

**RÉPONSE DE GAZ MÉTRO À UNE DEMANDE DE RENSEIGNEMENTS**

**Origine :** Demande de renseignements n° 1 en date du 6 juin 2011

**Demandeur :** Association des consommateurs industriels de gaz (Dr. Laurence Booth)

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**Dr. Booth's Information Requests to Dr. Morin**

**Références :** Gaz Métro-7, Document 12 Preuve du Dr Morin

**Question :**

- 1.1 On page 2 Dr. Morin details his educational and professional experience.
- a) Please provide pdf copies of his texts The New Regulatory Finance, August 2006 and Utilities' Cost of Capital, 1984.
  - b) Please indicate the last time Dr. Morin provided testimony before a Canadian regulatory board concerning the fair rate of return for a regulated utility.

**Réponse :**

- a) Dr. Morin's books The New Regulatory Finance and Utility Cost of Capital are commercially available directly from the publisher Public Utility Reports Inc. or can be ordered from Amazon, and cannot be reproduced without violating copyright laws.
- b) Dr. Morin's last appearance before a Canadian regulatory board was in 2004 on behalf of TransEnergie.

**Question :**

- 1.2 On page 6 Dr. Morin discusses Gaz Metro's requested capital structure
- a. Please discuss whether Dr. Morin has taken Gaz Metro's deemed preferred share component into account and if so how?
  - b. Please discuss whether deeming a preferred share component in the capital structure poses the same risk as actually having a preferred share component on which the company has to pay the required dividend.
  - c. Assuming that the preferred shares are simply deemed equity at a lower required rate of return please provide the average ROE of Dr. Morin's recommendations with Gaz Metro's existing and requested capital structures.

**Réponse :**

- a) Dr. Morin's focus was on the common equity component of GMLP's capital structure.
- b) As far as common equity holders are concerned, preferred equity constitutes senior leverage capital and from common shareholders' perspective is essentially non-tax deductible debt.
- c) See Dr. Morin's testimony page 72 lines 10-14.

**Question :**

**1.3** On pages 7-8 Dr. Morin discusses the problems induced by low allowed ROEs.

- a. In his second step Dr. Morin suggests that a utility might rely on more debt financing if the market to book ratio decreases and causes "potential dilution".
  - i. Please provide any real examples where a Canadian utility has voluntarily chosen to finance with debt for fear of diluting the common shareholders.
  - ii. Would Dr. Morin agree that dilution occurs when the stock price falls below the book value? If not why not?
  - iii. Since the concern is that the market price not drop below book value, what target market to book ratio would Dr. Morin recommend to insure that dilution does not occur and there is no incentive for the utility to issue debt rather than equity?
- b. In Dr. Morin's first step of a lower market price for the equity as investors correct for the inadequate ROE, would Dr. Morin agree that he is discussing a pure utility with traded equity and that as a result we can assess whether the ROE is adequate or not by observing the market to book ratio? If he disagrees can Dr. Morin provide copies of the relevant pages from his Utilities' Cost of Capital text 1984, where he disagrees with this proposition?

**Réponse :**

- a.
  - i. Unless one is privy to the ongoing discussions between the companies and their underwriters and potential investors, which Dr. Morin is not, it is virtually impossible to know whether a company tried to issue debt for fear of diluting the common shareholders, or whether the company wanted to issue at a particular time or had to wait, or under what terms and conditions.
  - ii. Dilution occurs whenever a company issues common stock.
  - iii. Dr. Morin does not believe that regulators should set an ROE so as to produce a specific target M/B ratio. The stock price is set by the market, not by regulators. The M/B ratio is the *result* of regulation, not its starting point. M/B ratios are determined by exogenous market forces and are

largely outside the direct control of regulators. Depressed or inflated M/B ratios are to a considerable degree a function of forces outside the control of regulators, such as the general state of the economy, or general economic or financial circumstances that may affect the yields on securities of unregulated as well as regulated enterprises. The fundamental goal of regulation should be to set the expected economic profit for a public utility equal to the level of profits expected to be earned by firms of comparable risk, in short, to emulate the competitive result, so as to assure the firm's credit and to attract needed capital.

- b. Dr. Morin disagrees with this proposition for reasons provided in response to request 1.3 a) (iii).

**Question :**

**1.4** On page 7 Dr. Morin states that adopting a lower ROE and common equity ratio than what he recommends would increase costs for GMLP's ratepayers.

- a. Since Gaz Metro's allowed ROE has largely been determined by an ROE formula and it has operated with 38.5% common equity and not 42.5%, would Dr. Morin judge the previously awarded financial parameters to have lead to higher costs for ratepayers? If so please indicate how the Regie or ratepayers can confirm this judgment?
- b. Please indicate any time since 1990 when Gaz Metro has been forced into issuing debt, rather than equity, due to an inadequate ROE and fear of dilution to the common shareholder.
- c. Please indicate any time when Gaz Metro has been unable to access debt markets on fair and reasonable terms and indicate how it met its financing and what the terms were.

**Réponse :**

- a. Dr. Morin did not study the impact of past decisions on revenue requirements as this was well outside the scope of his testimony.
- b. Unless one is privy to the ongoing discussions between GMLP/GMI and its underwriters and potential investors, which Dr. Morin is not, it is virtually impossible to know whether GMLP or its parent tried to issue debt due to an inadequate ROE or for fear of diluting the common shareholders, or whether the company wanted to issue at a particular time or had to wait, or under what terms and conditions.
- c. See b) above. The issue is not so much whether GMLP was able to attract capital or whether it was unable to issue debt but at what cost and under what terms.

**Question :**

**1.5** Stand-alone principle, page 10 and ownership structure of Canadian utilities (page 19-20).

- a. Can Dr. Morin please indicate the approximate % of rate of return regulated utility assets in Canada that are currently traded in the public equity markets as a pure utility, i.e., with negligible non-utility assets.
- b. Is Dr. Morin aware of whether or not the publicly traded utility % as defined in a) above has been increasing or decreasing over time?
- c. If Dr. Morin agrees that the % of publicly traded pure utilities in Canada is very low, does he judge this to be a violation of the stand-alone principle, that is, what is it that has led to the observation that most utilities are now part of utility holding companies?
- d. Further to c) above does the fact that corporate owners are willing to pay more for a utility than regular investors indicate that any fair rate of return estimates drawn from the capital market are over-estimates of the fair ROE? If not why not?

**Réponse :**

- a. Dr. Morin did not estimate the percentage of regulated utility assets that are currently traded in the public equity markets in Canada as pure utilities, but assumes such a percentage is very small, given his lengthy discussion on the scarcity of comparable utility companies in Canada on pages 18-19 of his testimony. In any event, such an endeavor was well outside the scope of his testimony.
- b. See response to a).
- c. No, it does not. The stand-alone principle is quite robust regardless of the abundance or scarcity of comparable companies. An investor is entitled to a fair return commensurate with the risk of the investment, regardless of the nature of that investment. Dr. Morin notes that the U.S. utility industry is not subject to the scarcity of pure-play companies as is the case in Canada.
- d. Dr. Morin is not aware that corporate owners are willing to pay more for a utility than it is worth, unless a control premium is involved. If a corporate owner were to pay a price above true economic value, the stock would be overvalued (i.e. low dividend yield) and the rate of return understated rather than overstated.

**Question :**

**1.6** Fair return standard, page 14

- a. Can Dr. Morin please confirm that when he discusses the need for returns to be “commensurate with returns on investments in other firms having corresponding risks”, he means investments in the *securities* of other companies, that is, he is being consistent with the NorthWestern Utilities decision.
- b. Further to a) above can Dr. Morin confirm that the rate of return so estimated from other securities is then applied directly to the book value of the regulated firm’s assets without any adjustment for differences between market versus book values?
- c. On page 16 can Dr. Morin confirm that when he talks about supply and demand he is talking about current investor interaction in the capital market and the opportunity cost reflects current market conditions?
- d. Can Dr. Morin confirm that the Canadian definition of a fair rate of return (Mr. Justice Lamont’s definition) came about as a result of a board’s right to change the allowed ROE as a result of changed conditions in the money market?

**Réponse :**

- a. It is confirmed.
- b. It is confirmed. See also response to 1.3. a) (iii).
- c. It is confirmed.
- d. It is confirmed.

**Question :**

**1.7** Dr. Morin discusses the paucity of pure play Canadian utilities on page 20.

- a. Please discuss why he never looked at the investment risk of GMLP?
- b. Does Dr, Morin consider Fortis and Emera as reasonably pure utilities?
- c. Does Dr. Morin regard Canadian Utilities as involving predominantly regulated assets and electricity generating assets covered by power purchase contracts?

