

BEFORE THE  
NEW YORK STATE  
PUBLIC SERVICE COMMISSION

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Proceeding on Motion of the Commission as to the  
Rates, Charges, Rules and Regulations of  
New York State Electric & Gas Corporation  
for Electric Service

Case 09-E-

Proceeding on Motion of the Commission as to the  
Rates, Charges, Rules and Regulations of  
New York State Electric & Gas Corporation  
for Gas Service

Case 09-G-

Proceeding on Motion of the Commission as to the  
Rates, Charges, Rules and Regulations of  
Rochester Gas and Electric Corporation  
for Electric Service

Case 09-E-

Proceeding on Motion of the Commission as to the  
Rates, Charges, Rules and Regulations of  
Rochester Gas and Electric Corporation  
for Gas Service  
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Case 09-G-

**DIRECT TESTIMONY OF  
SUSAN D. ABBOTT**

September 17, 2009

**DIRECT TESTIMONY OF SUSAN D. ABBOTT**

1 **Q. What is your name and for whom do you work?**

2 A. My name is Susan D. Abbott and I am President of Susan Abbott Consulting,  
3 LLC. I am an independent consultant to companies in the regulated water, gas  
4 and electric utilities sector providing advice surrounding questions relative to  
5 credit ratings, credit worthiness, and rating agency relationships.

6 **Q. What are your qualifications?**

7 A. I have worked in the financial services industry since 1977, first as an institutional  
8 investor and, most recently, as an investment banker. The vast majority of my  
9 career, however, was spent at Moody's Investors Service ("Moody's"), one of the  
10 three principal U.S. based global rating agencies. For a total of 13 of the 20 years  
11 I was employed by Moody's, I was either a member, or the Managing Director of  
12 the Power and Project Finance Group, and was responsible for ratings of electric  
13 utility, electric and gas combination utility, water utility, and project finance  
14 ratings. Since leaving Moody's, I have been involved in rating agency advisory  
15 work with clients, chaired many rating agency panels for the jointly sponsored  
16 "Dialogue with Wall Street" (produced by Edison Electric Institute ("EEI"), and  
17 Gee Strategies, the consulting firm formed by Robert Gee, a former Assistant  
18 Secretary at the Department of Energy, a former Commissioner with the Texas  
19 Railroad Commission, and a former staff attorney at the Federal Energy  
20 Regulatory Commission), which is a forum for discussion between financial  
21 market participants and regulators.

22 I have a Bachelor's Degree in Literature from Syracuse University and an  
23 M.B.A. in Finance from The University of Connecticut. I sit on the Board of

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1 Directors of the Student Managed Funds for the University of Connecticut and am  
2 a member of the UConn Business School Hall of Fame. I have lectured at The  
3 Business School of the University of Connecticut and Wharton Business School  
4 at the University of Pennsylvania, and I was a faculty member at the University of  
5 Idaho’s Public Utility Executive Course for 10 years. My CV is attached as  
6 Exhibit \_\_ (SDA-1).

7 I have testified in a number of rate proceedings. A list of testimony is provided in  
8 Exhibit \_\_ (SDA-2).

9 **Q. Have you previously testified before the New York State Public Service**  
10 **Commission (“Commission” or “NYPSC”)?**

11 A. Yes, I have. In April 2006, I testified on behalf of New York State Electric & Gas  
12 Corporation (“NYSEG”) in Case No. 05-E-1222.

13 **Q. What is the purpose of your testimony?**

14 A. I have been asked by NYSEG and Rochester Gas and Electric Corporation  
15 (“RG&E”) to use my extensive experience with creating and using credit ratings,  
16 and my 32 years of involvement in the financing of the utility industry, to provide  
17 testimony on the importance of credit ratings. I will provide perspective on the  
18 rating process, why credit ratings are important for regulated utilities and their  
19 customers, and why an “A” level rating in particular is advisable and desirable for  
20 utilities.

21 **Q. In brief, what is your conclusion?**

22 A. NYSEG and RG&E need to work toward an “A” level rating. The capital  
23 intensive nature of their businesses combined with the serious competition for

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1 funds in the marketplace requires that utilities such as NYSEG and RG&E gain  
2 and maintain an “A” level rating which would provide access to the capital  
3 markets at all times at reasonable cost. The only way these companies will be  
4 able to attain and maintain an improvement in their ratings is through regulatory  
5 support from the Commission.

6 **Q. Are you sponsoring any exhibits?**

7 A. Yes. Exhibit \_\_ (SDA-1) is my CV. Exhibit \_ (SDA-2) lists other proceedings in  
8 which I have previously provided expert testimony. Exhibit \_\_ (SDA-3) lists the  
9 credit rating symbols for the major ratings agencies. Exhibit \_\_ (SDA-4) provides  
10 three April 20, 2009 credit analyses from Standard and Poor’s (“S&P”) on  
11 NYSEG, RG&E and Energy East Corporation (“Energy East”) and an April 9,  
12 2009 S&P press release announcing ratings actions on RG&E (downgrade) and  
13 Energy East (upgrade). Exhibit\_\_ (SDA-5) is Moody’s April 8, 2009 rating  
14 action for NYSEG, RG&E and Energy East. Exhibit \_ (SDA-6) provides three  
15 July 29, 2009 credit analyses from Fitch Ratings (“Fitch”) on NYSEG, RG&E  
16 and Energy East. Exhibit \_ (SDA-7) lists Regulatory Research Associates’ ratings  
17 of the quality of regulation in each state. Exhibit\_\_ (SDA-8) is a June 29, 2009  
18 report from Moody’s downgrading Consolidated Edison, Inc. and its regulated  
19 utility subsidiaries by two notches. Exhibit \_ (SDA-9) is Moody’s June 30, 2009  
20 credit analysis of Consolidated Edison Company of New York, Inc. Exhibit  
21 \_\_ (SDA-10) is a February 2004 article entitled “S&P: Utility Regulation  
22 Determines Its Ratings.” Exhibit \_\_ (SDA-11) is an index of the workpapers that

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1 support my testimony. These workpapers have been provided to the Department  
2 of Public Service Staff in electronic format.

3 **BACKGROUND ON CREDIT RATINGS**

4 **Q. What are credit ratings?**

5 A. Credit ratings are gatekeepers to the financial marketplace. Their primary  
6 function is to convey the level of creditworthiness of companies wishing to access  
7 capital in the public debt markets. Credit ratings assist investors in determining:  
8 1) which companies fit their risk appetite; 2) the appropriate interest rate that  
9 should be paid relative to credit quality; and 3) the likelihood that their investment  
10 is going to behave as expected in terms of timely payment of interest and  
11 principal.

12 **Q. What do credit ratings mean?**

13 A. Each credit rating level is associated with a probability of default; the lower the  
14 rating, the higher the probability of default. When credit ratings fall from  
15 investment grade to non-investment grade, the probability of default rises rapidly  
16 to levels that are often double those of the lowest investment grade rating.  
17 According to Moody's, from 1982 through 2006 the average rate of default was  
18 13.4% by year 20 in the life of a "Baa" bond ("BBB" equivalent for both S&P  
19 and Fitch). In the same report, they calculated that 30.8% of "Ba" rated issuers  
20 default, a rate more than twice as high as "Baa" rated securities.<sup>1</sup> Conversely, an  
21 investor in an "A" rated issuer will experience a 6.4% rate of default over 20

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<sup>1</sup> Default and Recovery Rates of Corporate Bond Issuers, 1920-2006, Moody's (Jan. 2007).

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1 years, less than half that of a “Baa” rated investment and a quarter of the loss that  
2 can be expected for a “Ba” rated investment.<sup>2</sup>

3 **Q. How are credit ratings expressed?**

4 A. Credit ratings are conveyed as a series of letters and qualifiers used to indicate to  
5 investors the likelihood that a company issuing debt will pay principal and interest  
6 on time, in amounts expected. S&P defines its credit ratings as an “evaluation of  
7 default risk over the life of a debt issue, incorporating an assessment of all future  
8 events to the extent they are known or can be anticipated.”<sup>3</sup> Moody’s defines  
9 credit ratings as a tool to “provide investors with a simple system of gradation by  
10 which relative creditworthiness of securities may be noted.”<sup>4</sup> Fitch considers its  
11 role is “to gather and analyze a variety of financial, industry, market and  
12 economic information, synthesize that information, and publish independent,  
13 credible assessments of the creditworthiness of securities and issuers, thereby  
14 providing a convenient way for investors to judge the credit quality of various  
15 alternative investment options.”<sup>5</sup> S&P and Fitch use the same nomenclature,  
16 while Moody’s is slightly different. However, their credit ratings are comparable.  
17 In other words, a “BBB” from S&P and Fitch is equivalent to a “Baa2” from  
18 Moody’s. A complete list of credit rating symbols is attached as Exhibit \_\_  
19 (SDA-3).

20 **Q. How are credit ratings derived?**

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<sup>2</sup> Id.

<sup>3</sup> Corporate Ratings Criteria 2008, S&P Rating Services.

<sup>4</sup> Moody’s Sourcebook, Power and Energy Company (Oct. 2004).

