

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-0715

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-0716

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-0717

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-0718

**REBUTTAL TESTIMONY OF
SUSAN D. ABBOTT**

February 12, 2010

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1 **Q. Please state your name for the record.**

2 A. My name is Susan D. Abbott.

3 **Q. Are you the same Susan D. Abbott who filed direct testimony in this**
4 **proceeding?**

5 A. Yes.

6 **Q. What is the purpose of your rebuttal testimony?**

7 A. I have reviewed the Department of Public Service Staff's ("Staff") Policy Panel
8 and Finance Panel testimony in the above-captioned proceedings ("the rate
9 cases") before the New York Public Service Commission (the "Commission"). I
10 am responding to the following positions stated in Staff's testimony with which I
11 disagree:

12 1) Staff mistakenly assumes that its rate proposals would improve the
13 Companies' credit ratings;

14 2) Staff incorrectly downplays the importance of "A" credit ratings for
15 utilities and incorrectly states that New York State Electric & Gas
16 Corporation ("NYSEG") and Rochester Gas and Electric Corporation
17 ("RG&E" and together, the "Companies") have adequate access to capital
18 with their current "BBB" level credit ratings;

19 3) Staff is shortsighted in its view that seeking an "A" rating for the
20 Companies can wait indefinitely;

21 4) Staff incorrectly asserts that Iberdrola and Iberdrola USA should or could
22 do more to improve the Companies' credit ratings; and

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1 5) Staff is wrong to suggest that credit rating agencies do not understand or
2 fully appreciate the quality of regulation in New York.

3 **I. STAFF’S PROPOSAL DOES NOT PROVIDE THE CASH FLOW**
4 **NECESSARY TO IMPROVE THE COMPANIES’ CREDIT RATINGS**

5 **Q. Staff takes the position that the Companies should strive to improve their**
6 **credit ratings to the “BBB+/Baa1” level. Are Staff’s recommended rate**
7 **proposals helpful in moving the Companies along toward a higher rating?**

8 A. No. As I discussed in my Direct Testimony, in order to attain an “A-” credit
9 rating, both Companies would need to produce, or be expected to produce, cash
10 flow metrics in the “significant” range in the case of S&P, and at levels high
11 enough to counterbalance the “Ba” level regulatory environment according to
12 Moody’s. As I discuss in more detail below, however, Staff’s recommended rate
13 proposals would impose downward pressure on the Companies’ existing credit
14 ratings and preclude any rating improvement. Particularly troubling is Staff’s
15 recommendation to use certain theoretical excess depreciation reserves to reduce
16 rates by approximately \$40 million per year. The rebuttal testimonies of the
17 Policy Panel, the Depreciation Panel and John Reed discuss why Staff’s proposal
18 to use theoretical excess depreciation reserves as a rate moderator is
19 inappropriate, inconsistent with traditional depreciation methodologies and bad
20 policy generally. I will not repeat their testimony here; however, the Companies
21 have provided me with information that shows that Staff’s proposal on
22 depreciation would have a very significant adverse impact on cash flow, which

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1 would, in turn, significantly impair the Companies’ abilities to generate credit
2 metrics sufficient to maintain the Companies’ current ratings, let alone the higher
3 “BBB+/Baa1” ratings that Staff states that the Companies should reach.

4 **Q. Please explain how the credit metrics produced by Staff’s recommended**
5 **revenue requirement compare to S&P’s ratings methodology?**

6 A. As I discussed in my direct testimony, NYSEG’s own rate requests would
7 produce credit metrics that would barely clear the lower hurdles S&P has set to
8 reach an “A-” rating, and RG&E’s own rate request would produce credit metrics
9 that would only allow it to attain a “BBB+” rating. In response to NYSEG-RGE-
10 51, Staff states that it “believes the ratios produced by its revenue requirement are
11 consistent with its goals to stabilize and increase the utilities’ credit ratings.”
12 However, Staff has made a number of critical errors in its calculations by using
13 operating income rather than net income as the starting point of their calculations
14 (and thereby ignoring the Companies’ interest payments), and by ignoring the
15 cash flow impact of its proposed imputations and disallowances. This is not how
16 the credit rating agencies would calculate the Companies’ credit metrics, and
17 therefore, Staff’s mistakes would need to be fixed in order to be reflective of how
18 the credit rating agencies would view the Companies. The metrics shown below,
19 which are also shown on Exhibit __ (PPR-3), compare the Companies’ corrected
20 metrics against S&P’s requirements:

21
22
23

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	<u>Staff Recommendation</u>		<u>S&P “A”*</u>		<u>S&P “BBB”</u>	
Company	FFO Interest Coverage	FFO/Debt	FFO Interest Coverage	FFO/Debt	FFO Interest Coverage	FFO/Debt
NYSEG	4.0x	12.9%	3-4.5x	30%-45%	2-3.5x	12%-20%
RG&E	3.0x	12.0%	3-4.5x	30%-45%	2-3.5x	12%-20%

* Assumes an “Excellent” business risk profile.

