agreements as short-term debt for approved capital structure purposes;
- Authorization to issue securities, provided ALLETE does not exceed the limits of the approved equity ratio, maximum short-term debt ratio, or maximum capitalization for more than 60 days, without prior Commission approval; and
- Authorization on or before July 1, 2025, for the ability, if needed, to issue up to a total of $300 million of preferred stock to Canada Pension Plan Investment Board and Global Infrastructure Partners[1] in the second half of 2025, per certain parameters.

Minnesota Power requests approval of ALLETE's estimated consolidated capital structure and authorization to issue securities from the date of issuance of a Commission Order approving the instant petition through the latter of (1) May 1, 2026, or (2) the date at which the Commission issues a subsequent capital structure order.

II. PROCEDURAL BACKGROUND

February 28, 2025	Minnesota Power filed a petition requesting approval of its 2025 Capital Structure.

[1] *In the Matter of the Petition of Minnesota Power for the Acquisition of ALLETE by Canada Pension Plan Investment Board and Global Infrastructure Partners*, Minnesota Power, Petition, July 19, 2024, Docket No. E015/PA-24-198, (eDockets) 20247-208768-01.

III. DEPARTMENT ANALYSIS

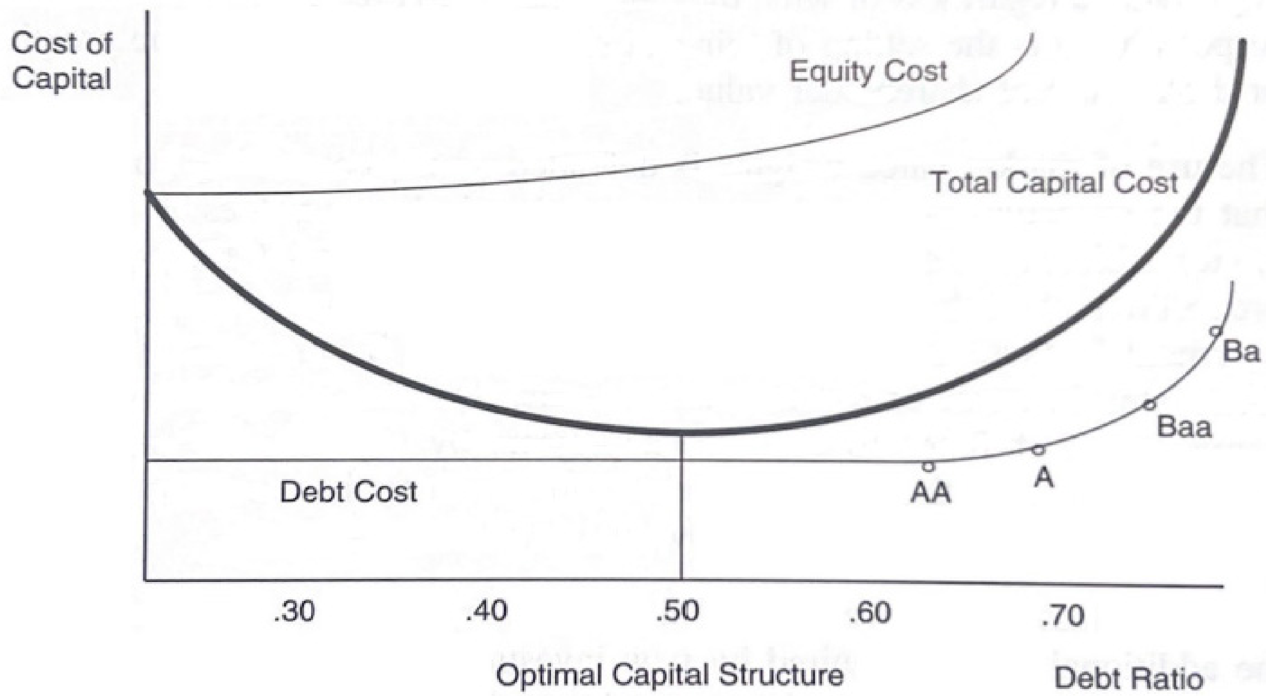
A. GENERAL DISCUSSION OF CAPITAL STRUCTURE THEORY

The mix of debt and equity a company uses to finance its operations is its capital structure. The relative amounts of each type of financing a company includes in its capital structure impacts the returns it must offer to debt and equity investors to entice them to provide the company with capital. Interest payments on debt are tax deductible, and therefore, all else equal, the use of debt financing creates tax savings, which can lower a company's total after-tax cost of financing. However, the use of debt (leverage) also creates fixed payment obligations (*i.e.*, interest and principal payments), for which a failure to pay could trigger a costly bankruptcy. Debt and equity investors are aware of the risks associated with high levels of debt, and as a result, require higher expected returns on their investments as leverage increases.

A company must appropriately balance these two competing factors (tax savings and increased costs due to higher financial risk) in determining its capital structure. Starting from a low level of debt, the tax savings generated by increasing the amount of debt in a company's capital structure often more than offsets the increase in the cost of debt and equity resulting from increased financial risk. Past a certain point, however, the increase in the costs of debt and equity will outweigh the additional tax savings.

Theoretically, every company has an optimal capital structure that balances these two effects and minimizes the company's cost of capital, after accounting for taxes. Figure 1 illustrates this relationship. As shown, both debt and equity costs increase with leverage, but "Total Capital Cost" (the weighted average cost of capital adjusted to reflect tax savings associated with debt) decreases as debt increases up to 50%, and then begins to rise as the effects of financial risk begin to outweigh the tax savings associated with increased leverage.

Figure 1
Relationship Between Capital Structure and the Cost of Capital[2]



While an optimal capital structure *theoretically* exists for each company, as a practical matter, it is difficult, if not impossible, to analytically determine what that capital structure is with precision. Because of this, historically, the Department has typically assessed the reasonableness of utilities' capital structures by simply comparing them to the capital structures of other utilities of comparable risk.

That simple comparison test, however, is a somewhat blunt tool. The range of capital structures used by other utilities is often so wide that it provides little insight into the reasonableness of a particular capital structure. In addition, there is often disagreement between the Department and the utilities about how to apply the test. The Department generally compares a utility's proposed capital structure only to publicly traded companies that are primarily comprised of utility operations. The utilities, however, often compare their proposed capital structure to the capital structures of other utility operating subsidiaries, which are not publicly traded. As the Department has discussed in recent rate cases, the utilities' comparisons create a problematic mismatch between (a) the proxy companies used to assess a utility's proposed capital structure (*i.e.*, utility operating subsidiaries) and (b) the proxy companies used to estimate a utility's cost of equity (*i.e.*, publicly traded parent or holding companies).[3]

[2] Morin, Roger A., *New Regulatory Finance* at 454 (2006). Note that this figure is just for illustrative purposes and is not necessarily drawn to a reasonable scale.
[3] *In the Matter of the Application of Minnesota Power for Authority to Increase Rates For Electric Service In the State of Minnesota*, The Department, Direct Testimony of Craig Addonizio p. 112, March 18, 2024, Docket No.E015/GR-23-155, (eDockets) 20243-204451-01.

In short, publicly traded parent companies often have higher debt ratios than their utility operating subsidiaries, which implies that they also likely have higher costs of equity.

However, in the absence of a better, more precise method of assessing capital structure, the Department used the comparison test to assess Minnesota Power's proposed capital structure, as discussed in greater detail below.

B. ADDITIONAL BACKGROUND ON ALLETE'S AND MINNESOTA POWER'S CAPITAL STRUCTURE

The Company's actual and proposed capital structures include financing associated with ALLETE's lines of business other than Minnesota Power's regulated operations. For ratemaking purposes, Minnesota Power removes financing attributable to ALLETE's other operations to derive a capital structure specific to Minnesota Power's regulated, jurisdictional operations.[4] ALLETE's overall equity ratio is inflated relative to Minnesota Power's regulated equity ratio due to equity-heavy financing arrangements used for certain of ALLETE's non-regulated operations. For this reason, ALLETE's capital structure is not reasonable for ratemaking purposes.

However, because Minnesota Power is an operating division of ALLETE, not a separate subsidiary, ALLETE is a public utility under Minn. Stat. § 216B.02, subd. 4 (2024) and any debt or equity issued to finance Minnesota Power's operations will be issued by ALLETE. ALLETE's capital structure and securities issuances are therefore subject to the Commission's authority per Minn. Stat. § 216B.49 (2024).

Generally, Minnesota Power's rates and utility practices are designed to insulate the Company's ratepayers from any effects of ALLETE's non-jurisdictional activities as much as possible. The Department is primarily interested in Minnesota Power's regulated capital structure, rather than ALLETE's overall capital structure. In reviewing ALLETE's capital structure as proposed in the Petition, the Department's intentions are to ensure that Minnesota Power's jurisdictional capital structure is reasonable and allow ALLETE the flexibility to finance its non-regulated operations as it sees fit subject to the constraint that the Company's ratepayers cannot be unreasonably harmed by those operations.

C. FILING AND REPORTING REQUIREMENTS

Minn. R. 7825.1300 and 7825.1400 (2023) and prior Commission Orders set forth a number of reporting requirements utilities must adhere to for the issuance of securities. The Department reviewed Minnesota Power's Petition and concludes the Company's Petition meets all applicable requirements.

[4] *In the Matter of the Application of Minnesota Power for Authority to Increase Rates for Electric Utility Service in Minnesota*, Minnesota Power, Direct Testimony and Schedules of Joshua D. Taran p. 5, November 1, 2023, Docket No. E015/GR-23-155 (eDockets) 202311-200095-04.

D. REASONABLENESS OF PROPOSED CAPITAL STRUCTURE AND CONTINGENCY RANGES

D.1. Summary of ALLETE's Recent and Proposed Capital Structures

ALLETE's actual consolidated capital structures for the past three years, and its projected capital structure for June 30, 2026 are presented below:

Table 1: Actual and Projected Consolidated Capital Structures ($ Millions)[5]

	Actual Dec. 31, 2022		Actual Dec. 31, 2023		Actual Dec. 31, 2024		Projected Jun. 30, 2026	
	($000s)	(%)	($000s)	(%)	($000s)	(%)	($000s)	(%)
Long-term Debt	1,751	33.23%	1,791	34.46%	1,799	34.67%	2,389	36.79%
Short-term Debt	170	2.23%	0	0.00%	-	0.00%	-	0.00%
Total Equity	3,348	63.54%	3,407	65.54%	3,391	65.33%	4,104	63.21%
Total Capitalization	5,269	100.00%	5,198	100.00%	5,190	100.00%	6,493	100.00%

Relative to its actual year-end 2024 capital structure, ALLETE's projected June 30, 2026 capital structure reflects increases of $590 million in net long-term debt and $713 million in additional equity, primarily the result of expected equity issuances rather than retained earnings.

On May 6, 2024, ALLETE announced that it had entered into an agreement to be acquired by Canada Pension Plan Investment Board ("CPP Investments") and Global Infrastructure Partners ("GIP," and together with CPP Investments, "the Partners). On the same day, ALLETE filed a Form 8-K with the Securities and Exchange Commission (SEC) that included the Agreement and Plan of Merger (Merger Agreement) ALLETE entered into with CPP Investments and GIP.[6]

Section 5.01(b) of the Merger Agreement places certain restrictions on the Company's ability to issue debt and equity while the merger is pending. Section 6.18 of the Merger Agreement provides that if the Merger has not been completed by June 30, 2025, and if ALLETE needs equity, ALLETE may notify the Partners of its intent to raise equity capital of up to a total of $300 million in the second half of 2025. Upon notification by ALLETE, the Partners have the option to provide the required equity via the purchase of preferred stock. If the Partners decline to provide some or all of the needed equity, ALLETE is permitted to issue common stock to raise the unfunded amount.

Consistent with these terms in the Merger Agreement, Minnesota Power requested authority to issue up to $300 million in preferred equity during the second half of 2025. The preferred equity would

[5] Petition, p. 4.

[6] The Form 8-K is available on the Investor Relations page of ALLETE's website and the SEC's website.

replace a portion of proposed common equity issuances.[7] The Department notes that if the Commission authorizes the Company to issue preferred equity as it has requested, any preferred equity it issues will take the place of common equity in its projected capital structure[8] As described below, the credit ratings agencies are unlikely to treat the preferred equity as comparable to ALLETE's common equity in assessing ALLETE's credit metrics and creditworthiness. Thus, Minnesota Power's presentation of its capital structure, in which common equity and preferred equity are combined into a single line, may not be appropriate. Table 2 presents ALLETE's recent and projected capital structure assuming it issues $300 million of preferred equity with the preferred equity identified separately from ALLETE's other equity.

Table 2: Actual and Projected Consolidated Capital Structures Including Preferred Equity ($ Millions)[9]

	Actual Dec. 31, 2022		Actual Dec. 31, 2023		Actual Dec. 31, 2024		Projected Jun. 30, 2026	
	($000s)	(%)	($000s)	(%)	($000s)	(%)	($000s)	(%)
Long-term Debt	1,751	33.23%	1,791	34.46%	1,799	34.66%	2,389	36.79%
Short-term Debt	170	3.23%	-	0.00%	-	0.00%	-	0.00%
Preferred Equity	-	0.00%	-	0.00%	-	0.00%	300	4.62%
Other Equity	3,348	63.54%	3,407	65.54%	3,391	65.34%	3,804	58.59%
Total Capitalization	5,269	100.00%	5,198	100.00%	5,190	100.00%	6,493	100.00%

As shown, $300 million of preferred equity would represent 4.62% of ALLETE's total capitalization.

D.2. Reasonableness of Proposed Capital Structure

The Department compared the ALLETE's proposed capital structure to the actual capital structures of other, risk-comparable electric utilities. 29 publicly traded companies classified by Value Line as electric utilities have S&P credit ratings between A- and BBB-, two notches above and one notch below ALLETE's credit rating of BBB.[10] At the end of 2024, the common equity ratios of those 29 companies ranged from 26.69% to 62.21% and averaged 40.47%.[11] ALLETE's projected equity ratio, regardless of how one categorizes its preferred equity, is near or above the top of that range, which is an indication that ALLETE has lower financial risk than other electric utilities.

However, as noted above, ALLETE's overall equity ratio is higher than Minnesota Power's jurisdictional equity ratio because of the high levels of equity financing attributable to ALLETE's non-regulated lines

[7] Petition, p. 4.
[8] Petition, p. 4.
[9] Petition, p. 4.
[10] Credit ratings of BBB- and above are generally referred to as "investment grade," while ratings below BBB- are considered "speculative grade." The Department did not include utilities with speculative credit ratings in its analysis.
[11] Department Attachment 1.

of business. Therefore, the Department attempted to review Minnesota Power's projected jurisdictional capital structure assuming it includes preferred equity. In response to information requests, Minnesota Power declined to provide its projected jurisdictional capital structure and also declined to explain how ALLETE expects to allocate preferred equity between Minnesota Power and ALLETE's non-regulated lines of business. Therefore, the Department attempted to estimate Minnesota Power's jurisdictional capital structure assuming ALLETE issues $300 million in preferred equity and allocates all of it to Minnesota Power.

**Table 3: Department Estimate of
Minnesota Power's Projected Jurisdictional Capital Structure
($ Millions)[12]**

	$ Millions	Ratio	Note
Common Equity	1,975	46.01%	Total Equity less Preferred Equity
Preferred Equity	300	6.99%	Assumed
Total Equity	2,275	53.00%	53% of Minnesota Power Total Cap.
Long-term Debt	2,017	47.00%	47% of Minnesota Power Total Cap.
Total Capitalization	4,292	100.00%	66% of ALLETE's Projected 6/30/2026 Total Cap. ($6,439 million)

If all $300 million of preferred equity is issued and allocated to Minnesota Power, its preferred equity ratio will be around 6.99%, and its common equity ratio will be around 46.01%.

As shown in Department Attachment 1, only four of the 29 Value Line electric utilities with credit ratings between A- and BBB- currently have preferred equity issued and outstanding, and the capital structure of only one of those four contains more than 1.5% of preferred equity (Edison International, 3.15%). Thus, while Minnesota Power's common equity ratio would be comparable to the average of other electric utilities, its preferred equity ratio would be somewhat high.

While the potential changes to ALLETE's and Minnesota Power's capital structure that would result from the issuance of preferred equity would not result in a capital structure that is significantly out of line with other electric utilities, the proposed issuance of up to $300 million in preferred equity would be a notable change for ALLETE and Minnesota Power, and the Company's Petition contained no explanation of why it would be reasonable. In response to an information request, the Company stated:

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[12] In Minnesota Power's most recent rate case, approximately 66% of ALLETE's 2024 test year total capital was attributed to Minnesota Power. See *In the Matter of the Application of Minnesota Power for Authority to Increase Rates for Electric Utility Service in Minnesota*, Minnesota Power, Workpapers and Studies – Part 2 of 4 at COC-1, November 1, 2023, Docket No. E015/GR-23-155 (eDockets) 202311-200092-06. Assuming this percentage will hold into to 2026, the Department multiplied it by ALLETE's projected total capitalization at June 30, 2026 of $6,493 million. The Department then split the resulting estimate of Minnesota Power's capitalization between debt (47%) and equity (53%) per Minnesota Power's response to an information request. See Department Attachment 2. Finally, the Department reclassified $300 million of the resulting equity balance as preferred equity, and the remainder as common equity.

> The Company actively negotiated for and continues to believe that the preferred equity investment from the Partners enables ALLETE to remain well-positioned to meet its financing needs during the interim period between signing the Merger Agreement and the closing of the Acquisition.[13]

However, the Company did not explain either in its Petition or in its information request response why it negotiated for this preferred equity option, or why it believes preferred equity is a better financing option than debt and common equity while the Acquisition is pending.

The Department is concerned that the Company's proposed use of preferred equity may be large enough in amount to have negative effects on ALLETE and Minnesota Power. Because preferred equity has characteristics of both debt and equity, the credit ratings agencies treat it as a hybrid instrument. Depending on the specific characteristics of a preferred equity issuance, the credit ratings agencies may treat none, all, or a percentage of the issuance as debt in assessing a company's credit metrics and leverage ratios. Minnesota Power stated that it believes both S&P and Moody's would likely treat its planned preferred equity issuances as half debt and half equity, but did not explain how it reached that conclusion.[14]

ALLETE's long-term debt ratio is projected to increase by 2.13 percentage points before accounting for the potential preferred equity, which, from the perspective of the credit ratings agencies, could increase it by another 2.31 percentage points if the preferred equity is treated as half equity half debt, and potentially up to 4.62 percentage points if all of the preferred equity is treated as debt, although that may be unlikely. Again, while these potential changes to ALLETE's and Minnesota Power's capital structures will not result in capital structures that are significantly out of line with other electric utilities, they are notable changes for a company in an 18-month period, and may cause ALLETE's credit metrics and ratings to deteriorate in a way that is harmful to Minnesota Power.

The Company seemingly has not assessed the likelihood of a negative impact on its credit metrics, credit ratings, or cost of capital from its requested preferred equity issuances. The Department asked Minnesota Power to provide all analysis it completed related to potential impacts issuing preferred stock as proposed in the Petition may have on ALLETE's credit metrics. In response, the Company provided no such analysis and instead stated that it does not intend to maintain preferred equity in its capital structure long term, and therefore does not anticipate material changes to its credit ratings.[15]

The Company also stated that it has conducted no analysis demonstrating that a regulated capital structure including up to $300 million of preferred equity is reasonable for Minnesota Power.[16] Again, the Company emphasized that it does not plan to maintain preferred equity in its capital structure long term and that instead the preferred equity is intended only to provide temporary bridge financing

[13] Department Attachment 3.
[14] Department Attachments 4 and 5.
[15] Department Attachment 6.
[16] Department Attachment 7.

during the interim period between the signing of the Merger Agreement and closing of the Acquisition. The Company also stated that if the Acquisition is approved and closes, the preferred stock would be converted to a common equity investment from the Partners.[17]

The Department has some concerns about the seeming lack of analysis and planning for the possibility that preferred stock issued pursuant to the Merger Agreement may remain in ALLETE's capital structure longer than intended. The Merger Agreement states that any preferred equity outstanding at the time the Merger closes will remain outstanding.[18] In addition, it is not a foregone that the Commission will approve the Acquisition. If the Commission doesn't, the preferred equity may remain outstanding.

In its response to an information request, the Company stated:

> In a scenario where the preferred shares were issued and the Acquisition does not close, the Company would analyze the cost and availability of alternative financing at that time and determine the best sources of capital to be able to continue to provide affordable, reliable service to customers. This would include analysis of the preferred equity against alternatives that may be available to replace it, and the Company would propose inclusion of the preferred equity only if it was the best ongoing solution to provide capital to the Company on behalf of its customers. *Ultimately, the Company will bear the burden of proof in demonstrating that all its costs are just and reasonable in a future rate case*. (*emphasis added)*[19]

The Department's concerns notwithstanding, because of the unique circumstances of the pending Acquisition, the Company's need for financing during the second half of 2025, and the fact that requested amounts of preferred equity will not result in capital structure for ALLETE or Minnesota Power that are significantly out of line with other electric utilities, the Department concludes that the Company's request is reasonable and recommends that the Commission approve it. However, the Department agrees with Minnesota Power that the Company will bear the burden of proof in its next rate case to demonstrate that all of its costs, including its cost of capital and capital structure, are reasonable. Neither the Department's recommendation for approval in this docket nor the Commission's final determination in this proceeding is a determination for purposes of rates.

D.3. Reasonableness of Proposed Contingency Ranges

D.3.1. Equity Ratio Contingency Range

Minnesota Power requested an equity ratio contingency range of +/- 15% around its proposed equity ratio for ALLETE of 63.21%, or 53.73% to 72.69%. The Company also requested the ability to exceed the approved range for up to 60 days without prior Commission approval.

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[17] Department Attachment 7.
[18] Section 2.01(f) of the Merger Agreement.
[19] Department Attachment 7.

The Commission has authorized Minnesota Power to use a 15% range around its projected common equity ratio and a 60-day grace period in each of the Company's last five capital structure proceedings. Given this history and the lack of adverse outcomes in recent years, the Department believes this practice has worked well enough to allow the Company sufficient financing flexibility, to keep the Company on sound financial footing, and to maintain needed oversight for the Commission. The Department therefore concludes continued adoption of this practice is reasonable. The Department notes that per Minnesota Power's presentation of its capital structure in its Petition, issuances of preferred equity will count towards this contingency range, but the Company will be limited to a maximum of $300 million of preferred equity, regardless of whether its total equity ratio is less than 72.69%.

Based on the above, the Department concludes that Minnesota Power's proposed equity ratio contingency range of 53.73% to 72.69% is reasonable and recommends that the Commission approve it.

D.3.2. Short-Term Debt Ratio Contingency Range

Minnesota Power requested permission to issue up to 15% of ALLETE's total capitalization as short-term debt. In recent years, the Commission has approved the 15% cap on ALLETE's short-term debt. Similar to the equity ratio contingency range, the Department concludes that this practice has worked well enough to provide the Company adequate short-term financial flexibility without adding undue risk to ratepayers. Therefore, the Department recommends the Commission approve Minnesota Power's request to issue short-term debt up to 15% of the Company's total capitalization.

D.3.3. Maximum Total Capitalization

Minnesota Power requested a maximum capitalization of $7,145 million, including a contingency of $652 million, or approximately 10% of its expected capitalization.[20] Exhibit L of the Company's Petition summarizes Minnesota Power's planned capital expenditures by functional area, and shows that the Company is planning significant investments in all areas (generation, transmission, and distribution). The 10% contingency for total capitalization is consistent with past practice, and the Department concludes that this practice has worked sufficiently well to balance financial flexibility for the utility with adequate oversight for the Commission. Therefore, the Department recommends that the Commission approve Minnesota Power's proposed maximum total capitalization.