<sup>5</sup> CEO Message, fitchratings.com (Feb. 1, 2009).

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1 A. The credit rating process is complex, and is more art than science. It attempts to  
2 describe to investors the likelihood that cash flow generated by a business will be  
3 sufficient to cover a company's fixed financial obligations. However, it is  
4 important to understand that fundamentally, rating agencies arrive at their  
5 opinions of the creditworthiness of a company by examining its financial results  
6 in light of its business risk.

7 **Q. Do all the rating agencies follow the same methodology in deriving credit**  
8 **ratings?**

9 A. No. Each rating agency has its own unique methodology, but the fundamental  
10 issues are the same. All rating agencies regard cash flow financial metrics as the  
11 most informative of all ratios, and examine the cash flow generating capacity of a  
12 company compared to that of its cash obligations. They combine that  
13 examination with a company's business risk profile to determine a final credit  
14 rating.

15 **Q. What are the criteria the rating agencies use in deciding credit ratings?**

16 A. S&P describes the intersection of financial and business risk through a credit  
17 ratings "grid" that overlays what they consider the three most important cash flow  
18 metrics onto assessed business risk. Most electric utilities are judged to have  
19 "excellent" or "strong" business risk. Therefore, to ascertain what a likely credit  
20 rating might be, one can chart the cash flow metrics a company produces on the  
21 three measures: funds from operations/debt ("FFO/Debt"), funds from  
22 operations/interest ("FFO/Interest"), and debt/capital. Charting an "A" rating for  
23 a company with "excellent" business risk requires that the company generate cash

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1 flow metrics commensurate with an “intermediate” or better financial risk  
 2 profile.<sup>6</sup> A company with “strong” business risk must generate financial metrics  
 3 characterized as “modest” to attain an “A” rating, etc. The following charts  
 4 indicate the expectations S&P has for differing rating categories. If NYSEG, for  
 5 example, is charted through the grid, its “excellent” business profile, and  
 6 “aggressive” financial profile<sup>7</sup> combine to produce its “BBB+” rating.

**Ratings Grid**

	Financial Risk					
	Minimal	Modest	Intermediate	Significant	Aggressive	Highly Leveraged
Business Risk						
Excellent	AAA	AA	A	A-	BBB	
Strong	AA	A	A-	BBB	BB	BB-
Satisfactory	A-	BBB+	BBB	BB+	BB-	B+
Fair		BBB-	BB+	BB	BB-	B
Weak			BB	BB-	B+	B-
Vulnerable				B+	B	CCC+

<sup>6</sup> Because of the high levels of leverage utilities employ, no utility is judged to have “minimal” financial risk.

<sup>7</sup> As expressed in S&P’s Research Update on Energy East dated April 9, 2009, in which S&P projected FFO/interest of 4x and FFO/debt of 20% for NYSEG.

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**Financial Risk Metrics**

U.S. Utilities<sup>8</sup>

	Cash Flow Statistics		Debt Leverage
Financial Risk	FFO/Debt (%)	FFO/Interest (x) <sup>9</sup>	Debt/Capital (%)
Modest	45-60	4-6	25-35
Intermediate	30-45	3-4.5	35-45
Significant	20-30	n/a	45-50
Aggressive	12-20	2-3.5	50-60
Highly Leveraged	Below 12	2.5 or less	Over 60

1 **Q. How does Moody’s methodology differ from S&P’s?**

2 A. Moody’s has quantified its methodology and published a report on August 13,  
 3 2009 explaining it. In its publications, S&P discusses the factors that they use to  
 4 formulate business risk profiles. Regulation is considered to be the most  
 5 important, but they also discuss issues like competitive position, management and  
 6 industry characteristics.<sup>10</sup> Moody’s, however, quantifies the effect regulation has  
 7 on credit ratings. S&P provides its final assessment of business risk by assigning  
 8 qualifiers to the varying levels such as “modest”, or “aggressive”, and then  
 9 defines the financial metrics required to achieve certain rating levels for the  
 10 various levels of business risk. Moody’s, on the other hand, while still assessing

<sup>8</sup> S&P adjusted its guidelines for all corporate entities in May 2009. Criteria Methodology: Business Risk/Financial Risk Matrix Expanded, S&P, RatingsDirect (May 27, 2009). However, the new corporate guidelines do not address FFO/Interest, which is a utility sector specific metric. Therefore, the chart above shows the utility guidelines for FFO/Interest that were last published at the end of November 2007; whereas, the guidelines for FFO/Debt and Debt/Capital, which are universal metrics, are taken from the 2009 adjusted guidelines.

<sup>9</sup> S&P’s utility analysts continue to focus on FFO/Interest. However, the agency has not yet designated a corresponding range for this metric for the new “significant” financial risk category. S&P’s corporate analysts focus on Debt/EBITDA (not shown in the chart above) instead of FFO/Interest.

<sup>10</sup> Corporate Ratings Criteria 2008, S&P Rating Services.

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1 financial health in light of levels of business risk, assigns weight to 8 or 9  
 2 different factors, depending on whether the company in question owns generation,  
 3 which cover both business risk and financial risk. Each factor is rated, and then  
 4 the ratings are weighted and summed. Moody’s considers the four most  
 5 important factors affecting the creditworthiness of utilities to be: 1) regulatory  
 6 framework; 2) ability to recover costs and earn returns; 3) diversification; and 4)  
 7 financial strength and liquidity. Each factor is assigned an alpha-numeric rating  
 8 such as “Baa” for regulatory framework, or “B” for diversification. Each factor in  
 9 turn has a pre-determined weight as follows:

<u>Factor</u>	<u>Factor Weighting</u>	<u>Sub-Factor</u>	<u>Sub-Factor Weighting</u>
Regulatory Framework	25%		25%
Ability to Recover Costs and Earn Returns	25%		25%
Diversification	10%	Market Position	5% *
		Generation and Fuel Diversity	5% **
Financial Strength, Liquidity and Key Financial Metrics	40%	Liquidity	10%
		CFO*** Interest Cov.	7.5%
		CFO as % Debt	7.5%
		RCF**** as % Debt	7.5%
		Debt/Cap.	7.5%

10 \* 10% weight for issuers that lack generation  
 11 \*\* 0% weight for issuers that lack generation  
 12 \*\*\* CFO=cash flow from operations  
 13 \*\*\*\* RCF=retained cash flow, or CFO minus dividends

14 Each sub-factor rating is multiplied by the assigned weight, and then those values  
 15 are summed to produce a composite weighted-average score. That score is  
 16 compared to the values, which range from 1 to 16, that are attached to each rating  
 17 gradation on Moody’s scale. For example, an “Aaa” rating receives a value of 1.

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1 An “Aa1” rating receives a value of 2. An “Aa2” receives a value of 3, and so on  
 2 to “B3” which receives a value of 16. The sum of the weighted ratings for the  
 3 utility in question is compared to the value of individual ratings, and a credit  
 4 rating can be surmised.

5 **Q. Can you illustrate how this works?**

6 A. Yes. A hypothetical company achieves the ratings shown on 8 factors. The  
 7 scores are weighted according to Moody’s assessment of the importance of each,  
 8 and then summed.

<u>Factor</u>	<u>Weight</u>	<u>Rating</u>	<u>Value<sup>11</sup></u>	<u>Weighted Value</u>
Regulatory Framework	25%	Ba	12	12 x 25% = 3
Rate Adjustment and Cost Recovery Mechanisms	25%	Ba	12	12 x 25% = 3
Diversification	10%	Ba	12	12 x 10% = 1.2
Liquidity	10%	Baa	9	9 x 10% = .9
Cash Flow Interest Coverage	7.5%	Aa	3	3 x 7.5% = .225
Cash Flow as % of Debt	7.5%	Aaa	1	1 x 7.5% = .075
Retained Cash Flow as % of Debt	7.5%	Aa	3	3 x 7.5% .225
Debt as % of Capitalization	7.5%	Ba	15	15 x 7.5% = .9
<b>Total</b>				<b>9.52</b>

9 Overlaying the 9.52 on the chart of the values of individual rating levels indicates  
 10 that our hypothetical company would have an indicative credit rating of “Baa3”.