These results clearly indicate that the Companies’ metrics, with the exception of current interest coverage for NYSEG, would preclude any ratings improvement for the Companies. Moreover, the Companies’ FFO/Debt metrics are on the low end of a “BBB” rating, which would put pressure on the Companies’ existing credit ratings. Furthermore, it is likely that the credit rating agencies would discount the interest coverage numbers shown for the Companies, as they currently reflect very low short-term interest rates that will be reset or refinanced at higher costs in the near future. Credit rating agencies are providing ratings on a forward looking basis, and therefore, would take into consideration the expected increase in the cost of debt. The difference in the current rate levels of nearly ½% as compared to the interest levels the Companies will have to pay when this debt is reset or refinanced will concern the rating agencies greatly since credit metrics will invariably deteriorate as a result.

Q. How would Staff’s overall recommendations in these rate cases likely be viewed by Moody’s?

A. Since Moody’s rating methodology ascribes a full 50% of the rating to the quality of regulation, little or no improvement in the level of support provided the Companies by the regulators will continue to suppress, and perhaps even depress the ratings. As I discuss in greater detail below, the return on equity (“ROE”),

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1 austerity and productivity imputations, and amortization of the theoretical
 2 depreciation reserve Staff recommends will not signal support but will only serve
 3 to depress further Moody’s opinion of regulatory support in New York. Since
 4 Moody’s already views regulation in New York State to be worthy of only a “Ba”
 5 rating, additional pressure from these items could conceivably lead to an
 6 assessment of “B” rated regulation in the State of New York. Since a “B” rating
 7 is a very harsh judgment, the following assumes the regulatory framework and
 8 rate adjustment and cost recovery mechanisms continue to be rated “Ba”.
 9 Nevertheless, the credit metrics resulting from the Staff’s proposal would depress
 10 the Companies’ ratings to the top of the “Ba” category (*i.e.*, non-investment
 11 grade). Moody’s methodology as applied to the results of the Staff
 12 recommendation, as corrected, would yield a “Ba1” rating for both Companies as
 13 follows:

Factor	Weight	Rating	Value*	Weighted Value
Regulatory Framework	25%	Ba	12	12 x 25% = 3
Rate Adjustment and Cost Recovery Mechanisms	25%	Ba	12	12 x 25% = 3
Diversification	10%	Baa	9	9 x 10% = .9
Liquidity	10%	Baa	9	9 x 10% = .9
Cash Flow Interest Coverage	7.5%	Baa	9	9 x 7.5% = .68
Cash Flow as % of Debt	7.5%	Ba	12	12 x 7.5% = .9
Retained Cash Flow as % of Debt	7.5%	Ba	12	12 x 7.5% = .9
Debt as % of Capitalization	7.5%	Baa	9	9 x 7.5% = .68
Total				10.96

14 * Aaa=1 Aa1=2 A1=5 Baa1=8 Ba1=11 B1=14
 15 Aa2=3 A2=6 Baa2=9 Ba2=12 B2=14
 16 Aa3=4 A3=7 Baa3=10 Ba3=13 B3=15
 17

18 I note that Moody’s would also likely consider the short-term nature of the
 19 existing low interest rates, and the increased expected costs of resetting or

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1 refinancing that debt, just as I discuss above with respect to S&P’s views of this
2 issue.

3 **Q. Staff suggests on pages 32-33 of the Staff Finance Panel that your Direct**
4 **Testimony “simplistically concludes that credit ratings are numerically**
5 **driven without regard to the quality of the metrics.” How do you respond?**

6 A. My Direct Testimony described the precise metrics that are published by Moody’s
7 and S&P and are therefore tangible evidence of the thresholds required by those
8 rating agencies for the applicable credit rating levels, including both quantitative
9 and qualitative impacts. I also discussed, at great length, the importance of the
10 regulatory environment in determining ratings. In fact, I referenced the
11 importance of regulation to a utility’s credit rating no less than 19 times in my
12 Direct Testimony. Staff seems to be seeking to discredit the rating agencies’ own
13 evaluation of the regulatory environment, rather than my recitation of how the
14 rating agencies consider regulation in their ratings process. I address this issue
15 further later in my Rebuttal Testimony.

16 **Q. Do you have any other concerns on this issue?**

17 A. I have been a credit analyst for 33 years. In that time I have seen ratings in the
18 electric utility industry migrate from an average of “AA” to “BBB.” The impetus
19 for that migration has been largely attributable to the financial stress construction
20 programs have put on utilities. The industry is embarking on the first major round
21 of construction activity since the 1980’s, and is starting from a position of
22 weakness: the average rating in the industry is, by sub-sector, “Baa1” for
23 transmission and distribution companies, “Baa1” for integrated utilities, and

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1 “Baa2” for utility parent companies.¹ While Staff contends that NYSEG and
2 RG&E are rated at the average of the industry, Staff overlooks the fact that
3 Moody’s and Fitch rate them one and two notches lower than that average. Staff
4 also does not address at all the fact that most other New York State utilities are
5 rated “A.” As I discussed in my initial testimony, the Companies’ lower ratings
6 compared to the other New York State utilities will make it considerably more
7 difficult for them to compete for capital in the post-recession world.