E. REQUEST FOR VARIANCE OF MINN. R. 7825.1000, SUBP. 6 (2024)

Minnesota Power requested the Commission grant a continuation of the variance to Minn. R. 7825.1000, subp. 6 (2024) to allow the Company to treat direct borrowing under a multi-year credit agreement as short-term debt.[21] Because the rule defines short-term securities as those with a date of maturity of no more than one year, to classify multi-year credit agreements as short-term debt,

[20] Petition, p. 1.
[21] Petition, p. 6.

Minnesota Power needs the Commission to approve the requested variance. To vary its rules, the Commission must determine, per Minn. R. 7829.3200, subp. 1 (2023), the variance satisfies three requirements:

A. Enforcement of the rule would impose an excessive burden upon the applicant or others affected by the rule;
B. Granting the variance would not adversely affect the public interest; and
C. Granting the variance would not conflict with standards imposed by law.

The Department agrees that the Company's requested variance satisfies the three requirements. Minnesota Power's current multi-year credit agreement resembles traditional short-term debt instruments. Classifying multi-year credit agreements as long-term debt could cause credit-rating agencies to react unfavorably, thus imposing an excessive burden on the Company and hurting ratepayers. In addition, classifying multi-year credit agreements as short-term debt would not conflict with any standards imposed by law. Therefore, the Department recommends the Commission continue to vary Minn. R. 7825.1000, subp. 6 (2023) and allow Minnesota Power to treat borrowing under multi-year agreements as short-term debt for approved capital structure purposes.

F. AMENDED ARTICLES OF INCORPORATION

The Company stated in its Petition that ALLETE's current Amended and Restated Articles of Incorporation are not consistent with the terms of the preferred stock contemplated in the Merger Agreement.[22] As a result, the Company stated that it expected to seek shareholder approval of an amendment to the current Articles of Incorporation at its 2025 Annual Meeting. That meeting took place on May 13, 2025, and ALLETE's shareholders approved the proposed amendment.

The Proposed Amendment presented to shareholders for a vote at the 2025 Annual Meeting is attached to these Comments as Department Attachment 8. Among other things, the amendment eliminates restrictions on common stock dividend declarations that would result in equity ratios below certain thresholds. In addition, ALLETE's prior Articles of Incorporation provided that if dividends on preferred stock were to be in default in an amount equal to four quarterly payments or more per share, ALLETE's preferred stockholders would automatically be entitled to elect a majority of ALLETE's board members until the missed dividends were paid. The proposed amendment exempts holders of a particular type of ALLETE's authorized preferred stock, Serial Preferred Stock A, from being allowed to vote for board members in this situation. Per the terms of the Merger Agreement, if ALLETE issues preferred stock to the Partners, it will be Serial Preferred Stock A, meaning that the Partners or any successive owners of the preferred stock issued pursuant to the Merger Agreement will not be able to elect a majority of ALLETE's board if ALLETE fails to make four consecutive dividend payments.

In response to information requests, the Company clarified that these amendments to its Articles of Incorporation were being proposed not because they are inconsistent with the term of the Merger

[22] Petition, p. 2.

Agreement, but simply because ALLETE does not intend to issue preferred equity in the future other than shares of Serial Preferred Stock A pursuant to the Merger Agreement.

The Department has no recommendations related to these amendments for the Commission and provides the above discussion for informational purposes only.

IV. DEPARTMENT RECOMMENDATIONS

The Department concludes Minnesota Power's Petition is reasonable and recommends the Commission take the following action:

1. Approve Minnesota Power's Petition which includes the following:
   - ALLETE's proposed capital structure, including an equity ratio of 63.21%;
   - An equity ratio contingency range of +/- 15% of its proposed equity ratio (i.e., 53.73 % to 72.69%);
   - Total consolidated capitalization of $7,145 million, including a proposed contingency reserve of $652 million;
   - Approval to issue short-term debt up to 15% of total capitalization;
   - Continuation of the variance of Minn. R. 7825.1000, subp. 6 (2024) to allow ALLETE to treat borrowing under multi-year credit agreements as short-term debt for approved capital structure purposes;
   - Authorization to issue securities, provided ALLETE does not exceed the limits of the approved equity ratio, maximum short-term debt ratio, or maximum capitalization for more than 60 days, without prior Commission approval;
   - Flexibility to issue up to $300 million in preferred stock to the Partners in the second half of 2025; and
   - Approval of ALLETE's estimated consolidated capital structure and authorization to issue securities from the date of issuance of a Commission Order approving the instant petition through the latter of (1) May 1, 2025 or (2) the date at which the Commission issues a subsequent capital structure order.

2. Require Minnesota Power to file its next request for approval of its securities issuance no later than March 1, 2026.

3. Require Minnesota Power to keep the Commission informed in a timely manner of any important developments in its pending acquisition and any rating agency actions.

4. Clarify the Order in this proceeding does not predetermine the Commission's decision in any future rate case the Company files.

Line No.	Company	Ticker	Reporting Period	S&P Credit Rating	Short-Term Debt	Current Portion Long-Term Debt	Non-Current Long-Term Debt	Total Common Equity	Total Preferred Equity	Total Equity	Total Capitalization	Short-Term Debt Ratio	Long-Term Debt Ratio	Common Equity Ratio	Preferred Equity Ratio	Total
1	Alliant Energy Corporation	LNT	2024	BBB+	558,000	1,171,000	8,677,000	7,004,000	-	7,004,000	17,410,000	3.21%	56.57%	40.23%	0.00%	100.00%
2	Ameren Corporation	AEE	2024	BBB+	1,143,000	317,000	17,262,000	12,114,000	-	12,114,000	30,836,000	3.71%	57.01%	39.29%	0.00%	100.00%
3	American Electric Power Company, Inc.	AEP	2024	BBB+	2,523,800	3,371,300	39,343,100	26,943,800	-	26,943,800	72,182,000	3.50%	59.18%	37.33%	0.00%	100.00%
4	Avista Corporation	AVA	2024	BBB	354,000	-	2,690,000	2,591,000	-	2,591,000	5,635,000	6.28%	47.74%	45.98%	0.00%	100.00%
5	Black Hills Corporation	BKH	2024	BBB+	133,800	-	4,250,200	3,501,500	-	3,501,500	7,885,500	1.70%	53.90%	44.40%	0.00%	100.00%
6	CenterPoint Energy, Inc.	CNP	2024	BBB+	500,000	66,000	20,397,000	10,666,000	-	10,666,000	31,629,000	1.58%	64.70%	33.72%	0.00%	100.00%
7	CMS Energy Corporation	CMS	2024	BBB+	65,000	1,191,000	15,194,000	8,006,000	224,000	8,230,000	24,680,000	0.26%	66.39%	32.44%	0.91%	100.00%
8	Consolidated Edison, Inc.	ED	2024	A-	2,670,000	-	24,651,000	21,962,000	-	21,962,000	49,283,000	5.42%	50.02%	44.56%	0.00%	100.00%
9	Dominion Energy, Inc.	D	2024	BBB+	2,500,000	1,685,000	37,486,000	26,262,000	991,000	27,253,000	68,924,000	3.63%	56.83%	38.10%	1.44%	100.00%
10	DTE Energy Company	DTE	2024	BBB+	1,067,000	1,291,000	20,672,000	11,699,000	-	11,699,000	34,729,000	3.07%	63.24%	33.69%	0.00%	100.00%
11	Duke Energy Corporation	DUK	2024	BBB+	3,584,000	4,303,000	75,816,000	49,154,000	973,000	50,127,000	133,830,000	2.68%	59.87%	36.73%	0.73%	100.00%
12	Edison International	EIX	2024	BBB	998,000	2,049,000	33,534,000	13,920,000	1,645,000	15,565,000	52,146,000	1.91%	68.24%	26.69%	3.15%	100.00%
13	Entergy Corporation	ETR	2024	BBB+	927,291	1,360,902	26,596,490	15,083,908	-	15,083,908	43,968,591	2.11%	63.58%	34.31%	0.00%	100.00%
14	Evergy, Inc.	EVRG	2024	BBB+	1,608,600	651,700	11,809,200	9,955,000	-	9,955,000	24,024,500	6.70%	51.87%	41.44%	0.00%	100.00%
15	Eversource Energy	ES	2024	BBB+	2,042,793	1,046,360	26,025,699	15,039,387	-	15,039,387	44,154,239	4.63%	61.31%	34.06%	0.00%	100.00%
16	Exelon Corporation	EXC	2024	A-	1,859,000	1,454,000	43,337,000	26,921,000	-	26,921,000	73,571,000	2.53%	60.88%	36.59%	0.00%	100.00%
17	FirstEnergy Corp.	FE	2024	BBB	550,000	974,000	22,487,000	12,455,000	-	12,455,000	36,466,000	1.51%	64.34%	34.16%	0.00%	100.00%
18	IDACORP, Inc.	IDA	2024	BBB	-	19,885	3,053,777	3,330,954	-	3,330,954	6,404,616	0.00%	47.99%	52.01%	0.00%	100.00%
19	NextEra Energy, Inc.	NEE	2024	A-	1,887,000	8,061,000	72,385,000	50,101,000	-	50,101,000	132,434,000	1.42%	60.74%	37.83%	0.00%	100.00%
20	NorthWestern Energy Group, Inc.	NWE	2024	BBB	100,000	299,950	2,695,343	2,857,700	-	2,857,700	5,952,993	1.68%	50.32%	48.00%	0.00%	100.00%
21	OGE Energy Corp.	OGE	2024	BBB+	469,300	32,400	5,020,900	4,640,900	-	4,640,900	10,163,500	4.62%	49.72%	45.66%	0.00%	100.00%
22	Otter Tail Corporation	OTTR	2024	BBB	69,615	-	943,734	1,668,499	-	1,668,499	2,681,848	2.60%	35.19%	62.21%	0.00%	100.00%
23	Pinnacle West Capital Corporation	PNW	2024	BBB+	568,450	800,000	8,058,648	6,754,311	-	6,754,311	16,181,409	3.51%	54.75%	41.74%	0.00%	100.00%
24	Portland General Electric Company	POR	2024	BBB+	-	170,000	4,386,000	3,794,000	-	3,794,000	8,350,000	0.00%	54.56%	45.44%	0.00%	100.00%
25	PPL Corporation	PPL	2024	A-	303,000	551,000	16,009,000	14,077,000	-	14,077,000	30,940,000	0.98%	53.52%	45.50%	0.00%	100.00%
26	Public Service Enterprise Group Incorporated	PEG	2024	BBB+	1,593,000	2,150,000	18,964,000	16,114,000	-	16,114,000	38,821,000	4.10%	54.39%	41.51%	0.00%	100.00%
27	Sempra	SRE	2024	BBB+	2,016,000	2,209,000	30,660,000	30,333,000	889,000	31,222,000	66,107,000	3.05%	49.72%	45.88%	1.34%	100.00%
28	The Southern Company	SO	2024	A-	1,338,000	4,709,000	58,490,000	33,208,000	-	33,208,000	97,745,000	1.37%	64.66%	33.97%	0.00%	100.00%
29	Xcel Energy Inc.	XEL	2024	BBB+	695,000	1,103,000	27,316,000	19,522,000	-	19,522,000	48,636,000	1.43%	58.43%	40.14%	0.00%	100.00%
	Minimum											0.00%	35.19%	26.69%	0.00%	
	Average											2.73%	56.54%	40.47%	0.26%	
	Maximum											6.70%	68.24%	62.21%	3.15%	

Source: S&P Capital IQ Pro

COMMERCE DEPARTMENT

Minnesota Department of Commerce
85 7th Place East | Suite 280 | St. Paul, MN 55101
Information Request

Docket Number: E015/S-25-138 ☐Nonpublic ☒Public
Requested From: Minnesota Power Date of Request: 4/10/2025
Type of Inquiry: Financial Response Due: 4/21/2025

SEND RESPONSE VIA EMAIL TO: Utility.Discovery@state.mn.us as well as the assigned analyst(s).
Assigned Analyst(s): Craig Addonizio, Justin Taylor
Email Address(es): craig.addonizio@state.mn.us, justin.taylor@state.mn.us
Phone Number(s): 651-539-1818, 651-539-1031

ADDITIONAL INSTRUCTIONS:
Each response must be submitted as a text searchable PDF, unless otherwise directed. Please include the docket number, request number, and respondent name and title on the answers. If your response contains Trade Secret data, please include a public copy.

Request Number:	**4**
Topic:	Minnesota Power's Projected Capital Structure
Reference(s):	Petition, Table 1

Request:

Please provide Minnesota Power's projected capital structure as of June 30, 2026 (*i.e.*, the capital structure that would be used for ratemaking purposes as opposed to ALLETE's projected capital structure, as shown in Table 1 of the Petition).

Response:

Minnesota Power's capital structure was 53 percent equity and 47 percent long-term debt as approved in its most recent rate case Docket No. E015/GR-23-155, and the Company projects to carry that capital structure going forward. Minnesota Power is committed to carrying the authorized capital structure, and historically has shown the ability to manage to the authorized capital structure.

To be completed by responder

Response Date:	4/21/2025
Response by:	Josh Taran
Email Address:	jtaran@allete.com
Phone Number:	218-355-3332

Minnesota Department of Commerce
85 7th Place East | Suite 280 | St. Paul, MN 55101
Information Request

Docket Number: E015/S-25-138
Requested From: Minnesota Power
Type of Inquiry: Financial

☐Nonpublic ☒Public
Date of Request: 4/30/2025
Response Due: 5/12/2025

SEND RESPONSE VIA EMAIL TO: Utility.Discovery@state.mn.us as well as the assigned analyst(s).
Assigned Analyst(s): Craig Addonizio, Justin Taylor
Email Address(es): craig.addonizio@state.mn.us, justin.taylor@state.mn.us
Phone Number(s): 651-539-1818, 651-539-1031

ADDITIONAL INSTRUCTIONS:
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Request Number:	**6**
Topic:	Financing if Commission denies authorization to issue preferred stock
Reference(s):	Petition at 15.

Request:

a. Does the Merger Agreement allow ALLETE to issue common stock if the Commission does not permit the issuance of preferred stock?

b. Please explain how ALLETE will meet its financing needs if the Commission denies its request to issue up to $300 million in preferred stock.

Response:

a. Pursuant to the interim operating covenants in Section 5.01 of the Merger Agreement, the Company would need to seek consent from the Partners to issue common stock beyond issuances made through the Dividend Reinvestment Program and Employee Stock Purchase Plan. The preferred equity was intended to allow the Company access to temporary bridge financing during the period between signing of the Merger Agreement and closing of the Acquisition.[1]
b. The Company actively negotiated for and continues to believe that the preferred equity investment from the Partners enables ALLETE to remain well-positioned to meet its financing needs during the interim period between signing the Merger Agreement and the closing of the Acquisition. Please see the Company's response to DOC IR 11 for additional information on the Company's intended use of preferred equity in its capital structure. The Company cannot speculate at this time as to what actions would be

[1] See ALLETE's definitive proxy statement dated July 22, 2024, "Background of Merger" section at 35 (reference to April 28, 2024). https://investor.allete.com/static-files/2de39a9f-5de7-414a-acf1-36c85f4c1bba

To be completed by responder

Response Date:	May 12, 2025
Response by:	Josh Taran
Email Address:	jtaran@allete.com
Phone Number:	218-355-3332

Minnesota Department of Commerce
85 7th Place East | Suite 280 | St. Paul, MN 55101
Information Request

Docket Number: E015/S-25-138 ☐Nonpublic ☒Public
Requested From: Minnesota Power Date of Request: 4/30/2025
Type of Inquiry: Financial Response Due: 5/12/2025

SEND RESPONSE VIA EMAIL TO: Utility.Discovery@state.mn.us as well as the assigned analyst(s).
Assigned Analyst(s): Craig Addonizio, Justin Taylor
Email Address(es): craig.addonizio@state.mn.us, justin.taylor@state.mn.us
Phone Number(s): 651-539-1818, 651-539-1031

ADDITIONAL INSTRUCTIONS:
Each response must be submitted as a text searchable PDF, unless otherwise directed. Please include the docket number, request number, and respondent name and title on the answers. If your response contains Trade Secret data, please include a public copy.

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taken under this hypothetical scenario. This decision would be based on market conditions at the time and availability and terms of other sources of capital.

To be completed by responder

Response Date: May 12, 2025
Response by: Josh Taran
Email Address: jtaran@allete.com
Phone Number: 218-355-3332

Minnesota Department of Commerce
85 7th Place East | Suite 280 | St. Paul, MN 55101
Information Request

Docket Number: E015/S-25-138 ☐Nonpublic ☒Public
Requested From: Minnesota Power Date of Request: 4/30/2025
Type of Inquiry: Financial Response Due: 5/12/2025

SEND RESPONSE VIA EMAIL TO: Utility.Discovery@state.mn.us as well as the assigned analyst(s).
Assigned Analyst(s): Craig Addonizio, Justin Taylor
Email Address(es): craig.addonizio@state.mn.us, justin.taylor@state.mn.us
Phone Number(s): 651-539-1818, 651-539-1031

ADDITIONAL INSTRUCTIONS:
Each response must be submitted as a text searchable PDF, unless otherwise directed. Please include the docket number, request number, and respondent name and title on the answers. If your response contains Trade Secret data, please include a public copy.

Request Number:	**7**
Topic:	S&P Treatment of Preferred Equity
Reference(s):	n/a

Request:

Please generally explain ALLETE's expectations as to how S&P Global Ratings will consider any preferred equity issued pursuant to the Merger Agreement when evaluating ALLETE's creditworthiness and how the agency will treat the preferred equity (*e.g.,* as debt, equity, or a combination of debt and equity) in assessing ALLETE's credit metrics. Please provide cites to any S&P's ratings methodology documents the Company relied on to support it answer.

Response:

The Company expects limited impacts on S&P's view of ALLETE's creditworthiness based on the potential issuance of preferred equity. This is evidenced by the lack of discussion on the topic in S&P's most recent credit report on the Company. The Company believes that S&P is viewing the potential for preferred equity as temporary bridge financing during the interim period before the Acquisition is closed and the Company can access common equity infusions from the Partners. See the response to DOC IR 11(b) for additional information on the Company's intended use of preferred equity.

While not the Company's intent, if preferred equity financing was included in its capital structure long-term, the Company believes S&P would analyze it under its 'Hybrid Capital: Methodology and Assumptions' General Criteria and it's likely that the preferred stock would receive 50% equity credit. See DOC IR 07.01 Attach.

To be completed by responder

Response Date:	May 12, 2025
Response by:	Josh Taran
Email Address:	jtaran@allete.com
Phone Number:	218-355-3332

S&P Global Ratings

RatingsDirect®

General Criteria:

Hybrid Capital: Methodology And Assumptions

February 10, 2025

OVERVIEW AND SCOPE

1. The criteria establish our framework for assessing equity content for and assigning a rating to a hybrid capital instrument, as well as clarifying how we consider the hybrid when assessing the capitalization or cash flow/leverage, and thus the creditworthiness of the issuer. Appendix A provides additional details on the criteria application, while certain terms are defined in the glossary (see Appendix B) and presented in title case on first reference. We use the terms hybrid capital instrument, hybrid instrument, and hybrid interchangeably in this article, and instrument refers to a hybrid capital instrument unless we specify otherwise. For information about the initial publication of this article as of Feb. 10, 2025, including key changes, the impact on ratings, and superseded criteria, see "Updated Hybrid Capital Criteria Published".

2. The criteria explain how we:

- Define a hybrid that falls under these criteria;
- Categorize a hybrid capital instrument by whether it has high, intermediate, or no equity content. The equity content determines how we consider it when assessing the capitalization or cash flow/leverage of the issuer; and
- Rate a hybrid capital instrument.

3. Hybrid capital generally refers to an instrument that has characteristics of both debt and equity, and therefore excludes common equity. S&P Global Ratings considers an instrument to be a hybrid capital instrument if, and only if, without causing a legal default or liquidation of the issuer, it can absorb losses or conserve cash. Examples of such loss absorption or cash conservation include:

- Deferral of the coupon;
- Write-down of principal; or
- Conversion into common equity or another hybrid capital instrument.

4. This applies to all hybrid instruments issued by corporate, financial institution, and insurance entities, non-U.S. public-sector funding agencies (PSFAs), and multilateral lending institutions (MLIs) and multilateral insurance institutions. Project finance issuances are excluded from the scope of this criteria.

5. For corporate ratings, securities held by an issuer's owner are governed by "The Treatment Of

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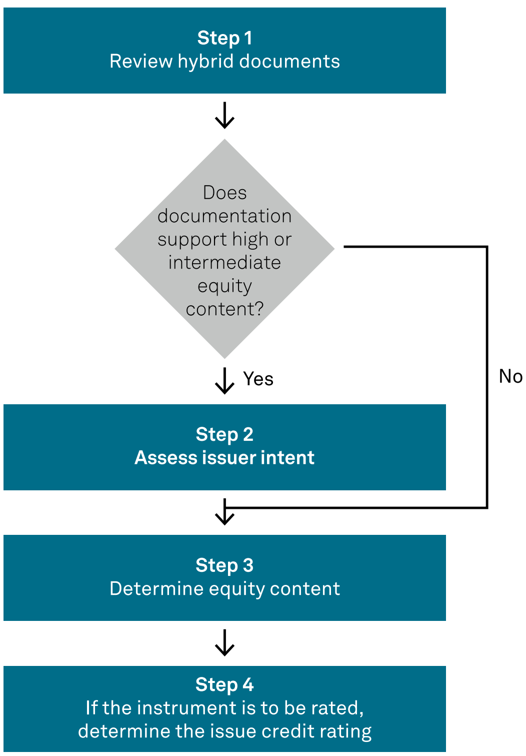
Non-Common Equity Financing In Nonfinancial Corporate Entities".

METHODOLOGY

6. These criteria provide our methodology for identifying, categorizing, and rating hybrid capital instruments. Although we apply consistent principles across all sectors, the treatment of certain hybrid instruments may reflect sector-specific characteristics. The sectoral classifications of certain financial services subsectors and PSFAs are summarized in table 3.

Chart 1

Assessing hybrid instruments



Source: S&P Global Ratings.

Equity Content: General Framework

7. This section describes the driving factors that govern how we assess the equity-like features of hybrid instruments. Our assessment initially focuses on the terms and conditions of the security, rather than the nomenclature alone. It also incorporates our view of issuer intent. An instrument may be considered to have high, intermediate, or no equity content, depending on the degree to which a hybrid instrument has equity-like features. Our view of its equity content can change over time. The key principles underpinning our view of a hybrid instrument's equity content are:

- Its ability to absorb losses or conserve cash, if and when needed; and

- Its availability to absorb losses or conserve cash, based on the hybrid instrument or its replacement remaining outstanding for a sufficiently long period.

8. To determine the equity content, we evaluate all the terms and conditions, and other relevant hybrid documentation, both separately and in a holistic manner. Where our assessment of the instrument does not lead to a clear and conclusive determination of the equity content, we will assign intermediate or no equity content if the hybrid could potentially have qualified for high equity content (with intermediate only assigned if the hybrid is consistent with the features for that category), and no equity content if the hybrid could potentially have qualified for intermediate equity content. Where we believe the instrument will not be available or that it cannot absorb losses or conserve cash in stress scenarios (see "Stress scenarios" in Appendix A for more details), we will assess the instrument as having no equity content, regardless of whether the terms and conditions might otherwise support higher equity content.