11 **Q. How are the rating factors determined?**

<sup>11</sup> Each rating, including refined notches such as Baa1 and Aa3, has a value between 1 and 16. The value assigned any given rating becomes the median when determining indicative ratings based on weighted scores, i.e., an “Aa1”, with a value of 2, will be the indicative rating for companies scoring between 1.5 and 2.5, while “Baa3”, with a value of 10, will be the indicative rating for companies scoring between 9.5 and 10.5. The complete scale is as follows:

- Aaa = 1 Aa1 = 2 A1 = 5 Baa1 = 8 Ba1 = 11 B1 = 14
- Aa2 = 3 A2 = 6 Baa 2= 9 Ba2 = 12 B2 = 15
- Aa3 = 4 A3 = 7 Baa3 = 10 Ba3 = 13 B3 = 16

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1 A. While Moody’s new rating methodology is not strictly formulaic, it provides a  
2 usable framework for investors and issuers to use to assess credit ratings. The key  
3 rating factors Moody’s has chosen to include in their written methodology  
4 comprise the issues that Moody’s deems “central to the assignment of ratings for  
5 companies in the sector.”<sup>12</sup> Interestingly, the quality of regulation determines a  
6 full 50% of a utility’s rating. S&P writes articles with titles such as “Utility  
7 Regulation Determines Its Ratings.” Moody’s has actually quantified the  
8 importance of regulation to the credit quality of utilities. Moreover, in addition to  
9 emphasizing that “the predictability and supportiveness of the regulatory  
10 framework . . . is a key credit consideration”, Moody’s also states that “[t]he  
11 ability to recover prudently incurred costs in a timely manner is perhaps *the single*  
12 *most important credit consideration* for regulated utilities as the lack of timely  
13 recovery of such costs has caused financial stress for utilities on several  
14 occasions.”<sup>13</sup>

15 **Q. What do the rating agencies consider to be the most important financial**  
16 **metric?**

17 A. As can be seen from both Moody’s and S&P’s rating methodologies, cash flow is  
18 the most important financial metric, simply because credit ratings are intended to  
19 measure the ability of a company to pay its financial obligations on time, and in  
20 amounts expected. Those financial obligations are cash obligations. Therefore,  
21 the ability of a company to generate cash flow in amounts that are sufficient to

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<sup>12</sup> Regulated Electric and Gas Utilities, Rating Methodology, Moody’s, at 1 (Aug. 2009).

<sup>13</sup> Id. (emphasis added).

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1 pay its obligations, plus have a cushion for unexpected events, is of utmost  
2 importance. The cash flow metric deemed most important is cash flow as a  
3 percentage of debt outstanding, or “FFO/Debt.” This measures the ability of a  
4 company to generate sufficient cash flow relative to its obligations, which often  
5 covers not just debt, but what rating agencies call “debt-like” obligations, or  
6 anything that is an ongoing obligation that must be satisfied with cash. The other  
7 cash flow metric that is weighted heavily is cash flow coverage of interest, or  
8 “FFO/Interest.” While this is an important metric, it is not considered as reliable  
9 an indicator as FFO/Debt because interest rates can fluctuate over short periods of  
10 time, thereby distorting the long term financial health of a company. Moody’s  
11 adds the metric called “retained cash flow” or cash flow from operations after  
12 dividends. Investors choose utilities partly because they pay good dividends and,  
13 therefore rating agencies view dividends as a quasi-fixed obligation (i.e., if a  
14 utility reduced or eliminated its dividend, it could suffer diminished access to  
15 equity capital as investors would look elsewhere for current income).

16 **Q. Why is cash flow more important than earnings?**

17 A. Rating agencies are assessing the likelihood that a company can satisfy its cash  
18 obligations such as interest and principal on debt. Those obligations can only be  
19 satisfied with cash. This is akin to a homeowner who has a mortgage that must be  
20 serviced with cash every month. Nothing else will satisfy the bank. If the cash is  
21 not sent to the bank on schedule, the homeowner may face dire consequences, like  
22 foreclosure. Likewise, a utility that borrows money must send, in cash, the  
23 interest owed on that debt on a regular basis to its bondholders. Otherwise the

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1 bondholders have the right to seize assets, or force the company into bankruptcy,  
2 depending on the terms of the bond or loan. Accounting statistics such as net  
3 income can reflect non-cash items, making them poor reflections of a company's  
4 ability to pay cash obligations.

5 **Q. Are other financial metrics besides cash flow metrics important?**

6 A. Rating agencies calculate dozens of metrics when doing a rating exercise. In the  
7 end, however, the cash flow metrics carry so much more weight than any others  
8 that they, in combination with business risk levels, effectively define the credit  
9 rating. Fitch describes the emphasis they place on cash flow when they state that  
10 "the financial assessment emphasizes cash flow financial measures rather than  
11 equity or earnings-based ratios. The analytical focus is on the adequacy of the  
12 utility's cash flow relative to fixed charges, debt obligations and capital  
13 expenditures as well as its capital structure, liquidity and profitability."<sup>14</sup> S&P  
14 emphasizes that "interest or principal payments cannot be serviced out of  
15 earnings, which is just an accounting concept . . . cash flow analysis is the single  
16 most critical aspect of all credit rating decisions."<sup>15</sup>

17 **Q. What factors affect cash flow?**

18 A. There are many, but the most important are the allowed return on equity, and  
19 timely and predictable cost recovery.

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<sup>14</sup> CEO Message, fitchratings.com (Feb. 1, 2009).

<sup>15</sup> Corporate Ratings Criteria 2008, S&P Rating Services.

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1 **Q. Can you elaborate?**

2 A. Yes. The allowed return on equity, while not assuring that return, is supposed to  
3 give the utility the *opportunity* to earn it. The lower the allowed return is set, the  
4 less cash the company will be allowed to generate, simply because cash flow is a  
5 function of allowed return on a specific level of equity. The lower either or both  
6 of those elements are, the less cash a company will be allowed to generate, and  
7 the lower its credit quality will be. Timely and predictable cost recovery is  
8 important because utilities spend hundreds of millions of dollars on assets that  
9 benefit their customers, but are not allowed to earn a return on those assets unless  
10 and until regulators approve a return of and on them. Therefore, that investment  
11 is being carried by the utility and its shareholders without earning any return on  
12 the capital spent, and in some cases, not receiving the return *of* the capital. This  
13 further depresses the utility's ability to generate cash flow in relation to its  
14 obligations, since it has most likely borrowed money to invest in the assets on  
15 which it is not earning a return. Similarly, timely and predictable recovery of  
16 deferred costs is important to a utility's credit standing since carrying those costs  
17 from rate case to rate case or even beyond, whether or not it is earning a non-cash  
18 return, weighs heavily on the company's financial health.

19 **Q. How are credit ratings used?**

20 A. Credit ratings are used by investors to help them determine which companies they  
21 should invest in, the appropriate interest rate that should be paid, and the  
22 likelihood that they will receive timely payment of interest and principal. The  
23 term "investment grade" was coined by the U.S. marketplace to describe bonds

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1 with credit risks suitable for banks, and today forms a floor for creditworthiness  
2 for many institutional investors in terms of what regulations or internal guidelines  
3 allow.

4 **Q. Can investors invest in companies with any level credit rating?**

5 A. Not necessarily. Institutional investors have a fiduciary responsibility to their  
6 clients, and in some cases are not allowed to invest in fixed income securities  
7 rated below a certain level. A combination of internal charters and standards, and  
8 external regulations, prohibit many investors from investing in fixed income  
9 instruments that are rated below “A” in some cases, or “BBB” in others. For  
10 instance, SEC regulation 2a7 restricts mutual funds and money market funds from  
11 investing in commercial paper of companies rated anything but “A-1/P-1” or “A-  
12 2/P-2”,<sup>16</sup> the two highest short-term rating categories of S&P and Moody’s.  
13 Insurance companies may invest in bonds with ratings below “BBB-/Baa3”, but  
14 they are required by the insurance regulators to provide reserves to guard against  
15 losses on investments rated below those levels, making investments in non-  
16 investment grade securities extremely expensive. A myriad of internal and other  
17 regulatory requirements restrict many investors from investing in “non-investment  
18 grade” securities. Therefore, borrowers with less than investment grade ratings  
19 who also have a significant need for funds can be severely disadvantaged by  
20 being denied unimpeded access to the marketplace as a result of their credit  
21 ratings.

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<sup>16</sup> See Exhibit \_\_ (SDA-3) for a complete list of ratings and the correlation of long-term and short term ratings.

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**NYSEG/RG&E CREDIT RATINGS**

**Q. What are NYSEG’s and RG&E’s credit ratings?”**

A. The issuer or issuer default credit ratings assigned to NYSEG and RG&E by the three major U.S. rating agencies are as follows:

<b><u>Company</u></b>	<b><u>S&amp;P</u></b>	<b><u>Moody’s</u></b>	<b><u>Fitch</u></b>
NYSEG	BBB+/stable	Baa2/stable	BBB/negative
RG&E	BBB/stable	Baa2/stable	BBB-/stable

RG&E’s credit rating was downgraded by S&P on April 9, 2009, immediately following the Commission’s dismissal of RG&E’s January 2009 rate cases. S&P cited “financial metrics more appropriate for the ‘BBB’ rating and greater regulatory risk than some of the other Energy East utilities.” See Exhibit \_\_ (SDA-4). Additionally, Moody’s downgraded both NYSEG and RG&E on April 8, 2009, citing the Commission’s “refusal to hear the January 2009 rate case filings made by NYSEG and RG&E . . . .” See Exhibit \_\_ (SDA-5). It is worth noting that Moody’s maintains NYSEG’s and RG&E’s ratings at the same level despite differences in financial condition. Moody’s appears to feel that the common regulatory regime and financial protections (i.e., dividend restrictions) provide support for common ratings.