8 **II. THE BENEFITS OF SEEKING AN “A” CREDIT RATING**

9 **Q. Is there an important difference between the rating levels of “Baa/BBB” and**
10 **“A”?**

11 A. Yes. “Baa/BBB” ratings, while investment grade, are not rating levels without
12 discernable risk. Because of that risk, capital is more expensive for “Baa/BBB”
13 rated issuers, and access is less assured. “A” rated obligations, on the other hand,
14 “are considered upper-medium grade and are subject to *low* credit risk”²
15 (emphasis added). As I outlined in my Direct Testimony, an “A” rated utility will
16 always benefit from a lower cost of debt than “Baa/BBB” rated utilities, and will
17 have better access to capital, even in the worst of times.

18 **Q. Was that difference discernable during the 2008-2009 financial crisis?**

19 A. Yes. During the recent financial crisis, *no* utilities could access the capital
20 markets during a 10 day period in September 2008, and only “A” and “Aa/AA”

¹ U. S. Utilities Face Challenges Beyond Near-Term, Industry Outlook, Moody’s Investors Service (Jan. 2010).

² *Rating Definitions*, Moodys.com.

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1 rated utilities could access it for some time after the market reopened.³ The
2 commercial paper market which is very important to the utility industry, “literally
3 evaporated.”⁴ In addition, when “Baa/BBB” rated issuers re-entered the market
4 the spread over Treasuries was sometimes double what they had been paying prior
5 to the crisis, and the coupons paid were as much as 50% higher.⁵ Since the crisis
6 started to ease, rates have approached pre-crisis levels for “Baa/BBB” rated
7 companies, and market access has eased. Other markets, however, such as the
8 bank market, remain difficult relative to pre-crisis periods. Bank lines of credit
9 are no longer available on the terms or at the costs they were pre-financial crisis.
10 This is extremely important to the electric sector as the bank line market is very
11 important to daily operations. Many companies that had expiring lines during the
12 crisis found that they could only renew them on 365 day terms and at much higher
13 prices than they were used to paying. Overall, the crisis showed the importance
14 of having an “A” level rating to ensure capital access.

³ Utility New Issue Summary, UBS (Dec. 1, 2008).

⁴ The Financial Crisis and Its Impact on the Electric Utility Industry, Edison Electric Institute (Feb. 2009).

⁵ According to UBS, Consumers Energy, a “Baa1/BBB” utility, raised 10 year secured debt in the public bond market and paid 245 basis points over Treasuries on September 8, 2008. It was the last utility to raise money in the public markets until September 25, 2008. On November 13, 2008, Cleveland Electric Illuminating, similarly rated “Baa2/BBB+,” borrowed, also on a secured basis and for the same term, at 513.6 basis points over Treasuries. Likewise, Ohio Power Company paid 5.75% for unsecured debt on September 4, 2008, while Dominion Resources paid 8.875% for unsecured debt on November 25, 2008. The two companies were rated “A2/BBB+” and “Baa2/A-,” respectively.

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1 **Q. How do you respond to Staff’s suggestion that NYSEG’s and RG&E’s**
2 **current “BBB/Baa” level credit ratings provide adequate and “unfettered”**
3 **access to capital?**

4 A. Access to capital is dependent on the risk appetite of investors. Moody’s
5 definition of a “Baa” rating is that it is “considered medium-grade and as such
6 may possess certain *speculative* characteristics”⁶ (emphasis added). By
7 definition, “speculative” means engaging in business transactions involving
8 considerable risk. Since the entire industry is engaged in a new round of heavy
9 capital expenditures, the competition for funds will be stiff. Investors will have a
10 choice of utilities in which to invest, and they are likely going to favor utilities
11 with a higher rating due to their lower risk profile and ability to withstand
12 dislocations in the marketplace.

13 **Q. Staff characterizes your description of the “fierce” competition in the**
14 **marketplace for funds as hyperbole. Staff also states that “BBB” utilities**
15 **have been able to access the long-term debt markets during most of the**
16 **financial crisis. How do you respond?**

17 A. No hyperbole was intended. The conditions in the bond market under normal
18 circumstances, never mind under the unusual conditions that have prevailed for
19 the past 18 months, will be challenging. Furthermore, the need for utilities to
20 raise money and access the markets will likely be substantially greater in the next
21 five years than over the past 18 months. The Brattle Group estimates that the

⁶ *Rating Definitions*, Moodys.com.