**Réponse :**

- a. Please see Dr. Morin’s comprehensive discussion of GMLP’s relative investment risks on pages 60-63 of his testimony.
- b. Dr. Morin considers Fortis and Emera as reasonably pure regulated utilities with at least 80% of their assets regulated.
- c. Dr. Morin considers companies with 50% to 80% of their assets regulated as mostly regulated companies.

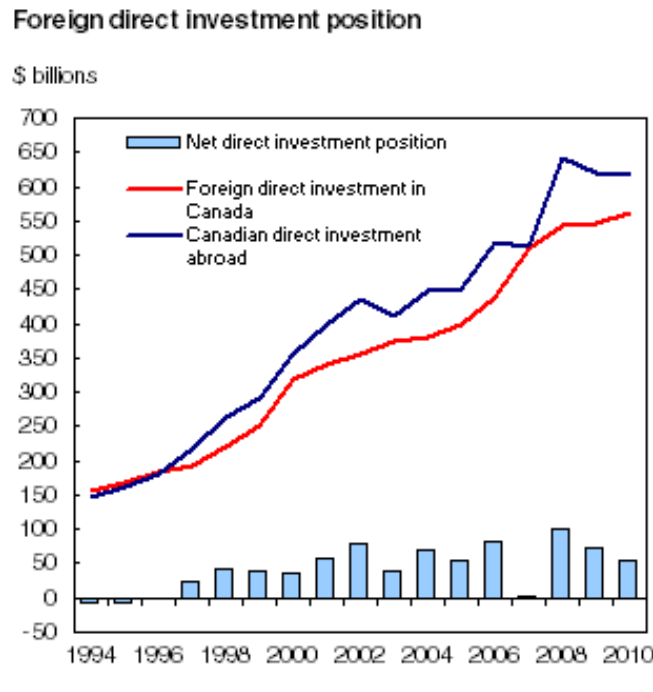
**Question :**

- 1.8** Dr. Morin discusses his risk-free rate assumptions on pages 23-25
- a. Why is it noteworthy that the yield on US government treasuries (page 25) is currently 5.0%, of what relevance is this to a fair rate of return in C\$?
  - b. Dr. Morin reports the consensus forecast for the long Canada bond as 3.9%, please indicate what the yield was at the time the US Treasury yield was 5.0%.
  - c. Would Dr. Morin agree that the yield on Canadian government bonds is currently at least 0.60% lower than the equivalent yield on US government bonds?
  - d. Can Dr. Morin explain in detail why the Canadian government has no problem financing its borrowing at bond yields significantly lower than those paid by the US Government? That is, what is the missing factor that makes US government bond yields of 5.0% fair and Canadian government bond yields much less than that also fair?
  - e. Given the differences observed above and Dr. Morin's view that the long government bond yield is the best risk free rate for setting utility returns why would Dr. Morin not expect Canadian utility fair rates of return to be less than those in the US?

**Réponse :**

- a. With similar government bond yields in the U.S. and Canada for decades, the U.S. interest rate environment is a relevant benchmark for Canadian investors. The comparison becomes even more germane given the significant and growing integration of the Canadian and U.S. capital markets. A dramatic development of the last two decades has been the integration of world financial markets into one global "supermarket". Global corporations and global investors are well-positioned to access this market, and arbitrage short-run disparities in the cost of funds between markets. Their activity tends to drive national capital costs toward a single global standard. When capital flows freely from one location to another, competitive forces of supply and demand will quickly eliminate any price or rate of return disparities, other than those arising from differences in risk. Thus cost of capital differences cannot persist in an integrated capital market.

As displayed from the Statistics Canada graph below, foreign direct investment in Canada and Canadian direct investment abroad, particularly in the U.S., have grown exponentially since 1994, attesting to a high degree of integration in global capital markets. In short, it is Dr. Morin's judgment that it is appropriate to take the U.S. experience into account and that investors take the U.S. experience into account.



- b. Dr. Morin does not understand the question. Comparing an actual yield on US Treasury bonds with a forecast yield on a Canada bond is quite inconsistent. A more appropriate comparison is to compare the forecast yield in both cases and/or to compare the actual yield in both cases. Dr. Morin chose the former.
- c. It is agreed at this point in time. Dr. Morin notes that the forecast yields on Canada bonds and US Treasury bonds are much closer as per the April 2011 Consensus Forecast. See also the response to (a)
- d. It was well outside the scope of Dr. Morin's testimony to assess the reasons for the differential in yields between Canada and the U.S. Bond yield differentials are fundamentally driven by inflation differentials, fiscal/monetary policy differentials, and forecast economic activity differentials. Large budget deficits and political uncertainty in the US relative to Canada are reasonable explanations for the differential at this point in time. Moreover, the consumer price index in the US is forecast to exceed that of Canada in 2011.
- e. Notwithstanding the fact that cost of capital differences cannot persist in an integrated capital market, Canadian utilities must compete for capital with U.S. utilities and, therefore, must offer comparable returns if they are to be successful. Another way of stating the matter is that Canadian allowed ROEs must satisfy the comparable returns standard. The comparability criterion is not being met if allowed returns for Canadian utilities are lower than allowed returns in the U.S.

**Question :**

- 1.9 On page 26 Dr. Morin indicates that GMLP's natural gas distribution assets are not publicly traded.
- a. Please confirm that these assets are indirectly traded through Valener Inc, with the following quote for May 30, 2011

**Valener Inc**

(Public, TSE:VNR) [Watch this stock](#)  
 Find more results for [VNR](#)

<a href="#">S&amp;P TSX</a>	13,829.66	0.23%
<a href="#">VNR</a>	16.68	-0.77%

**16.68**  
 -0.13 (-0.77%)  
 May 30 - Close

TSE data delayed by 15 mins - [Disclaimer](#)  
 Currency in CAD

- b. Please discuss in detail why observing Gaz Metro's risk indirectly is inferior to looking at a sample of US utilities and estimating the fair return from foreign assets traded in a foreign capital market?
- c. Please confirm that the following comes directly from Gaz Metros web site at <http://www.corporatif.gazmetro.com/Investisseurs/Default.aspx?culture=en-ca>:

**« Gaz Métro and Valener complete reorganization :**

*On October 1, 2010, Gaz Métro Limited Partnership (Gaz Métro) and Valener Inc. (Valener) announced that the plan of arrangement providing for the reorganization of Gaz Métro's public ownership structure into a new dividend-paying publicly listed corporation named "Valener Inc." has been completed, effective September 30, 2010.*

*Pursuant to the Reorganization, all of the units held by public unitholders of Gaz Métro were exchanged, on a one-for-one basis, for common shares of Valener. Consequently, former public unitholders of Gaz Métro retain, indirectly through Valener, their proportionate economic interest of approximately 29% in Gaz Métro.*

*The units of Gaz Métro were delisted from the Toronto Stock Exchange. Trading of the common shares of Valener on the Toronto Stock Exchange has commenced on October 1, 2010, under the symbol "VNR".»*



**Réponse :**

- a. Valener is a new publicly listed corporation that owns an economic interest of approximately 29% in GMLP.
- b. In order to meet the comparability and fairness standards of Hope, Bluefield, and NorthWestern, it is imperative to examine groups of utility companies comparable in risk to GMLP, including groups of US utilities, given the scarcity of comparables in Canada. Moreover, Canadian utilities must compete for capital with U.S. utilities and, therefore, must offer comparable returns if they are to be successful. See response to Question 1.8 (a) for relevance of, and need to examine, U.S. comparables
- c. It is confirmed.

**Question :**

**1.10** Beta estimates page 27-28

- a. Please confirm that the beta estimates are adjusted using the Blume adjustment towards 1.0?
- b. Please confirm that Dr. Morin is aware that the Regie in D-2009-156 paragraph 269 expressed its view that betas should be adjusted towards their own mean rather than the grand mean of all stocks, i.e., 1.0?
- c. Please indicate any Canadian regulator that has accepted the idea that actual beta estimates should be adjusted toward 1.0 rather than the utility mean.
- d. Please indicate the underlying actual beta estimates consistent with the adjusted betas reported by Dr. Morin in Appendix C pages 1-3.
- e. Please indicate whether Dr. Morin is aware of any published research that justifies utility betas being adjusted toward 1.0 rather than the utility mean.

**Réponse :**

- a. It is confirmed.
- b. It is confirmed. Dr. Morin notes that beta estimates from Value Line, Bloomberg, Morningstar, Merrill Lynch, and others are highly visible, widely available to investors, and are used by investors. It is unrealistic to think that investors perceive these published estimates from these well-known and well-respected providers of investment information as distorted and somehow proceed on their own account to correct these beta estimates by performing formal specialized statistical adjustments. Dr. Morin reiterates that adjusted betas are a standard means of estimating betas, and are widely disseminated to investors by the aforementioned investment research firms.