As discussed in more detail below, all of the rating agencies view the credit ratings of NYSEG and RG&E independently from those of their direct and ultimate parents, Energy East and Iberdrola, S.A. (“Iberdrola”). S&P affirmed NYSEG’s credit rating and downgraded RG&E while upgrading Energy East;

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1 Fitch recently maintained NYSEG’s and RG&E’s credit ratings while upgrading  
2 Energy East; and Moody’s generally views operating companies on a standalone  
3 basis from their parent companies.

4 **Q. How do NYSEG’s and RG&E’s credit ratings compare to ratings of other**  
5 **New York State domiciled utilities?**

6 A. NYSEG’s and RG&E’s credit ratings are generally multiple notches lower than  
7 the ratings of any other New York State electric and gas utility, and NYSEG and  
8 RG&E are the only combination electric and gas utilities in New York State that  
9 lack “A” level credit ratings from any of the three major rating agencies. The  
10 other utilities’ credit ratings are as follows:

<u>Company</u>	<u>S&amp;P</u>	<u>Moody’s</u>	<u>Fitch</u>
Central Hudson	A/stable	A3/negative	A-/stable
Consolidated Edison	A-/stable	A3/stable	BBB+/stable
Orange & Rockland	A-/stable	Baa1/stable	A-/stable
Niagara Mohawk	A-/stable	A3/stable	A-/stable
National Fuel Gas	BBB/stable	Baa1/stable	A-/stable
KeySpan Gas East <sup>17</sup>	A/stable	A3/stable	A-/stable

11 **Q. Why does it matter that all other New York State electric and gas utilities**  
12 **have significantly higher credit ratings than NYSEG and RG&E?**

<sup>17</sup> Moody’s and Fitch list KeySpan Gas East as the entity they rate, while S&P lists KeySpan Energy Delivery Long Island and KeySpan Energy Delivery New York as rated entities. However, both carry an “A” rating from S&P, so they have been consolidated into KeySpan Gas East for purposes of illustration in the chart above.

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1 A. The competition for funds in the infrastructure sector, of which utilities of all  
2 kinds are a part, is becoming fierce. The California Public Employees Retirement  
3 system estimates that there will be a need for \$20 trillion of investment in the  
4 North American infrastructure sector over the next 25 years. EEI estimates that  
5 the U.S. electric utility sector alone will require \$1.5 trillion of investment from  
6 2010 through 2030, excluding additional amounts for the impact of climate  
7 change legislation. Capital expenditures for the industry of \$85.5 billion in 2008  
8 created negative free cash flow of \$20.9 billion, meaning companies cannot fund  
9 their capital programs internally and must turn to the capital markets to make up  
10 the shortfall. In addition to restrictions imposed by internal guidelines as well as  
11 external regulation, investors limit their exposure to any one regulatory  
12 jurisdiction, and will likely invest in the stronger utilities. Therefore, if NYSEG  
13 and RG&E had “A” level credit ratings, they could compete on a more even  
14 footing with other New York State domiciled utilities to capture their needed  
15 share of investment dollars. Importantly, as reported by Moody’s, spreads  
16 between “A” rated issues and “Baa” (“BBB” in S&P and Fitch nomenclature)  
17 rated issues remain historically high. As the NYSEG and RG&E testified  
18 previously in their January rate filings, that spread was 159 basis points as of  
19 December 2008 during the height of the global financial crisis. On August 21,  
20 2009, that spread was still 65 basis points. While market conditions have  
21 improved since the height of the crisis, it is unlikely, given current economic  
22 conditions, the state of the financial industry, and the growing government budget  
23 deficit, that spreads between “A” and “BBB” rated issues will return to the 6 to 25

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1 basis point range that existed prior to the financial crisis. It is more likely that  
2 they will remain high (as they have been throughout the financial crisis) in  
3 addition to being unpredictable. There are global economic factors that have been  
4 identified by authorities such as Moody’s that point to a good deal of uncertainty  
5 regarding the shape of the global economic recovery, and therefore the  
6 predictability of credit spreads. Moody’s highlights that the economics of global  
7 de-leveraging are unknown, that risk aversion is such that “funding liquidity is a  
8 pervasive and sometimes alarming problem” and “that nobody really knows by  
9 how much private saving rates must go up to create the conditions of a sustained  
10 rebound.”<sup>18</sup> Moody’s concludes its report with the question, “Will credit  
11 allocation ever again be as it was during the last 15 years?”<sup>19</sup> Because of this  
12 pervasive uncertainty and the magnitude of the range of spreads during the  
13 ongoing financial crisis, it is critical that utilities that are facing large capital  
14 spending programs gain and maintain “A” level credit ratings to minimize the  
15 impact on their customers of the cost of funds necessary to fulfill the utility’s  
16 obligation to serve.

**NEW YORK REGULATION**

17  
18 **Q. What is the quality of regulation in the State of New York?**

19 A. The quality of regulation is assessed by investors and rating agencies alike.  
20 However, Regulatory Research Associates (“RRA”), a subsidiary of the financial  
21 information provider SNL, does nothing but assess the quality of regulation, and

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<sup>18</sup> Credit Uncertainty: Global Corporate Finance, Risk Factors to Watch in 2009, Moody’s, Special Comment (Jan. 13, 2009).

<sup>19</sup> Id.

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1 provides a service to the financial community that details regulatory activity in the  
2 U.S. utility sector. They evaluate regulatory bodies on a scale of Above Average  
3 1 to Below Average 3. The entire scale is found in Exhibit \_\_ (SDA-7). RRA  
4 views the Commission as “Average 3” which is one rating below the absolute  
5 middle of the scale.

6 **Q. Why is the NYPSC rated at Average 3?**

7 A. Primarily because of a “long history of authorizing below-industry average  
8 returns on equity.”<sup>20</sup> As the NYPSC itself recently noted in a June 30, 2009 letter  
9 to Assemblyman Kevin Cahill in Cases 08-E-0887 and 08-G-0888 (the “Cahill  
10 Letter”), the Commission’s allowed returns on equity are “among the lowest  
11 equity returns in the country.” RRA stated in its most recent update on the  
12 Commission that the 9.1% return on equity adopted in three rate proceedings over  
13 the past year were “by far, the lowest return[s] authorized nationwide in at least  
14 the last 30 years.”<sup>21</sup> RRA’s rating on the NYPSC was dropped from Average 2 to  
15 Average 3 in 2007 after the NYPSC’s 9.1% ROE award to Orange & Rockland.  
16 The NYPSC consistently follows some processes that provide additional  
17 certainty, such as deferral accounting for increases in items such as net plant,  
18 pension expense and labor costs and, in some cases, provides an ROE premium to  
19 take account of the risk associated with multi-year plans. However, those  
20 adjustments, although positive in some respects, do not counteract the harmful  
21 effects on a utility’s cash flow and its financial health of the very low returns on

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<sup>20</sup> New York State Public Service Commission, SNL Interactive (July 7, 2009).

<sup>21</sup> Id.

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1 equity awarded in New York, the NYPSC’s practice of letting deferrals mount for  
2 many years without allowing for timely cost recovery, and the tendency of the  
3 New York Department of Public Service Staff to raise (and re-raise) old  
4 previously-litigated cost recovery issues in each utility rate case.

5 **Q. Do the rating agencies evaluate regulation like RRA does?**

6 A. Yes. While the rating agencies follow RRA’s work, subscribe to their services,  
7 and read their reports with interest, they also maintain independent assessments of  
8 regulation on a jurisdictional basis. For example, Fitch states in a November 17,  
9 2008 report that “the ratings of utilities operating in states with relatively low  
10 authorized ROEs and significant regulatory lag are more likely to suffer future  
11 credit deterioration . . . .”<sup>22</sup> Fitch highlights “states with challenging regulatory  
12 environments include[ing] Arizona, Missouri, New Mexico, New York, and  
13 Vermont.”<sup>23</sup> Additionally, S&P divides the credit supportiveness of all regulatory  
14 jurisdictions into five categories: (1) most credit supportive; (2) more credit  
15 supportive; (3) credit supportive; (4) less credit supportive; and (5) least credit  
16 supportive. New York is categorized as less credit supportive.<sup>24</sup> In Moody’s  
17 most recent report on NYSEG, it rated New York State regulation “Ba” (which  
18 rating, with respect to issuers, would be non-investment grade).

19 **Q. Are there recent examples of the effect of low ROEs on New York State**  
20 **utilities?**

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<sup>22</sup> EEI 2008 Wrap-Up: Cost of Capital Rising, Fitch (Nov. 17, 2008).

<sup>23</sup> Id.

<sup>24</sup> S&P Credit FAQ Answers Questions on U.S. Utility Regulatory Environment Assessments, S&P (Nov. 25, 2008).