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1 utility sector alone will spend up to \$2.023 trillion⁷ between 2010 and 2030 on
2 new construction. Even Staff proposes significant increases in capital
3 expenditures for the Companies compared to previous years. There is
4 approximately \$31.2 trillion of bonds outstanding in the U.S. market, of which
5 corporate bonds make up 20%. That means that the utility sector alone will
6 consume almost a third of the capacity of the corporate bond market. In addition,
7 federal agencies and municipal entities consume 47% of market capacity, and
8 utilities will be competing with them for infrastructure funds. Therefore, the
9 competition for capital will indeed be fierce in the immediate future and in the
10 longer term. Simply because “BBB” may have been able to access the markets in
11 the past does not alleviate my concern.

12 **Q. Are the benefits of obtaining an “A” rating significant and meaningful?**

13 A. Yes. Staff asserts that obtaining an “A” rating could be a disadvantage, because it
14 is expensive to maintain the more conservative capital structure required for that
15 rating. As I have discussed here and in my Direct Testimony, however, access to
16 capital is the most important consideration. Not even taking into consideration
17 the recent and ongoing dislocation in the financial markets, the “Baa/BBB”
18 category remains problematic. As Moody’s points out, “the sector’s key financial
19 credit metrics are generally stable, but not improving . . . This erosion of financial
20 strength may ultimately lead to lower ratings.”⁸ A consistent and sustained

⁷ Transforming America’s Power Industry: The Investment Challenge 2010-2030, The Brattle Group (Nov. 2008).

⁸ U. S. Utilities Face Challenges Beyond Near-Term, Industry Outlook, Moody’s Investors Service (Jan. 2010).

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1 deterioration in important cash flow measurements in the transmission and
2 distribution sector since 2005 has been cited by Moody’s as a factor that will
3 “eventually erode much of the ‘cushion’ that utilities currently enjoy within their
4 respective rating categories.”⁹ The erosion of the cushion puts a “Baa/BBB” rated
5 issuer in jeopardy of falling below the investment grade line. The Companies’
6 cushion does not provide much comfort. Only S&P has a “BBB+” rating on
7 NYSEG; whereas Moody’s and Fitch rate NYSEG “Baa2/stable” and “BBB with
8 a negative watch,” respectively, and Fitch applies a “BBB-/stable” rating to
9 RG&E. The short distance from non-investment grade is dangerous. During the
10 height of the financial crisis, Citigroup declared that “‘BBB’ credit [became] the
11 new ‘BB.’”¹⁰ Since utilities have little choice as to when they must access the
12 capital markets, becoming the “new BB” while still carrying a “BBB” rating
13 presents unnecessary and undesirable risks.

14 **III. STAFF’S VIEW THAT SEEKING AN “A” RATING FOR THE**
15 **COMPANIES CAN WAIT UNTIL THE FUTURE IS SHORTSIGHTED**

16 **Q. Staff concedes that consideration of a higher rating than the “BBB+/Baa1”**
17 **level it recommends for the Companies for now is justified, but should be**
18 **addressed in the future. How do you respond?**

19 A. Staff does not provide any reasonable basis for deferring any plan for the
20 Companies to move to an “A” level rating. The view that the current “BBB”
21 ratings are adequate given the extensive capital expenditures and other challenges

⁹ *Id.*

¹⁰ Global Power Financing: Annual Review for 2008 and Prospects for 2009, Citi (Feb. 2009).

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1 that NYSEG and RG&E face is shortsighted. Staff argues that while
2 consideration of moving toward an “A” rating is justified, the topic “should be
3 debated in subsequent rate cases and viewed in the context of the then prevailing
4 economic conditions” (Staff Finance Panel, page 23, lines 6-9). Thus, Staff
5 merely punts the issue without providing any reasonable rationale for such a
6 delay.

7 **Q. Why do the Companies need to improve their credit ratings beyond the**
8 **“BBB+/Baa1” level now?**

9 A. In addition to the additional benefits an “A” level rating would provide that I
10 discuss above, there are three primary reasons why this issue cannot wait. First,
11 credit ratings do not change overnight. It is not up to the Companies, or the
12 Commission, to effect a change in NYSEG’s or RG&E’s ratings single-handedly.
13 Either party can only contribute to the conditions that will allow the rating
14 agencies to change the ratings. If elements such as stronger cash flow and more
15 supportive regulation are put in motion now, the Companies may be able to
16 qualify for a higher rating more quickly in the near future and, therefore, be able
17 to better support their capital programs. Second, Staff’s wait-and-see approach
18 ignores the risk of another economic dip in this recession, or the occurrence of
19 another recession before the Commission adequately engages on this topic.
20 Waiting increases the risk that improvement in the Companies’ credit ratings will
21 not happen before the next financial crisis hits. Third, utilities (such as the
22 Companies) engaged in heavy capital spending need robust credit metrics to

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1 maintain their ratings. The Companies cannot afford to go into a capital program
2 with weak and deteriorating credit metrics.