9. We assess issuer intent in determining whether the hybrid instrument would be available for loss absorption or cash conservation, if and when needed. The instrument will be classified as having no equity content if there is material uncertainty regarding whether the issuer will 1) keep it (or its replacement) outstanding for a sufficiently long period and 2) use it to absorb losses or conserve cash when needed.

10. We consider factors including, but not limited to, public statements regarding replacement, as well as our view of the issuer's capital strategy, and the issuer's past behavior concerning hybrid issues. Other factors include attempts to circumvent any restrictions on optional calls through repurchases, or where there is reason to think the issuer will do so in the future.

11. If the terms and conditions in the hybrid issuance or related agreements would lead us to assess the hybrid as having no equity content, our assessment of issuer intent cannot lead to an assessment of intermediate or high equity content.

12. A particular term or condition of the instrument may cause us to assess it as having no equity content upon issuance, but subsequently become obsolete (for example, due to the passage of time). In such cases, we will reassess the equity content, to the extent that we determine the issuer exhibits an intent to allow the instrument to absorb losses or conserve cash in stress scenarios.

13. We will typically reassess all of an issuer's hybrids and assess any future issue of hybrids as having no equity content if the issuer redeems any part of a hybrid that we assessed as having intermediate or high equity content before its Effective Maturity date, and does not replace it with an equivalent or stronger equity content instrument (see "Hybrid redemptions/repurchases and replacement" in Appendix A for more details on redemptions, both with and without replacement, and on features that may affect the likelihood of redemption). However, we may keep intermediate or high equity content on the remaining outstanding hybrid issues and continue to assign equity content to future hybrid issuances where:

- Creditworthiness has improved (see "Assessing improvement of creditworthiness" in Appendix A for details), and lack of replacement will not cause us to lower the long-term credit rating on the issuer or revise the outlook on the long-term credit rating to negative (or from positive to stable at the same rating level);
- The hybrid was redeemed due to an External Event; or
- The Redemption is immaterial in the context of the capital structure.

14. Where an issuer repurchases an existing hybrid (or takes similar action, excluding the exercise of a call option), even within five years of issuance date, generally, we would not change our view of the equity content of existing hybrid instruments (or preclude intermediate or high equity content for

future hybrid issuances) if it issues a replacement instrument and meets all of the following conditions:

- The replacement issuance has the same or higher level of equity content as the original instrument, or is a new issuance of common equity.
- The replacement issuance does not, in our view, materially weaken the creditworthiness of the issuer, including that it will not cause a lowering of the long-term credit rating or cause a downward revision to the outlook on the long-term credit rating.
- Our view of issuer intent--in particular, our view of the issuer's long-term intent to retain hybrid capital as a layer of capital to absorb losses or conserve cash in a stress scenario--remains supportive.

15. We assess a hybrid as having no equity content if, based on the hybrid documentation, a worsening of the issuer's creditworthiness would cause:

- The cost of servicing or the likelihood of redeeming the hybrid to increase; or
- The effective maturity date to move to an earlier date, whether this is due to a sliding step-up or other feature.

16. When loss absorption or cash conservation would be achieved by deferring coupon payments, the issuer must be able to defer payments for at least five years. If it cannot, we assess the hybrid as having no equity content.

17. For prudentially regulated entities, if a hybrid can only absorb losses in a Nonviability scenario--for example, at a breach of the minimum regulatory capital standard required to maintain its license--then we assess it as having no equity content.

18. We consider the views of regulators, insofar as they may influence the structure, terms, and payment of the issuance. For prudentially regulated banks and insurers, we assign no equity content to the instrument (or the portion of the issuance) where it is not included in regulatory capital. In jurisdictions where the regulators have expressed no view on a specific hybrid capital instrument, we will base our assessment on our view of the likely regulatory policy with respect to the instrument. For instruments that are included in regulatory capital, including those that are grandfathered by the regulators, we assess the hybrid instrument in line with the remainder of these criteria.

19. If we consider that a hybrid issued by an operating subsidiary can absorb losses or conserve cash to the benefit of the broader group, and it meets the conditions for high or intermediate equity content, we will assign such content to the instrument for the purposes of our group consolidated analysis (see "Hybrid instruments issued by operating companies" in Appendix A for an example). Hybrids issued by operating subsidiaries that cannot benefit the wider group in this way are treated as having no equity content in our group consolidated analysis. If, however, they can absorb losses or conserve cash at the issuer level, they are eligible for equity content in our analysis of the operating subsidiary on a stand-alone basis.

20. We typically assign no equity content to a hybrid originally issued to one or two investors by nonprudentially regulated entities, unless the instrument is issued to a government, invested in by the investor as a form of support during stress, or if the single or dual investor in the hybrid holds a relatively low percentage of the aggregate amount of intermediate (equity content) hybrids outstanding (see "Hybrids issued by nonprudentially regulated entities with one or two investors" in Appendix A for details). If a hybrid issued by a nonprudentially regulated entity is not issued to one or two investors originally, as stipulated above, but it subsequently comes to our attention that ownership of the hybrid series has evolved in the secondary market such that it is now owned

by one or two investors, and we expect that ownership structure to be retained in future, we may decide to remove any equity content that was previously assigned.

21. We typically apply the sector-specific hybrid criteria applicable to the issuer, even where the parent entity operates in a different sector. For example, a hybrid issued by an insurer in a bank group is analyzed under the insurance hybrid criteria, rather than the bank hybrid criteria.

Equity Content Categories

22. This section should be read in conjunction with the above general framework and the sector-specific sections below on additional considerations for corporate issuers, financial institutions, insurance institutions, and MLIs and multilateral insurance institutions, which describe our additional sector-specific criteria. Table 3 further clarifies how we apply the sector-specific criteria to certain financial services subsectors and PSFAs.

23. We assess hybrid securities as having high, intermediate, or no equity content.

High Equity Content

24. We typically assign high equity content to mandatory convertible securities (MCS) that have the following characteristics (see "Mandatory convertible securities" in Appendix A for details):

- If the issuer credit rating (ICR) is 'BBB-' or higher (stand-alone credit profile [SACP] is 'bbb-' or higher for banks), the issue converts into ordinary equity in no more than three years; if the ICR is in the 'BB' rating category (SACP is 'bb' category for banks), the issue converts in no more than two years; if the ICR is in the 'B' rating category (SACP is 'b' category for banks), the issue converts in no more than one year (for bank non-operating holding companies [NOHCs], the reference in all rating categories is the group SACP, rather than the SACP);
- The instrument includes a conversion price floor equal to or higher than the issuer's share price at the time of issue (adjusted for any subsequent share issuances); and
- We consider the issuer committed to allowing conversion and do not expect it to undermine the conversion benefit through subsequent stock repurchases.

25. Typically, we also assign high equity content to mismatched MCS (that is, transactions under which the debt remains outstanding after the associated equity issuance) so long as the associated equity issuance meets the above conditions, and we are confident that the issuer will use the proceeds of the equity issuance to repay debt (see "Mismatched mandatory convertibles" in Appendix A for details).

26. We typically assign high equity content to hybrids held solely by or on behalf of a government if we anticipate that the hybrid will absorb losses or conserve cash in a stress scenario (which, in the case of prudentially regulated banks and insurers, is equivalent to a going-concern basis) and it meets all of the following conditions:

- The government has invested in the instrument to rescue or provide extraordinary support to an issuer, or as part of a long-term support arrangement for 1) a bank, or 2) a specific project of an issuer that is of significant importance to the government.
- In the case of a bank hybrid, the government appears likely to continue to support the bank, even if it does not strengthen quickly. Examples of ongoing support include conversion of a bank hybrid capital instrument into common equity and the waiver of coupons or fees.
- During a period of stress at the issuer, we do not expect the hybrid to be redeemed unless it is

replaced by similar hybrid capital instruments owned by the government, or by common equity. Similarly, we do not expect the instrument to be sold to a nongovernment investor during the period of stress. If the issuer is a bank and the hybrid has an effective maturity date, the government has stated that only the bank's retained earnings would be used for redemption, and we expect that after such a redemption the bank's SACP will be at 'bbb-' or higher.

- The instrument is subordinated in liquidation (or an equivalent proceeding) to senior debt obligations of the issuer.
- Cash coupons are fully discretionary; deferred payments are not subject to a dividend or interest rate that is materially higher than the initial dividend or coupon; and payment flexibility can be exercised independently of all other hybrid capital instruments in the public market.
- The hybrid is not subject to "Criteria - Corporates - General: The Treatment Of Non-Common Equity Financing In Nonfinancial Corporate Entities," which covers corporate hybrids for which the government is also a strategic owner of the issuer.

Intermediate Equity Content

27. In order to achieve intermediate equity content, the instrument must:

- Be available and able to absorb losses or conserve cash in stress scenarios, before the point of nonviability or bankruptcy (or similar proceedings), whichever is earlier.
- Have a residual time until the effective maturity exceeding 20 years if the issuer ICR is at 'BBB-' or higher; 15 years if the ICR is in the 'BB' category; and 10 years if the ICR is in the 'B' category or lower (except for banks' Tier 2 going-concern Contingent Capital and for prudentially regulated insurers, for which a shorter time is acceptable, as explained in "Equity Content: Additional Considerations For Financial Institutions" and "Equity Content: Additional Considerations For Insurance Institutions" below). In this analysis, we generally use the ICR for entities other than banks, but we may use the SACP instead in circumstances where this better reflects the likelihood that the instrument will absorb losses or conserve cash (see table 1 for the residual time until the effective maturity for bank hybrids).
- Be subordinated in liquidation or equivalent proceedings to all senior debt obligations of the issuer.
- Not be callable within five years of the issue date (unless the call option is based on an external event). Also see "Make-whole clauses" in Appendix A.
- Be able to absorb losses or conserve cash, such as via nonpayment of dividends or coupons, or principal write-down, for at least five years without triggering a default or wind-up of the issuer.
- Be free from terms or features that discourage or materially delay deferral--such as a higher rate on accrued deferred amounts, or a Look-Back or similar Pusher restrictions of more than one year (see "Look-back periods" in Appendix A for more details), or most Alternative Payment Mechanisms (or similar) that do not incorporate adequate anti-dilution features--and shareholder approval is not required to activate a deferral (see "Restriction on the issuer's ability to defer payments" and "Features that mitigate concerns about APM usage" in Appendix A for more details and examples). Coupons can be either cumulative or noncumulative.
- If the instrument converts to equity on a preset date, the conversion price floor is typically equal to or higher than the issuer's share price at the time of issue (adjusted for any subsequent share issuances). Also see "Treatment of contingent capital instruments that have mandatory conversion features issued by Australia-regulated financial institutions and insurers" in

Appendix A for specific details on conversion features for such issuers.

No Equity Content

28. We assign no equity content to hybrid instruments that do not meet the requirements for high or intermediate equity content, including when issuer intent is lacking, and therefore treat these instruments as akin to debt in our analyses, where applicable (see "No Equity Content" in Appendix A for more details).

29. If the effective maturity of a hybrid would be accelerated in the event of a rating deterioration, we classify it as having no equity content.

Equity Content: Sector-Specific Criteria

Additional considerations for corporate issuers

30. We apply the following additional criteria when assessing the equity content of hybrids issued by a corporate entity.

31. The nominal value of hybrid instruments eligible to achieve intermediate or high equity content (excluding MCS) may constitute up to 15% of a corporate issuer's capitalization, as defined in "Corporate Methodology: Ratios And Adjustments." All hybrid instruments in the capital structure are accounted for in order of decreasing equity content, when assigning equity content. Where more than 15% of capitalization consists of hybrid capital instruments, and we anticipate that this will continue, we generally classify all hybrid amounts in excess of 15% of capitalization as having no equity content. However, an issuer's capitalization could decline because operating performance has deteriorated, as demonstrated, for example, by asset write-downs or operating losses. In such a case, we would not generally adjust the amount of hybrids receiving intermediate or high equity content, even if the amount of hybrids exceeds 15% of capitalization.

32. Where a corporate issuer redeems a hybrid without replacement to reduce aggregate hybrids outstanding to allow for the ratio of hybrid debt to capitalization to decrease from above 15%, and such redemption would have no or minimal negative impact on creditworthiness, we typically do not reclassify the equity content of its remaining hybrids.

33. The treatment of hybrids for the purposes of our leverage and debt service ratio calculations depends on the equity content classification and is explained in the Hybrid Capital Instruments section of "Corporate Methodology: Ratios And Adjustments".

Additional considerations for financial institutions

34. We apply the following additional criteria when assessing the equity content of hybrids issued by a financial institution (see table 3 for the treatment of certain financial services subsectors and PSFAs). Total adjusted capital (TAC) and adjusted common equity (ACE) are defined in the bank capital criteria "Risk-Adjusted Capital Framework Methodology".

Table 1

Treatment Of Hybrid Equity Content In Banks

Equity content category*	Maximum amount in TAC§	Qualifying instruments
High	Included in TAC at par amount, with no limit for qualifying government-owned hybrids for banks and up to 50% of ACE for MCS; for MLIs, included in TAC at par amount up to an amount equivalent to 50% of ACE	See "Equity Content Categories--High Equity Content"
Intermediate	Included in TAC at par amount, to an amount equivalent to up to 33% of ACE	Hybrids that meet all of the following conditions:
		1) Able to defer coupons, write down principal, or convert into common equity, without triggering a default or wind-up of the issuer;
		2) Have no material restriction on the ability to defer or otherwise absorb losses while the issuer is a going concern;
		3) Are perpetual or have a residual time until the effective maturity of at least 20 years if the issuer SACP assessment is 'bbb-' or higher, at least 15 years if the SACP category is 'bb', at least 10 years if the SACP category is 'b' (the reference point is the ICR, in the case of a NOHC), or a shorter residual life if they are Tier 2 going-concern contingent capital instruments as described in paragraph 36; and
		4) Do not contain a Step-Up clause, or an alternative incentive to redeem, associated with a call date during the residual life periods described above. If a step-up clause applies during the residual life period, the instrument may still qualify for this equity content category if it also contains a contingent capital feature that can be activated on a going-concern basis and is consistent with the features outlined in paragraph 36.
No	Not included in TAC	Instruments not meeting the requirements for high or intermediate equity content.

*In addition to meeting the features outlined in the table, the instruments must be included in regulatory capital to qualify for the high or intermediate categories. §We use the par amount unless an eligible instrument is subject to regulatory amortization. If so, we include the amortized amount in TAC until the aggregate amount of eligible instruments exceeds the TAC limits shown in this table. TAC--Total adjusted capital. ACE--Adjusted common equity. MCS--Mandatory convertible securities.

35. **Intermediate equity content.** If a bank hybrid capital instrument is a going-concern contingent capital instrument, we consider the regulatory classification of the instrument. If the instrument forms a part of Tier 1 regulatory capital, or if the regulation for the issuer does not differentiate between Tier 1 and Tier 2 capital, then the going-concern contingent capital qualifies as intermediate equity content if, in addition to meeting the cross-sector characteristics, it also meets the features shown in table 1.

36. If a going-concern contingent capital instrument is classified as Tier 2 regulatory capital (whether deferrable or nondeferrable), it qualifies as intermediate equity content if it meets all the following features:

- Residual time to the effective maturity date of at least 15 years if the SACP is 'bbb–' or higher; or at least 10 years if the bank's SACP is 'bb+' or lower. We use the ICR as a reference point if the issuer is an NOHC;

- Even in cases where regulatory approval is required for any redemption, the Hybrid Documentation stipulates that it may only be replaced by issuing new common equity instruments or by an equivalent or stronger instrument (with high or intermediate equity content) and that such a replacement would take place before the redemption of the instrument; and
- A conversion feature that transforms it into common equity or a feature allowing a permanent write-down of at least 25% of the principal. The triggers for these features would kick in mandatorily and on a going-concern basis. A temporary write-down would still be consistent with this condition if the permanent portion of any write-down is at least 25% of principal.

Additional considerations for insurance institutions

37. For all insurance sectors, we apply our insurance capital model criteria, "Insurer Risk-Based Capital Adequacy--Methodology And Assumptions," with respect to hybrid capital limits.

38. To be eligible for intermediate equity content, hybrids issued by prudentially regulated insurance companies must have a residual time until the effective maturity exceeding 10 years.

Additional Considerations For MLIs And Multilateral Insurance Institutions

39. If a hybrid is eligible for high or intermediate equity content, then we:

- Include it in the issuer's TAC in accordance with the limits in the "Maximum Amount In TAC" column of table 1 (which we also use for banks) if the issuer is an MLI, or
- Use the limits in "Insurer Risk-Based Capital Adequacy--Methodology And Assumptions" if the issuer is a multilateral insurance company.

40. If the MLI or multilateral insurance institution is subject to regulatory capital requirements, then a hybrid is only eligible for high or intermediate equity content if it is included in regulatory capital.

41. For us to assign equity content to a hybrid, we would expect to receive comfort that the issue of the hybrid has been approved and authorized in accordance with the governance structures established by the entity's member governments, in addition to assessing the features outlined elsewhere in the criteria. An MLI or multilateral insurance institution hybrid receives no equity content if it is convertible into common equity, unless it is clear that the investor is able to own common equity in the entity, and that the conversion would take place automatically if the conversion trigger occurs. (For example, the conversion, and the associated creation of new common equity, would not require any authorization or approval once the trigger event occurs.) To be eligible for equity content, the amount of common equity created on the conversion must be equal to the principal amount of the hybrid. (For example, a $100 million principal hybrid would convert into $100 million of common equity on the MLI's balance sheet.) If the convertible hybrid can be traded to another investor, then we don't assign any equity content because it is not clear that all future investors would be able to own common equity in the entity.

High equity content

42. A hybrid that an MLI or multilateral insurance institution issues is eligible for high equity content if

it meets the features outlined in the cross-sector hybrid capital criteria for high equity content--including the bank-specific references in paragraph 24 (for an MCS) or paragraph 26 (for other instruments)--and is invested in only by member governments. Unless it is an eligible mandatory convertible security (MCS), it also has all the MLI/multilateral insurance institution sector-specific features outlined for an intermediate equity content hybrid as proposed below. For instruments other than an MCS, it also clearly absorbs losses before a hybrid issued to nongovernment investors. (But if not, it could be eligible for intermediate equity content if it meets all the features for that category.) For instruments other than an MCS, the mandatory coupon deferral trigger would be set to occur at an earlier level than for an intermediate equity content hybrid.

Intermediate equity content

43. To be eligible for intermediate equity content, a hybrid that an MLI or multilateral insurance institution issues must be consistent with cross-sector criteria for that category (including the bank-specific references in paragraph 27) and all of the following apply:

- Has no stated maturity;
- Does not contain a step-up clause, or an alternative incentive to redeem, associated with a call date;
- In addition to a mandatory coupon deferral if a specific going-concern capital-based financial trigger is breached, has no material restriction on the ability to defer or otherwise absorb losses while the issuer is a going concern;
- In addition to a coupon deferral feature, has a mandatory permanent write-down of 100% of principal or conversion into new common equity that occurs before the drawdown of any callable capital and before default on any senior obligations (if the entity does not have any callable capital, then the write-down or conversion occurs before default on senior obligations); and
- The hybrid documentation stipulates that it may only be replaced by issuing new common equity instruments (such as by a general capital increase) or by an equivalent or stronger instrument (with high or intermediate equity content) and that such a replacement would take place before the redemption of the instrument.

44. The level of the capital-based financial trigger that corresponds to a going-concern basis could differ by entity depending on the nature of its assets. If the entity is subject to regulatory capital requirements, then the capital-based financial trigger will be based on a regulatory capital ratio. If not, then the trigger will be based on an MLI equity-to-assets ratio, using the entity's reported members' equity and assets. We define MLI equity as paid-in equity from shareholders and accumulated profit reserves.

Assigning An Issue Credit Rating To A Hybrid Instrument

General Principles

45. For instruments that are ratable, we assign an issue credit rating by notching down from the starting point for that issuer. Notching for hybrid instruments generally combines: 1) one or two notches for subordination and 2) one or more notches to reflect the risk of loss absorption or cash conservation. This applies to all hybrids, even those that have no equity content.

46. We do not rate a hybrid instrument if it has a loss-absorption or cash conservation trigger that is not related to the issuer's creditworthiness. Examples of such triggers include those linked to an issuer's market capitalization or share price. Others include those based on regulators' concerns about financial stability in the broader market, or linked to events or situations that cannot be observed using public information, for example, where a regulator has full discretion to activate the trigger while an issuer is still a going concern. However, if the regulator's discretion extends only to deciding whether an issuer is about to breach a defined and observable regulatory ratio, or only to deciding whether an issuer is nonviable, then the instrument is a nonviability contingent capital (NVCC) instrument and is ratable.

47. A debt instrument that transforms into a hybrid instrument upon a trigger event will be rated based on its hybrid features if we anticipate that the trigger will be activated at or before loss absorption or cash conservation on an equivalent hybrid instrument.

48. If a hybrid instrument has a guarantee from a higher-rated entity, then we apply our criteria "Guarantee Criteria."

49. Table 3 provides further clarification regarding the application of criteria to certain financial services subsectors and PSFAs.

Starting point for notching in corporate and insurance entities

50. For corporate and insurance entities (including insurance NOHCs) we generally assign an issue credit rating to a hybrid capital instrument by notching down from the ICR on the issuer. That said, we exclude any elements of support that we do not expect to apply to the hybrid from our starting point. For example, if the ICR includes uplift for potential extraordinary group, government, or additional loss-absorbing capacity (ALAC) support that we do not expect to apply to the hybrid, we typically exclude those elements of potential support from the starting point for notching (see "Starting Point For Notching For Insurance Subsidiaries Of Banking Groups" in Appendix A for an example). For example, we may notch down from the SACP in certain cases instead.

Notching for subordination

51. For corporate entities, our criteria "Reflecting Subordination Risk In Corporate Issue Ratings" describes how we notch down to reflect the subordination of hybrid capital instruments.

52. For hybrids issued by banks and insurance entities (including NOHCs), MLIs, and multilateral insurance institutions, where the applicable starting point for notching is 'bbb-' or 'BBB-' or higher, we deduct one notch for subordination. Otherwise, we deduct two notches for subordination.

53. We do not deduct additional notches for different degrees of subordination in any sector.

Notching for risk of loss absorption or cash conservation

54. We reflect the risk of loss absorption or cash conservation, either of which create payment risk, by deducting one or more notches. See "Deferral Triggers And Impact On Notching For Corporates And Prudentially Regulated Insurance Entities" in Appendix A for more details, for example on our treatment of multiple deferral triggers.

55. Instruments issued by prudentially regulated entities that have a mandatory contingent capital clause based on a nonviability trigger are rated one notch lower than an equivalent hybrid instrument that does not have such a feature, unless the clause is only activated after the issuer's share capital has been depleted to zero.

56. If we consider that the payment risk (that is, the likelihood of loss absorption or cash conservation) for a specific instrument is not reflected in either the starting point or the minimum notching, we apply wider notching at issuance. We may also revise the notching as part of our surveillance if the payment risk increases or decreases over the life of the instrument. We do not impose a limit on the number of notches that we may deduct for payment risk.

57. If the instrument includes features that enable the issuer to modify it in such a way that the risk of loss absorption or cash conservation would increase, we incorporate those features into the rating from the issue date. Where an external event must occur before an issuer may modify the instrument, we do not typically incorporate the potential change in the terms of the instrument into the rating.