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1 A. Yes. The Commission’s most recent rate order for Consolidated Edison, which  
2 included a 10% return on equity using a 48% equity capital structure, was not  
3 sufficient to maintain the ratings of Consolidated Edison and its operating  
4 subsidiaries, and has raised concerns among financial analysts and rating agencies  
5 that watch regulated utilities in New York State. Moody’s downgraded  
6 Consolidated Edison, Inc., Consolidated Edison Company of New York, Inc., and  
7 Orange and Rockland Utilities, Inc. all by two rating notches, an uncommon  
8 move, as a result of “challenging regulatory and operating environments for the  
9 foreseeable future.” Exhibit \_\_ (SDA-8). Moody’s states that the “regulatory  
10 environment has become more challenging in recent years” and that its view  
11 “reflects the steady decline in allowed ROEs as evidenced by the decline in the  
12 allowed ROE in CECONY’s electric business from the 11.1% that existed  
13 through most of the 1990s and the early part of this decade to the 9.1% authorized  
14 for the 2009 rate year.” Exhibit \_\_ (SDA-9). Moody’s also states that it  
15 considers “the PSC’s requirement that CECONY implement a \$60 million  
16 austerity program” to be “symptomatic of a less constructive regulatory  
17 environment.” Id. Moody’s goes on to say that, while it understands the  
18 motivation for the actions the regulators have taken relative to an ongoing audit of  
19 the company’s capital spending program and an accounting investigation, for  
20 which the best case outcome would be “neutral,” these regulatory activities  
21 “increase the risk that CECONY could suffer a degradation of either its financial  
22 profile or *the reliability and safety of its systems or both.*” Id. (emphasis added).

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1 **Q. Are there other recent examples where the quality of New York regulation**  
2 **has impacted the credit ratings of a New York State utility?**

3 A. Yes. On September 9, 2009, Moody’s downgraded the long-term rating of  
4 Central Hudson Gas & Electric Corporation (“Central Hudson”) from “A2” to  
5 “A3” while maintaining its negative rating outlook. This downgrade occurred  
6 despite the rate relief the Commission recently provided Central Hudson.  
7 Moody’s states that “[t]he increased dependence on rate filings to address  
8 regulatory lag in the currently challenging economic environment adds to credit  
9 uncertainty.”<sup>25</sup> The rating agency concludes that “[t]he likelihood of a further  
10 rating downgrade would increase if . . . we detect signs that regulatory  
11 supportiveness is lacking in the currently pending rate case.”<sup>26</sup>

12 **Q. Are there any indications that regulatory activity has affected the credit**  
13 **ratings of NYSEG and RG&E?**

14 A. Yes. In April of 2009, Moody’s downgraded both NYSEG and RG&E citing the  
15 Commission’s refusal to hear the January 2009 rate cases, which “will make it  
16 difficult for the two utilities to proceed with minimum required capital  
17 expenditures as mandated in the September 2008 order . . . .” Exhibit \_\_ (SDA-  
18 5). S&P also downgraded RG&E immediately following the Commission’s  
19 dismissal of RG&E’s January 2009 rate cases, citing “greater regulatory risk.”  
20 Exhibit \_\_ (SDA-4).

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<sup>25</sup> Moody’s downgrades Central Hudson G&E to A3; outlook remains negative, Moody’s (Sept. 9, 2009).

<sup>26</sup> Id.

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1 **Q. Was there any indication that Moody’s was concerned about regulation in**  
2 **New York prior to the April downgrades?**

3 A. Yes. Moody’s put NYSEG and RG&E on review for downgrade on September  
4 16, 2008 upon the completion of the purchase of the parent company, Energy  
5 East, by Iberdrola. Even though Moody’s stated that it views the “acquisition of  
6 EEC by Iberdrola SA as a strong credit positive,” the rating agency nevertheless  
7 placed both NYSEG and RG&E on review for downgrade each as a result of “the  
8 company’s regulatory risk profile, which . . . has weakened from a more favorable  
9 historical position, placing it in the Ba category.”<sup>27</sup>

10 **Q. Why should the Commission care what the rating agencies say?**

11 A. A company’s creditworthiness, as expressed through its credit ratings, will dictate  
12 its ability to attract capital at reasonable cost in increasingly competitive markets.  
13 In addition, part of the assessment of a company’s creditworthiness is whether it  
14 has adequate access to both the equity and debt markets. Access to the equity  
15 markets depends largely on a utility’s ability to earn a return that is comparable to  
16 other utilities with similar risk profiles, in addition to its dividend policy, and  
17 access to the debt markets depends on a company’s credit rating.

18 **IMPORTANCE OF “A” LEVEL CREDIT RATINGS**

19 **Q. Why is it important for utilities in particular to have solid investment grade**  
20 **credit ratings?**

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<sup>27</sup> Rochester Gas and Electric Corporation and New York State Electric & Gas Corporation, Credit Opinions, Moody’s (Oct. 16, 2008).

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1 A. Utilities are capital intensive companies and require access to the capital markets  
2 at reasonable cost at all times. The lower the credit rating, the higher the risk  
3 profile and the higher the cost of borrowed money. In addition, lower rated  
4 companies have not been able to access the capital markets at all during certain  
5 periods in the past year. Even creditworthy utilities have been shut out of various  
6 markets at times during the market dislocations that resulted from the sub-prime  
7 mortgage crisis.

8 **Q. Is it more important currently to have a solid investment grade rating than**  
9 **in the past?**

10 A. It is important for utilities to maintain an investment grade rating at all times.  
11 Credit ratings cannot be moved up and down at will, and in fact, take years to  
12 recover if lost. Moody's did a study in 2003 that demonstrated that only 30% of  
13 companies that lost their investment grade rating recovered it within a 5 year  
14 period. More importantly, the utility sector is entering a period of heavy capital  
15 spending needed to refurbish, rebuild and expand systems to provide for a  
16 growing customer base and to meet mandated requirements for environmentally  
17 conscious investment. The draft New York State Energy Plan (the "Plan")  
18 recently found that "because New York's electric infrastructure is old, significant  
19 capital investments will need to be made in the utilities' electric transmission and  
20 distribution systems to meet future electric demand and allow them to continue to  
21 provide reliable service."<sup>28</sup> The Plan continues to note that investor-owned  
22 utilities in New York project that infrastructure investments "could be over \$13

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<sup>28</sup> Draft 2009 State Energy Plan, New York State Energy Planning Board, at 58 (Aug. 2009).

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1 billion for the next five years . . . .”<sup>29</sup> Without adequate access to capital,  
2 providing for the needed infrastructure to produce and distribute required amounts  
3 of power becomes, in the end, much more expensive than it otherwise would be.  
4 In addition, periods such as the current one, when utilities are engaged in heavy  
5 construction activity, present higher levels of operational and financial risk.  
6 During these periods, utilities are more vulnerable to credit quality diminution  
7 that may, or may not, result from something the utility itself is doing. Problems  
8 could just as easily stem from economic dislocations or other extraneous events as  
9 from activity peculiar to a specific utility. Therefore, having an adequate cushion  
10 of creditworthiness to guard against unexpected events is most important during  
11 these periods. Chairman Brown recognizes how important it is to maintain a  
12 cushion against unexpected events. He stated at a FERC Technical Conference  
13 that utilities “do not want to be rated at the lower end of the BBB range because  
14 an unexpected shock could move [a utility] outside the investment grade range.”<sup>30</sup>  
15 Moreover, the Department of Public Service Staff itself recently stated in its cost  
16 of capital testimony in Case 09-E-0948 regarding Consolidated Edison: “we do  
17 not wish to set a course that would result in a low investment grade rating,  
18 because such ratings entail an undesirable diminishment in financing options and  
19 flexibility. Such ratings could also put the Company in a position where an  
20 unexpected event could cause it to lose its investment-grade rating, which might

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<sup>29</sup> Id.

<sup>30</sup> Docket No. AD09-2-000, FERC Technical Conference – Credit and Capital Issues Affecting the Electric Power Industry, Speaker Materials of the Honorable Garry A. Brown, Chairman, New York State Public Service Commission, at 3 (Jan. 13, 2009).

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1 put in jeopardy its ability to provide safe and adequate service.”<sup>31</sup> This is a  
2 significant issue for RG&E, which already carries the lowest investment grade  
3 rating (“BBB-”) from one of the major rating agencies, due to its “marginally  
4 investment grade credit profile.” Exhibit \_\_ (SDA-6).

5 **Q. Can you describe in more detail the consequences of having difficulty**  
6 **accessing capital?**

7 A. Yes. Utility finance is complex with a steady stream of both long- and short-term  
8 financings. Funds are needed to pay large amounts to suppliers of essential goods  
9 and services on an ongoing basis, maintain creditworthiness for counterparties,  
10 and access large amounts of capital frequently, especially during a construction  
11 cycle. Being unable to access funds can place the completion of critical  
12 infrastructure construction in jeopardy and undermine reliability of service. A  
13 company’s creditworthiness, as expressed through its credit ratings, will dictate its  
14 ability to attract capital in an increasingly competitive capital market.

15 **Q. Why is the capital market “increasingly competitive?”**

16 A. NYSEG and RG&E will undoubtedly have a need for large amounts of capital,  
17 particularly as the need to expend resources on their systems increases over the  
18 next decade. The economy will not remain in a dormant state forever, and the  
19 infrastructure grows older every day. Since credit ratings do not move easily or  
20 often, laying the foundation for an “A”-level rating for these companies now will  
21 greatly benefit ratepayers in the future. As delineated in an article in Electric

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<sup>31</sup> Case 09-E-0428, In the Matter of Consolidated Edison Company of New York, Prepared Testimony of Staff Finance Panel, at 33 (filed Aug. 2009).