3 **Q. Do you have any other comments on this issue?**

4 A. Yes. Moody’s, in its latest Industry Outlook publication, highlights the
5 challenges that face the industry, which include “regulation... political support...
6 and resource availability,” all of which “raise the business and operating risk
7 profile for the sector.”¹¹ The ratings agency goes on to say that “inadequate
8 attention to these challenges could conceivably push much of this sector into the
9 non-investment grade category,” and that “the recent financial turmoil has
10 underscored the benefits of strong credit ratings.”¹² These comments were written
11 approximately at the time Staff submitted its testimony, and therefore there is no
12 distortion relative to timing and the financial crisis in Moody’s comments. Staff,
13 on the other hand, appears rather blithe about the financial crisis being “over” and
14 assumes there is the luxury of time to contemplate the issue of credit quality.

¹¹ *Op. Cit.* Moody’s.

¹² *Op. Cit.* Moody’s.

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1 **IV. STAFF'S ANALYSIS OF THE COMPANIES' CREDIT RATINGS**
2 **WOULD REQUIRE SUBSIDIZATION, RATHER THAN SUPPORT,**
3 **FROM THEIR PARENT COMPANIES**

4 **Q. Staff contends that NYSEG's and RG&E's ultimate parent, Iberdrola,**
5 **should do more to improve the Companies' financial health, and that you**
6 **ignored Iberdrola's role. How do you respond?**

7 A. First, I did not ignore the role Iberdrola has played in the attempt to shore up the
8 Companies' financial health. In fact, I specifically noted the fact that the parent
9 companies have foregone dividends from NYSEG and RG&E, and have provided
10 temporary loans and other forms of financial support in an attempt to improve the
11 Companies' creditworthiness. I stressed that because they are regulated entities
12 with streams of revenue that are dependent upon state regulated rates, the
13 Companies can only make marginal changes to their financial picture unilaterally.

14 **Q. Why does being a regulated company allow only marginal changes to credit**
15 **quality?**

16 A. Regulated companies cannot change pricing to reflect changes in the cost of their
17 inputs without state regulatory review and approval. Regulators need to work
18 with the Companies to make sure they can recover their costs in rates. As a result,
19 rating agencies, such as Moody's and S&P consider regulation to be the most
20 important element of a credit rating. In fact, Moody's in particular has designated
21 that 50% of the rating for any given utility is determined by the quality of
22 regulation.

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1 **Q. How does support from a parent figure into a rating?**

2 A. As mentioned, a parent company can forego dividends to help strengthen the
3 balance sheet of its subsidiaries, which NYSEG's and RG&E's parent companies
4 have already done. A parent company cannot, however, change the utility
5 subsidiary's cash flow, which is of even greater importance to credit quality than
6 strengthening the balance sheet. Only the regulatory agency can implement rate
7 modifications to improve the utility subsidiary's cash flow.

8 **Q. Iberdrola assumed the debt of Iberdrola USA. Why couldn't Iberdrola also**
9 **assume the debt of NYSEG and RG&E to help raise their ratings to the "A"**
10 **level?**

11 A. Iberdrola does not own any of NYSEG's or RG&E's utility assets or hold any of
12 their debt directly. Iberdrola's "A3/A-" rating is based on the combination of its
13 credit metrics and its business profile. It would make little sense for a parent
14 company to assume the debt of its operating subsidiaries without obtaining
15 corresponding rights to utility assets or revenues. More importantly, an Iberdrola
16 assumption or guarantee of NYSEG's or RG&E's debt would be inconsistent with
17 the extensive ring-fencing measures implemented by the Commission in order to
18 protect NYSEG and RG&E from activities at upstream parent companies. That
19 ring-fencing works both ways. If NYSEG and RG&E are "protected" from the
20 parent companies, the parent companies should likewise be "protected" from the
21 ring-fenced subsidiaries. To suggest that Iberdrola should be the sole supporter of
22 NYSEG and RG&E abuses the concept of separation the Commission fought so
23 long and hard to establish. Moody's report entitled "Covenants and Ring-Fencing

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1 for Wholly-Owned Subsidiaries” issued in May 2007 provides some guidance on
2 the importance of this two-way street. In order to find that ring-fencing measures
3 are effective, Moody’s appears to require a “[p]rohibition on all transactions with
4 the parent and the affiliates that are not (i) in the ordinary course of business and
5 (ii) on an arm’s length basis.”¹³ Guaranteeing or assuming a utility subsidiary’s
6 debt would only be in the “ordinary course of business” or on an “arm’s length
7 basis” if collateral or cash flow were provided to a parent company that would
8 justify such a guarantee or assumption of debt. However, Staff has not suggested
9 any such security or collateral for such a measure. Furthermore, it is not clear that
10 such a conveyance of such security would even be consistent with the
11 Commission’s current regulatory requirements.