58. Payment-in-kind (PIK) instruments (including toggle notes) are typically not subject to notching for the risk of loss absorption or cash conservation, as the imputed promise will not generally be breached before the instrument's maturity date. However, if a PIK instrument's terms and conditions create an imputed promise that the investor will receive payments in cash during the instrument's life (and these payments can be deferred), we typically treat the feature as equivalent to cumulative coupon deferability and notch as if the instrument contained such a deferability feature.

59. We cap at 'CCC' our rating on a hybrid instrument that has a contingent capital trigger leading to common equity conversion or principal write-down, or both, that is based on a specified rating change. Note that we do not consider a contingent capital trigger to be based on a rating change if it is based on an entity entering into bankruptcy or similar proceedings.

60. We apply "Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings," where the risk of loss absorption or cash conservation exceeds a 'B-' scenario. We first determine the likelihood of the instrument defaulting, and then adjust for subordination where relevant, subject to a floor at 'C' for subordinated instruments and at 'CC' for unsubordinated instruments. See "S&P Global Ratings Definitions" for situations where the rating on a hybrid capital or similar instrument goes to 'D'.

Rating The Hybrid Instrument: Additional Considerations For Banks

61. The criteria in this section apply to all ratable bank hybrid instruments, regardless of their equity content classification or whether they are considered part of regulatory capital. This section also applies to certain nonbank financial institution (NBFI) subsectors and PSFAs, as shown in table 3, and also gives the approach for rating bank conventional nondeferrable subordinated debt instruments that are not classified as hybrids. See "Rating The Hybrid Instrument: Additional Considerations For Banks" in Appendix A for more details, including on the use of the different steps outlined in this section.

62. To assign a rating to a bank hybrid capital instrument, we deduct notches from our starting point.

63. The sum of the total number of notches deducted in each step is deducted from the starting point to arrive at the issue credit rating on the hybrid (see table 2).

Table 2

Rating Bank And Bank Nonoperating Holding Company (NOHC) Hybrid Capital Instruments

Instrument features	Number of notches
Step 1: Standard notching	
Step 1a: Whenever an instrument is subordinated to senior unsecured debt in resolution or liquidation, regardless of its labeling, deduct notches to reflect contractual subordination. Notching does not vary for different subcategories of contractual subordination.	One notch where the starting point is 'bbb-' or above; otherwise two notches.
Step 1b: If the instrument has a discretionary or mandatory deferral clause that would lead to coupon deferral and the regulator classifies it as regulatory capital, deduct notches. This applies even if coupon deferral can only occur when a bank breaches its minimum regulatory capital requirements (see further details below).	For a regulatory Tier 1 instrument in a jurisdiction that has adopted or is planning to adopt the general provisions of Basel III or equivalent measures, deduct two notches. Otherwise, deduct one notch.
Step 1c: Identify whether the instrument has a mandatory contingent capital clause leading to common-equity conversion or a principal write-down, or both; or whether the relevant regulatory or legal framework creates the equivalent of such a clause.	Deduct one notch, in line with paragraphs 55, 70, and 71.
Step 2: Additional notching	
Step 2a: If the instrument has a mandatory going-concern trigger (either statutory or contractual) linked to a regulatory capital ratio in the form of a specific number, deduct notches as specified to factor in the difference between our expectations of a bank's regulatory ratios and the regulatory ratio level that triggers the loss absorption or cash conservation. Step 2a and Step 1c both apply for such an instrument.	If so, deduct additional notches or apply rating caps, as follows, when we expect the regulatory capital ratio to stay within a given range of the trigger or at a minimum level:
	--If 301 bps-700 bps: deduct one notch;
	--If 201 bps-300 bps: deduct two notches;
	--If 101 bps-200 bps: deduct four notches; or
	--If up to 100 bps: deduct four notches and set the issue credit rating no higher than 'CCC'.
Step 2b: Identify whether the instrument has loss absorption or cash conservation risks that neither our assessment of the starting point nor the standard notching in Steps 1a to 1c and Step 2a fully captures.	If so, deduct one, two, or three additional notches, depending on the likelihood of nonpayment on the instrument.
Step 2c: Identify whether the instrument has a contingent capital clause based on a rating change trigger that leads to common-equity conversion or a principal write-down, or both.	Refer to paragraph 59.

bps--Basis points.

Starting point for standard notching for banks and bank NOHCs

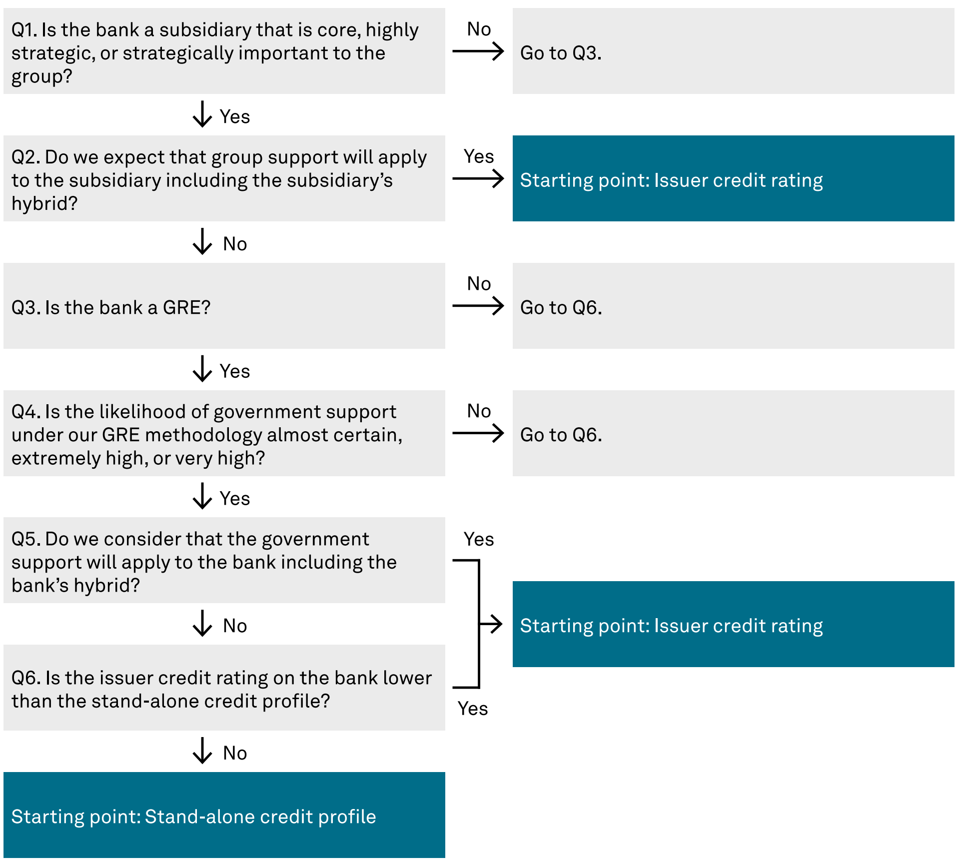
64. We assign a rating to an operating bank's hybrid capital instrument by notching down from the bank's SACP, except in the following situations, when the starting point is the ICR:

- If the bank is a subsidiary that is core, highly strategic, or strategically important, and we expect that group support will apply to the subsidiary, including the subsidiary's hybrid;

- If the bank is a government-related entity, the likelihood of government support under our criteria "Rating Government-Related Entities: Methodology And Assumptions," is almost certain, extremely high, or very high; and we consider that the government support will apply to the bank, including the bank's hybrid; or
- If the ICR on a bank is lower than the SACP.

Chart 2

Starting point for notching an operating bank's hybrid capital instrument



GRE--Government-related entity. Source: S&P Global Ratings.

65. Where the hybrid instrument is issued by an NOHC, the starting point is typically:

- The lower of the ICR and the group SACP (subgroup SACP, if the issuer is the NOHC of a subgroup); or
- The lower of the ICR and the GCP (subgroup GCP, if the issuer is the NOHC of a subgroup).

66. The starting point for the NOHC hybrid is, however, the GCP (subgroup GCP, if the issuer is the NOHC of a subgroup), if:

- The ICR of the operating entity (in the relevant group or subgroup) is the starting point for an equivalent hybrid issued by the operating entity; and
- We expect that external support in the GCP will apply to the NOHC hybrid.

Standard Notching

67. For all bank hybrid capital instruments, our notching methodology starts with standard notching, which is the sum of:

- Step 1a: Notching for contractual subordination;
- Step 1b: For the risk of a partial or untimely payment; and
- Step 1c: Where applicable, for a mandatory contingent capital clause leading to conversion into common equity, a principal write-down, or both.

68. **Further details on step 1b:** We deduct one notch in the following cases:

- A Tier 1 instrument that is not subject to Basel III;
- A Tier 2 instrument that has a deferrable coupon;
- A legacy Tier 1 instrument that is not subject to the general provisions of Basel III (or equivalent rules) or where the issuer is not in a jurisdiction that plans to adopt Basel III or any equivalent measures;
- A deferrable instrument issued by a company that is not subject to Tier 1 or Tier 2 regulatory capital classifications; or
- A hybrid instrument that has restrictions preventing coupon nonpayment.

69. We deduct two notches in the following cases:

- A regulatory Tier 1 instrument issued by a bank that is subject to, or in a jurisdiction that plans to adopt, the general provisions of Basel III or equivalent rules;
- A legacy Tier 1 instrument that is now subject to Basel III or equivalent rules;
- A Tier 2 or other hybrid instrument for which coupon deferral risk is linked to a Tier 1 instrument; or
- A hybrid instrument for which Basel III provisions apply or will be adopted, even if it has a restricted ability to defer coupon payments.

70. **Further details on step 1c:** We deduct one notch for going-concern or NVCC clauses unless:

- We anticipate that the regulatory environment is such that the bank is likely to receive pre-emptive extraordinary government support if it is in distress, at a relatively early stage of its deterioration; and
- The regulator's statements suggest that such pre-emptive government support would not constitute a nonviability event and would therefore not lead to a principal write-down or equity conversion of the hybrid.

71. We would not typically deduct a notch for Tier 3 or similar instruments that are only subject to write-down or conversion in a resolution.

Additional Notching

72. Additional notching is applied to address the following risks:

- Step 2a: The instrument has a statutory or contractual mandatory going-concern trigger that is linked to a specific regulatory capital ratio, expressed as a number.
- Step 2b: Loss absorption or cash conservation risks that are not captured elsewhere in our assessment.
- Step 2c: Contingent capital clauses based on a rating change.

73. **Further details on step 2a:** We deduct further notches in line with the capital ratio ranges shown under step 2a in table 2 if the trigger results in deferral of coupons, or is a contingent capital trigger that leads to a principal write-down or conversion into common equity.

74. In these cases, the deduction reflects the difference between our expectations of a bank's regulatory ratios and the regulatory ratio level that triggers the loss absorption or cash conservation, based on the lowest regulatory capital ratio we expect for the subsequent 12-24 months, or a higher capital ratio if we strongly expect that capital will strengthen imminently in response to actions the bank has announced.

75. We consider a trigger that relates to compliance with a minimum regulatory capital requirement to maintain a banking license to be a nonviability trigger, in which case step 2a does not apply.

76. **Further details on step 2b:** We deduct up to three notches for loss-absorption risks that the standard notching and step 2a do not capture, depending on the likelihood of loss absorption on the instrument.

77. We cap our rating on a hybrid issued by a bank subsidiary of an operating bank at the level we would rate an otherwise identical hybrid issued by the parent bank (even if no such hybrid has been issued). We would not cap the rating at the level of the rating on an otherwise identical hybrid issued by an NOHC in the banking group. We also do not cap the rating on the subsidiary's hybrid if the ICR on the subsidiary is higher than that on the parent bank.

Nondeferrable subordinated bank debt (NDSD)

78. We classify NDSD (see "Bank nondeferrable subordinated debt (NDSD) hybrids" in Appendix A for more details) as hybrids, and rate it using the steps outlined in table 2 (including the relevant starting points) if the instrument:

- Has a contractual or statutory mandatory contingent capital feature that enables it to absorb losses before a legal default of the issuer; or
- Constitutes part of a bank's regulatory capital and has a higher default risk than the bank's senior debt due to a discretionary contractual or statutory contingent capital feature or resolution regime arrangements.

79. Conventional bank NDSD is not classified as a hybrid. See "Financial Institutions Rating Methodology" for the criteria for assigning ratings to these instruments.

Rating The Hybrid Instrument: Additional Considerations For MLIs And Multilateral Insurance Institutions

80. We apply the "Rating The Hybrid Instrument: Additional Considerations For Banks" section, including the starting point and notching approach in table 2 and associated text. MLI hybrids are therefore rated with reference to the SACP of the entity, except in the cases outlined in that section. Hybrid instruments do not, in our view, transfer or extend the preferred creditor status of the MLI to the hybrid investors, even if/when converted into common equity.

81. For step 1b, we deduct one notch if the entity is not subject to Tier 1 regulatory capital measures.

82. For step 1c, we generally deduct a notch for the principal write-down feature.

83. We apply step 2a using an MLI equity-to-assets ratio if the entity is not subject to a regulatory capital ratio.

SECTOR CLASSIFICATION OF CERTAIN FINANCIAL SERVICES SUBSECTOR ISSUERS AND PSFAS

Table 3

Subsectors As Defined In The Glossary

	Which section of the hybrid criteria to apply?		
	For equity content categorization	**For incorporating equity content category into issuer credit analysis**	**For rating the issue**
Financial services companies			
Financial services finance companies (FSFC) that are prudentially regulated	Cross-sector	Corporate	Bank
Other FSFCs	Cross-sector	Corporate	Corporate
Asset managers	Cross-sector	Corporate	Corporate
Certain financial market infrastructure companies (FMI)*	Cross-sector	Corporate	Bank
Other FMIs	Cross-sector	Corporate	Corporate
Nonbank financial institutions (NBFI)			
NBFI finance companies	Bank	Bank	Bank
NBFI securities firms	Bank	Bank	Bank
U.S. business development companies	Bank	Bank	Bank
Larger securities firms	Bank	Bank	Bank
Nonprudentially regulated holding companies of an insurance group	Cross-sector	Insurance	Insurance
Alternative investment funds (AIF)			
Alternative investment funds	Cross-sector	Corporate	Corporate

Table 3

Subsectors As Defined In The Glossary (cont.)

	Which section of the hybrid criteria to apply?		
	For equity content categorization	For incorporating equity content category into issuer credit analysis	For rating the issue
Non-U.S. public-sector funding agencies (PSFAs)			
Non-U.S. public-sector funding agencies	Bank	Bank	Typically Bank

For other issuers that have a banking license, but where we do not use our bank criteria to assign the ICR and SACP, we generally use our bank criteria to rate the hybrid issue and the sector-specific criteria consistent with that used for the ICR/SACP to assess equity content. *Certain FMIs refers to those FMIs that are subject to Basel capital guidelines and have banking operations, however limited, and their holding companies that are prudentially regulated.

APPENDIXES

APPENDIX A: ADDITIONAL DETAILS ON THE CRITERIA APPLICATION

84. This appendix provides additional information related to the main body of this criteria article. It is intended to be read in conjunction with those criteria in the main body.

Equity Content--General Framework

Stress scenarios

85. We consider hybrid instruments as having equity content, despite their debt-like features, because they can absorb losses or conserve cash in stress scenarios, to the benefit of more senior creditors.

86. Examples of stress scenarios could include the following situations:

- The issuer has experienced a significant decline in creditworthiness, for example, into the 'B' rating category.
- An issuer initially rated in the 'B' category is now having difficulty accessing alternative sources of capital as a result of company-specific or market-related issues.
- For a bank that had an SACP of 'bbb-' or higher at the time of issuance, we generally expect its going-concern hybrid capital instruments to absorb losses early enough for the bank to maintain an SACP of at least 'b+'.

Hybrid redemptions/repurchases and replacement

87. Generally, we consider that redemptions negate the potential availability of hybrid issuance to absorb losses or conserve cash. Accordingly, the factors we consider when assessing redemption of a hybrid include the reason why the issuer chose to redeem the instrument. In particular, we assess what the redemption tells us about the issuer's intent to maintain the ability and availability of the hybrids to absorb losses and conserve cash, the use of hybrids within the

issuer's capital structure, and the potential impact on the issuer's creditworthiness.

88. When assessing hybrid redemptions, we do not consider that hybrid replacement is necessary when the redemption amount is immaterial in the context of the issuer's credit profile. Further, we typically consider redemptions of up to 10% over any 12-month period of aggregate hybrids outstanding, and up to 25% over any 10-year period, to be immaterial; therefore, they would not require replacement. We may allow for a higher percentage where we consider there has been a transformational divestment in the company and such redemption would have no or minimal negative impact on creditworthiness.

89. That said, our assessment also considers the credit effect of any redemption on an individual issuer's overall credit profile, and we assess the issuer's intent in redeeming the hybrids. If we anticipate the redemption will have a materially negative effect on an issuer's credit profile, a redemption without replacement may undermine our view of the equity content of the issuer's existing and future hybrids, even if the repurchase amount is within these guidelines.

90. In practice, for corporate and other nonprudentially regulated issuers (excluding nonprudentially regulated insurance holding companies), we consider a mix of 50% common equity and 50% debt to be an acceptable alternative to refinancing with 100% hybrid capital, for hybrids receiving intermediate equity content.

91. For example, consider a corporate issuer that has a $1 billion intermediate equity content hybrid which can be called now, plus several other hybrids that we classify as having intermediate equity content. The issuer calls the $1 billion intermediate equity content hybrid, and funds the call and replaces the instrument with $500 million of common equity and $500 million of nonhybrid debt. This financing would not lead us to question issuer intent and the intermediate equity content classification on the other hybrids (all other things being equal) because the issuer has replaced the hybrid with $500 million of common equity.

92. **Timing of issuance of a replacement hybrid:** A replacement hybrid can be issued up to or on the date the original hybrid is redeemed. We must be confident that it is being issued to replace the original hybrid, and that it otherwise qualifies for intermediate or high equity content. A new issuance of common equity can also be used to replace a hybrid.

93. **Terms and conditions:** A replacement hybrid need not have the same terms and conditions as the original instrument to qualify for intermediate or high equity content. For example, a hybrid with a noncall period of 10 years could be replaced by a hybrid with a noncall period of five years, assuming the replacement hybrid otherwise meets the criteria for intermediate equity content. If the original hybrid had intermediate equity content, the replacement hybrid must have intermediate or high equity content, or be a new issuance of common equity.

94. **Assessing equity content when an exchange or tender offer does not receive 100% take-up:** In the following examples, we are indifferent as to whether the redemption takes place as an exchange or a tender offer.

95. Consider, for example, a situation where an issuer issues a $1 billion replacement hybrid two years before the five-year, first call option date on an existing $1 billion intermediate equity content hybrid, and then immediately tenders for the original instrument, but attracts only 50% take-up under the tender offer. If we are confident that the replacement instrument is intended to replace the original instrument, and it meets our criteria for intermediate equity content, we would ascribe intermediate equity content to the full amount of the new hybrid.

96. The residual amount of the original hybrid would be regarded as having no equity content if we expect the issuer to redeem the remaining amount at the call date or repurchase it before the call date. Such a scenario would not adversely affect our view of the equity content of the group's

other existing or future hybrid issuances, all other things being equal.

97. Consider, for example, a situation where an issuer undertakes an exchange offer with an existing $1 billion intermediate hybrid two years before a five-year first call date, but attracts only 80% take-up under the exchange offer:

- If the new instrument qualifies for intermediate equity content and we consider that the issuer remains committed to maintaining the total $1 billion of hybrid capital as a permanent part of its capital structure, we would generally continue to maintain intermediate equity content on both the remaining portion of the existing instrument and the new instrument.
- If, on the other hand, we expect the total outstanding amount of hybrid capital to reduce, we could reassess issuer intent toward its hybrid capital instruments, depending on the magnitude and potential impact on the issuer's creditworthiness.

98. **Assessing equity content if instruments remaining outstanding following an exchange or tender offer are redeemed without replacement:** If, for example, 20% of a hybrid remains outstanding following an offer and is redeemed without replacement, this would not necessarily disqualify the issuer from intermediate or high equity content on all current and future hybrids. The level of equity content for the replacement hybrid would depend on our assessment of the feasibility of replacing the residual hybrid amount and the impact on the issuer's credit profile of not replacing it. If we consider that due to the size of the residual amount, it is not practical to issue equity or to raise a new hybrid as a replacement, we may continue to assign intermediate or high equity content to the issuer's existing and future instruments. However, this would assume that the reduction in hybrid capital is immaterial to the issuer's credit profile, and that the issuer's intentions toward its remaining hybrid capital remain supportive.

99. To illustrate this further, if we assume that the initial instrument was $250 million, and hence, the residual 20% was $50 million, we may consider it unfeasible to raise equity or issue a replacement instrument for the remaining amount. Accordingly, assuming that a redemption without replacement would have no material impact on the issuer's credit profile, we may continue to ascribe equity content to the issuer's existing and future hybrids. However, if the initial instrument was $1.5 billion, and the remaining 20% was $300 million, we would be less likely to consider redemption without replacement as consistent with having intermediate equity content.

100. **Replacing a hybrid with a larger instrument:** If an issuer issues an intermediate replacement hybrid that is larger than the one being replaced, we may assess the equity content of the full amount of the replacement instrument as intermediate if:

- It meets our criteria for intermediate equity content;
- We do not expect the hybrid issuance to exceed any applicable limits or typical thresholds over the financial forecast horizon; and
- We consider issuer intent supportive of this assessment.

101. **Follow-on issuances:** In some cases, a hybrid we regard as having intermediate equity content may be issued, and then, several months later, the size of the original hybrid is increased by making a follow-on issuance to raise additional proceeds.

102. We generally treat all hybrid follow-on issuances (such as tap issuances and top-ups) as stand-alone issuances for the purposes of assessing equity content. Accordingly, in this case, the follow-on issuance would need to qualify as having intermediate equity content in its own right, including having at least five years from the date of issuance until the first call date.

103. **Assessing improvement of creditworthiness:** For corporate issuers (excluding nonprudentially regulated insurance holding companies), when assessing whether creditworthiness has improved, we look at the company's creditworthiness pro forma for the redemption of the hybrids and any replacement financing. We then compare that to the date when the most recent additional hybrid was issued (excluding refinancings). Although we do not require that the rating has been raised to indicate improved creditworthiness, we do not consider that marginal improvements in creditworthiness offset the impact of redeeming a hybrid without replacing the instrument to be redeemed. Furthermore, in assessing redemptions without replacement, we would typically expect at least five years to have elapsed since issuance. A shorter time frame could lead us to question whether the issuer intends the hybrids to be available to absorb losses or conserve cash when needed.

104. For bank and insurance groups subject to prudential regulatory oversight, we generally anticipate that the regulator would expect the bank or insurance group to hold certain levels of hybrid or higher-quality capital, to maintain its solvency. Therefore, if a bank or insurer (or its NOHC) calls or redeems a hybrid without replacing it, we would generally expect that its creditworthiness would not be harmed, and that the group will continue to maintain sufficient capital adequacy to support its ratings.

Hybrid instruments issued by operating companies

105. Where a group subsidiary issued the hybrid to a third party and we anticipate that the instrument's loss-absorption capabilities will benefit the group, we may include the instrument's equity content in our analysis of the GCP, if the hybrid meets the relevant criteria for intermediate or high equity content.

106. Consider an example where an insurance operating subsidiary issues a hybrid security to a third party. We would expect a close alignment of the operating subsidiary's business risks with those of the broader group. In this case, we would expect the group to benefit because the hybrid would absorb losses or conserve cash at the operating subsidiary, thus reducing or removing any need for support from the group.