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1 Perspectives on February 9, 2009, the last construction cycle in the utility industry  
2 was completed almost 30 years ago, and the industry is embarking on a new  
3 construction cycle. David Owens, Executive Vice President of the Edison  
4 Electric Institute, pointed out in his remarks on February 12, 2009 to Wall Street  
5 in a presentation entitled “Electricity: Powering the Change that America Needs,”  
6 that “at the onset of our last major capital expenditure cycle in the 1970s and  
7 1980s, our senior debt was largely rated “A” and “AA.” Today, the average S&P  
8 senior debt rating is “BBB”. All of the rating agencies have highlighted the need  
9 for additional significant infrastructure investing, and consider it one of, if not the  
10 most important long-term issue facing the industry today. Moody’s states that  
11 while the “fundamental credit outlook for the . . . electric utility sector currently  
12 remains stable,” the stability of credit metrics in the industry over the past few  
13 years has become “a credit negative since stronger metrics would be needed to  
14 offset the pace of rising business and operating risk.”<sup>32</sup> Those risks reference the  
15 building cycle in which the industry is currently engaged. Moody’s also opined  
16 that “deferrals and delays are temporary solutions,”<sup>33</sup> addressing the concept that  
17 utilities will not need to spend as much as previously thought because of the  
18 economic slowdown. In reality, utilities invest for the needs of the public for 30  
19 and 40 years. Any temporary slow down will need to be caught up eventually.  
20 As Moody’s so succinctly put it, “the sector’s substantial negative free cash flow

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<sup>32</sup> Industry Outlook, U.S. Electric Utility Sector, Moody’s (Jan. 2008).

<sup>33</sup> U.S. Investor Owned Electric Utilities, Industry Outlook, Moody’s Global Infrastructure, Moody’s (Jan. 2009).

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1 generation creates a need for unfettered access to the capital markets. This  
2 represents a fundamental weakness to the sector's business plan."<sup>34</sup>

3 **Q. Are utilities a good investment?**

4 A. Investments in utilities are considered to be safer than those in many other  
5 industrial companies. So when the market is disrupted or the economy falters,  
6 investors tend to take money out of higher yielding but riskier investments like  
7 industrials, and put it in less risky, lower yielding investments like "A" level  
8 utility stocks and bonds and government debt. This phenomenon is generalized as  
9 a "flight to quality."

10 **Q. Has the "flight to quality" made access to capital easier for utilities?**

11 A. There is no doubt that there has been a "flight to quality," and that "A" level  
12 utilities have benefited from it. However, the ongoing market instability resulting  
13 from the sub-prime mortgage problem is a good example of how access to the  
14 marketplace can be shut off, or made more difficult, for even creditworthy  
15 borrowers by extraneous, unforeseen events. It emphasizes that a strong credit  
16 rating is essential to ongoing, unimpeded access to the capital markets. When the  
17 U.S. capital markets were frozen for 10 days in September 2008, the first issuers  
18 that opened the market back up were three "A" level rated utilities and two "A"  
19 level rated energy companies.<sup>35</sup> Moody's emphasizes that their view of the

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<sup>34</sup> Id.

<sup>35</sup> Utility New Issue Summary, UBS (Dec. 1, 2008).

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1 industry having a stable near-term ratings outlook “incorporates an assumption  
2 that utilities will continue to have *unfettered access* to the capital markets.”<sup>36</sup>

3 **Q. How does a utility maintain “unfettered access” to the capital markets?**

4 A. The only reliable way is to maintain an “A” level credit rating. As mentioned  
5 previously, it was “A” level rated utilities that led the way when the public bond  
6 markets opened up after being essentially frozen for 10 days. It is more likely that  
7 a company with an “A” level rating could access the credit markets at reasonable  
8 prices even during times of financial market distress. While the markets have  
9 eased somewhat, it is highly unlikely that they will return to the easy credit stance  
10 of the last 15 years. Market volatility remains, and spreads between credit rating  
11 categories remain substantially higher than they were prior to the credit crisis.  
12 The average spread during the financial crisis, has been around 112 basis points.  
13 Interestingly, while the absolute cost of “BBB” rated debt as measured by  
14 nominal interest rates is similar today to the level experienced before the credit  
15 crisis, the cost of funds for “A” rated issues was 39 basis points lower on August  
16 13, 2009 than it was the week of April 25, 2008. This trend demonstrates the  
17 increased risk aversion of investors today toward lower-rated issuers. In addition,  
18 given the magnitude of the need for capital by the utility sector, competition for  
19 funds will be fierce, which in itself will drive up costs.

20 **Q. Have there been indications from the NYPSC that it values an “A” level**  
21 **credit rating?**

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<sup>36</sup> U.S. Investor-Owned Electric Utilities; Somewhat Insulated but not Immune from Credit Market Stress, Economic Weakness, Special Comment, Moody’s Global Infrastructure, Moody’s (Oct. 2008) (emphasis added).

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1 A. Yes. At the height of the financial crisis, NYPSC Chairman Garry Brown  
2 addressed the FERC Technical Conference referenced earlier. During his  
3 remarks, he stated that “[l]arge capital programs . . . make it very important that  
4 electric utilities continue to have access to the financial markets, and regulatory  
5 policies should support utilities’ ability to raise capital.”<sup>37</sup> He went on to say that  
6 the spread between the cost of funds for a “BBB” rated issuer and an “A” rated  
7 issuer “may indicate that A is cheaper to ratepayers now.”<sup>38</sup> Additionally, the  
8 Commission recently noted in the Cahill Letter that the wide basis point spreads  
9 between “BBB” and higher rated issuers throughout the financial crisis have led  
10 investors to require “a large premium to invest in [‘BBB’ rated] instruments.”<sup>39</sup>

11 **Q. Have conditions in the capital markets improved?**

12 A. While the capital markets have loosened up a bit, and financing is possible for  
13 “BBB” rated utilities when that was not necessarily the case in September of  
14 2008, the spreads between “A” rated issues and “BBB” rated issues have ranged  
15 from 159 basis points in December 2008 to 64 basis points as of August 13, 2009.  
16 In addition, continued economic dislocation worldwide creates unpredictable  
17 market conditions.

18 **Q. What difference does a wide spread between rating categories make to the**  
19 **customers of NYSEG and RG&E?**

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<sup>37</sup> Docket No. AD09-2-000, Speaker Materials of the Honorable Garry A. Brown, at 2.

<sup>38</sup> Cahill Letter, at 3.

<sup>39</sup> Id. at 2.

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1 A. As stated above, the average basis point spread between “A” rated issuers and  
2 “BBB” rated issuers during the financial crisis has been around 112 basis points.  
3 That means that on a \$100 million bond issue, the “BBB” rated issuer will pay  
4 \$1,120,000 more in interest every year. However, this is the cost of debt on \$100  
5 million for one year only. Utilities finance their assets to mirror the life of the  
6 asset, as is good corporate finance practice. Since the assets have long lives, say  
7 30 years, utilities typically finance them with 30 year debt. In nominal dollars,  
8 that \$1,120,000 becomes \$33,600,000 over the 30 years. In addition, if the  
9 company has to pay almost \$34 million extra for debt, that precludes it from using  
10 that money for other purposes, creating an opportunity cost for both the company  
11 and its customers. Multiply those two issues by the approximately \$250+ million  
12 annual capital expenditure needs at NYSEG and RG&E, and the cost of  
13 maintaining a “BBB” rating rather than an “A” rating becomes very clear very  
14 quickly.

15 **Q. Are there any other issues relative to credit rating levels that are of concern?**

16 A. Yes. Since investors are loath to “fill up” on individual names (i.e., invest to the  
17 upper limit of their authorization in any one given company), utilities are  
18 challenged to continue to have good access to capital when they are in a heavy  
19 capital expenditure period. “A” level rated issuers are likely to enjoy a higher  
20 level of investment authorization by lenders than “BBB” level rated issuers,  
21 making the availability of funds to “A” level rated issuers greater during times  
22 when a company needs it most.

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1 **Q. What are the implications for utilities of investors' caution and requirement**  
2 **for increasing returns?**

3 A. Utilities are, by and large, in or entering into a heavy construction period in which  
4 systems will be renewed, repaired and updated. That construction period will last  
5 many years. The Brattle Group describes this period in the executive summary of  
6 its report Transforming America's Power Industry by stating, "The U.S. electric  
7 utility industry faces the greatest challenge in its history."<sup>40</sup> The report goes on to  
8 explain that the industry will need to spend \$1.5 trillion to \$2.0 trillion in the next  
9 20 years, depending on climate legislation. Therefore, the ability of any  
10 individual utility to raise the amounts of money it needs to successfully fulfill its  
11 obligations to its customers requires that it remain an attractive investment so that  
12 market access is assured. In addition, should spreads between "BBB" and "A"  
13 rated issuers remain relatively high, serious consideration needs to be made of the  
14 efficacy of utilities having "A" level credit ratings in order to keep the cost of  
15 providing service low.