12 **Q. Why can’t Iberdrola do more to improve the Companies’ credit ratings?**

13 A. Iberdrola is an indirect upstream shareholder. It is not in the business of directly
14 managing its indirect utility subsidiaries’ day-to-day operations. Iberdrola cannot
15 do anything to affect, for example, customer usage, regulatory structure, or
16 political mandates. Parent companies may be able to affect the structure of their
17 subsidiaries’ balance sheets, but can do nothing to improve their utility
18 subsidiaries’ cash flows, which are critical to credit quality. The operating
19 utilities can propose rate modifications, but state regulators are the only ones who
20 can approve and set rates for the Companies with the kind of cash flows that the

¹³ Covenants and Ring-Fencing for Wholly-Owned Subsidiaries, Special Comment, Moody’s Investor Service, at 3 (May 2007).

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1 Companies need to improve and sustain their desire for improved credit ratings.

2 Iberdrola is not capable of, nor is it responsible for, doing that.

3 **V. CREDIT RATING AGENCIES HAVE INDEPENDENTLY AND**
4 **PROPERLY ASSESSED THE QUALITY OF REGULATION IN NEW**
5 **YORK STATE**

6 **Q. Staff argues that the rating agencies don't understand the complexity of**
7 **regulation in the State of New York. How do you respond?**

8 A. I'm afraid that it is Staff that doesn't understand the financial community's view
9 of regulatory practices. As discussed later, the "complexity" of regulation in New
10 York is hardly unique. Staff has clearly missed the point that allowed equity
11 ratios and ROE levels, as well as the ability to earn that return, are the most
12 important components of the assessment of regulatory support in any state.
13 Adjustment mechanisms are considered a credit benefit, as mentioned previously,
14 but rating agencies focus on earned returns and cash flows.

15 **Q. Are the various regulatory mechanisms employed by New York State**
16 **unappreciated by the rating agencies?**

17 A. While the "risk reducing measures" cited by Staff do not go unnoticed, they are
18 used by numerous other states and do not impact a company's credit quality as
19 much as the allowed equity ratio and ROE level, as well as the ability to earn that
20 ROE. The ability to earn allowed returns hinges on allowed equity ratios, and
21 timely and predictable cost recovery, which "is perhaps the single most important

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1 credit consideration.”¹⁴ Many of Staff’s proposals in these proceedings, including
2 the proposed amortization of excess theoretical depreciation reserves, productivity
3 and austerity imputations, one-time write-offs and denial of deferral treatment for
4 uncontrollable costs are all inconsistent with a predictable and supportive
5 regulatory environment.

6 **Q. How does Moody’s assess regulatory environments?**

7 A. As described in detail in my Direct Testimony, Moody’s clearly chronicles the
8 issues that are of greatest import to them in their rating deliberations. The
9 “regulatory framework”¹⁵ accounts for 25% of the rating, and the “ability to
10 recover costs and earn returns”¹⁶ accounts for another 25%. Fully 40% of the rest
11 of the rating depends on “financial strength and liquidity,”¹⁷ which is captured
12 primarily in four key ratios, three of which are cash flow measurements.¹⁸
13 Moody’s also considers “the predictability and supportiveness of the regulatory
14 framework in which [a company] operates...”¹⁹

15 **Q. How would the rating agencies react to Staff’s proposal for the amortization
16 of excess theoretical depreciation reserves in particular?**

17 A. The change being proposed by Staff is not consistent with the type of “predictable
18 and supportive” regulatory frameworks discussed above, and would seriously
19 impact the Companies’ cash flow metrics. Thus, the credit rating agencies would
20 view Staff’s proposal as a negative development both because it indicates

¹⁴ U. S. Utilities Face Challenges Beyond Near-Term, Industry Outlook, Moody’s Investors Service (Jan. 2010).

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1 inconsistency in regulatory treatment, and diminishes the ability of the Companies
2 to generate cash flow sufficient to support their current ratings.

3 **Q. How do you know the rating agencies would react negatively to the proposed**
4 **amortization of theoretical depreciation?**

5 A. The Florida Public Service Commission recently denied almost the entire rate
6 increase request of Florida Power & Light Company (“FPL”), based primarily on
7 the amortization of FPL’s theoretical excess depreciation reserve. Both S&P and
8 Moody’s immediately put FPL Group and its subsidiaries on CreditWatch with
9 negative implications because “the lower than expected revenues...are likely to
10 impede the ability of the company to achieve credit metrics that support current
11 ratings.”²⁰

12 **Q. Does New York State offer unique ratemaking techniques as they suggest?**

13 A. No. Many states employ various techniques, which Staff generally calls “risk
14 reducing measures.” Moody’s has not only reviewed and acknowledged these
15 methods, but it also came to a clear conclusion about them in its most recent
16 Industry Outlook published in January 2010, when Moody’s stated:

¹⁵ *Op. Cit.* Moody’s.