- c. Dr. Morin is not aware of any Canadian decisions which have specifically relied on the adjustment methodology. See response to (b) above.
- d. Dr. Morin does not understand what is meant by actual beta estimates. The beta estimates reported in Appendix C are the actual betas. If one wishes to deconstruct the actual beta estimates from Value Line and Bloomberg, one merely has to run the Blume adjustment formula in reverse. The Value Line and Bloomberg methodologies give approximately 2/3 weight to the calculated “raw” beta and 1/3 weight to the equity market beta of 1.0.
- e. Dr. Morin is unaware of such research. See response to (b) above.

**Question :**

**1.11** On pages 29-30 Dr. Morin uses relative standard deviations as a measure of risk.

- a. Please indicate where in the academic literature there is any support for using relative standard deviations as a risk measure for individual securities, rather than portfolios.
- b. Please provide copies of any PowerPoint slides or lecture notes where Dr. Morin has taught either MBA or undergraduate students that relative standard deviations are a valid risk measure for individual securities. (please provide the course outline and the session where the course was taught)
- c. Please indicate the time period over which the standard deviations were estimated and the underlying data so the calculations can be verified.
- d. Please provide the standard deviation for the long Canada and long US treasury bond returns for the exact same time periods as for the data in Appendix C page 5.
- e. Please subtract the standard deviation of the long Canada and long US treasury return respectively from both the utility and overall market returns and calculate the ratio of the incremental risk of the utility standard deviation to that of the market for both Canada and the US.

**Réponse :**

- a. Standard deviation is a widely accepted measure of stand-alone risk. Moreover, the formal definition of the beta risk measure is a direct function of standard deviation:

$$\beta = \frac{\sigma_{\text{stock}}}{\sigma_{\text{index}}} \times \rho_{\text{stock/index}}$$

where  $\sigma$  denotes standard deviation and  $\rho$  denotes correlation and “index” refers to a broad market index of stocks.

- b. Dr. Morin’s national lecture/seminar series sponsored by The Management Exchange, Exnet, and the SNL Center for Financial Education, that have been taught for some twenty five years across the U.S. include proprietary material and PowerPoint slides that highlight the role of standard deviation as a valid measure of risk. The content of these seminars is drawn from Dr. Morin’s latest textbook *The New Regulatory Finance Chapter 3 Section 3.1 entitled Standard Deviation as a Risk Measure* which contains a thorough discussion of standard deviation as a valid measure of risk. It is also noteworthy that Value Line routinely provides standard deviation estimates in the Value Line Investment Analyzer software. Dr Morin also notes that, in practice, beta and standard deviation are highly correlated as shown on Figure 3.11 in the aforementioned textbook. This is not surprising given the definition of beta in part (a) which includes the standard deviation as a determinant of beta. Dr. Morin also notes that most, if not all, college-level finance/investment textbooks contain a discussion of standard deviation as a measure of investment risk.
- c. Value Line computes standard deviation over a five year period.
- d. Dr. Morin did not perform such calculation nor does he possess the data required to perform such calculations as they were not germane to his testimony and well outside its scope. Providing the response to this request requires a very large amount of work involving a large amount of data. Dr. Morin seriously doubts the value of such an exercise and has placed no reliance at all on such data in arriving at his recommendation. Dr. Morin does point out that the standard deviation of long US Treasury returns over the last five years or any other period can be calculated from the Morningstar (formerly Ibbotson Associates) Valuation Yearbook 2011 edition which has data going back to 1930, but only annual return data are available from that source.
- e. Dr. Morin does not possess such data. See response to (d).

**Question :**

**1.12 Market risk premium estimates on page 30**

- a. Dr. Morin prefers the equity risk premium over income returns to that over total returns, would Dr. Morin agree that the only difference is that in doing so he ignores the capital gain earned on the long bond as a result of declines in interest rates? If not why not and explain in detail.
- b. Would Dr. Morin agree that declines in interest rates also affect the equity market and that the long bull market in equities that started in 1981 was caused in part by a drop in interest rates over that period?

- c. Would Dr. Morin agree that calculating the market risk premium over income returns only makes sense if the capital gain in equities caused by declining interest rates is also excluded? If not why not.
- d. Please indicate any published academic research that supports the use of an equity return over bond income as a valid method of calculating the equity market risk premium.
- e. Please confirm that the Dimson et al study finishes in 2007 at the top of the bull market.
- f. Please confirm that in D-2009-156 paragraph 252 the Regie determined “the market risk premium prior to the financial crisis to be in a range 5.50-5.75%.
- g. Please indicate whether in Dr. Morin’s judgment financial market conditions in both the US and Canada still reflect the “financial crisis” and if so what objective criteria he bases this judgement on.

**Réponse :**

- a. Dr. Morin disagrees. The use of the equity risk premium over income returns is a more reliable estimate of the historical MRP because the income component of total bond return (i.e., the coupon rate) is a far better estimate of expected return than the total return (i.e., the coupon rate plus capital gains/losses), because both realized capital gains and realized losses are largely unanticipated by investors. Dr. Morin also notes that the influence of unexpected capital gains is offset by the influence of unexpected capital losses.
- b. Dr. Morin disagrees with the notion of the “*long bull market in equities that started in 1981 caused... by a drop in interest rates over that period.*” Given the collapse of the “dot.com” bubble in 2001 and the great recession and stock market collapse of 2008-09, one can hardly term the last 30 years as a “*long bull market*”.
- c. No, because the influence of unexpected capital gains can be offset by the influence of unexpected capital losses over such a long period.
- d. See Ibbotson Associates (now Morningstar) Valuation Yearbook 2011 edition for support of the use of an equity return over bond income as a valid method of calculating the market risk premium. This document is protected by copyright and can be commercially obtained from the Morningstar web site.
- e. It is confirmed.
- f. It is confirmed. However, in Decision D-2007-116 for Gaz Metro, prior to the financial crisis of 2008-2009, the Regie determined that the MRP is in the range of 5.4% to 5.9%. It stands to reason that following the devastating impact of the 2008-2009 financial crisis which admittedly has abated somewhat and the persistent volatility on equity markets, investor aversion, hence the MRP, stand at the very least in the upper portion of a range of results, if not higher.

- g. The devastating impacts of the 2008-2009 financial crisis have abated somewhat, but there are lingering effects that remain, as evidenced by the yield spreads of corporate bond yields over long Canada bonds that have fallen since the crisis but still remain above their pre-crisis levels.

**Question :**

**1.13** Dr. Morin discusses the integration of world equity markets on pages 32-34.

- a. Please indicate whether any of the following major Canadian utilities are cross listed in the US: GMLP (Valener), Canadian Utilities, Emera, Fortis, Pacific Northern Gas or TransAlta.
- b. Can Dr. Morin discuss whether any of the utilities referenced in a) above have raised capital in the United States?

**Réponse :**

- a. All the cited companies are traded on the TSE, and TransAlta is traded on the NYSE. All the companies mentioned except Valener are covered extensively in the Value Line Data Base along with their U.S. peers.
- b. Dr. Morin is not aware of the capital-raising activities of these companies in the U.S.

**Question :**

**1.14** DCF estimate of the US market return and risk premium, page 36

- a. Dr. Morin adds a 2.4% dividend yield to an 8.96% composite growth rate for an expected market return of 11.58%. Please confirm that this forecast is for the future dividend growth rather than earnings growth as required by the DCF model?
- b. Please provide Dr. Morin's expected long run growth rate for the US economy and support this estimate with reference to independent forecasts.
- c. Please confirm that the growth in a) is assumed to go on forever and discuss the implications of b) being less than the dividend growth in a) (if it is).
- d. Please confirm that the difference between the compound and arithmetic mean (AM) return increases with the volatility in the arithmetic return and if the AM is distributed lognormal the difference is exactly half the variance of the return.
- e. Please confirm that if earnings are more volatile than dividends then the growth rate in earnings will exceed that in dividends for the same reason as in d) above. If not please explain why not in detail.

- f. Please discuss whether the papers referenced on page 37 use earnings or dividend forecasts and whether they are adjusted for the well known analyst optimism bias.

**Réponse :**

- a. Under the auspices of the standard DCF model, earnings and dividends are assumed to grow at the same rate, along with book value and stock price.
- b. A long-term forecast of nominal growth in Gross Domestic Product (GDP) can be formulated by combining a long-term inflation estimate with a long-term real growth rate forecast as follows:

$$\text{GDP Nominal Growth} = \text{GDP Real Growth} + \text{Expected Inflation}$$

The growth rate in U.S. real GDP has been reasonably stable over time. Therefore, its historical performance can be used as a reasonable estimate of expected long-term future performance. The growth in real GDP for the 1929-2009 period was approximately 3.5%.