Hybrids issued by nonprudentially regulated entities with one or two investors

107. In our view, issuers of hybrid securities will likely find it more difficult to defer coupon payments in times of credit stress if just one or two investors hold the hybrid series and expect to receive the entire payment. Such investors may have a strong influence, which we consider detrimental to the likelihood that the issuer will choose to defer payment to absorb losses or conserve cash for the benefit of more senior debtholders.

108. In some cases, investors in hybrids are under common control. We consider the nature and extent of that control in our assessment. For example, if several funds controlled by a single fund provider invest in a hybrid issuance, we may consider those funds a single investor.

109. We may consider hybrid instruments that have only one or two investors to have equity content if they were issued to the investors during a period of credit stress, giving rise to our reasonable expectation that the one or two investors were aware of the realistic prospect that these hybrids may be required to absorb losses or conserve cash. In this regard, we consider stress to include scenarios where the issuer would otherwise have difficulty raising capital, or we believe that, due to the credit stress facing the company, the hybrid capital is being provided on more favorable

terms than would otherwise be available. In addition, we may assign equity content to a hybrid that was originally sold to one or two investors if that hybrid has the same Terms and Conditions as existing intermediate equity content hybrids, subject to the condition that the single or dual investor in the new hybrid will hold 25% or less of the aggregate notional amount of intermediate (equity content) hybrids outstanding, and provided that all other criteria to achieve intermediate equity content are met.

Make-whole clauses

110. For hybrid instruments, the term "make whole" can be used for different types of clauses.

111. A "make-whole clause," for example, can specify a period during which the issuer may redeem the instrument by paying the net present value of future cash flows until the first call date or the maturity, in addition to the principal amount and any accrued coupons. In such cases, the net present value calculation is typically based on a discount rate that is lower than the coupon rate on a similar hybrid.

112. We do not consider that this type of make-whole clause creates an expectation that the issue will be redeemed during the make-whole period. Accordingly, we do not view it as a call feature in our hybrid analysis, even if it is referred to as a make-whole call clause in the hybrid documentation.

113. Another type of make-whole clause is designed to ensure that hybrid noteholders are compensated if the issuer subsequently issues a new instrument on terms more favorable to the new hybrid noteholders. Such a clause may push up the coupon rate on the original instrument when a similar instrument is issued with a higher coupon rate, for example. Alternatively, it may lower the conversion price for a convertible instrument when common shares are issued at a lower price. Such make-whole clauses are not consistent with intermediate or high equity content, in our view.

Equity Content Categories

High Equity Content

Mandatory convertible securities

114. If we come to believe that an MCS will not absorb losses through conversion before default or the point of nonviability, we may reassess it as having no equity content, even if we previously considered it to have high equity content. This may occur if the issuer undergoes such a precipitous decline in its creditworthiness that we no longer expect it to be able to convert the hybrid to common equity before becoming a nonviable entity.

115. In some cases, the risk of failure to absorb losses may be mitigated; for example, if the instrument has a contingent capital feature, such as a credit-related trigger that absorbs losses through conversion or some other means, and this feature would be triggered before the issuer became a nonviable entity.

Mismatched mandatory convertibles

116. Mandatory convertible instruments usually convert directly into common stock. An alternative structure, known as equity units, comprises a debt instrument and a forward contract that obliges

the investor to purchase common equity. In the mismatched equity unit version, the debt remains outstanding after the common stock issuance, and the common stock issuance raises a second set of proceeds. If we believe that the issuer will immediately use the equity proceeds to repay the debt, and it meets the other criteria for high equity content, we will assign high equity content to the equity unit at the time of the initial issuance. Otherwise, we treat the two transactions--the initial debt and the subsequent equity issuance--as separate transactions in our analysis, and would only factor in the equity issuance once it occurs.

Intermediate Equity Content

Restriction on the issuer's ability to defer payments

117. To attain intermediate equity content, the instrument must be free from features that would materially delay deferral, such as look-back or similar features that last more than a year. Other examples of such features include:

- A clause that requires coupons to be paid as long as a prudentially regulated issuer meets the minimum regulatory capital requirements to maintain its license;
- A clause that requires coupons to be paid if an issuer has sufficient distributable reserves according to the most recent financial statements;
- A clause indicating that the issuer can defer coupons when a certain condition is met (for example, the issuer can defer coupons as long as it has not made payments on junior or pari passu instruments within a set period) if any resulting delay to the deferral could be material.
- Pusher circularity--a situation where pusher clauses on two or more parity instruments refer to each other, potentially preventing deferral of distributions on any of the instruments.

Treatment of step-ups that use a floating rate

118. For a step-up where a floating rate is used, we assess the credit spread before and after switching the floating rate.

119. Consider a scenario where a fixed coupon of 954bps changes at year 10 to a floating benchmark rate plus 675bps. In this case, we consider the 10-year swap rate at issuance to be a 10-year fixed-interest base rate. Therefore, a 10-year swap rate of 504bps at issuance in our scenario implies a credit spread during the first 10 years of 450bps (= 954bps–504bps). We therefore recognize the step-up as 225bps (= 675bps-450bps).

120. In some markets or under some regulations, the 10-year swap rate (504bps, in this example) is split into the 10-year government bond yield and the swap spread. Assuming a 10-year government bond yield of 442bps, this gives a swap spread of 62bps (= 504bps–442bps). We can also represent the amount of the step-up as below, giving the same result of 225bps.

- Step-up = credit spread in the floating coupon rate after the step-up – (initial credit spread to the 10-year government bond yield – swap spread)

Replacement capital covenants and public statements of replacement intent

121. In some jurisdictions, such as Japan, RCCs are not feasible under local laws. As described in our

definition of material incentive to redeem, issuers other than financial institutions and prudentially regulated insurers in these jurisdictions, an issuer's public statement of intent regarding future hybrid replacement may mitigate steps-ups of up to 100bps for issuers rated 'BBB-' or higher (and up to 200bps for issuers rated below this level).

122. For those issuers, a statement of intent can mitigate a step-up of this magnitude in a hybrid instrument when the following conditions are met:

- The statement of intent is publicly available, typically in the indenture or agreement of the hybrids and in one of the following: the issuer's annual report, an individual press release, or a statement issued at a public investor relations meeting; and
- Any step-up of more than 25 bps will not occur before year 10 and there is no call option before year five.

Look-back periods

123. The concept of the look-back period applies not only to pushers but also to cases where an issuer can choose to defer after breaching certain financial tests. For example, the terms and conditions provide that the issuer may defer payment of interest on a hybrid when it has reported losses in two consecutive years. In practice, this means that the issuer can't defer interest for more than a year after it starts to generate losses. We consider this equivalent to a look-back period of more than one year.

124. When we calculate the length of any look-back period, our calculation typically starts from the date of the last payment on, or repurchase of, a junior or pari passu instrument mentioned in the look-back or pusher clause. Also, our calculation extends only until the last hybrid payment date when the pusher pushes the issuer to pay.

125. For example: A hybrid includes a three-month look-back based on common dividend payments. The hybrid pays in arrears on Jan. 1 and July 1 of each year, and the issuer typically pays common dividends on Jan. 2, April 2, July 2, and Oct. 2. On April 2, 2016, it pays a common dividend. On April 3, the company's business prospects suddenly worsen and the issuer considers deferring payments on the hybrid. However, the pusher clause requires the issuer to pay on the hybrid on July 1 because it has made the April 2 common dividend payment. Therefore, assuming the company pays no further common dividends, it will not be allowed to defer payments on the hybrid until Jan. 1, 2017. As such, the first nonpayment date on the hybrid will occur almost nine months after the previous common dividend payment, or 12 months from the hybrid payment on Jan. 1, 2016. However, we interpret this as a three-month look-back, from April 2, 2016, until July 1, 2016, not a nine-month or 12 month look-back.

Features that mitigate concerns about APM usage

126. A timely payment APM gives the issuer an incentive to repurchase the stock issued under the APM. Therefore, we typically consider that a hybrid with this feature has no equity content unless it prohibits repurchasing of the stock for at least 12 months from the cure date.

127. Coupled with an optional deferral feature, we consider that a settlement APM discourages issuers from deferring coupon payments. Therefore, we typically consider that a hybrid with this or a similar feature has no equity content.

128. A hybrid instrument that has a settlement APM may achieve intermediate equity content if it incorporates adequate protection to limit the extent of potential equity dilution, such as in the following examples:

- Where the APM requires the issuer (whether legally or on a best-effort basis) to settle any optionally deferred payments by issuing a new instrument, such requirement does not occur prior to five years after the initial deferral and the new issuance;
- If the APM requirement to issue a new instrument occurs only when the issuer chooses to settle after the optional deferral at any time but (1) common shares that are required to be issued for such optional settlement are limited to a maximum 2% of the total number of shares outstanding during the period the deferral continues and (2) additional hybrids that are required to be issued for such optional settlement are limited to a maximum 25% of the initial hybrid principal amount.

Treatment of contingent capital instruments that have mandatory conversion features issued by Australia-regulated financial institutions and insurers

129. Contingent capital instruments that have mandatory conversion features that have been issued by a regulated Australian financial institutions or insurance entity, or a New Zealand financial institution or insurer that is a subsidiary of such an Australian group can generally be eligible for intermediate equity content, on the basis of the current applicable regulatory framework, if they meet all of the following characteristics, even when there are more than three years remaining to the mandatory conversion date:

- The conversion price floor cannot be below 50% of the common share price at the time of the initial issuance;
- The ICR is 'BBB-' or higher;
- The underlying instrument is preferred stock or its equivalent;
- Absent the conversion feature, the instrument would qualify as intermediate equity content under our criteria;
- We expect that the issuer will not reverse the share issuance (via conversion) with share repurchases; and
- We expect that the regulator intends that the issue will remain a component of the issuer's capital base for a long time, both before and after conversion.

130. We could extend this treatment to other jurisdictions in the future if the regulatory expectations are similar to those in Australia.

No Equity Content

131. An instrument that we classify as having no equity content is generally treated as akin to debt in our analysis of the issuer's credit profile. However, if a rating committee considers that a hybrid with no equity content provides a meaningful incremental benefit to an issuer's credit profile, beyond that of traditional debt, our analysis may still incorporate these benefits.

132. For example, if a corporate entity has issued a hybrid that has material credit-supportive features, but no longer qualifies as having intermediate equity content because its effective maturity date is less than 20 years away, we may reflect the benefits of the hybrid in other aspects of our corporate methodology. Similarly, if a corporate hybrid with no equity content includes a PIK feature that is being utilized, and we consider that this materially benefits the issuer's credit profile, we may focus our analysis of the issuer's financial risk profile more heavily on certain supplemental ratios, such as funds from operations cash interest coverage.

Real estate investment trust (REIT) hybrids

133. We typically assign no equity content to hybrids issued by a REIT or a similar tax-driven ownership structure if the instrument includes a dividend stopper that requires that ordinary dividend payments must be stopped before the hybrid coupon can be deferred. In our view, the loss of favorable tax treatment that would result from a failure to distribute taxable income if the dividend stopper was triggered would more than outweigh the cash flow benefit of any coupon deferral. We consider that this gives the issuer a strong incentive to avoid coupon deferral on the hybrid instrument, or to redeem it before deferring hybrid coupons.

134. That said, we may assess REIT hybrids as having intermediate equity content if the hybrid issuer can continue to distribute sufficient taxable income to ordinary unitholders to maintain the REIT's tax status, while deferring on its hybrid coupon payments.

PIK instruments

135. PIK instruments do not typically meet our criteria to be treated as having intermediate or high equity content, for a variety of reasons. In their simplest form, PIK instruments pay interest in kind for a predetermined period (which may be the life of the instrument) and are similar to zero-coupon bonds. Although such issues do not require companies to pay cash during the period, their generally steep interest rate and rapid accretion give the issuer a strong incentive to refinance the issue, undermining its availability to absorb losses or conserve cash. Moreover, issuers often issue PIK instruments to achieve a short-term objective; as such, we are typically skeptical about their willingness to maintain PIK instruments over the longer term.

136. Although PIK (or similar) instruments lack cash payments, which can help issuers to avoid cash outflows for a specified period, we generally consider that paying in kind or accreting on an ongoing basis (as opposed to only in a stress scenario) could harm an issuer's creditworthiness. If an issuer experiences any stress just before a mandatory PIK period ends, the accreted amount could exacerbate the damage to its creditworthiness. In our view, features that allow issuers to defer payments offer most benefit when the flexibility is reserved for periods of financial distress. PIK and similar instruments can also incorporate other features that undermine the potential availability and ability of the instrument to act like equity in a time of stress. For example, they may feature a dividend stopper that applies while the instrument is accreting/paying-in-kind.

Assigning An Issue Credit Rating To A Hybrid Instrument

Deferral Triggers And Impact On Notching For Corporates And Prudentially Regulated Insurance Entities

137. When hybrids have multiple deferral triggers, the notching is based on the trigger that we expect to be reached or exercised first.

138. We do not impose a limit on the number of notches that we may deduct for payment risk. Examples of where more than one notch may apply--either at issuance or later--include:

- Instruments with optional loss absorption and cash conservation, where the issuer is experiencing greater financial distress or cash availability is constrained;
- Instruments where the ICR from which it would be notched includes support that would not be attributable to the hybrid instrument; or

- Instruments that have a mandatory coupon deferral trigger that could be reached when the entity is still a going concern and that it materially increases payment risk.

139. Mandatory triggers include those related to an issuer's financial statements and financial statement metrics that can be reached when the entity is still a going concern (that is, a going-concern trigger). Examples may include features requiring coupon deferral if the issuer's earnings have been below a certain threshold, or if distributable items are insufficient to cover the coupon.

140. When rating hybrids, we consider how much payment risk is already incorporated into the ICR. We expect that as the risk of nonpayment increases--for example, as a mandatory deferral trigger point approaches or we gain increasing confidence that an optional deferral could be exercised--hybrid instrument ratings will generally follow a measured transition to default. This could come through the lowering of the ICR, resulting in a lower hybrid rating based on standard notching; the widening of the notching between the hybrid rating and the ICR; or a combination of both.

141. When we anticipate that coupon deferral is likely within the next 12 months, we apply our 'CCC' criteria to rate the hybrid instrument.

142. Where the ICR would encompass a deterioration in creditworthiness that makes a deferral more likely (for example, reduced solvency level) and would be at or close to default when a deferral trigger would be breached, then wider notching between the hybrid and ICR is not as necessary.

143. In circumstances where ICR is more resilient to these deteriorations, but the risk of default via deferral increases, then notching can widen, to manage the transition of the hybrid rating.

144. For insurance hybrids, in order to assess the relationship between ICR and hybrid rating, we consider how both would respond to stress or volatility. This is informed by a number of factors, including:

- The insurer's risk appetite and business profile;
- The actions that management could take to preserve or repair capital (for example, purchasing reinsurance or implementing hedges);
- Volatility (historical and expected) of an insurer's regulatory solvency;
- Insurer's target solvency levels and group support;
- Current and expected proximity to mandatory deferral triggers;
- Expectations regarding regulatory actions; and
- Market conditions and the insurer's operating environment.

145. Based on our understanding of these factors, we believe that certain jurisdictions, such as the European Economic Area, Switzerland, Australia, Bermuda, Canada, and the U.S., the minimum notching described in the criteria would generally be sufficient to reflect the incremental payment risk for hybrids issued by insurers with regulatory solvency ratios of at least 165%. In these jurisdictions, the capital regulatory solvency capital requirement is calibrated to a robust level (for example, it may be based on a one-in-100- or one-in-200-year confidence level).

146. For hybrid instruments issued in these jurisdictions by insurers with solvency ratios of below 140%, we anticipate that payment risk will be higher and that the rating will typically be below investment grade. Ratings may be higher than indicated above in circumstances where the factors mentioned in paragraph 63 specific to a company or a particular regulatory regime--for example, Canada's Life Insurance Capital Adequacy Test--result in solvency ratios that may be less

sensitive to shocks, or payment risk otherwise significantly less, than would typically be expected.

147. For other markets, where the regulatory solvency requirement that will trigger coupon deferrals is calibrated to a less-onerous 95th percentile confidence level, standard notching would typically apply for hybrids issued by insurers with solvency ratios in excess of 3x the trigger level. For hybrid instruments issued in these jurisdictions by insurers with solvency ratios of below 2x the trigger level, we expect the rating will typically be below investment grade. As in other jurisdictions, ratings may be higher than indicated here if company- or market-specific factors lead us to consider an issuer's solvency ratio less sensitive to shock than may otherwise be expected.

148. Conversely, we may apply wider notching when payment risk is greater than that indicated in the previous examples. Consider, for example, an 'A+' rated issuer in a jurisdiction with robust capital requirements. It has a solvency ratio of 170%, but exhibits significant exposure to catastrophe risk which could lead to material volatility in its regulatory solvency. In this situation, we may widen the notching on the hybrid rating to reflect the potential for a decline in solvency and increased payment risk.

149. For prudentially regulated insurance entities, if the predefined regulatory solvency ratio trigger is set at a level where, upon a breach or likely breach, the regulator might require or expect measures to be taken that are intended to help preserve or repair the insurer's solvency position, we would typically classify these as going-concern level triggers. For example, if an insurance operating company within a prudentially regulated insurance group issues a hybrid with a mandatory deferral trigger based on a group solvency ratio, we treat this as a going-concern trigger if it corresponds to a going concern level for the operating entity.

150. Where insurance hybrids have mandatory deferral triggers based on a group solvency ratio, we may apply a different notching to hybrids issued by an insurance holding company than we apply to hybrids issued by an operating company in the same group, if we consider the payment risk is materially different. For example, in cases where we rate an insurance holding company lower than its operating subsidiaries to reflect the holding company's reliance on distributions from operating subsidiaries to honor its obligations, we may consider a group solvency ratio trigger to be at the point of nonviability for the holding company, but at a going-concern trigger level for the operating subsidiaries. In such situations, we may consider the lower rating on a holding company's hybrids already reflects the increased payment risk and additional notching may not be required. We may also assess the holding company's other sources of income and liquidity to service the financial obligation when determining whether that trigger is set at the point of nonviability. We may also assess the holding company's other sources of income and liquidity to service the financial obligation when determining whether that trigger is set at the point of nonviability.

Starting Point For Notching For Insurance Subsidiaries Of Banking Groups

151. When the ICR of an insurance subsidiary of a banking group includes additional loss-absorbing capacity (ALAC) support, but we do not expect such support to benefit a hybrid issued by the insurance subsidiary, the starting point for notching would exclude the ALAC support.

152. Consider a situation where an insurance entity is rated 'A', based on an SACP of 'bbb' and three notches of uplift for group support as a strategically important subsidiary of a banking group. The banking group has a GCP of 'a+', which benefits from one notch of ALAC support; the group SACP is 'a'. If we determine that ALAC support does not apply to hybrid instruments issued by the insurance subsidiary, but that group support applies to the hybrid, we would remove the ALAC support in determining the starting point for notching and limit uplift for group support to one notch below the group SACP. Thus, the starting point would be 'a-'. If neither ALAC nor group

support applies to the hybrid, the starting point is the SACP--'bbb'.

Rating The Hybrid Instrument: Additional Considerations For Banks

Standard notching: Further details on Step 1b

153. We deduct a notch for a hybrid with restrictions on coupon deferral because these instruments offer a bank the legal right to defer paying coupons.

Standard notching: Further details on Step 1c

154. We deduct a notch where we consider a mandatory contingent capital clause applies. Such a clause may be included in an instrument's documentation or the relevant regulatory or legal framework may imply an equivalent clause. We do not deduct a notch if a contractual clause is discretionary and we do not expect regulators to enforce it.

155. The deduction would generally apply to Tier 3 instruments when we consider that there is incremental default risk due to the instrument's possible conversion or write-down relative to the default risk represented by the SACP. For example, we would typically not apply the 1c notch if the Tier 3 instrument was only expected to absorb losses after the full conversion or write-down of more junior instruments, including Tier 1 and Tier 2 regulatory capital instruments, and if the bank's SACP adequately captured the Tier 3 instrument's risk of conversion or write-down.

Additional notching: Further details on Step 2a

156. Examples of a mandatory going-concern regulatory capital-based trigger described as a specific regulatory capital ratio include where the hybrid documentation states the loss absorption on an instrument is mandatory if a specified capital ratio falls below a defined level expressed as a number, for example, 10%, or where the regulation or legislation defines a mandatory loss absorption trigger ratio as a number, such as 10%.

157. We typically treat the entry of a capital ratio into a regulatory capital conservation buffer range as a discretionary trigger. The notching for this risk is in step 2b instead of step 2a.

Additional notching: Further details on Step 2b

158. Where we see risks such as those listed below, and we consider that these are not fully captured in the starting point or the standard notching or step 2a, we typically deduct one notch, but can increase this to two or three notches, depending on our view of the likelihood of the clause being triggered.

- If reporting a loss in a particular accounting period leads to mandatory deferral on an instrument and prevents the bank from using its reserves to offset the impact of the loss;
- If a bank is at risk of insufficient distributable reserves for a regulator to permit payment on a hybrid capital instrument--even though nondistributable reserves are available;
- If there is a risk of a statutory or regulatory ruling that prohibits or restricts coupon payments, as has occurred, for example, when the European Commission required banks to stop coupon payments or otherwise bail-in bank hybrid capital instruments after ruling that the banks had received state aid;

- If we see a heightened risk of a bank or regulator activating a discretionary deferral clause. For example, when a bank's regulatory capital position means that it is at heightened risk of being subject to restrictions on capital distribution applicable for ratios within the ranges specified by Basel III's conservation buffer. This notching typically applies only to hybrids issued by banks whose regulatory capital levels are within the buffer ranges. However, we would also apply this notching if we see a heightened risk that a bank's regulatory capital will fall into the capital conservation buffer range that applies to that bank, and that this would trigger a decision by the bank or regulator to stop payments; or
- If we see an increased likelihood of default for a hybrid issued by an NOHC because: 1) we believe there is an heightened probability that the dividends or coupons the NOHC relies on to service its instruments will be curtailed; 2) the NOHC has a higher likelihood of regulatory intervention that would be detrimental to creditors than the operating bank; or 3) the starting point is the GCP or Group SACP rather than the ICR and has not fully reflected the increased likelihood of default arising from the NOHC's structural subordination.

Bank nondeferrable subordinated debt (NDSD) hybrids

159. We rate bank NDSD as hybrids in countries where the regulatory and legal frameworks, including bank resolution regimes, could cause NDSD debt to be converted into bail-in capital, or cause untimely or partial payment of coupon or principal without provoking a legal default or the bank's liquidation. In such jurisdictions, the government is unlikely to support the payment of NDSD, even though it may support a bank's senior debt.

160. Consequently, we use the section under the heading "Starting point for standard notching for banks and bank NOHCs" to determine the appropriate starting point for the issue credit rating on NDSD that is considered a hybrid. To determine whether Table 2 applies for a bank NDSD, we assess whether the legal and regulatory frameworks allow the authorities to instigate restructuring of a failing bank to the detriment of the NDSD holders.

161. For example, in some jurisdictions, the authorities could order the write-down of principal or transfer a nondeferrable subordinated instrument to a different legal entity from that carrying the senior debt, while also protecting the senior creditors. Such flexibility may be written into legislation, or be indicated by previous regulatory actions or the statements of those authorities.

162. Although the authorities may have power to force a default on NDSD to protect senior creditors in some jurisdictions, as described above, it may be uncertain whether they will use this option. In rare circumstances, a government may indicate its intention to prevent losses on NDSD. Under our rating methodology, we would then notch down from the ICR, instead of from the SACP.