¹⁶ *Op. Cit.* Moody’s.

¹⁷ *Op. Cit.* Moody’s.

¹⁸ Cash from Operations, pre-working capital plus interest/interest;
Cash from operations pre-working capital/debt;
Cash from operations pre-working capital-dividends/debt; and
Debt/regulated asset value.

¹⁹ *Op. Cit.* Moody’s.

²⁰ Research Update: Florida Power and Light, Standard and Poor’s (Jan. 14, 2010).

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1 [W]e view these tracker mechanisms as a credit benefit, as they are
2 designed to ensure recovery of a specific set of costs. Still, we remain
3 cautious about longer-term risks associated with future requests for base
4 rate relief, presumably due to the trackers crowding-out other financial
5 recovery requests. We believe regulators and residential consumers
6 remain focused on the ultimate all-in costs, and not so much on the rate
7 structure components.²¹

8
9 As mentioned, many other states employ adjustment mechanisms to provide for
10 more timely recovery of various costs, and the rating agencies clearly take those
11 into account when they evaluate the quality of regulation in a particular
12 jurisdiction. Adjustment mechanisms alone, however, do not lead the financial
13 community to assess regulatory environments as positive. Credit rating agencies
14 and the financial community are most concerned with a utility's ability to
15 generate cash flow at levels that will support a quality rating, which is primarily
16 driven by the allowed ROE and cost recovery. If an ROE is set at a low level and
17 other regulatory policies work to prevent a utility from actually achieving that
18 allowed ROE, then all the adjustment mechanisms in the world are not going to
19 improve cash flow enough to result in a higher rating. Dr. Makholm also
20 discusses how the practices that Staff touts as risk reducing mechanisms (*e.g.*,
21 commodity pass-through clauses and the use of a forward-looking test year) do
22 not actually make the New York regulatory environment unique among its other
23 state peers, nor do these practices merit New York's unreasonably low allowed
24 ROEs.

²¹ U. S. Utilities Face Challenges Beyond Near-Term, Industry Outlook, Moody's Investors Service (Jan. 2010).

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1 **Q. What about the articles Staff cites regarding the importance of these**
2 **adjustment mechanisms?**

3 A. In Staff’s response to NYSEG-RGE-53, Staff provides certain articles written by
4 investors and credit rating agencies as evidence that adjustment mechanisms equal
5 high quality regulation. However, Staff fails to mention that Regulatory Research
6 Associates (“RRA”) and the credit rating agencies repeatedly highlight the fact
7 that overall regulatory support is more critical to credit quality than the individual
8 adjustment mechanisms employed by state commissions. For example, the
9 Moody’s report on Orange & Rockland Utilities, Inc. (“O&R”) cited by Staff
10 highlights O&R’s weakening financial profile and attributes it to “rising capital
11 spending and declining allowed ROE’s.”²² In that same report, Moody’s stated
12 that “O&R’s regulatory environment has become more challenging in recent
13 years.”²³ Similarly, an S&P report cited by Staff that focuses on fuel and
14 purchased power cost adjustment mechanisms also highlights that “it is critical to
15 note that FPPA’s (fuel and purchased power adjustments) are not a substitute for
16 supportive regulation.”²⁴

²² Orange and Rockland Utilities, Inc., Credit Opinion, Moody’s Investors Service (June 30, 2009).

²³ *Id.*

²⁴ Fuel and Power Adjusters Underpin Post-Crisis Credit Quality of Western Utilities, Global Credit Portal, RatingsDirect, Standard and Poor’s (Oct. 14, 2004).

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1 **Q. Do other state regulatory commissions employ adjustment mechanisms?**

2 A. Yes. A number of states employ a variety of mechanisms meant to provide more
3 timely recovery of costs incurred to maintain service quality and help utilities
4 produce cash flows sufficient to maintain or improve credit quality.

5 **Q. Can you cite examples?**

6 A. Certainly. There are numerous examples, but I offer three in the chart below.
7 The chart contains, as reported by RRA, a list of mechanisms offered by the
8 states, the credit ratings of the major utilities in those jurisdictions, and the
9 rankings by RRA of those state commissions. The rating agencies rely upon RRA
10 for its consistent reporting on regulatory activity including the structure of
11 regulation. As can be easily seen, it is not the adjustment mechanisms that lead
12 the financial community to assess regulatory environments as positive. It is the
13 ability of a utility to generate cash flow at levels that will support a quality rating.
14 Wisconsin, with the least number of adjustment mechanisms, has the best
15 regarded regulatory environment,²⁵ and the highest credit ratings. The reason is
16 simply that the Wisconsin commission strives to provide an environment where
17 companies have a “reasonable opportunity to maintain solid credit quality
18 metrics.”²⁶ Adjustment mechanisms do not necessarily, in and of themselves,
19 provide that opportunity.