The long-term expected inflation rate can be obtained by comparing the yield on long-term U.S. Treasury bonds with the yield on inflation-adjusted bonds of the same maturity. The difference between the yield on 30-year Treasury bonds as of June 2011 and the yield on inflation-adjusted bonds ("Treasury Inflation Protected Securities," or "TIPS") for the same maturity is 2.5%. Using the above formula, the long-term expected GDP nominal growth is 6.0% (3.5% + 2.5% = 6.0%).

Morningstar's *Stocks, Bond, Bills and Inflation 2011 Classic Yearbook*, uses 5.8%, as its estimate of the U.S. economy long-term growth rate in the DCF model.

- c. (a) It is confirmed. (b) Dividends cannot grow at a faster rate than the economy forever.
- d. It is confirmed.
- e. Both earnings and dividends can grow and are assumed to grow around the same growth trend even though earnings are more volatile than dividends.
- f. Dividend forecasts are very scarce and most research dealing with this topic relies on earnings forecasts in view of their wide availability. Dr. Morin reiterates that under the auspices of the standard DCF model, earnings and dividends are assumed to grow at the same rate.

**Question :**

- 1.15 Dr. Morin's observations on the MRP on pages 38-39.

- a. Is Dr. Morin aware of the recent surveys of professors, analysts and company executives of the size of the market risk premium carried out by Professor Fernandez at IESA?
- b. Would Dr. Morin confirm that the Brearly text referred to is not a Canadian, but a US text?
- c. Can Dr. Morin provide his CAPM estimate on page 39 using the historic data on the Canadian market risk premium and his unadjusted beta estimates?

**Réponse :**

- a. Yes.
- b. It is confirmed.
- c. Dr. Morin does not rely on unadjusted beta estimates as stated in the question.

**Question :**

**1.16** Empirical CAPM (ECAPM) estimates on page 39-42

- a. Can Dr. Morin confirm that his ECAPM is based on the empirical asset pricing literature that uses the 30 return on the treasury bill as the risk free rate? If he can not do so please provide the results from any asset pricing test that use the long bond return as the risk free rate.
- b. Can Dr. Morin confirm that current Canadian treasury bill yields are approximately 1.0% or about 3.0% less than the risk free rate used in his estimates, so that he is already adding at least 3% to the sort of ECAPM model tested in the literature?
- c. Can Dr. Morin estimate the long run excess return of the long government bond over the Treasury bill return in both the US and Canada using data from at least the past 50 years.
- d. Can Dr. Morin provide evidentiary support for any Canadian regulator placing any reliance on an ECAPM?

**Réponse :**

- a. While most of the empirical studies reported in Appendix A rely on short-term Treasury securities yield as proxy for the risk-free rate, the two studies reported on pages 8-9 of Appendix A are performed using the yield on long-term Treasury securities. Dr. Morin points out that the Security Market Line using the long-term risk-free rate has a higher intercept and a flatter slope than the Security Market Line using the short-term risk-free rate. Therefore, because the use of the long-term Treasury yield as a proxy for the risk-

free rate partially incorporates the desired effect of using the ECAPM, Dr. Morin has relied on an alpha value in the lower portion of the observed range to counter this effect.

- b. It is confirmed. However using a risk-free rate of 1% in implementing the CAPM or the ECAPM would produce ROE results that are less than 6% and make little economic sense.
- c. According to the latest Morningstar Valuation Yearbook, 2011 edition, long government bond returns over Treasury bill returns for the 1926-2011 period was 2.2% in the U.S. The corresponding figure for Canada is 1.8% over the 1926-2007 period according to Brealey, Myers, Marcus, Maynes, and Mitra Fundamentals of Corporate Finance, 4<sup>th</sup> Canadian edition.
- d. Dr. Morin is not aware of any regulatory that has formally endorsed the ECAPM although he is aware of several regulators in the U.S. that have placed reliance on the ECAPM.

**Question :**

**1.17** ECAPM equation page 42

- a. Can Dr. Morin confirm that his equation on page 42 can be simplified to the following simply by factoring the market risk premium, if he can not so confirm please explain why not:

$$K = R_F + (0.25 + 0.75 * \beta)(R_M - R_F)$$

- b. Can Dr. Morin confirm that his ECAPM simply takes the already adjusted beta coefficient and then adjusts it again, so the adjusted beta of 0.70 becomes a “doubly adjusted” beta of 0.775? If not please explain why not.

**Réponse :**

- a. As a matter of pure arithmetic, this is correct. See answer (b) below.
- b. The question implies that the use of “adjusted” betas with an Empirical CAPM analysis double-counts the effect of changing the slope of the capital market line. Contrary to such suggestion, the Empirical CAPM is not an adjustment (increase or decrease) in beta. Instead, the Empirical CAPM is a formal recognition of the fact that empirical evidence demonstrates that the observed risk-return tradeoff is flatter than predicted by the CAPM.

The Empirical CAPM and the use of adjusted betas comprise two separate features of asset pricing. Assuming *arguendo* a company’s beta is estimated accurately, the CAPM will still understate the return for low-beta stocks. Furthermore, if a company’s beta is understated, the Empirical CAPM will also understate the return for low-beta stocks. Both adjustments are necessary.



The graph on page 42 of Dr. Morin's testimony demonstrates that the Empirical CAPM is a return (vertical axis) adjustment and not a beta (horizontal axis) adjustment. Moreover, the use of adjusted betas compensates for interest rate sensitivity of utility stocks not captured by unadjusted betas.

**Question :**

**1.18** Experienced utility risk premium estimates, page 43 on

- a. Please provide the average market to book ratio for each year since 1930 for the US utility data in Appendix C, page 6 referred to as RAM-3.
- b. Please provide all theoretical justification for applying a US risk premium to a Canadian forecast long term risk free rate.
- c. Please add a time variable starting at 1 for 1932 and provide a simple regression model estimate of the utility risk premium estimated in Appendix C, page 6 against the time variable and report the results plus the forecast by inserting T=80 for the test year. Alternatively would Dr. Morin confirm that the forecast utility risk premium using this model is 3.03% which is 2.5% less than the average he reports.
- d. Would Dr. Morin provide the source of the data and confirm that it is for large utility holding companies?
- e. Would Dr. Morin confirm that regulation has reduced utility risk since 1932 by using forward test years, removing the commodity component of gas/electricity costs and unbundling? If it is Dr. Morin's view that there has been no decline in utility risk since 1932 in the US, is it also his judgement that this also applies to Canadian utilities?
- f. Please confirm that if there has been increased regulatory protection then a reduction in the required risk premium that has not been accompanied by a reduction in the allowed ROE would lead to capital gains and higher experienced utility risk premia, if not why not?

**Réponse :**

- a. Dr. Morin does not have the requested information and nor did he rely on such information to arrive at his recommendation.
- b. The US risk premium serves as one of several proxies for the risk premium prevailing in the Canadian utility industry.
- c. Dr. Morin did not perform such a calculation or rely on such a model. To the extent that the historical risk premium estimated follows what is known in statistics as a random walk, one expects the equity risk premium to remain at its historical mean. The best

estimate of the future risk premium is the historical mean. If there is no evidence that the market price of risk or the amount of risk in common stocks has changed over time, that is, if there is no significant serial correlation in the successive risk premiums from year to year, which there is not, it is reasonable to assume that these quantities will remain stable in the future.

- d. The source data is for the companies that make up the S&P Utility Index, and the bond yields are from Morningstar. The companies in the index are necessarily utility holding companies whose shares are publicly-traded.
- e. This is not confirmed. Dr. Morin's view is that utility risks have escalated over time. While some elements of risk have been mitigated by relying on forward test years, reducing the commodity component of gas/electricity costs, and other means, other risks have surfaced and intensified over the years, such as competition, deregulation, restructuring, unbundling, construction risks, environmental compliance risks, and in some cases regulatory risks. One only has to observe the steady decline in utility bond ratings over time from the AA level to the Baa level to confirm such a decline in utility risks over time. It is also interesting to note the steady increase in allowed risk premium over time documented on page 48 of Dr. Morin's testimony.
- f. It is not confirmed. The reverse hypothesis is equally, if not, supportable. If there has been increased risk over time as discussed above, then an increase in the required risk premium that has not been accompanied by an increase in the allowed ROE would lead to capital losses and lower experienced risk premia.

**Question :**

**1.19** Allowed utility ROE risk premiums in the US, page 40-41

- a. Please confirm that the utility risk premium from Appendix C, page 9 referred to as RAM-5 is 5.2% and less than the 5.5% historic estimated risk premium that Dr. Morin believes is valid as a going forward risk premium from the data in Appendix C, page 7.
- b. Please confirm that all else constant if the allowed utility risk premium of 5.2% is less than the true utility risk premium of 5.5% then utility investors would be unhappy and the utility shares would sell at a discount to their book value, since the fair return is less than that allowed. If Dr. Morin can not so confirm please explain why not in detail.
- c. Please provide the average market to book ratios of the firms covered in the data in Appendix C, page 9.