APPENDIX B: GLOSSARY

Alternative coupon-settlement mechanism (ACSM)/alternative payment mechanism (APM): A provision that:

- Requires the issuer (usually on a best-effort basis) to settle deferred payments (resulting from either a mandatory or optional deferral feature) with the proceeds of issuing a new instrument ("settlement APM"), or
- Allows the issuer to avoid a mandatory deferral by issuing a new instrument before the hybrid payment date and using the proceeds to make timely hybrid payment ("timely payment APM").

The terms ACSM and APM are interchangeable.

Banks: As used in this criteria, includes banks, other deposit-taking institutions (including entities such as building societies), finance companies, bank nonoperating holding companies, and securities firms.

Basel III or equivalent measures: A regulatory framework that includes a regulatory capital buffer for banks, defined using a range of ratios. Under such a framework, as soon as a bank's regulatory capital ratio falls within the buffer range, it is required to reduce or restrict distributions on its capital instruments.

Callable/call option: Allows the issuer to redeem a hybrid capital instrument at a specified price at a specified time. Our assessment of equity content is not affected where an instrument is callable following an external event.

Callable capital: A common, but not universal, characteristic of MLIs and multilateral insurance institutions that refers to the portion of the entity's capital subscriptions that is not "paid-in" but that each shareholder has committed to provide in certain circumstances (generally, only to prevent a default on an MLI's debt). It therefore differs from hybrid capital that is paid-in by investors when the hybrid instrument is issued.

Contingent capital: An instrument that absorbs losses by converting into common equity or writing down principal following activation of a trigger. The conversion or write-down may be mandatory or optional and the trigger may be activated while the issuer is still a going concern (going-concern contingent capital) or in a nonviability situation (nonviability contingent capital).

Conventional nondeferrable subordinated debt for a bank: A nondeferrable subordinated instrument that has the same default risk as senior debt, has no contingent capital clause, and does not absorb losses before a legal default of the issuer.

Defer, deferability, and deferral: As used in this criteria article, refers to all cases where coupon payments are cancelled, not paid, or only partially paid on the payment date. This applies when timely full payment is at the issuer's discretion or prohibited either under the terms of the instrument or by the regulator.

We use these terms to cover situations where payments are suspended and the issuer is obliged to at least make efforts to settle the cumulative deferred payments, as well as cases where payments are cancelled, omitted, or forgone and the issuer is not obliged to make any attempt to settle the payment, once deferred.

Dividend stopper: Prevents an issuer from making payments on, or repurchasing pari passu or more junior instruments after deferring payments on a hybrid instrument, unless it has cured the arrears and resumed payments on the deferred instrument.

Effective maturity: The effective maturity of an instrument is the earlier of the following:

- The legal maturity date.
- The date at which an investor put option or similar feature is exercisable.
- The scheduled maturity date. We recognize a scheduled maturity as the effective maturity if the terms require an issuer to take all commercially reasonable effort to refinance an instrument on a particular date and to repeat the attempt periodically if the issuer is unsuccessful at refinancing the issue.

- The date on which there is a Material Incentive To Redeem the instrument.
- The date when our view of issuer intent leads us to consider redemption likely, even without a material incentive to redeem, and to consider replacement with an equal or higher equity content instrument unlikely.

Equity unit: A type of mandatory convertible security, structured as a unit, that combines two components:

- A forward contract that requires the investor to purchase--and the company to sell--the company's common shares at a predetermined price (or formula); and
- A company's debt (or preferred stock) security with a maturity or call date that may or may not match the common stock issuance date under the forward contract.

External event: External events include:

- Changes to tax law that result in the loss of tax deductibility of interest on a hybrid instrument or increase the withholding tax payable;
- Accounting changes that affect the initial equity classification of the instrument;
- Regulatory changes that reduce equity content or capital eligibility;
- Revisions to rating agency criteria that reduce the instrument's equity content; and
- Changes in control.

Tax law, accounting, and regulatory changes are considered external events unless a change has been announced at the date of issuance that we expect to affect the hybrid issuance on implementation.

Going concern: Generally refers to an issuer that is able to function; has enough resources to continue to meet its financial obligations as they fall due; and, in the case of prudentially regulated financial services entities, doesn't face the threat of liquidation, insolvency, or nonviability. If an issuer is not nonviable, we consider it a going concern.

Hybrid documentation: The material that we examine when reviewing the structure of a hybrid instrument. It includes, but is not limited to, the hybrid offering circular, prospectus, and the information memorandum or agreement that contains the legal terms and conditions of the hybrid. We also review associated documentation that is relevant to how the issuer will use the instrument, such as guarantees, deeds, waivers, covenants, and other contractual and transactional documentation. Documentation for other hybrids from the same issuer (or a group member) may be relevant if the instruments are linked. We also review published statements that do not constitute part of the legal terms and conditions, but that influence issuer behavior (such as language relevant to replacement intent). This body of material establishes the features of the instrument and whether it could be eligible for equity content.

Look-back and look-back period: A hybrid capital instrument feature, also referred to as a pusher or mandatory payment provision, that prohibits the issuer from deferring coupons on the hybrid instrument for a specified period (the look-back period) after a certain event. Possible events include payment of a dividend on, or repurchase of, common equity or any instrument ranked pari passu with the hybrid instrument. A particular risk is that look-back clauses on two or more parity instruments may refer to each other, which could prevent deferral of distributions on any of these instruments (look-back circularity).

Mandatory convertible securities (MCS): Securities that will be converted automatically into the issuer's common equity upon a predetermined date. MCS also includes equity units. In either case, the initial instrument could either be a loss-absorbing instrument or debt with fixed payment obligations. If an instrument mandatorily converts into common equity upon breaching a specific trigger, we consider the instrument to be a hybrid contingent capital instrument.

Material incentive to redeem: We consider the date on which the issuer has a material incentive to redeem a hybrid instrument on a particular date or event to be the effective maturity of the hybrid instrument.

Examples include:

- A discrete call followed by an extended noncall period. For example, an instrument that has a call option on a specific date and is not callable for more than five years thereafter.
- A material increase in the cost of servicing the instrument, for example, by materially increasing the coupon rate or credit spread (such a feature is often referred to as a step-up). This may include implicit step-ups linked to changes in the benchmark interest rate.

We assess coupon rate step-ups using the sector-specific approach below (see "Treatment of step-ups that use a floating rate" in Appendix A for our treatment of step-ups that use a floating rate). If the coupon rate steps up multiple times, we assess the cumulative effect.

For banks, we consider that any step-up constitutes a material incentive to redeem. For corporates and insurers, the incentive to redeem is material at a step-up of:

- Above 100 basis point (bps) for issuers rated 'BBB-' or higher, and above 200 bps for issuers rated 'BB+' or lower, in all cases regardless of whether it is mitigated by a Replacement Capital Covenant (RCC), or by issuer statements regarding intention to replace the hybrid; or
- 26 bps-100 bps (or 26 bps-200 bps for issuers rated 'BB+' or lower) unless it is mitigated by an RCC, or by an issuer's public statement of intent regarding future hybrid replacement in jurisdictions where RCCs are not feasible under local laws (see "Replacement capital covenants and public statements of replacement intent" in Appendix A for more details). For prudentially regulated insurers, an RCC is necessary when step-ups of this magnitude occur within the first 10 years of issuance. When market spreads rise dramatically, we may accept a step-up equivalent to no more than 50% of the original credit spread, subject to a cap of 200 basis points, where such a step-up is explicitly accepted by insurance regulators.

Nonviability: Generally applies to a prudentially regulated financial services entity that is in breach of, or about to breach, prudential regulatory requirements that could result in regulatory actions such as a withdrawal of its license, a required cessation of business, or a regulatory determination that the issuer is nonviable. See "contingent capital" for "nonviability contingent capital" (NVCC).

Payment-in-kind instruments: An instrument that can pay interest in kind. Typically issued by corporates rated 'BB+' and lower, PIK instruments have several forms. In the simplest form, PIK instruments pay interest in kind from the outset and for the life of the instrument. Instead of interest being paid in cash, the investor receives more of the same note, or the note's principal is increased, in accordance with the terms. Some PIK instruments initially require that the issuer make interest payments in cash, but allow a switch to paying in kind under certain circumstances.

Others initially require payment in kind, and switch to cash after a specified period. Toggle notes are another form of PIK instrument, for which the issuer can choose to switch between paying interest in cash or in kind.

Prudentially regulated entities: Companies (or groups of companies) that are subject to regulation and supervision that includes assessment of the adequacy of their capitalization.

Pusher: In a hybrid capital instrument, typically refers to a feature where any payment on, or repurchase of, a junior or pari passu instrument during a certain period (the "look-back period") would require, or "push," the issuer to continue timely payment on a hybrid. Most pushers are economically equivalent to a look-back feature. Some instruments use the term to mean a clause under which, if the issuer makes any payment on, or repurchases, junior or pari passu instruments, it must settle any payments it has already deferred on the hybrid instrument. This is often referred to as a "settlement pusher." We do not use the term "pusher" in this way. A settlement pusher feature does not restrict the issuer's ability to start deferring interest and does not create any circularity. Table 4 compares settlement pushers, look-back features, and common Dividend Stoppers.

Table 4

Comparison Of Common Dividend Stoppers, Pushers (Of Timely Payment)/Look-Backs, And Settlement Pushers

Hybrid features	Trigger event	Effect	Impact on equity assessment
Common dividend stopper	Deferral on hybrid	No common stock dividend	Neutral in general, potentially negative for real estate investment trusts
Pusher (of timely payment)/Look-back	Repurchase of or payment on junior or pari passu instrument	Obligation to make timely payment on hybrid	Negative if look-back exceeds one year or creates circularity
Settlement pusher	Repurchase of or payment on junior or pari passu instrument	Obligation to settle already deferred hybrid payment, if any	Neutral in general

Redemption: A hybrid is redeemed when the issuer repays the principal and retires the instrument. In this article, the words "redeem" and "redemption" refer to repayment of principal before the official maturity date, unless specifically noted otherwise, and include a repurchase of the instrument, except in the context of call options. An issuer may repurchase an instrument through a buyback on the open market, a tender offer, or an exchange with another instrument.

Replacement capital covenant (RCC): A legally binding commitment to replace a redeemed hybrid with a new instrument of equal or greater equity content.

Sliding step-up: A feature where a step-up date is altered following a defined event, such as a rating change. Step-up dates may slide in to an earlier date or slide out to a later date. Alternative names for such a feature include a dynamic step-up date.

Step-up: A feature where the coupon rate or credit spread on a hybrid capital instrument increases at a future date, usually as an incentive for the issuer to call the instrument. We typically calculate the step-up as the difference in the credit spread where a rate resets during the life of the instrument.

Tier 1, Tier 2, and Tier 3 instruments (banks only): Tier 1 and Tier 2 are prudential regulatory classifications of hybrid capital instruments and are used to determine how the instrument may be included in regulatory capital measures. Tier 3 is not always a regulatory classification. It can also refer to instruments that the issuer has structured to be senior to Tier 1 and Tier 2 instruments, but junior to senior unsecured instruments, in the event of a resolution.

Where a regulator does not classify a nonbank financial institution's instruments as being Tier 1 or Tier 2 capital, although they are classified as being part of regulatory capital, the concept becomes irrelevant to our determination of equity content. We therefore classify the instruments as having high, intermediate, or no equity content based on whether they are otherwise consistent with the characteristics of these equity content categories. If the regulator were to introduce these concepts, we would reclassify the equity content of these instruments accordingly.

Toggle note: A specific type of PIK instrument designed to facilitate switching back and forth between cash payments and PIK distributions, at the issuer's discretion. The issuer increases remuneration during those periods when it pays interest in kind.

KEY CHANGES

- A hybrid is no longer eligible for high or intermediate equity content if it has a feature (such as a sliding step-up date) that revises the effective maturity to an earlier date if the issuer is downgraded. If a downgrade happens, the hybrid could lose equity content sooner than it would have without the feature, which could reduce the issuer's flexibility to manage its refinancing and call decisions in a stress scenario. In particular, such a feature could make investors more likely to expect that, even after a downgrade, a hybrid issuer would still exercise its call option on the first call date.
- We amended paragraphs 15 and 29 to address this topic. We also added a definition of a sliding step-up to the glossary section.
- We have not changed our treatment of hybrids that have a sliding step-up feature that pushes the effective maturity date out to a later date if the issuer is upgraded, as long as the date cannot subsequently slide back in.

IMPACT ON OUTSTANDING RATINGS

We expect nine hybrid capital instruments, issued by three corporate entities, to be reclassified as having no equity content, rather than intermediate equity content. Based on our preliminary testing, we don't expect any impact on our issuer credit ratings on these entities, or on our issue credit ratings on the hybrids, as a direct result of the criteria change.

RELATED PUBLICATIONS

Fully Superseded Criteria

- Hybrid Capital: Methodology And Assumptions, March 2, 2022

Related Criteria

- Alternative Investment Funds Methodology, Aug. 30, 2024
- Methodology For Rating Non-U.S. Public-Sector Funding Agencies, July 26, 2024
- Multilateral Lending Institutions And Other Supranational Institutions Ratings Methodology, July 26, 2024
- Risk-Adjusted Capital Framework Methodology, April 30, 2024
- Insurer Risk-Based Capital Adequacy--Methodology And Assumptions, Nov. 15, 2023
- Financial Institutions Rating Methodology, Dec. 9, 2021
- Insurers Rating Methodology, July 1, 2019
- Group Rating Methodology, July 1, 2019
- Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- Guarantee Criteria, Oct. 21, 2016
- Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings, Oct. 1, 2012

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Minnesota Department of Commerce
85 7th Place East | Suite 280 | St. Paul, MN 55101
Information Request

Docket Number: E015/S-25-138 ☐Nonpublic ☒Public
Requested From: Minnesota Power Date of Request: 4/30/2025
Type of Inquiry: Financial Response Due: 5/12/2025

SEND RESPONSE VIA EMAIL TO: Utility.Discovery@state.mn.us as well as the assigned analyst(s).
Assigned Analyst(s): Craig Addonizio, Justin Taylor
Email Address(es): craig.addonizio@state.mn.us, justin.taylor@state.mn.us
Phone Number(s): 651-539-1818, 651-539-1031

ADDITIONAL INSTRUCTIONS:
Each response must be submitted as a text searchable PDF, unless otherwise directed. Please include the docket number, request number, and respondent name and title on the answers. If your response contains Trade Secret data, please include a public copy.

Request Number:	**8**
Topic:	Moody's Treatment of Preferred Equity
Reference(s):	n/a

Request:

Please generally explain ALLETE's expectations as to how Moody's will consider any preferred equity issued pursuant to the Merger Agreement when evaluating ALLETE's creditworthiness and how the agency will treat preferred equity (*e.g.,* as debt, equity, or a combination of debt and equity) in assessing ALLETE's credit metrics. Please provide cites to any Moody's ratings methodology documents the Company the Company relied on to support it answer.

Response:

The Company expects limited impacts on Moody's view of ALLETE's creditworthiness based on the potential issuance of preferred equity. This is evidenced by the lack of discussion on the topic in Moody's most recent credit reports on the Company. The Company believes that Moody's is viewing the potential for preferred equity as temporary bridge financing during the interim period before the Acquisition is closed and the Company can access common equity infusions from the Partners. See the response to DOC IR 11(b) for additional information on the Company's intended use of preferred equity.

While not the Company's intent, if preferred equity was included in its capital structure long-term, the Company believes Moody's would analyze it under its 'Hybrid Equity Credit' Rating Methodology, and it is likely that the preferred stock would receive 50% equity credit. See DOC IR 08.01 Attach.

To be completed by responder

Response Date:	May 12, 2025
Response by:	Josh Taran
Email Address:	jtaran@allete.com
Phone Number:	218-355-3332

MOODY'S
INVESTORS SERVICE

CROSS-SECTOR METHODOLOGY

Rating Methodology
Hybrid Equity Credit

TABLE OF CONTENTS

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This rating methodology replaces the *Hybrid Equity Credit* methodology published in September 2018. While this methodology reflects many of the same core principles as the 2018 methodology, we have simplified our framework for ascribing equity credit to hybrid instruments of investment-grade issuers. We have also modified our equity-credit classification scale and clarified how we assess shareholder loans. We have also made editorial changes to enhance readability.

Introduction

In this rating methodology, we explain our general approach to ascribing equity credit to hybrid instruments globally (including shareholder loans) issued by investment-grade and speculative-grade issuers other than banks. A hybrid instrument is a subordinated security (e.g., subordinate debt, preferred stock) that is not common equity and for which the omission of scheduled dividend, interest or principal payments is contractually allowable. A hybrid instrument also may be subject to contractually allowable write-downs of principal or conversion of the hybrid host security to common equity.[1] Based on these and other structural features, hybrid instruments have both debt and equity characteristics. Where hybrid instruments are material and we consider them to be relevant to our quantitative analysis of an issuer, we ascribe equity credit and make related financial statement adjustments to consider in our assessment of credit risk and to improve the comparability of financial data across peers.[2] Where a security includes other features or terms that are relevant to an issuer's credit profile (i.e., beyond those used to ascribe hybrid equity credit), including those resulting from regulatory standards, we consider how these features or terms affect the issuer's overall credit fundamentals, regardless of ascribed equity credit.

We assess whether a hybrid instrument's priority of claim is junior to a more senior obligation. Where this is not the 'case, we typically do not ascribe equity credit to the instrument.

This rating methodology was updated on July 3, 2024. We have updated the contact names in the methodology.

1 Therefore, the host security is a hybrid in the case of a convertible hybrid.

2 For an explanation of our standard adjustments, please see the cross-sector methodologies that describe our financial statement adjustments in the analysis of non-financial corporations and financial institutions. A link to a list of our sector and cross-sector methodologies can be found in the "Moody's related publications" section.

Due to structural subordination, we typically do not ascribe to the parent any equity credit ascribed to hybrid instruments issued by a subsidiary. However, there may be limited cases where we consider the parent's creditors would benefit from a hybrid instrument issued at a subsidiary, based on the hybrid instrument's structural features, the corporate structure or regulatory treatment. For example, we may ascribe equity credit where parent debt is guaranteed by the subsidiary issuing the hybrid instrument, or where issuance is by a purely financing subsidiary or by a subsidiary subject to a consolidated regulatory framework, e.g., Solvency II insurance regulation.

For a security that is represented in financial reporting as more than one instrument (e.g., bifurcated reporting as two instruments, one debt and the other equity), our analysis is performed only on the instrument component with material hybrid characteristics. Derivatives do not typically meet our definition of a hybrid instrument.

Our presentation of this cross-sector methodology proceeds with the following sections: (i) the scope of this methodology; (ii) the basket classification framework; (iii) the ascribing of equity credit to hybrid instruments issued by investment-grade entities; and (iv) the ascribing of equity credit to hybrid instruments issued by speculative-grade entities including shareholder loans. In the appendix, we discuss the hybrid equity credit cap as it applies to hybrid instruments issued by investment-grade issuers.

Scope

This methodology applies to hybrid instruments that are issued by insurance companies and brokers, finance companies, securities industry market makers, securities industry service providers, and asset managers globally. This methodology also applies to hybrid instruments issued by non-financial corporations, including commercial real estate operating companies and investment trusts (REITs).[3]

In cases where a sector methodology provides more specific guidance on hybrid equity credit, that guidance applies to that sector.

This methodology does not apply to banks, nor does it apply to those securities industry market makers rated using our methodology for banks.

In addition, this methodology does not apply to sovereigns, regional and local governments (including US public finance issuers), nonprofit organizations, multilateral development banks, project finance issuers or corporate infrastructure issuers with structural features that are highly similar to those found in project finance. Our approach for these issuers uses the broad principles outlined in this methodology as we analyze the credit support that hybrid equity may provide, but in these cases we adapt our approach to align with the relevant transaction-specific financial and legal structures.[4]

Our basket classification framework

We classify hybrid instruments into low (L), medium (M) and high (H) "basket" categories, with instruments placed into basket L receiving the least amount of equity credit and instruments placed into basket H receiving the greatest amount of equity credit. Each basket category corresponds to a specific equity credit percentage (see Exhibit 1), and these percentages are used to adjust an issuer's financial statements as part of our standard adjustments.[5] We consider the scorecard metrics to which adjustments are applied in our analysis of an issuer's overall credit fundamentals and the mix of its capital structure.

For investment-grade issuers, we use the entire basket spectrum shown in Exhibit 1 to adjust certain balance sheet accounts, whereas for speculative-grade entities, we ascribe either no equity credit (basket L) or full equity credit (basket H) to adjust all

3 Please see our sector methodology for REITs and other commercial real estate firms. A link to a list of our sector and cross-sector methodologies can be found in the "Moody's related publications" section.

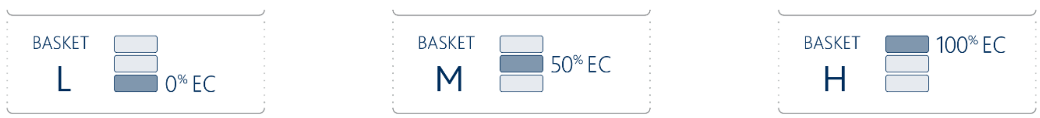
4 A link to a list of our sector and cross-sector methodologies can be found in the "Moody's related publications" section.

5 For an explanation of our standard adjustments, please see the cross-sector methodologies that describe our financial statement adjustments in the analysis of non-financial corporations and financial institutions. A link to a list of our sector and cross-sector methodologies can be found in the "Moody's related publications" section.

financial statements. We may also consider other metrics. For example, for our analysis of a hybrid instrument's income statement or cash flow statement impact on an issuer's financial flexibility, we may consider both coverage of interest and coverage of interest and dividends.

If an issuer that has hybrid instruments outstanding moves from investment-grade to speculative-grade status, the speculative-grade approach would apply, and vice versa. For government-related issuers, our approach is based on the issuer's senior unsecured (or equivalent) rating regardless of the level of the Baseline Credit Assessment (BCA).[6]

Exhibit 1
Level of equity credit (EC)*



* For investment-grade issuers, we limit the total equity credit that may be ascribed to the issuer's hybrid securities. The equity credit percentages shown apply where the total hybrid equity credit accorded an issuer does not exceed our equity credit cap. Hybrid issuances that exceed the cap are placed into a basket, but they are generally ascribed 0% equity credit. Please see the appendix for more information of the cap's application to hybrid instruments.