16 **Q. Why is it so important that market access be "assured"?**

17 A. Utilities have an obligation to serve their customers, which includes an obligation  
18 to maintain reliable electric and gas delivery systems to meet demand. Therefore,  
19 it is critical that utilities maintain access to the capital markets in both good and  
20 bad times in order to be able to provide safe and reliable electric and gas delivery  
21 service.

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<sup>40</sup> Transforming America's Power Industry: The Investment Challenge 2010-2030, The Brattle Group, prepared for The Edison Foundation (Nov. 2008).

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1 **Q. How does a utility attain an “A” level credit rating?**

2 A. The rating process involves a complex exercise that strives to balance financial  
3 results against qualitative risks. Dozens of financial metrics are calculated, but  
4 the most important are those that measure the level of cash flow a company is  
5 able to generate. Those levels are compared to the fixed obligations a company  
6 has. The resulting metrics are viewed in relation to the degree of business risk,  
7 and a credit rating is derived. In order for a utility to attain an “A” level credit  
8 rating, its financial metrics must remain within a tolerable range of those listed in  
9 the various ratings matrices, and its business risk must remain at the level that  
10 allows its financial metrics to produce an “A” level rating. An important issue for  
11 attainment of any rating level is whether the degree to which regulators allow a  
12 company returns on equity, and a cost recovery that allows those returns to be  
13 achieved, results in cash flow metrics that are commensurate with the  
14 requirements the rating agencies stipulate.

15 **Q. What would be necessary for NYSEG and RG&E to attain “A” level credit**  
16 **ratings?**

17 A. While the ratings grids are “guidelines,” NYSEG’s and RG&E’s current credit  
18 metrics fall precisely into the parameters required for a “BBB” level rating.  
19 Therefore, it can be assumed that to attain an “A-” credit rating, both companies  
20 would need to produce, or be expected to produce, cash flow metrics in the  
21 “significant” range in the case of S&P, and at levels high enough to  
22 counterbalance the “Ba” level regulatory environment according to Moody’s.  
23 The following chart compares the financial metrics S&P expects for an “A-”

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1 rating to the financial metrics that would be produced both with and without the  
 2 rate increases being requested by NYSEG and RG&E. Financial risk must  
 3 improve to levels that would at least be considered “significant” in order for the  
 4 companies to achieve an “A-” credit rating, even with their “excellent” business  
 5 risk profiles.

Metric	FFO/Debt	FFO/Interest <sup>41</sup>	Debt/Capitalization
S&P	20%-30%	3x-4.5x	45%-55%
NYSEG w/o rate relief	9.5%	2.8x	
with rate relief	20.9%	4.9x	51.6%
RGE w/o rate relief	8.7%	2.4x	
with rate relief	19.8%	3.9x	52%

6 Prior to S&P changing its guidelines in May 2009, S&P stated in an April 9, 2009  
 7 report that it expected NYSEG’s interest coverage to be 4x, but that FFO/Debt  
 8 was expected to be well below the at-that-time-required 25%. As can be seen  
 9 from the chart above, NYSEG’s FFO/debt metrics in the absence of rate relief are  
 10 well below the new ranges expected from S&P. With the requested rate relief,  
 11 NYSEG will fall within the low end of the range of metrics that are considered  
 12 satisfactory for an “A-” rating. However, heavy capital programs exacerbated by a  
 13 difficult regulatory environment could continue to depress NYSEG’s credit rating  
 14 despite metrics that seem well within the expected range.

15 As of April 2009, S&P expected RG&E’s financial profile to fall to the  
 16 bottom of the “aggressive” financial category, with 2x FFO/Interest coverage,

<sup>41</sup> FFO/Interest number for S&P benchmarks represents the old ranges the utility group used since they have not yet published new guidelines for this metric.

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1 10% FFO/Debt, and 60+% Debt/Capital. Without rate relief RG&E’s metrics  
 2 would fall into the “highly leveraged” category, qualifying it for no more than a  
 3 “BB” rating. With the rate relief being requested, RG&E’s metrics qualify for a  
 4 “BBB+” rating according to S&P’s benchmarks in all categories other than  
 5 FFO/Debt (which is just outside of the required range). As with NYSEG, the  
 6 capital program and difficult regulatory environment could counteract the  
 7 improvement in the metrics to continue to depress RG&E’s credit rating.

8 **Q. How do the companies’ financial metrics compare to what Moody’s looks**  
 9 **for?**

10 A. Using Moody’s template, and comments it has made in its reports on NYSEG, the  
 11 following can be assumed:

Metric	Regulatory Framework	Returns and Cost Recovery	Diversification	Financial Strength
NYSEG <sup>42</sup>	Ba (25% x 12)	Ba (25% x 12)	Baa (10% x 9)	Baa (40% x 9)
RG&E	Ba (25% x 12)	Ba (25% x 12)	Baa (10% x 9)	Ba (40% x 12)

12 According to Moody’s newly quantified methodology, NYSEG currently barely  
 13 qualifies for a “Baa3” rating, and RG&E for a “Ba2” rating. If the rate relief  
 14 being requested is granted, and the perception of regulation in New York State  
 15 improves as a result, NYSEG could qualify for a “Baa1” or even an “A3” rating,  
 16 and RG&E for a “Baa2” or perhaps even a “Baa1” rating. To the extent that

<sup>42</sup> The calculation is as follows:  
 (.25x12)+(.25x12)+(.10x9)+(.10x9)+(.075x9)+(.075x9)+(.075x9)+(.075x6)=10.275.

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1 Moody's continues to see fit to keep the ratings of NYSEG and RG&E on par  
2 with each other, a "Baa1" rating for each would be a reasonable assumption.

3 **Q. What can NYSEG and RG&E do to improve their financial metrics?**

4 A. Since the onset of the financial crisis, both NYSEG and RG&E have withheld  
5 dividends to parent companies, relied on temporary loans and other forms of  
6 financial support from their parent companies, and implemented temporary  
7 austerity measures in order to improve their financial health. However, because  
8 they are regulated entities, the companies can only make marginal changes to  
9 their financial picture unilaterally. The key to gaining and maintaining "A" level  
10 credit ratings is regulatory support. Moody's states "the support provided to the  
11 U.S. electric utility sector by state regulators is the primary foundation for long-  
12 term credit stability."<sup>43</sup> Moreover, Moody's has clarified in its new rating  
13 methodology for utilities that 50% of a utility's credit rating is determined by  
14 regulatory factors. These regulatory factors for NYSEG and RG&E are currently  
15 at the "Ba" level. S&P echoes these sentiments by stating "the assessment of  
16 regulatory risk is perhaps the most important factor in Standard & Poor's Ratings  
17 Services' analysis of a U.S. regulated, investor-owned utility's business risk."<sup>44</sup>  
18 S&P is so focused on regulation in the utility sector that Transmission &  
19 Distribution World published an article in February 2004, a copy of which is  
20 attached as Exhibit \_\_ (SDA-10), entitled "S&P: Utility Regulation Determines  
21 Its Ratings," which delineated S&P's process of evaluating regulatory activity.

<sup>43</sup> U.S. Investor Owned Electric Utilities, Industry Outlook, Moody's Global Infrastructure, Moody's (Jan. 2009).

<sup>44</sup> Assessing U.S. Utility Regulatory Environments, Ratings Direct, S&P (Nov. 7, 2008).

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1 The final sentence in the article states, “[i]n the end, the regulation of public  
2 utilities is the defining element of the industry and is often the determining factor  
3 in the ratings of a utility.” S&P has reiterated several times since then that  
4 regulation is the single most important element in credit ratings of utilities,  
5 including in a March 2008 report that stated “as always, regulatory risk remains  
6 the key feature for regulated utilities.”<sup>45</sup> Moody’s similarly opines that  
7 “[r]egulators have the last word.”<sup>46</sup>

8 **Q. Are there any particular issues that would assist NYSEG and RG&E toward**  
9 **attaining an “A” level credit rating?**

10 A. Yes, there are several. First, the companies need increased returns on equity in  
11 order to improve their cash flow, which is the basis of all ratings. Second, rates  
12 based on stand-alone capital structures would improve the opportunity for both  
13 companies to improve cash flow. Third, the companies need more timely and  
14 predictable recovery of deferred costs.

15 **Q. Have the credit rating agencies made any recent statements about the**  
16 **importance of regulatory support for the companies?**

17 A. Yes. All the major rating agencies have stated that regulatory support will be a  
18 key factor in determining the companies’ future credit ratings. Fitch recently  
19 stated that regulatory decisions regarding the timing and amount of recovery of  
20 increased operating costs and mandated capital expenditures by the NYPSC will

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<sup>45</sup> Credit Perspectives: Regulatory Risk Remains for U.S. Utilities, S&P, Credit Trends, Ratings Direct (Mar. 24, 2008).

<sup>46</sup> U.S. Investor Owned Electric Utilities, Industry Outlook, Moody’s Global Infrastructure, Moody’s (Jan. 2009).