**Réponse :**

- a. It is not confirmed. The two estimates are simply two different estimates of the "true" utility going forward risk premium, one relying on regulatory decisions and the other on historical return data. Dr. Morin's final risk premium estimates of equity capital costs are

summarized on page 50 and are based on three different perspectives; the three ROE estimates are 10.2%, 10.4%, and 10.6%, and average 10.4%.

- b. It is not confirmed. First, Dr. Morin does not agree that the “true” risk premium is 5.5%. The latter is one of many estimates. Second, there are myriad factors that affect utility stock prices, including the overall market, inflation, interest rates, risk aversion, monetary/fiscal policies and growth expectations to name some. Third, even if such factors were held constant, the utility shares would not necessarily sell at a market to book (M/B) ratio less than unity. It is inconceivable that utility M/B ratios would fall from their present level of approximately 1.4 to below 1.0 for a decrease in required return of 0.3% as the question suggests. Consider a stock with a prospective dividend of \$2.00, expected growth of 5%, and a required return of 10%. According to the standard DCF model, the stock should trade at \$40. With an increase in the risk premium of 0.3% that is from 5.2% to 5.5%, the required return becomes 10.3% and the stock now trades at \$37, a fall of 7.5%. Such a fall occurs regardless of the level of M/B ratio.
- c. Dr. Morin does not have the M/B ratios of some 560 companies involved in some 560 decisions going back to 1986, and nor is this information relevant or necessary to Dr. Morin’s recommended ROE.

**Question :**

**1.20** DCF Analysis, pages 50-54

- a. Dr. Morin uses analyst growth expectations for use in the constant perpetual Gordon growth model on page 52, please confirm that these growth forecasts are for earnings and not dividends and provide the time horizon for the growth estimates.
- b. Please confirm that there is an extensive literature supporting the observation that analyst growth forecasts are optimistic, i.e., biased high estimates of the actual earnings growth achieved.
- c. For the US utilities in Appendix C, pages 10-13 referred to as RAM -6 and RAM-7 please provide the actual dividend per share and earnings per share for each year since 1990 and indicate the average growth rate relative to the growth rate in US GDP during that period (use both arithmetic and compound growth rates).
- d. Please indicate whether or not you agree that it is normal practise, such as before the FERC in the US, when doing a DCF analysis such as contained in these pages to assume the analyst growth rate for a 5 year horizon and then that growth tapers off to the forecast long run GDP growth rate. Please explain why Dr. Morin has not followed this practise but instead assumed that growth goes on forever.
- e. Please provide the number of analysts providing the growth forecasts for each company in Appendix C, page 10 and page 13.

**Réponse :**

- a. It is confirmed. The time horizon is five years.
- b. While there is an extensive literature supporting the over-optimism of analyst growth forecasts, at least for the unregulated sector, Dr. Morin disagrees that this criticism applies to the utility sector. Using virtually all publicly available analyst earnings forecasts for a large sample of companies (over 23,000 individual forecasts by 100 analyst firms), a study by Lys and Sohn shows that stock returns respond to individual analyst earnings forecasts, even when they are closely preceded by earnings forecasts made by other analysts or by corporate accounting disclosures<sup>1</sup>. Using actual and IBES data from 1982-1995, a study by Easterwood and Nutt regresses the analysts' forecast errors against either historical earnings changes or analysts' forecasting errors in the prior years.<sup>2</sup> Results show that analysts tend to under-react to negative earnings information but overreact to positive earnings information.

Academic papers have also found that companies with less variability in their earnings than the average traded company (like utilities) tend to have more accurate forecasts. This suggests analyst forecasts for the utility industry are likely to be more accurate and less prone to potential bias when compared to forecasts for other industries. Consistent with this notion, Capstaff et al. in 2001 found that "analysts' forecasts for the health care and public utilities were the most accurate... part of the explanation may be the low earnings volatility..."<sup>3</sup> Similarly, Markov and Tamayo (2006) found that the autocorrelation in analyst forecast errors for the utilities industry is close to zero - "This is not surprising. The quarterly earnings process for a utility firm is more likely to be stationary and present better opportunities for learning than other firms."<sup>4</sup> Thus, analysts are more likely to make accurate forecasts for utilities than for other industries. It is therefore important to not over-emphasize the general academic research, which tends to look to all sorts of different companies. This is especially true since much of the empirical literature dates prior to the efforts of the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE) to reform the influence of investment bankers on analysts.

It is possible that even if the analysts' forecasts are biased, they are still closer to future earnings than the historical averages, although this hypothesis has not been tested in the recent studies. One way to assess the concern that analysts' forecasts may be biased upward is to incorporate into the analysis the growth forecasts of independent research firms, such as Value Line, in addition to the analyst consensus forecast. Unlike investment banking firms and stock brokerage firms, independent research firms such as Value Line have no incentive to distort earnings growth estimates in order to bolster interest in common stocks.

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<sup>1</sup>Thomas Lys & Sungkyu Sohn, *The Association Between Revisions of Financial Analysts' Earnings Forecasts and Security Price Changes*, 13 *Jrnl of Acctg. and Economics* 341 (1990).

<sup>2</sup>John Easterwood & Stacey Nutt, *Inefficiency in Analysts' Earnings Forecasts: Systematic Misreaction or Systematic Optimism?*, 54 *The Journal of Finance* 1777 (1999).

<sup>3</sup>J. Capstaff, K. Paudyal and W. Rees, *A Comparative Analysis of Earnings Forecasts in Europe*, *Journal of Business Finance & Accounting* 28, page 548 (2001); p. 548.

<sup>4</sup>S. Markov and A. Tamayo, *Predictability in Financial Analyst Forecast Errors: Learning or Irrationality?* *Journal of Accounting Research* 44 (2006); p. 750.

In short, the magnitude of the optimism bias for large rate-regulated companies in stable segments of an industry is likely to be very small. Empirically, the severity of the optimism problem is unclear for regulated utilities, if a problem exists at all. It is interesting to note that Value Line forecasts for utility companies made by independent analysts with no incentive for over- or understating growth forecasts are not materially different from those published by analysts in security firms with incentives not based on forecast accuracy, and may in fact be more robust.

- c. This request is well beyond the scope of Dr. Morin's testimony. Dr. Morin did not rely on actual dividend/earnings data going back more than twenty years and nor did he rely on GDP growth rates going back twenty years. Providing the response to this request would require a very large amount of work involving a large amount of costly data to obtain. Dr. Morin seriously doubts the value of such an exercise and has placed no reliance at all on such data in arriving at his recommendation. Anyhow, such an extensive data mining exercise would prove redundant because historical growth patterns are already taken into account by analyst in making their forecasts. Dr. Morin did rely on forecasts of earnings.
- d. Dr. Morin has no problem with the implementation of the two-stage renditions of the DCF model, whereby the second stage growth is assumed to taper off to the forecast long run GDP growth rate. This procedure was unnecessary in this case since the average first-stage growth rate forecasts were reasonably close to the forecast GDP growth rate of approximately 5.5% - 6.0%, and would have produced similar results.
- e. This information is not available to Dr. Morin.

**Question :**

**1.21** Business risk differences between GMLP and US UHCs, pages 63-64

- a. Please confirm that the estimates on page 63 are almost entirely obtained from US UHCs, if not please weight each estimate by whether it is for the US or Canada and provide a summary weighted average of the Canadian content in Dr. Morin's estimates.
- b. Please indicate if Dr. Morin is aware of any regulator in Canada who has accepted that Canadian utilities have the same overall risk as US utilities and deserve the same ROE.
- c. Is it Dr. Morin's judgment that both S&P and Moody's regards the risk of US and Canadian utilities to be the same? If so please provide any documentation supporting this assumption.
- d. In terms of the 0.40% extra risk premium for GMLP, please indicate how this is based on observed beta differences when he has not estimated GMLP's beta?

- e. Why should the Regie accept Dr. Morin's *assumption* (page 64) of a beta difference for GMLP of 0.05, when there is no documentary evidence to support it?

**Réponse :**

- a. The estimates rely on both Canadian and US market data.
- b. Dr. Morin is not aware of such a position.
- c. No, they do not judge the investment risks from a bondholder's perspective to be identical.
- d. Based on several proxies, GMLP's beta is estimated to be 0.70 as discussed extensively on page 27-28 of his testimony.
- e. Dr. Morin's 40 basis points adjustment is based on three considerations: 1) observed beta differentials, 2) differential common equity ratio requirements for S&P Business Risk Score, and 3) application of informed judgment. The observed beta differential of 0.05 is based on the observed spread in utility betas as measured by the standard deviation. The latter varies from 0.06 to 0.10 for the four proxy groups of utilities shown on pages 1-4 of Appendix C. It is reasonable to assume that GMLP's beta risk would be one standard deviation higher than the average risk utility, that is, 0.06 – 0.10 higher. For reasons of conservatism, Dr. Morin assumed a differential beta of 0.05.