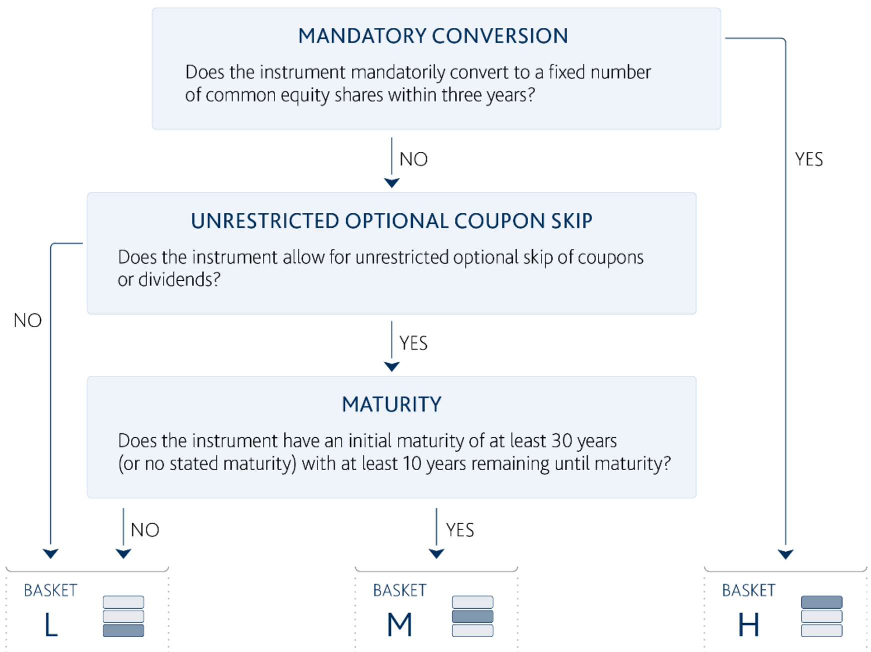
Source: Moody's Investors Service

Ascribing equity credit: Hybrid instruments issued by investment-grade entities

In ascribing equity credit to hybrid instruments of investment-grade entities, we focus on a few basic features of a security, principally whether it is mandatorily convertible to a fixed number of common equity shares, its coupon skip provisions (the term coupon skip refers to payments that are skipped on a cumulative or non-cumulative basis) and its maturity profile. The flowchart in Exhibit 2 is a simplified depiction of our approach to ascribing equity credit to hybrid instruments issued by investment-grade entities. Additional considerations are detailed in the corresponding sections for mandatory conversion, unrestricted optional coupon skip and maturity. Because the flowchart applies only to hybrid instruments, it does not apply to senior debt or common equity. In addition, we do not typically make basket adjustments to instruments (including shareholder loans) of investment-grade issuers in cases where such instruments are held by related parties.

6 For an explanation of the Baseline Credit Assessment, please refer to *Rating Symbols and Definitions* and to our cross-sector methodology for government-related issuers. A link to a list of our sector and cross-sector methodologies and a link to *Rating Symbols and Definitions* can be found in the "Moody's related publications" section.

Exhibit 2
Ascribing equity credit to hybrid instruments issued by investment-grade entities



Source: Moody's Investors Service

Mandatory conversion

A hybrid instrument that mandatorily converts to a fixed number of common equity shares within three years is placed into basket H, reflecting a Yes answer to the mandatory conversion question, as shown in Exhibit 2.[7] If the answer to the question on mandatory conversion is No, then less equity credit is ascribed to the instrument, and it is placed into either basket L or basket M depending on the answers to the questions in the following sections about the instrument's coupon skip and maturity characteristics.

In addition, if the instrument is subject to a write-down or converted to common equity shares as a going concern in the event of a breach of a regulatory solvency threshold, we would place the instrument into basket H. Conversely, if the instrument is subject to a write-down or converted to common equity shares as a gone concern in the event of a breach of a regulatory solvency threshold, we would answer No to the question in this section of the flowchart.

Unrestricted optional coupon skip

This section is relevant for instruments where we have a No answer to the mandatory conversion question and addresses whether an instrument's terms include an option to skip coupon or dividend payments. An instrument that does not allow for optional coupon skip is placed directly into basket L and thus does not receive equity credit. An instrument with an optional coupon-skip mechanism is placed into either basket L or basket M, depending on its maturity characteristics, as discussed in the following section.

In answering the unrestricted optional coupon skip question, we consider that a hybrid instrument has an option to skip payment, leading to a Yes answer, provided that such optionality is unrestricted based on the considerations described here. Hybrid

[7] Convertible instruments may feature a variety of other hybrid characteristics that benefit the issuer or other creditors. Where these are material, they are considered qualitatively in our credit analysis of an issuer.

instruments in certain jurisdictions include dividend pushers, which restrict the ability of an issuer to opt to skip a coupon payment.[8] Dividend pushers are instrument features that require an issuer to make payment on a hybrid instrument if the issuer has made payment on an instrument with the same or lower priority of claim. If an issuer has to stop payments on parity and more junior securities for a long period before skipping a hybrid coupon, its ability to avail itself of cash flow relief might come too late to avoid a default. All else being equal, a hybrid instrument with a dividend pusher of more than six months receives a No answer to this question and placement into basket L.

Also, hybrid instruments are placed into basket L if the coupons must be paid upon payment on junior or parity securities. However, if such payments on the parity or more junior security were made at the issuer's discretion, we consider that the instrument has an unrestricted optional coupon skip.

In addition, the coupon skip option should be available to the issuer for a length of time sufficient, typically at least several years, for the issuer to return to a stronger credit profile. In the absence of a sufficient length of time, the instrument is placed into basket L.[9]

Maturity

The final question in our assessment of a hybrid's equity credit addresses maturity. This question is relevant for instruments where we have a No answer to the mandatory conversion question and a Yes response to the coupon skip question.

An instrument with an initial maturity of at least 30 years (or that has no stated maturity) with at least 10 years remaining until maturity is placed into basket M, reflecting a Yes answer to the maturity question. If the answer to this question is No, then the instrument is placed into basket L. For this question, we consider add-on offerings, or "taps," occurring within one year of the initial offering as part of the initial offering.

For instruments with meaningful step-ups, we use the time to the first call date of the instrument as the effective maturity instead of the stated maturity. Where there are no meaningful step-ups, we do not consider an instrument's first call date in answering the question about maturity.[10] A step-up is the contractual increase in the credit spread applying to a hybrid instrument's coupon or dividend if the hybrid instrument is not called at a preset date. A step-up can occur with or without a coupon reset.

A step-up in any amount prior to 10 years after issuing the instrument is considered meaningful, except for change-in-control events. After year 10, we consider a step-up as meaningful if it exceeds 100 basis points. Where there is a change-in-control event, we consider a step-up of more than 500 basis points to be meaningful. For instruments for which the coupon or dividend resets from a fixed rate to a fixed rate or from a fixed rate to a floating rate, we make a determination whether a meaningful step-up exists. Our assessment is based on whether the contractual interest rate spread over the risk-free rate at the time that the rate resets exceeds 100 basis points from the initial contractual interest rate spread.

For instance, a hybrid instrument with a No answer to the mandatory conversion question maturing in 30 years and featuring optional deferral and a small step-up (e.g., 50 bps) at year 10 is placed into basket M. However, if the same instrument included a

[8] For clarity, language stating that if a hybrid coupon is skipped, coupon payments on junior (and, also in some cases, parity) securities must also be stopped (i.e., "dividend stoppers") represents a provision that is distinct from dividend pushers. Dividend stoppers do not affect the equity credit we ascribe but may be considered qualitatively.

[9] Other creditor-friendly forms of coupon skip, including mandatory requirements to suspend coupons on a hybrid, do not affect the equity credit we ascribe but are considered qualitatively in our overall credit analysis of the issuer. In addition, settlement provisions (e.g., cumulative or non-cumulative) do not affect the equity credit we ascribe but may be considered qualitatively. Non-cumulative hybrid instruments are those where skipped coupons are canceled and do not have to be repaid.

[10] Equity credit is based principally on the criteria herein, including the maturity question. However, in our credit analysis, we may consider other features that incentivize but do not obligate a borrower to redeem a hybrid instrument qualitatively, including in conjunction with our analysis of financial policy. For example, we may consider the likely effects on borrower behavior of an instrument with a springing conversion to equity feature, which provides an incentive to the borrower to redeem the instrument in order to avoid the dilutive effect of conversion. Conversely, allowing conversion to equity ultimately reduces debt and provides credit support in a time of stress. Also, the sudden, public expression of the intention to call a hybrid may indicate a credit weakness.

large step-up (e.g., 150 basis points) at year 10 with a first call date at year five, we consider that the effective maturity is five years, and the security is placed into basket L.

In addition, we consider that a rate step-up has not occurred in cases where a rate step-up is followed by a full step-down in rate before the first call date.

Ascribing equity credit: Hybrid instruments issued by speculative-grade entities including shareholder loans

We ascribe either no equity credit (basket L) or full equity credit (basket H) to hybrid instruments issued by speculative-grade entities and make related financial statement adjustments. For an explanation of our standard adjustments, please see the cross-sector methodologies that describe our financial statement adjustments in the analysis of non-financial corporations and financial institutions.[11]

Relative to investment-grade issuers, speculative-grade issuers are materially closer to default, have shorter-dated, dynamic and typically more complex capital structures, and have debt with more covenants. Speculative-grade issuers often opt to cease hybrid coupon payments because such actions are contractually allowable without triggering a default. Also, there is less certainty relative to investment-grade issuers that speculative-grade issuers will make hybrid coupon payments, particularly if they can avoid a debt default by ceasing hybrid coupon payments. However, our analysis of any credit support that hybrid instruments provide to a speculative-grade issuer's capital structure and financial flexibility is often more nuanced than what is reflected in our adjusted financial metrics based on this binary approach to ascribing equity credit to these instruments.

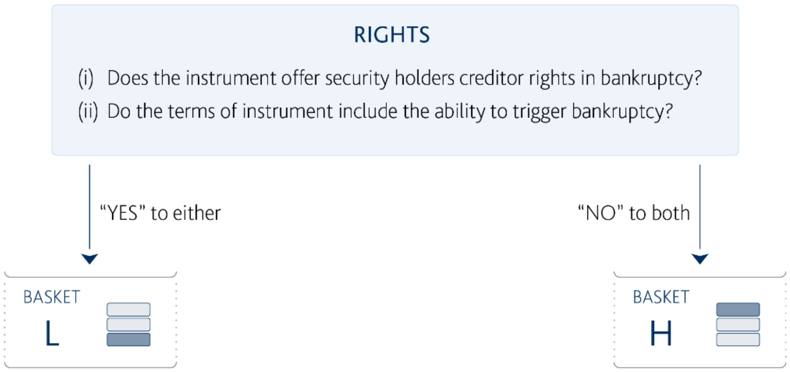
Our approach ascribing equity credit to hybrid instruments of speculative-grade issuers reflects our expectation about the treatment these instruments would receive in a bankruptcy scenario.[12] Specifically, we assess certain rights, i.e., whether the terms of a hybrid include the ability to trigger bankruptcy upon certain events or offer security holders creditor rights in bankruptcy, as shown in Exhibit 3. A hybrid instrument that provides for either of these rights, receives 0% equity credit (basket L) and therefore is treated as 100% debt in calculating a speculative-grade issuer's financial metrics. A hybrid instrument that provides neither of these rights, such as preferred stock and other similar equity instruments, receives 100% equity credit (basket H) in calculating the issuer's adjusted financial metrics.

[11] A link to a list of our sector and cross-sector methodologies can be found in the "Moody's related publications" section.

[12] Thus, our approach for speculative-grade issuers is aligned with our definition of default in that only debt instruments or debt-like obligations can default and with the application of our LGD model, which is used to help assign ratings to debt issued by speculative-grade corporates. Please see our cross-sector methodology for loss given default for speculative-grade companies. A link to a list of our sector and cross-sector methodologies can be found in the "Moody's related publications" section.

Exhibit 3

Ascribing equity credit to hybrid instruments† issued by speculative-grade entities



† The flowchart does not apply to shareholder loans.

Source: Moody's Investors Service

For clarity, certain deeply subordinated instruments held by the owners of the issuer's common stock, often referred to as shareholder loans and typically issued by corporates, feature specific conditions that make them effectively functionally equivalent to equity (i.e., with no ability to influence the probability of default and loss given default on the more senior debt of a company). For speculative-grade issuers, if the shareholder loans meet the criteria described in the "Treatment of shareholder loans" section that follows, we treat them as similar to equity from a credit perspective.

Treatment of shareholder loans

The majority of shareholder funding for many corporate transactions is made through the issuance of shareholder-owned deeply subordinated debt. In many countries in Europe, for example, these instruments are called shareholder loans or preferred equity certificates.[13]

Shareholder loans are often structured to provide a level of credit support that is equivalent to equity from the perspective of the issuer's other creditors, similar to what we observe for preferred stock instruments in the US. The primary principle in our approach to ascribing equity credit to shareholder loans of speculative-grade issuers is an assessment, based on credit documentation, including the loan, bond and inter-creditor agreements, that the credit risk associated with more senior debt would not be affected by the relative proportions of equity and shareholder loans in the issuer's capital structure.

While transactions structures may vary, shareholder loans of speculative-grade issuers that are placed into basket H (100% equity credit) share the characteristics shown below in bold. In each bullet, we also describe the related structural features that are present in the transaction documentation of these instruments.

» **A shareholder loan is junior to all liabilities, with the exception of other tranches of shareholder loans that also meet the conditions for placement into basket H.** The subordination of the shareholder loan is captured in transaction documentation, typically an inter-creditor agreement or subordination agreement that also documents enforcement processes and the application of recovery proceeds. In addition, the shareholder loan likely is or will be contractually subordinated to all liabilities within the rated group, including non-financial liabilities such as trade creditors.[14] In certain cases, holders of the shareholder loan may have a claim following an insolvency event. In assessing such scenarios, we consider whether the inter-creditor agreement provides credit support by ensuring that any claim is junior to all other debt claims, in particular, whether proceeds

[13] In regions where preferred stock is commonly issued by corporates (e.g., North America), the issuance of shareholder loans that would meet the conditions for 100% equity credit is likely to be rare or even non-existent.

[14] The presence of preference shares that rank junior to the shareholder loan would not compromise equity credit for the shareholder loan if other eligibility tests are met.

from any enforcement of collateral are applied first to all other financial and non-financial creditors until those claims have been fully discharged before any proceeds go to shareholder loans. The maturity of any shareholder loan typically extends beyond the maturity of any other debt or debt-like obligation within the rated group. This is an important consideration due to inherent uncertainties in insolvency proceedings in a number of jurisdictions.

» **The shareholder loan does not affect the issuer's probability of default or the position or recovery prospects of any other creditors within the rated group following any form of default or bankruptcy proceeding.** Therefore, a number of features are absent from the terms of the shareholder loan and the inter-creditor agreement. These features include covenants (other than informational covenants where failure to comply has no consequences), acceleration rights, the right to declare default or an event of default; or, if such rights exist, they are unenforceable until all debt that ranks senior to the shareholder loans has been repaid in full. The following would also be absent from shareholder loan transaction documentation:

  – Security encumbrances within the rated group.
  – Amortization, redemption or other prepayment allowable prior to maturity of the instruments in the capital structure that rank senior to the shareholder loans, except to the extent that such payments could have been accommodated out of equity distributions in an all-equity structure and are subject to a restricted payments test, which is no different than the typical restrictions on repurchasing common stock.
  – Enforceable put options prior to the maturity of the debt, even if permitted by a restricted payments test.

» **The economic interests of the common equity and the shareholder loan are enduringly aligned.** Typically, the alignment is achieved through "stapling" (i.e., evidence at issuance that the shareholder loan is owned by the common stockholders and, after issuance, restrictions on transferability of the shareholder loan to a party other than a common shareholder that ensure that such alignment is maintained).[15]

» **Protections for other creditors are present in the event changes are made to the terms of the shareholder loan.** Any changes to the terms of financing documentation, including the shareholder loan and the inter-creditor agreement, that affect any of the conditions outlined above need majority approval of senior financial creditors, or equivalent protections are present.[16]

For shareholder loans that meet the criteria for equity treatment, their impact on a company's credit risk profile can depend on a number of factors including, for example, the issuer's financial policy, the economic interests of the lender/shareholder, the financial sponsor's track record, and the evolution of an issuer's capital structure, including our assessment of the likely scenarios for the replacement of the shareholder loan or a financial sponsor's exit. For example, shareholder loans may allow a sponsor to add capital on a tax-advantaged basis into a multi-level corporate structure while concurrently retaining equity. Our credit analysis would also assess what the issuance of shareholder loans instead of common equity implies about financial policy.

We may assess whether more senior debtholders are protected from cash leakages resulting from cash interest or principal payments associated with the shareholder loan. Similarly, we do not consider that the presence of the shareholder funding implies greater flexibility to increase cash distributions. Hence, for a shareholder loan receiving full equity credit, a restricted payments test should not differentiate in any way between a dividend payment on common equity and a cash payment made under the shareholder loan.[17]

Subsequent to the initial assignment of a company's ratings based on the issuance of a shareholder loan meeting the requirements for placement into basket H, if we become aware that any of the terms have changed such that the required conditions discussed above are no longer met, we treat the shareholder loan as 100% debt in calculating a company's adjusted financial metrics. Where

15 While differences in percentage ownership of the common equity and the shareholder loan may arise, for example, to facilitate management incentives, the stapling provides sufficient overlap in ownership to ensure commonality of interests.

16 Equivalent protections would ensure that permitted changes are (i) minor, administrative or correct a technical error; or (ii) not materially less favorable to senior financial creditors.

17 Early distribution of cash in a highly leveraged company is credit negative and may negatively affect the corporate family rating even in the absence of an explicit debt adjustment. The payment could affect other metrics, including free cash flow, and would also weigh on financial policy considerations.

we consider that this change materially affects credit risk, ratings would reflect our revised view of the creditworthiness of the company, including the likelihood of a default and the expected loss suffered in the event of default.

In some structures, once the senior debt of the company has been refinanced or paid off, the restrictions imposed by the inter-creditor agreement may no longer apply, and standard covenants within the shareholder loan may have force, including rights to trigger a default event and acceleration. In these cases, we would usually consider the specific terms of the inter-creditor and shareholder loan agreements, and we may not be able to ascribe equity credit if the issuer has the right to subsequently issue new senior debt without the protections of the original inter-creditor agreement in place.

Appendix

Limit on hybrid equity credit for investment-grade issuers[18]

We limit the amount of total equity credit that can be ascribed to all hybrid instruments within an issuer's capital structure to 30% of the company's adjusted equity.[19] That is, we ascribe equity credit only to the extent that:

$$\frac{\textit{Hybrid Equity Credit}}{\textit{Adjusted Equity}} \leq 30\%$$

The hybrid equity credit cap applies to hybrid instruments issued by investment-grade issuers.[20] We may consider excluding hybrid instruments from the cap in cases where these instruments are, in effect, a class of common equity.

Hybrid issuances that exceed the cap are still placed in a basket but are typically treated as 100% debt in the calculation of financial metrics. Where there is an exceedance of the cap, issuers would receive equity credit from these basketed securities in the event that room is created under the cap in the future.

The greater the total hybrid equity credit ascribed to an issuer's hybrid instruments, the smaller the amount that can be added, subject to the cap. For example, if a company has adjusted equity outstanding of $2.94 billion, including equity credit ascribed of $140 million, then subject to the 30% cap, the maximum possible equity credit for the issuer would be $1.2 billion.[21] If the company were to issue hybrid instruments, this maximum would apply regardless of the amount of hybrid instruments issued to-date or in the future or the combination of instruments involved. In this context, if $140 million of equity credit has been ascribed to hybrid instruments issued by the company, then the headroom for ascribing additional equity credit would sit below the cap by the amount of equity credit already ascribed. In this example, the company has $1.06 billion of headroom based on $140 million of existing equity credit.

The table below further illustrates this example. For each hybrid basket, we show the threshold for the additional amount of hybrid instruments beyond which the company's total equity credit would be limited to the $1.2 billion cap. We also illustrate, at each basket level, the amount of additional equity credit that would be ascribed subject to the issuer's existing headroom, and the issuer's total equity credit, following the hypothetical issuance of $1.1 billion issuance of hybrid instruments.

18 Please refer to the "Scope" section.

19 The numerator (hybrid equity credit) is the total amount of equity credit ascribed to the issuer's hybrid instruments. The starting point for the denominator (adjusted equity) is the issuer's reported equity (less any minority interest included therein), to which we apply our standard adjustments, one of which is an adjustment for hybrid equity credit, and we may also apply non-standard adjustments. Please see our cross-sector methodologies that discuss standard adjustments in the analysis of, respectively, non-financial corporations and financial institutions.

20 The hybrid equity cap does not apply to speculative-grade issuers. Given other, more significant sources of risk for speculative-grade issuers, any added risk from hybrid instruments not behaving as expected does not have the same relative importance for the average speculative-grade versus the average investment-grade issuer.

21 Based on how we define the equity credit ratio and the 30% cap requirement, the maximum available equity credit is formulaically three-sevenths of the adjusted equity outstanding excluding equity credit ascribed to-date. That latter figure is $2.8 billion in this example. The maximum available equity credit is therefore $1.2 billion, and the remaining headroom is $1.06 billion.

Exhibit 4

Illustration of hybrid equity credit tolerance

(USD Millions)

Adjusted Equity (including equity credit to date)	Ascribed Equity Credit to date	Equity Credit Ratio	Equity Credit Cap*	Headroom	Moody's Basket	Basket Equity Credit	Additional-issuance Threshold**	Illustrative Issuance	Additional Equity Credit***	Total Equity Ascribed	Equity Credit Ratio (by scenario)
					L	None	Unlimited†	Unlimited†	None	$140	4.8%
$2,940	$140	4.8%	$1,200	$1,060	M	50%	$2,120	$1,100	$550	$690	20%
					H	100%	$1,060	$1,100	$1,060	$1,200	30%

† Unlimited from the perspective of the cap because no equity credit is given to a basket L hybrid.

* We use the threshold ratio defined above to compute the maximum available equity credit. In particular, 1,200/(2,800 + 1,200) = 30%. The 4.8% equity credit ratio is well below the 30% limit and is based on existing hybrid equity credit as a percentage of adjusted equity, i.e., 140/(140 + 2,800) = 4.8%.

** The threshold represents the additional amount of hybrid instruments beyond which no further equity credit would be ascribed. Based on the $1,060 million headroom, the threshold for issuing hybrid instruments placed into basket M is 1,060/0.50 = 2,120.

*** The additional equity that would be ascribed from a $1,100 million issuance depends on the basket classification of the hybrid instruments issued and is subject to the headroom ($1,060 million). For example, additional equity credit in the basket H scenario is limited to the headroom ($1,060 million).

Source: Moody's Investors Service

Exhibit 5 summarizes how the cap and adjusted equity are calculated for investment-grade issuers:

Exhibit 5

Calculating the 30% equity credit cap

Cap condition:	Hybrid Equity Credit / Adjusted Equity ≤ 30%
Numerator:	Sum of the amount of each of the issuer's hybrid instruments times the equity credit level associated with that instrument's basket
Denominator:	Adjusted Equity = Reported Equity +/- Moody's standard adjustments (including hybrid equity credit) +/- non-standard adjustments

Source: Moody's Investors Service

In some instances, we may consider that there is a substantial difference between equity as stated on an issuer's balance sheet and the economic value of the company. For example, some companies show negative balance sheet equity but consistently report net income and cash flow that implies a substantially higher economic value. In such cases, where balance sheet equity is minimal or negative, we may use an EBITDA multiple to estimate enterprise value and arrive at a proxy for reported equity in the above ratio.[22]

22 For such companies with low or negative equity, we typically use the following as a proxy for the as-reported equity: 6x EBITDA - Total Liabilities + Deferred Taxes + Minority Interest.

Moody's related publications

Cross-sector credit rating methodologies are typically applied in tandem with sector credit rating methodologies, but in certain circumstances may be the basis for assigning credit ratings. A list of sector and cross-sector credit rating methodologies can be found here.

For data summarizing the historical robustness and predictive power of credit ratings, please click here.

For further information, please refer to *Rating Symbols and Definitions*, which is available here.

Authors
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Laura Barrientos

Report Number: 1350874

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the issuer/deal page on https://ratings.moodys.com for the most updated credit rating action information and rating history.