²⁵ “Above Average/2” is the highest rating currently awarded to any regulatory jurisdiction even though the scale goes to “Above Average/1.”

²⁶ SNL Financial, <http://snl.com> (viewed Jan. 23, 2010).

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Most Recent Opinions as Reported by RRA as of 1/23/2010

1
2

State	Adjustment Clauses	RRA Ranking	Rationale for Ranking	Rating
Arizona	<ul style="list-style-type: none"> ▪ Fuel/purchased power ▪ Systems benefit ▪ Competition rules compliance ▪ Transmission cost adjustor 	Average/3	Politicization of process, exorbitant regulatory lag	APS-Baa2 TEP-Baa3
California	<ul style="list-style-type: none"> ▪ Performance based rated making ▪ Automatic cost-of-capital recovery mechanism ▪ Purchased power ▪ Incentive gas cost recovery ▪ Revenue adjustment (decoupling) 	Average/1	Incentive ratemaking, performance based ratemaking, supportive returns on equity allowed, various other recovery mechanisms	PG&E-A3 SCE-A3 SDG&E-A2
Wisconsin	<ul style="list-style-type: none"> ▪ Fuel and purchased power recovery mechanisms on a prospective basis ▪ Gas cost recovery incentives 	Above Average/2	Forecasted test periods, equity-rich capital structures, cash return on at least 50% of CWIP, “reasonable opportunity to maintain solid credit quality metrics...”	WEP-A1 WP&L-A2 NSP-WI-A3 MGE-Aa3 Wisconsin P.S.-A2
New York	<ul style="list-style-type: none"> ▪ Semi automatic fuel adjustment ▪ Market power adjustment clause ▪ Commodity adjustment clause ▪ Decoupling mechanisms 	Average/3	Below average returns on equity, timely recovery of purchased power costs	NYSEG-Baa2 RG&E-Baa3 Central Hudson- A3 ConEd – A3 O&R – Baa1

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While these are only three examples to compare against New York State, it is obvious that RRA prefers “supportive regulation” that includes higher ROEs and rate structures that allow a utility to earn that return. For example, California employs many adjustment mechanisms, including decoupling, that are similar to those offered in New York, but California’s regulatory environment enjoys a higher ranking than New York’s primarily because it offers higher allowed ROEs. Higher ROEs and supportive rate structures will lead to higher ratings of both utility debt and regulatory commissions.

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1 **Q. The Staff Policy Panel suggests on pages 21 and 22 of its testimony that the**
2 **Companies’ alleged “complaints” about the Commission adversely affect the**
3 **rating agencies’ opinions of New York regulation. Is that accurate?**

4 A. No. Rating agencies are independent third parties. Rating agencies obtain input
5 from utilities, state commissions and other experts like RRA, and then make an
6 informed, independent assessment of a company’s financial situation based upon
7 an unbiased evaluation of whether a state commission has provided a company
8 with the ability to generate cash flows sufficient to produce financial results
9 sufficient to support a particular rating. Moody’s states that it “typically do[es]
10 not take rating actions based on a staff, administrative law judge or intervener
11 recommendation, but prefer[s] to see the actual commission-issued written
12 orders.”²⁷ Nothing a company says about its particular regulator influences the
13 rating agencies more than that regulator’s actual decisions.

14 **Q. What particular regulatory decisions have the greatest influence on the**
15 **rating agencies?**

16 A. As I mention above and in my Direct Testimony, rating agencies focus first and
17 foremost on the ability of a utility to generate cash flow at levels that will support
18 a quality credit rating, which is primarily driven by the allowed ROE and timely
19 and predictable cost recovery. Therefore, setting supportive allowed ROE levels
20 and providing for timely and predictable cost recovery represent the most direct
21 ways that regulators can influence utility credit ratings. As Dr. Makholm’s
22 rebuttal testimony discusses in detail, Staff has proposed the use of unreasonably

²⁷ *Op. Cit.*, Moody’s.

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1 low ROEs. Staff has also recommended numerous cost disallowances,
2 productivity and austerity imputations, and deferral accounting rejections that
3 would impair the Companies’ ability to recover costs in a timely and predictable
4 fashion, and likely would lead to an inability to achieve their allowed ROEs.
5 These recommendations will influence the rating agencies’ evaluation of the
6 regulatory environment in New York much more so than the other risk reducing
7 adjustment mechanisms that Staff discusses. Thus, Staff’s contention that the
8 Companies “focus the attention of credit rating agencies on a rate of return
9 number outside the context of the many risk reducing rate mechanisms employed
10 in New York” ignores the rating agencies’ primary focus on “earned returns and
11 cash flows.”²⁸

12 **Q. Does that conclude your Rebuttal Testimony?**

13 A. Yes, it does.

²⁸ *Op. Cit.* Moody’s.