**Question :**

**1.22** Bond yields and S&P Business Risk Assessment, page 65

- a. Please provide a table of the monthly yields on the long term debt that is allocated to Gaz Metro from January 2007 with the corresponding yield on A rated Canadian issues, the Bloomberg A rated utility index and the long Canada benchmark bond.
- b. Please provide a table showing S&P's current business risk ranking and the corresponding current bond rating for all US utilities and discuss what the typical business risk ranking is for each bond rating category from BB to AA.
- c. Given b) above would Dr. Morin agree that the typical S&P business risk ranking is excellent even for US utilities with sub investment grade bond ratings?
- d. Given b) above why would S&P rate a US utility BB when it also rates it as having an excellent business risk ranking?
- e. Please indicate whether any of the US utilities in b) above have a 7.5% deemed preferred share component?

- f. Please provide any evidentiary support for the claim that GMLP is perceived by investors as a “slightly above average risk energy utility” and whether this assessment is relative to US or Canadian benchmarks.

**Réponse :**

- a. See attached Excel file.
- b. See attached S&P document. As seen from the document, the “excellent” designation applies to most utilities. According to S&P, approximately 140 of the nearly 200 utilities possess the “excellent” appellation. The “excellent” designation is intended to show that relative to other industries, the utility industry generally possesses an excellent business risk profile.
- c. See response to (b).
- d. It is conceivable that S&P would rate a utility BB when it also rates it as “excellent” from a business risk point of view because the utility is highly leveraged, or “aggressively leveraged” as S&P calls it.
- e. Dr. Morin does not have access to the actual or deemed preferred equity data for some 200 utilities in the U.S. nor does he considers this relevant. The actual amount of preferred equity in US utility capital structures is very small, almost zero. With regards to the deemed preferred component, it is almost non-existent in the US, as most regulators rely on actual capital structures which have very little, if any, preferred equity.
- f. The statement is applicable to both US and Canadian utilities. As has been consistently recognized by the Regie in several past rate decisions, GMLP possesses higher than average investment risk. GMLP’s relative investment risks are fully discussed on pages 65-68 of Dr. Morin’s testimony.

**Question :**

**1.23 GMLP Business risk discussion pages 65-68**

- a. The Regie conducted a thorough examination of Gaz Metro’s business risk in 2007 and confirmed in D-2009-156 (paragraph 282) that it felt that risk had not changed. For each of the risks itemised on pages 65-68 please indicate what has changed since 2009 and fully explain why.
- b. Dr. Morin assesses Gaz Metro’s business risk to be higher than for a benchmark utility would he agree that this higher business risk can be offset by either a higher allowed ROE, a higher common equity ratio or some combination of both, but that it is important not to double count any adjustment?

- c. Please indicate where in his analysis he has taken account the deemed 7.5% preferred share component and would he agree that deeming preferred shares does not pose the same financial risk as actually having them. If not, why not?

**Réponse :**

- a. Gaz Métro, appuyée par la preuve du Dr Morin, considère que la forte concurrence de l'électricité au Québec et la composition de sa clientèle sont quelques-uns des éléments qui démontrent un risque d'affaires plus élevé par rapport aux distributeurs repères.

Dans le cadre des Causes tarifaires 2008 et 2010, la Régie, après de longs et coûteux débats d'experts, a conclu que Gaz Métro avait un risque plus élevé que les distributeurs repères. Les constats qui ont justifiés les conclusions de la Régie demeurent et Gaz Métro n'a pas cru justifié de réinvestir des sommes importantes afin de débattre à nouveau de cette question dans la cause actuelle.

- b. Yes, it is agreed.
- c. See response to Question 1.2.

**Question :**

**1.24** Deemed capital structures of Canadian LDCs, pages 70-76

- a. For each Canadian LDC listed in Appendix C, page 14, please provide the amount of debt and shareholder's equity used for rate making purposes.
- b. Please provide a weighted average common equity ratio using the regulated shareholder's equity for each of the utilities as weights.
- c. Please provide the DBRS bond ratings for each of the Canadian utilities in Appendix C, page 14.
- d. Please confirm that the BCUC increased the former Terasen Gas (BC Gas) common equity ratio from 33% to 35% and then 40% due to the significant increase in competition from BC Hydro and the relative decline in traditional housing (which use gas) and increased condo units (that use electricity).
- e. Please confirm that the "peers" for Gaz Metro are normally Terasen Gas, ATCO Gas, Union Gas and Enbridge Gas Distribution? If not please explain which other gas LDCs would be regarded as comparable to Gaz Metro.
- f. Please confirm that most US regulators do not "deem" common equity ratios but leave this to the discretion of management unless it is regarded as egregious? If Dr. Morin disagrees please provide specific examples of US regulators that deem common equity for ratemaking purposes in the same way as Canadian regulators with their corresponding equity ratios.



- g. Please provide the S&P bond ratings for the US utilities with ROE data in Appendix C pages 15-16 and confirm that these equity ratios were those set by regulators on which their revenue requirements were based, consistent with regulatory practice in Canada.
- h. Please provide a breakdown of the bond rating by rating class from sub BB to AAA for the full universe of US utilities and comment on whether Dr. Morin's target of a strong "A" bond rating is met in practice.

**Réponse :**

- a. La preuve de Gaz Métro (Gaz Métro-7, Document 11) se réfère uniquement aux pourcentages d'équité présentés à l'annexe 1 de la pièce Gaz Métro-7, Document 11.
- b. La preuve de Gaz Métro (Gaz Métro-7, Document 11) se réfère uniquement aux pourcentages d'équité présentés à l'annexe 1 de la pièce Gaz Métro-7, Document 11.
- c. The DBRS bond ratings are available publicly on the DBRS website : [www.dbrs.com](http://www.dbrs.com)
- d. Please refer to IR 5.5 from ACIG to Gaz Métro on business risk.
- e. None of the companies cited in the question are publicly-traded pure-plays for GMLP. Terasen is owned by Fortis, ATCO Gas is a subsidiary of Canadian Utilities, Union Gas is a Spectra Energy company created in 2007 from the natural gas business of Duke Energy which in turn had previously acquired Westcoast Energy, and Enbridge Gas Distribution is owned by Enbridge. Dr. Morin considers the four groups of utilities described on pages 1-4 of Appendix C as reasonable "normal" proxies for GMLP.
- f. It is confirmed.
- g. See the S&P document attached in response to 22 (b) for utility bond ratings. The source document on which the aggregate data of Appendix C pages 15-16 is based does not provide the specific utility cases on which the data are based. There are nearly 600 decisions reported. It would be computationally burdensome and costly to produce individual company data on 600 decisions over the 1997-2010 period. Dr. Morin does confirm that the equity ratios reported were set by regulators.
- h. See the attached "ratings roundup" Moody's document "Regulated Electric and Gas Utilities," for the distribution of utility bond ratings by rating category.

**Question :**

**1.25** Impact of capital costs on revenue requirement, page 78

- a. Please provide an estimate of the pre-tax cost capital for Gaz Metro (interest, income taxes and net income) with Dr. Morin's recommended capital structure and ROE, the current allowed financial parameters assuming the existing ROE formula and Dr. Morin's recommended ROE with the existing common equity ratio.
- b. Would Dr. Morin agree that an insufficiently leveraged operating company allows the holding company to issue more debt and capture the debt tax shields at the holding company level, rather than being passed onto ratepayers? If not please explain in detail why not.
- c. Would Dr. Morin confirm that the double leverage phenomenon is common for Canadian utilities and that the operating company debt, for example of EGDI or Enbridge Pipelines, trades on lower yields than that of their parent Enbridge Inc?

**Réponse :**

- a. Pre-tax cost of capital for Gaz Metro with the recommended structure and ROE is 9.65 %. With the current structure and 9.09 % ROE, pre-tax cost of capital would be 9.01 %. Finally, with the current structure but proposed ROE, cost of capital would be 9.41 %.
- b. Dr. Morin disagrees. It is inconceivable that an operating utility company with too much equity would not be imputed a more leveraged capital structure by the regulator in order to minimize revenue requirements and achieve a cost-efficient capital structure.
- c. Under the double leverage approach, the operating subsidiary company's equity capital is traced to its source, namely the parent's debt and equity capital. The cost of equity to the operating subsidiary is then the overall weighted average of capital to the parent, since the equity capital is said to have been raised by the parent through a mixture of debt and equity. The parent's composite capital cost is imputed to the subsidiary's equity. Dr. Morin is unaware of any Canadian regulator which explicitly applies this approach to regulating Canadian utility companies.