MOODY'S
INVESTORS SERVICE

Minnesota Department of Commerce
85 7th Place East | Suite 280 | St. Paul, MN 55101
Information Request

Docket Number: E015/S-25-138 ☐Nonpublic ☒Public
Requested From: Minnesota Power Date of Request: 4/30/2025
Type of Inquiry: Financial Response Due: 5/12/2025

SEND RESPONSE VIA EMAIL TO: Utility.Discovery@state.mn.us as well as the assigned analyst(s).
Assigned Analyst(s): Craig Addonizio, Justin Taylor
Email Address(es): craig.addonizio@state.mn.us, justin.taylor@state.mn.us
Phone Number(s): 651-539-1818, 651-539-1031

ADDITIONAL INSTRUCTIONS:
Each response must be submitted as a text searchable PDF, unless otherwise directed. Please include the docket number, request number, and respondent name and title on the answers. If your response contains Trade Secret data, please include a public copy.

Request Number:	**9**
Topic:	Potential impact of preferred equity issuance on ALLETE's credit ratings
Reference(s):	n/a

Request:

a. Please provide any analysis, qualitative or quantitative, the Company has produced about the potential impacts issuing preferred stock as contemplated by the Merger Agreement might have on ALLETE's credit ratings and metrics.

b. If either or both S&P Global Ratings and Moody's give preferred equity issued pursuant to the Merger Agreement only partial or no equity credit in evaluating ALLETE's credit worthiness and credit metrics, would ALLETE be able to adjust its capital structure or take other steps if necessary to avoid a potential downgrade?

Response:

a. As discussed in response to DOC IRs 7 and 8, the Company does not intend to maintain preferred equity in its capital structure long-term and as such does not anticipate material changes to its credit ratings based on potential temporary issuance of preferred equity. See the response to DOC IR 11(b) for additional information on the Company's intended use of preferred equity.
b. As discussed in part a. above, the Company does not anticipate material impacts of preferred equity during the interim time period between the signing of the Merger Agreement and closing of the Acquisition and does not anticipate getting no equity credit from the preferred stock, should it be required. Ultimately, timely approval and closing of the Acquisition will be important to allow the Company to receive capital infusions from the Partners in exchange for the issuance of common equity to fund necessary utility capital projects.

To be completed by responder

Response Date:	May 12, 2025
Response by:	Josh Taran
Email Address:	jtaran@allete.com
Phone Number:	218-355-3332

Minnesota Department of Commerce
85 7th Place East | Suite 280 | St. Paul, MN 55101
Information Request

Docket Number: E015/S-25-138 ☐Nonpublic ☒Public
Requested From: Minnesota Power Date of Request: 4/30/2025
Type of Inquiry: Financial Response Due: 5/12/2025

SEND RESPONSE VIA EMAIL TO: Utility.Discovery@state.mn.us as well as the assigned analyst(s).
Assigned Analyst(s): Craig Addonizio, Justin Taylor
Email Address(es): craig.addonizio@state.mn.us, justin.taylor@state.mn.us
Phone Number(s): 651-539-1818, 651-539-1031

ADDITIONAL INSTRUCTIONS:
Each response must be submitted as a text searchable PDF, unless otherwise directed. Please include the docket number, request number, and respondent name and title on the answers. If your response contains Trade Secret data, please include a public copy.

Request Number:	**11**
Topic:	Minnesota Power's Ratemaking Capital Structure
Reference(s):	Company response to DOC IR 4

Request:

a. In its response to DOC IR 4, the Company stated that Minnesota Power's projected ratemaking capital structure as of June 30, 2026 is unchanged from its last rate case (53 percent equity and 47 percent debt). Please provide Minnesota Power's ratemaking capital structure, with preferred equity separate from common equity, assuming ALLETE issues $300 million in preferred equity pursuant to the Merger Agreement.

b. Please provide all analysis the Company has produced, or had produced on its behalf, demonstrating that Minnesota Power's capital structure, assuming it includes up to $300 million of preferred equity, is reasonable and will not unnecessarily raise Minnesota Power's cost of capital.

Response:

a. As described in response to DOC IR 10, the Company does not intend for preferred equity to remain in its capital structure long term, but is instead intended to provide temporary bridge financing during the interim period between the signing of the Merger Agreement and closing of the Acquisition.

b. The Company has not produced, nor has had produced on its behalf, analysis to demonstrate that a capital structure including $300 million of preferred equity is reasonable for inclusion in Minnesota

To be completed by responder

Response Date:	May 12, 2025
Response by:	Josh Taran
Email Address:	jtaran@allete.com
Phone Number:	218-355-3332

COMMERCE DEPARTMENT

Minnesota Department of Commerce
85 7th Place East | Suite 280 | St. Paul, MN 55101
Information Request

Docket Number: E015/S-25-138
Requested From: Minnesota Power
Type of Inquiry: Financial

☐Nonpublic ☒Public
Date of Request: 4/30/2025
Response Due: 5/12/2025

SEND RESPONSE VIA EMAIL TO: Utility.Discovery@state.mn.us as well as the assigned analyst(s).
Assigned Analyst(s): Craig Addonizio, Justin Taylor
Email Address(es): craig.addonizio@state.mn.us, justin.taylor@state.mn.us
Phone Number(s): 651-539-1818, 651-539-1031

ADDITIONAL INSTRUCTIONS:
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Power's ratemaking capital structure at this time, since the Company is not seeking recovery of preferred equity costs in this docket.

It is important to note that:

- In a scenario where the Acquisition is approved by the Commission and closes, the preferred stock would be converted to a common equity investment from the Partners.
- In a scenario where the preferred shares were issued and the Acquisition does not close, the Company would analyze the cost and availability of alternative financing at that time and determine the best sources of capital to be able to continue to provide affordable, reliable service to customers. This would include analysis of the preferred equity against alternatives that may be available to replace it, and the Company would propose inclusion of the preferred equity only if it was the best ongoing solution to provide capital to the Company on behalf of its customers. Ultimately, the Company will bear the burden of proof in demonstrating that all its costs are just and reasonable in a future rate case.

To be completed by responder

Response Date:	May 12, 2025
Response by:	Josh Taran
Email Address:	jtaran@allete.com
Phone Number:	218-355-3332

ALLETE, INC.
PROPOSED AMENDMENT
TO
ARTICLES OF INCORPORATION AS
AMENDED AND RESTATED AS OF MAY 8, 2001
(AS AMENDED AS OF SEPTEMBER 20, 2004,
MAY 28, 2009, AND
MAY 19, 2010)

If shareholders approve Item 4 at the 2025 Annual Meeting of the Shareholders, the following amendment to ALLETE's Amended and Restated Articles of Incorporation (the "Articles") will be adopted, as described below, with deletions indicated by strike outs and additions indicated by underlining;

1. Article III, Section 5 of the Articles will be amended to read in its entirety as follows:

"5. ~~For the purpose of this (fifth) paragraph of this Article III of these Articles: (i) the term "Common Stock Equity" shall mean the sum of the stated capital of the outstanding Common Stock, premium on Common Stock and the earned surplus and the capital and paid-in surplus of this Corporation, whether or not available for the payment of dividends on the Common Stock; (ii) the term "total capitalization" shall mean the sum of the stated capital applicable to the outstanding stock of all classes of this Corporation, the earned surplus and the capital and paid-in surplus of the Corporation, whether or not available for the payment of dividends on the Common Stock of the Corporation, any premium on Capital Stock of the Corporation and the principal amount of all outstanding debts of the Corporation maturing more than twelve months after the date of the determination of the total capitalization; and (iii) the term "dividends on Common Stock" shall embrace dividends and distributions on Common Stock (other than dividends or distributions payable only in shares of Common Stock), and the purchase or other acquisitions for value of any Common Stock of this Corporation or other stock, if any, subordinate to its 5% Preferred Stock and Serial Stocks.~~ Subject to the rights of the holders of the 5% Preferred Stock~~,~~ and Serial Stocks and subordinate thereto <u>(including those set forth in any certificate of designation filed with respect to any series of Serial Stock)</u> (and subject and subordinate to the rights of any class of stock hereafter authorized), the Common Stock alone shall receive all dividends and shares in liquidation, dissolution, winding up or distribution other than those to be paid on shares of 5% Preferred Stock and Serial Stocks, as hereinbefore provided. ~~So long as any shares of 5% Preferred Stock, or Serial Stocks are outstanding, this Corporation shall not declare or pay any dividends on the Common Stock, except as follows:~~

~~(1) If and so long as the Common Stock Equity at the end of the calendar month immediately preceding the date on which a dividend on Common Stock is declared is, or as a result of such dividend would become, less than 20% of total capitalization, the Corporation shall not declare such dividends in an amount which, together with all other dividends on Common Stock declared within the year ending with and including the date of such dividend declaration, exceeds 50% of the net income of the Corporation available for dividends on the Common Stock for the twelve full calendar months immediately preceding the month in which such dividends are declared; and~~

(2) ~~If and so long as the Common Stock Equity at the end of the calendar month immediately preceding the date on which a dividend on Common Stock is declared is, or as a result of such dividend would become, less than 25% but not less than 20% of total capitalization, the Corporation shall not declare dividends on the Common Stock in an amount which, together with all other dividends on Common Stock declared within the year ending with and including the date of such dividend declaration, exceeds 75% of the net income of the Corporation available for dividends on the Common Stock for the twelve full calendar months immediately preceding the month in which such dividends are declared; and~~

(3) ~~At any time when the Common Stock Equity is 25% or more of total capitalization the Corporation may not declare dividends on shares of the Common Stock which would reduce the Common Stock Equity below 25% of total capitalization, except to the extent provided in subparagraphs (1) and (2) above.~~"

2. Article III, Section 7 of the Articles will be amended to read in its entirety as follows:

"7. <u>Subject to the terms set forth in in any certificate of designation filed with respect to any series of Serial Stock</u>, ~~This~~ <u>this</u> Corporation, by a majority vote of its Board of Directors, may at any time redeem all of the Serial Preferred Stock or Serial Preferred Stock A or may from time to time redeem any series or any part of any series thereof, by paying in cash the redemption price or prices fixed for the series of Serial Preferred Stock or Serial Preferred Stock A to be redeemed by resolution or resolutions of the Board of Directors establishing such series, plus unpaid accumulated dividends, if any, to the date of redemption."

3. Article III, Section 8 of the Articles will be amended to read in its entirety as follows:

"8. <u>[Deleted and intentionally reserved]</u> ~~Notice of the intention of this Corporation to redeem all or any part of the 5% Preferred Stock or all or any part of the Serial Preferred Stock or all or any part of the Serial Preferred Stock A shall be mailed 30 days before the date of redemption to each holder of record of preferred stock to be redeemed, at his post office address as shown by this Corporation's records; but no failure to mail such notice nor any defect therein nor in the mailing thereof shall affect the validity of the proceedings for the redemption of any shares of preferred stock so to be redeemed. At any time after such notice has been mailed as aforesaid, this Corporation may deposit the aggregate redemption price (or the portion thereof not already paid in the redemption of such preferred stock) with any bank or trust company in the City of New York, New York, or in the City of Duluth, Minnesota, named in such notice, payable to the order of the record holders of the preferred stock so to be redeemed, on the endorsement, if required, and surrender of their certificates, and thereupon said holders shall cease to be shareholders with respect to said shares, and from and after the making of such deposit, said holders shall have no interest in or claim against this corporation with respect to said shares, but shall be entitled only to receive the said moneys from said bank or trust company, with interest, if any, allowed by such bank or trust company on such moneys deposited as in this paragraph provided, on endorsement, if required, and surrender of their certificates as aforesaid. Any moneys so deposited, plus interest thereon, if any, and remaining unclaimed at the end of six years from the date fixed for redemption, if thereafter requested by resolution of the Board of Directors, shall be repaid to the Corporation and in the event of such repayment to the Corporation such holders of record of the shares so redeemed as shall not have made claim against such moneys prior to such repayment to the Corporation, shall be deemed to be~~

~~unsecured creditors of the Corporation for an amount without interest equivalent to the amount deposited, plus interest thereon, if any, allowed by such bank or trust company, as above stated for the redemption of such shares and so paid to the Corporation. If less than all of the shares of the 5% Preferred Stock or less than all of the shares of any series of the Serial Preferred Stock are to be redeemed, the shares to be redeemed shall be selected by lot, in such manner as the Board of Directors of this Corporation shall determine, by an independent bank or trust company selected for that purpose by the Board of Directors of this Corporation. If less than all of the shares of any series of the Serial Preferred Stock A are to be redeemed, the shares to be redeemed shall be selected by lot, pro rata, or by such other method, and in such manner as the Board of Directors of this Corporation shall determine. Nothing herein contained shall limit any right of this Corporation to purchase or otherwise acquire any shares of 5% Preferred Stock or Serial Preferred Stock or Serial Preferred Stock A.~~"

4. Article III, Section 9 of the Articles will be amended to read in its entirety as follows:

"9. Except as hereinafter otherwise provided or as otherwise provided in any certificate of designation filed with respect to any series of Serial Stock, every shareholder of record or his legal representative, at the date fixed for the determination of persons entitled to vote at the meeting of shareholders, or, if no date has been fixed, then at the date of the meeting shall be entitled at such meeting to one vote for each share of Common Stock, 5% Preferred Stock or Serial Preferred Stock standing in his name on the books of the Corporation. There shall be no cumulative voting by any class, series or shares of stock of this Corporation."

5. Article III, Section 10 of the Articles will be amended to read in its entirety as follows:

"10. If and when dividends payable on any of the preferred stocks other than the Serial Preferred Stock A shall be in default in an amount equal to four full quarterly payments or more per share, and thereafter until all dividends on any of ~~the~~ such preferred stocks in default shall have been paid, the holders of all of the then outstanding preferred stocks other than the Serial Preferred Stock A (such preferred stocks, the "Voting Preferred Stock"), voting as a class, shall be entitled to elect the smallest number of directors necessary to constitute a majority of the full Board of Directors, and the holders of the Common Stock, voting as a class, shall be entitled to elect the remaining directors of the Corporation, anything herein or in the Bylaws to the contrary notwithstanding. The terms of office, as directors, of all persons who may be directors of the Corporation at the time shall terminate upon the election of a majority of the Board of Directors by the holders of the Voting Preferred Stock ~~preferred stocks~~, except that if the holders of the Common Stock shall not have elected the remaining directors of the Corporation, then, and only in that event, the directors of the Corporation, as constituted just prior to the election of a majority of the Board of Directors by the holders of the Voting Preferred Stock ~~preferred stocks~~, shall elect the remaining directors of the Corporation. Thereafter, while such default continues and the majority of directors are being elected by the holders of the Voting Preferred Stock ~~preferred stocks~~, the remaining directors, whether elected by directors, as aforesaid, or whether originally or later elected by holders of the Common Stock, shall continue in office until their successors are elected by holders of the Common Stock and qualify.

~~For the purposes of this (tenth) paragraph of this Article III of these Articles, every shareholder of record, or his legal representative, of Serial Preferred Stock A shall be~~

~~entitled to one vote, for each share, standing in his name on the books of the Corporation, with a liquidation preference of $100 as established in a resolution or resolutions of the Board of Directors providing for the issue of shares of each series and each share of Serial Preferred Stock A with a liquidation preference of less than $100 shall be afforded its proportional, fractional vote.~~

For purposes of this (tenth) paragraph, there shall be no cumulative voting by any class, series or shares of stock of this Corporation."

6. Article III, Section 11 of the Articles will be amended to read in its entirety as follows:

"11. If and when all dividends then in default on the Voting Preferred Stock ~~preferred stocks~~ then outstanding shall be paid (and such dividends shall be declared and paid out of any funds legally available therefore as soon as reasonably practicable), the holders of the Voting Preferred Stock ~~preferred stocks~~ shall be divested of any special right with respect to the election of directors and the voting power of the holders of the Voting Preferred Stock ~~preferred stocks~~ and the holders of the Common Stock shall revert to the status existing before the first dividend payment date on which dividends on any of the Voting Preferred Stock ~~preferred stocks~~ were not paid in full; but always subject to the same provisions for vesting such special rights in the holders of the Voting Preferred Stock ~~preferred stocks~~ in case of further like default or defaults on dividends thereon. Upon the termination of any such special voting right upon payment of all accumulated and defaulted dividends on the Voting Preferred Stock ~~preferred stocks~~, the terms of office of all persons who may have been elected directors of the Corporation by vote of the holders of the Voting Preferred Stock ~~preferred stocks~~, as a class, pursuant to such special voting right shall forthwith terminate, and the resulting vacancies shall be filled by a vote of the majority of the remaining directors."

7. Article III, Section 12 of the Articles will be amended to read in its entirety as follows:

"12. In case of any vacancy in the office of a director occurring among the directors elected by the holders of the Voting Preferred Stock ~~preferred stocks~~, voting as a class, the remaining directors elected by the holders of the Voting Preferred Stock ~~preferred stocks~~, by affirmative vote of a majority thereof, or the remaining director so elected if there be but one, may elect a successor or successors to hold office for the unexpired terms of the director or directors whose place or places shall be vacant. Likewise in case of any vacancy in the office of a director occurring among the directors not elected by the holders of the Voting Preferred Stock ~~preferred stocks~~, the remaining directors not elected by the holders of the Voting Preferred Stock ~~preferred stocks~~, by affirmative vote of a majority thereof, or the remaining director so elected if there be but one, may elect a successor or successors to hold office for the unexpired term of the director or directors whose place or places shall be vacant."

8. Article III, Section 13 of the Articles will be amended to read in its entirety as follows:

"13. Whenever the right shall have accrued to the holders of the Voting Preferred Stock ~~preferred stocks~~ to elect directors, voting as a class, then upon request in writing signed by any holder of Voting Preferred Stock ~~preferred stock entitled to vote~~, delivered by registered mail or in person to the president, a vice president or secretary, it shall be the duty of such officer forthwith to cause notice to be given to the shareholders entitled to vote of a meeting to be held at such time as such officer may fix, not less than ten nor more than sixty days after the receipt of such request, for the purpose of electing ~~elected~~ directors. At all meetings of shareholders held for the purpose of electing directors during such time as the holders of the Voting Preferred Stock ~~preferred stocks~~ shall have the special right, voting as a class, to elect directors, the presence in person or by proxy of the holders of a majority of the outstanding Common Stock shall be required to constitute a quorum of such class for the election of directors, and the presence in person or by proxy of the holders of a majority of the outstanding Voting Preferred Stock ~~preferred stocks~~ shall be required to constitute a quorum of the Voting Preferred Stock ~~preferred stocks~~ for the election of directors; provided, however, that the absence of a quorum of the holders of Common Stock or of Voting Preferred Stock ~~preferred stocks~~ shall not prevent the election at any such meeting or adjournment thereof of directors by such other class or classes if the necessary quorum of the holders of stock of such other class or classes is present in person or by proxy at such meeting or any adjournment thereof; and provided further that in the event a quorum of the holders of the Common Stock is present but a quorum of the holders of the Voting Preferred Stock ~~preferred stocks~~ is not present, then the election of the directors elected by the holders of the Common Stock shall not become effective and the directors so elected by the holders of the Common Stock shall not assume their offices and duties until the holders of the Voting Preferred Stock ~~preferred stocks~~, with a quorum present, shall have elected the directors they shall be entitled to elect; and provided further, however, that in the absence of a quorum of the holders of either the Common Stock or the Voting Preferred Stock ~~preferred stocks~~, a majority of the holders of the stock of the class or classes who are present in person or by proxy shall have power to adjourn the election of the directors to be elected by such class or classes from time to time without notice other than announcement at the meeting until the requisite amount of holders of such class or classes shall be present in person or by proxy, but such adjournment shall not be made to a date beyond the date for the mailing of notice of the next annual meeting of the Corporation or special meeting in lieu thereof.

~~For the purpose of determining a quorum of the preferred stocks, as required by this (thirteenth) paragraph of this Article III of these Articles, each share of Serial Preferred Stock A with a liquidation preference of $100 shall be counted as a whole share; and each share of Serial Preferred Stock A with a liquidation preference of less than $100 shall be counted as a proportional, fractional share.~~

~~For the purpose of any vote of the preferred stocks, as required by this (thirteenth) paragraph of this Article III of these Articles, each share of outstanding Serial Preferred Stock A shall be entitled to the same vote provided for in the tenth paragraph of this Article III of these Articles.~~"

9. The first paragraph of Article III, Section 15 of the Articles will be amended to read in its entirety as follows:

"15. So long as any shares of the 5% Preferred Stock or any shares of any series of the Serial Preferred Stock ~~or the Serial Preferred Stock A~~ are outstanding, the Corporation shall not, without the consent (given by vote at a meeting called for that purpose) of the holders of a majority of the total number of shares of the Voting Preferred Stock ~~preferred stocks~~ then outstanding:"

10. The first paragraph of Article VI of the Articles will be amended to read in its entirety as follows:

Subject to the provisions of Article III hereof and subject to the terms set forth in any certificate of designation filed with respect of any series of Serial Stock, (1) the management of this Corporation shall be vested in a Board of Directors, the number of which shall be fixed from time to time exclusively by the Board of Directors pursuant to a resolution adopted by affirmative vote of the majority of the Disinterested Directors, as defined in Article VII, but the number of Directors shall be no less than nine (9) and no greater than fifteen (15), but no decrease shall have the effect of shortening the term of any incumbent Director. Directors shall be elected annually by the stockholders by ballot by a majority vote of all the outstanding stock entitled to vote, to hold office until their successors are elected and qualify; (2) subject to any rights then existing by applicable law with respect to cumulative voting, the stockholders at any meeting by a majority vote of all the outstanding stock entitled to vote, at an election of directors, may remove any director and fill the vacancy; (3) subject to the rights of the holders of any class or series of the then outstanding shares of voting capital stock of this Corporation, newly created directorships resulting from any increase in the authorized number of Directors or any vacancies in the Board of Directors resulting from death, resignation, retirement, disqualification, removal from office or other cause may be filled only by the shareholders or by the affirmative vote of a majority of the Disinterested Directors then in office, although less than a quorum. Directors so elected shall hold office for a term expiring at the time of the next annual election of Directors by the stockholders and until their successors are duly elected and qualify.

CERTIFICATE OF SERVICE

I, Sharon Ferguson, hereby certify that I have this day, served copies of the following document on the attached list of persons by electronic filing, certified mail, e-mail, or by depositing a true and correct copy thereof properly enveloped with postage paid in the United States Mail at St. Paul, Minnesota.

Minnesota Department of Commerce
Comments

Docket No. E015/S-25-138

Dated this **20th** day of **May 2025**

/s/Sharon Ferguson

#	First Name	Last Name	Email	Organization	Agency	Address	Delivery Method	Alternate Delivery Method	View Trade Secret	Service List Name
1	Matthew	Brodin	mbrodin@allete.com	Minnesota Power		30 West Superior Street Duluth MN, 55802 United States	Electronic Service		No	S-25-138
2	Generic	Commerce Attorneys	commerce.attorneys@ag.state.mn.us		Office of the Attorney General - Department of Commerce	445 Minnesota Street Suite 1400 St. Paul MN, 55101 United States	Electronic Service		Yes	S-25-138
3	Sharon	Ferguson	sharon.ferguson@state.mn.us		Department of Commerce	85 7th Place E Ste 280 Saint Paul MN, 55101-2198 United States	Electronic Service		No	S-25-138
4	Lori	Hoyum	lhoyum@mnpower.com	Minnesota Power		30 West Superior Street Duluth MN, 55802 United States	Electronic Service		No	S-25-138
5	Generic Notice	Residential Utilities Division	residential.utilities@ag.state.mn.us		Office of the Attorney General - Residential Utilities Division	1400 BRM Tower 445 Minnesota St St. Paul MN, 55101-2131 United States	Electronic Service		Yes	S-25-138
6	Will	Seuffert	will.seuffert@state.mn.us		Public Utilities Commission	121 7th Pl E Ste 350 Saint Paul MN, 55101 United States	Electronic Service		Yes	S-25-138