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1 be “a primary determinant of future credit quality” for both NYSEG and RG&E.  
2 See Exhibit \_\_ (SDA-6). Fitch further stated with respect to NYSEG that  
3 “[m]aintaining current ratings will largely depend on the outcome of the next  
4 distribution rate filing, which is expected to be submitted in September 2009.” Id.  
5 Moody’s also cites the “challenging regulatory environment in New York” as a  
6 major rating driver for both Companies and stated that “[t]he degree to which  
7 weakness in financial performance persists” will be influenced by the level of  
8 regulatory support from this Commission. See Exhibit \_\_ (SDA-5).

9 **Q. Are there additional benefits to NYSEG and RG&E of having an “A” level**  
10 **credit rating that have not been discussed?**

11 A. Aside from the restrictions investors must comply with as outlined above,  
12 investors also may have limits on the exposure they have to any one regulatory  
13 jurisdiction. If the other New York utilities remain rated higher than NYSEG and  
14 RG&E, then utility investors, who usually have a more conservative approach  
15 than other investors, will be more attracted to those utilities. Additionally, as  
16 delineated above, the cost of funds for “A” rated utilities is much lower than that  
17 for “BBB” rated issuers. Those costs will be passed onto ratepayers, and will be  
18 imbedded in rates for a long period of time since utilities fund their long-lived  
19 assets with long-term debt. In addition, a higher credit rating provides a utility’s  
20 business counterparties with more confidence in their dealings with the utility,  
21 which translates to lower cost to the utility for goods and services.

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**STANDALONE CAPITAL STRUCTURES**

1  
2 **Q. What has the Commission said about the use of standalone capital structures**  
3 **by NYSEG and RG&E?**

4 A. It is my understanding that the Commission has stated that it would be appropriate  
5 for NYSEG/RG&E to use standalone capital structures once they implemented  
6 the bankruptcy preferred shares required in the Commission's order approving the  
7 merger transaction between Iberdrola and Energy East. For example, in the  
8 Commission's April 2009 order dismissing NYSEG's and RG&E's rate filings,  
9 the Commission stated that it would be "improper to employ a stand-alone equity  
10 ratio for the Companies" since NYSEG and RG&E had "not completed the step  
11 of creating and designating a holder of the special voting share of preferred  
12 stock."<sup>47</sup> The Commission went on to state that "[u]ntil that critical step is  
13 completed, it is not possible to view the Companies as independent from their  
14 corporate parents."<sup>48</sup>

15 **Q. Have NYSEG and RG&E implemented the bankruptcy preferred shares**  
16 **required by the Merger Order?**

17 A. Yes. It is my understanding that NYSEG and RG&E have now taken the final  
18 necessary step required by the Commission for their use of standalone capital  
19 structures by implementing the bankruptcy preferred shares.

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<sup>47</sup> Case 09-E-0082, et al., Order Dismissing the January 2009 Rate Filings, at 33, 38 (issued Apr. 8, 2009).

<sup>48</sup> Id. at 38-39.

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1 **Q. Is there any other evidence that supports the use of standalone capital**  
2 **structures for NYSEG and RG&E?**

3 A. Yes. In its order approving NYSEG’s and RG&E’s bankruptcy preferred shares,  
4 the Commission suggested that NYSEG and RG&E should provide “written  
5 evidence, from at least two independent major credit rating agencies, that support  
6 evaluating the ratings of NYSEG and RG&E, and treating their capital structures,  
7 as stand-alone companies.”<sup>49</sup> As described below, not just two, but all three  
8 major credit rating agencies already view NYSEG and RG&E on a standalone  
9 basis and independent from their parent companies, Iberdrola and Energy East.

10 **Q. How does S&P view NYSEG and RG&E?**

11 A. S&P views the companies independently from their parents. In its most recent  
12 reports, S&P clarifies that the credit ratings for NYSEG and RG&E “reflect  
13 [their] individual credit quality” and explain as a more general matter with respect  
14 to all the Energy East utilities that “[t]he ratings on the U.S. utilities are now  
15 based largely on each utility’s stand-alone credit profile up to the existing ‘A-’  
16 Iberdrola rating.” Exhibit \_\_ (SDA-4). One of the reasons S&P can assess the  
17 utilities on a stand-alone basis is because none of the Energy East subsidiaries  
18 “individually is a significant source of cash flow for [Iberdrola],” Exhibit \_\_  
19 (SDA-4), and S&P is therefore no longer concerned that the parent company will  
20 lean on the utilities for cash flow to the detriment of the utilities themselves.  
21 Moreover, S&P’s standalone treatment of Energy East, NYSEG, RG&E and their  
22 affiliates is evidenced by S&P’s most recent ratings action for each of the

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<sup>49</sup> Case 07-M-0906, Order Authorizing Issuance of Preferred Stock, at 5-6 (issued June 24, 2009).

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1 Companies: S&P downgraded RG&E's credit rating one notch, maintained  
2 NYSEG's credit rating, upgraded Energy East's credit rating one notch due to  
3 Iberdrola's assumption of its long-term debt, and upgraded the credit ratings of  
4 certain other Energy East utilities based upon their independent business and  
5 financial profiles.

6 **Q. How does Fitch view NYSEG and RG&E?**

7 A. Fitch also views NYSEG and RG&E independently from their parent companies,  
8 as evidenced by Fitch's July 29, 2009 issuances for Energy East, NYSEG and  
9 RG&E. In particular, Fitch upgraded Energy East from "BBB" to "BBB+" on  
10 July 9, 2009 to reflect the assumption of Energy East debt by Iberdrola.  
11 However, Fitch maintained RG&E's "BBB-" rating due to its "marginally  
12 investment grade credit profile", as well as NYSEG's "BBB" issuer default rating  
13 with a negative outlook that will be resolved based upon "the outcome of the next  
14 distribution rate filing, which is expected to be submitted in September 2009."  
15 The disparate treatment of Energy East from its subsidiaries, NYSEG and RG&E,  
16 reflects Fitch's views of NYSEG and RG&E on a stand-alone basis, separate and  
17 apart from Fitch's views of Energy East. See Exhibit \_\_ (SDA-6).

18 **Q. How does Moody's view NYSEG and RG&E?**

19 A. In Moody's report on October 16, 2008 on NYSEG, the factors that Moody's  
20 cites as key to NYSEG's creditworthiness are *NYSEG's* business risk profile,  
21 *NYSEG's* execution risk relative to the extensive capital program, *NYSEG's*  
22 regulatory risk, and *NYSEG's* credit metrics and liquidity. Any movement of  
23 Energy East's ratings with its subsidiary's ratings reflects the weakness of Energy

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1 East’s subsidiaries and a concern about the ability of those subsidiaries to provide  
2 Energy East with sufficient dividends to service its own debt. Moody’s  
3 determines credit ratings based on consideration of the individual companies  
4 primarily. Moody’s then only considers other members of the corporate family to  
5 the extent that those other members might have a positive or negative effect on  
6 the particular company that is being rated. In the case of NYSEG and RG&E,  
7 financial protections have been put in place that would alleviate any concerns  
8 Moody’s would have regarding the transfer of financial assets from NYSEG or  
9 RG&E to Energy East or Iberdrola. These financial protections include:

- 10 • NYSEG and RG&E have each modified their corporate bylaws to establish an  
11 independent consent right - through the issuance of a special share of  
12 preferred stock - to prevent a bankruptcy, liquidation, receivership, or similar  
13 proceeding at either of the Companies from being caused by the bankruptcy of  
14 Iberdrola, Energy East, or any of their affiliates;
- 15 • Dividend restrictions that allow no more than 100% of retained earnings to be  
16 paid out to the parent under normal circumstances, and allow no dividends if  
17 ratings on the lowest level of debt of Iberdrola, Energy East, NYSEG or  
18 RG&E falls to the lowest investment grade level (“BBB-”/”Baa3”) and has a  
19 negative watch or review for downgrade attached;
- 20 • Prohibitions on the transfer of any moneys, assets, rights or other items of  
21 value without the consent of the Commission if a dividend restriction is in  
22 place;

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- 1           • Prohibitions on loans or any other form of financial assistance from NYSEG  
2           and RG&E to their parent companies;
- 3           • Restrictions on money pool participation that allow NYSEG and RG&E to  
4           participate in money pools only if all other participants except Iberdrola and  
5           Energy East are regulated utilities operating in the United States and prohibit  
6           Iberdrola’s or Energy East’s participation in such money pools except as  
7           lenders;
- 8           • Prohibitions on providing goods or services to affiliates on preferential terms,  
9           under a Code of Conduct; and
- 10          • Prohibitions on affiliate cross-default provisions that could impact NYSEG or  
11          RG&E.

12          These requirements provide a very strong package of financial protections that  
13          addresses the concerns rating agencies have about the transfer of financial assets  
14          from subsidiaries to parents and serves to allow Moody’s to separate the credit  
15          ratings of the subsidiaries from those of the parent companies.

16          **Q. Does that conclude your testimony?**

17          A. Yes.