The double leverage approach has been largely abandoned in view of its serious conceptual and practical limitations and violations of basic notions of finance, economics, and fairness. The assumptions which underlie its use are questionable, if not unrealistic. Chapter 20 of Dr. Morin's book The New Regulatory Finance contains a complete discussion of the ill-fated double leverage approach. The double leverage approach should not be used in regulatory proceedings and is not currently being used to the best of Dr. Morin's knowledge in Canada.

**Question :**

**1.26** ROE proportionality factor page 79

- a. Please provide the underlying data for the regression estimate reported on page 79.
- b. Please re-estimate the regression model for the period 1992-2010.
- c. Please provide a graph of the interest rates for the entire period 1986-2010 and discuss whether there was anything unusual about the period 1986-1992 and whether Dr. Morin considers such a relationship to represent the future path of interest rates in both the US and Canada.
- d. In terms of the study filed by Dr. Morin in 1998, please discuss what weight the Regie should apply to a study that is now 13 years old and based on data from this period of very high interest rates.
- e. In terms of the ROE formula on page 81, please provide any documentation to support the assumption that equity returns vary with 50% of the corporate spread.

**Réponse :**

- a. See attached document entitled Allowed Risk Premium vs Yield.
- b. The requested regression can be easily performed via Excel from the data provided in (a).
- c. The interest rate data are shown on the attached document provided in (a). There is a clear downward trend in interest rates over the 1986-2010 period. With regards to the future path of interest rates, Dr. Morin does not engage in the business of forecasting interest rates in the US and Canada.
- d. The reason why the study is based on the 1980-1994 period is that after 1994, most utility allowed ROEs in Canada were based on predetermined formula approaches. It is interesting to note that in Canada, an almost identical relationship to that of the US between ROE decisions and the contemporaneous level of interest rates prevails.
- e. According to Dr. Morin's judgment, the California adjustment mechanism which adjusts the ROE by 50% of the change in utility bond yields (see page 16 of the California generic decision, *Decision Establishing a Multi-Year Cost of Capital Mechanism for the Major Energy Utilities*, May 29, 2008.) and the OEB adjustment mechanism (see OEB Decision EB-2009-0084) which is virtually identical to the California mechanism provide a reasonable method of allowing for changes in utility risk as well as changes in interest rate levels.

**Question :**

1.27 Appendix A

- a. In terms of the zero beta model on page 6, please confirm that the Rf in brackets should be the return on the zero beta portfolio.
- b. In terms of Black's zero beta model please confirm that using the forecast yield on the long Canada bond automatically increases the "risk-free" rate over the 30 day Treasury bill rate and is consistent with Black's zero beta model.
- c. In terms of the alpha factor that Dr. Morin suggests is 2.0%, would Dr. Morin agree that the average difference between the 30 day treasury bill rate and the long bond rate has averaged 1.30%? If not please provide the estimates for the period 1926-1984 discussed on page 7 with the underlying data.
- d. Would Dr. Morin accept that the current difference between the Treasury bill rate and the long Canada bond is approximately 3.0% and at least 1% greater than his alpha factor?
- e. Please confirm that the Harris et al study on page 11 has the utility risk premium at 4.15% and the observed actual beta at 0.57.
- f. Please confirm that the Harris et al study used analyst earnings growth estimates in the DCF estimates and to the extent that these overestimate actual dividend growth estimates their DCF estimates and risk premium estimates are biased high. If not why not.
- g. Please re-estimate the ECAPM values on pages 13-14 with the Harris et al utility unadjusted beta of 0.57.

**Réponse :**

- a. It is confirmed.
- b. It is confirmed.
- c. It is confirmed.
- d. It is confirmed.
- e. It is confirmed.
- f. It is agreed. See Dr. Morin's response to Request 1.20 (b) on the issue of analyst forecasts over-optimism.
- g. See Dr. Morin's discussion of unadjusted betas in response to Request 1.10 (b). Using an unadjusted beta of 0.57, the cost of capital is determined as follows:

$$\begin{aligned} K &= R_F + \alpha + \beta (MRP - \alpha) \\ K &= 5\% + 2\% + 0.57(7\% - 2\%) \\ &= 9.85\% \end{aligned}$$

The latter estimate is in fact Dr. Morin's ROE recommendation with a common equity ratio of 42.5%. Using the second variation of the ECAPM, virtually the same

result is obtained:

$$\begin{aligned} K &= R_f + 0.25 \text{ MRP} + 0.75 \beta \text{MRP} \\ K &= 5\% + 0.25 \times 7\% + 0.75 \times 0.57 \times 7\% \\ &= 9.8\% \end{aligned}$$

**Société en commandite Gaz Métro  
Cause tarifaire 2012, R-3752-2011**

**2007-01-01**

Maturity Date	GZMCN 5.4 04/15/13 Corp 2013-04-15			GZMCN 10.45 10/16 Corp 2016-10-31			GZMCN 4.93 06/19 Corp 2019-06-18			
	YLD_YTM_MID	Taux Utilité A	Taux Govt	YLD_YTM_MID	Taux Utilité A	Taux Govt	YLD_YTM_MID	Taux Utilité A	Taux Govt	
1	2007-01-31	#N/A	N/A	4,734	4,698	4,137	#N/A	N/A		
2	2007-02-28	#N/A	N/A	4,59	4,551	3,974	#N/A	N/A		
3	2007-03-30	#N/A	N/A	4,679	4,652	4,046	#N/A	N/A		
4	2007-04-30	#N/A	N/A	4,727	4,704	4,128	#N/A	N/A		
5	2007-05-31	#N/A	N/A	5,07	5,043	4,514	#N/A	N/A		
6	2007-06-29	#N/A	N/A	5,177	5,123	4,566	#N/A	N/A		
7	2007-07-31	#N/A	N/A	5,206	5,184	4,545	#N/A	N/A		
8	2007-08-31	#N/A	N/A	5,205	5,102	4,390	#N/A	N/A		
9	2007-09-28	#N/A	N/A	5,205	5,101	4,273	#N/A	N/A		
10	2007-10-31	#N/A	N/A	5,205	5,072	4,240	#N/A	N/A		
11	2007-11-30	#N/A	N/A	4,963	4,775	3,881	#N/A	N/A		
12	2007-12-31	#N/A	N/A	5,062	4,813	3,919	#N/A	N/A		
13	2008-01-31	#N/A	N/A	4,867	4,752	3,669	#N/A	N/A		
14	2008-02-29	#N/A	N/A	4,837	4,521	3,347	#N/A	N/A		
15	2008-03-31	#N/A	N/A	4,614	4,341	3,106	#N/A	N/A		
16	2008-04-30	#N/A	N/A	4,676	4,557	3,235	#N/A	N/A		
17	2008-05-30	#N/A	N/A	4,749	4,741	3,417	#N/A	N/A		
18	2008-06-30	#N/A	N/A	4,749	4,870	3,525	#N/A	N/A		
19	2008-07-31	#N/A	N/A	4,749	4,772	3,452	#N/A	N/A		
20	2008-08-29	#N/A	N/A	4,749	4,694	3,248	#N/A	N/A		
21	2008-09-30	#N/A	N/A	4,749	5,102	3,470	#N/A	N/A		
22	2008-10-31	5,282	4,321	2,639	6,103	5,427	3,264	#N/A	N/A	
23	2008-11-28	5,172	4,333	2,242	6,103	5,053	2,842	#N/A	N/A	
24	2008-12-31	4,265	3,793	1,508	6,103	4,511	2,114	#N/A	N/A	
25	2009-01-30	4,397	4,109	1,898	6,103	4,761	2,478	#N/A	N/A	
26	2009-02-27	4,659	3,959	1,887	6,103	4,665	2,486	#N/A	N/A	
27	2009-03-31	4,659	3,815	1,611	6,103	4,535	2,210	#N/A	N/A	
28	2009-04-30	4,659	3,323	1,406	5,162	4,710	2,523	#N/A	N/A	
29	2009-05-29	3,658	3,356	1,802	5,162	4,662	2,897	#N/A	N/A	
30	2009-06-30	3,658	3,251	1,851	5,162	4,384	2,901	4,741	4,809	2,901
31	2009-07-31	3,553	3,021	1,890	5,162	4,398	3,018	4,836	4,843	3,018
32	2009-08-31	3,172	2,849	1,764	5,162	4,210	2,883	4,506	4,665	2,883
33	2009-09-30	3,128	2,657	1,896	5,162	4,041	2,821	4,515	4,474	2,821
34	2009-10-30	3,108	2,628	1,853	4,163	4,121	2,949	4,516	4,543	2,949
35	2009-11-30	3,108	2,397	1,573	4,163	3,286	2,371	4,442	4,384	2,697
36	2009-12-31	2,829	2,620	1,922	3,916	3,565	2,768	4,442	4,719	3,100
37	2010-01-29	2,829	2,371	1,635	3,916	3,239	2,458	4,321	4,406	2,805
38	2010-02-26	2,829	2,390	1,595	3,916	3,259	2,491	4,33	4,401	2,853
39	2010-03-31	2,829	2,817	2,032	3,916	3,541	2,899	4,33	4,576	3,111
40	2010-04-30	3,134	2,490	1,908	4,074	3,691	3,002	4,33	4,575	3,353
41	2010-05-31	3,134	2,621	1,823	3,974	3,751	2,743	4,254	4,539	3,039
42	2010-06-30	2,946	2,116	1,393	3,974	3,299	2,325	4,254	4,023	2,746
43	2010-07-30	2,546	2,132	1,469	3,974	3,309	2,304	4,174	4,044	2,711
44	2010-08-31	2,144	1,941	1,206	3,367	3,019	2,043	3,814	3,702	2,323
45	2010-09-30	2,196	2,094	1,378	3,289	3,003	2,025	3,774	3,682	2,304
46	2010-10-29	2,239	2,023	1,414	3,259	2,910	1,975	3,725	3,655	2,294
47	2010-11-30	2,54	2,246	1,615	3,619	3,243	2,343	3,949	3,943	2,622
48	2010-12-31	2,463	2,278	1,680	3,754	3,300	2,420	3,957	3,970	2,701
49	2011-01-31	2,385	2,174	1,667	3,692	3,377	2,499	4,071	4,110	2,800
50	2011-02-28	2,519	2,389	1,844	3,692	3,522	2,632	4,074	4,120	2,894
51	2011-03-31	2,467	2,440	1,831	3,711	3,628	2,774	4,137	4,205	2,942
52	2011-04-29	2,356	1,824	1,384	3,539	3,458	2,581	3,94	4,043	2,768
53	2011-05-31	2,184	1,678	1,255	3,305	3,239	2,348	3,675	3,890	2,710



**GZMCN 7.05**

10/30 Corp

2030-10-30

YLD_YTM_MID	Taux	
	Utilité A	Taux Govt
5,161	5,137	4,267
5,049	5,011	4,141
5,159	5,126	4,239
5,164	5,164	4,237
5,361	5,376	4,448
5,474	5,491	4,548
5,531	5,536	4,527
5,518	5,557	4,488
5,694	5,594	4,460
5,61	5,501	4,405
5,509	5,455	4,179
5,316	5,376	4,128
5,514	5,453	4,183
5,534	5,373	4,064
5,411	5,331	3,927
5,58	5,506	4,076
5,65	5,569	4,153
5,593	5,620	4,134
5,675	5,623	4,149
5,672	5,668	4,066
6,251	6,074	4,303
7,112	6,723	4,409
7,138	6,757	4,070
6,832	6,397	3,555
7,13	6,685	3,913
6,785	6,624	3,839
6,569	6,397	3,617
6,901	6,434	3,891
5,943	6,127	4,064
5,79	5,628	3,966
5,527	5,605	4,063
5,527	5,397	4,006
5,527	5,343	3,945
5,527	5,404	4,022
5,527	5,323	3,941
5,527	5,621	4,186
5,476	5,387	3,993
5,433	5,447	4,033
5,365	5,462	4,072
5,321	5,381	4,031
5,293	5,385	3,725
5,1	5,152	3,611
5,12	5,183	3,670
4,904	4,933	3,398
4,711	4,807	3,313
4,773	4,831	3,346
4,924	4,849	3,061
5,202	4,840	3,122
5,202	4,982	3,275
5,202	4,950	3,299
5,122	5,046	3,350
5,071	4,947	3,205
4,868	4,738	3,074

**GZMCN 6.3**

10/33 Corp

2033-10-31

YLD_YTM_MID	Taux	
	Utilité A	Taux Govt
5,133	5,156	4,267
5,044	5,030	4,141
5,175	5,153	4,239
5,146	5,159	4,237
5,362	5,361	4,448
5,455	5,482	4,548
5,504	5,524	4,527
5,483	5,576	4,488
5,554	5,627	4,460
5,459	5,484	4,405
5,449	5,452	4,179
5,322	5,363	4,128
5,504	5,503	4,183
5,533	5,467	4,064
5,438	5,381	3,927
5,59	5,557	4,076
5,625	5,615	4,153
5,598	5,649	4,134
5,623	5,646	4,149
5,74	5,726	4,066
6,238	6,203	4,303
7,346	6,810	4,409
6,303	6,757	4,070
6,895	6,397	3,555
7,089	6,685	3,913
7,041	6,624	3,839
6,844	6,397	3,617
6,439	6,434	3,891
6,353	6,127	4,064
5,539	5,628	3,966
5,812	5,605	4,063
5,35	5,397	4,006
5,34	5,343	3,945
5,407	5,404	4,022
5,389	5,323	3,941
5,613	5,621	4,186
5,41	5,387	3,993
5,517	5,447	4,033
5,312	5,462	4,072
5,331	5,381	4,031
5,298	5,385	3,725
5,162	5,152	3,611
5,109	5,183	3,670
4,984	4,933	3,398
4,735	4,807	3,313
4,802	4,831	3,346
4,953	4,942	3,471
5,052	4,918	3,496
5,237	5,086	3,704
5,043	4,996	3,676
5,125	5,131	3,782
5,071	5,085	3,717
4,861	4,857	3,492

**GZMCN 5.7**

07/36 Corp

2036-07-10

YLD_YTM_MID	Taux	
	Utilité A	Taux Govt
5,202	5,156	4,267
5,053	5,030	4,141
5,173	5,153	4,239
5,213	5,159	4,237
5,39	5,361	4,448
5,521	5,482	4,548
5,497	5,524	4,527
5,495	5,576	4,488
5,507	5,627	4,460
5,418	5,484	4,405
5,199	5,452	4,179
5,305	5,363	4,128
5,52	5,503	4,183
5,383	5,467	4,064
5,261	5,381	3,927
5,588	5,557	4,076
5,588	5,615	4,153
5,801	5,649	4,134
5,898	5,646	4,149
5,84	5,726	4,066
6,156	6,203	4,303
7,375	6,810	4,409
7,178	6,817	4,070
6,817	6,489	3,555
7,093	6,734	3,913
6,975	6,691	3,839
6,795	6,420	3,617
7,05	6,459	3,891
6,172	6,145	4,064
5,53	5,637	3,966
5,374	5,593	4,063
5,328	5,354	4,006
5,413	5,319	3,945
5,492	5,384	4,022
5,411	5,338	3,941
5,643	5,626	4,186
5,353	5,367	3,993
5,436	5,435	4,033
5,298	5,430	4,072
5,346	5,336	4,031
5,304	5,369	3,725
5,196	5,166	3,611
5,193	5,193	3,670
4,971	4,952	3,398
4,924	4,829	3,313
4,996	4,906	3,346
5,086	4,954	3,471
5,203	4,960	3,496
5,125	5,108	3,704
5,042	5,015	3,676
5,14	5,151	3,782
5,125	5,112	3,717
4,864	4,901	3,492



Dettes Gaz Métro

	<b>2008-oct-14</b>	<b>2009-juin-18</b>	<b>2006-juil-10</b>	<b>2000-oct-26</b>	<b>2003-oct-31</b>
<b>Issue Date</b>	<b>2008-oct-14</b>	<b>2009-juin-18</b>	<b>2006-juil-10</b>	<b>2000-oct-26</b>	<b>2003-oct-31</b>
<b>Maturity Date</b>	<b>2013-avr-15</b>	<b>2019-juin-18</b>	<b>2021-juil-12</b>	<b>2030-oct-30</b>	<b>2033-oct-31</b>
<b># years</b>	4,5	10-janv-00	15-janv-00	30-janv-00	30-janv-00
<b>Amount ( M\$)</b>	150	100	150	125	125
<b>Price</b>	99,945	99,984	99.665	99.838	99.413
<b>Coupon rate (%)</b>	5,400	4,930	5,450	7,050	6,30 coupon
	5,414 (yield)	4,932 (yield)	5,483 (yield)		6,343 (yield)
<b>Spread over Canada</b>	260bps	140	77 bp	135.0 bp	95 bp
<b>Benchmark Canada</b>	interp. 3.75 jun/12 3.50 jun/13	interp. 3.75 jun/19 8.00 jun/23	4.000 jun/16	8.000 jun/27	5.750 jun/29
<b>Series</b>	<u>Série L</u>	<u>Série L</u>	<u>Série J</u>	<u>Série I</u>	<u>Série I</u>
<b>Tranche</b>		Tranche I	Tranche VI	Tranche I	

**STANDARD  
& POOR'S**

# Global Credit Portal

## RatingsDirect®

April 1, 2010

### Issuer Ranking:

## U.S. Regulated Electric Utilities, Strongest To Weakest

### Primary Credit Analyst:

John W Whitlock, New York (1) 212-438-7678; john\_whitlock@standardandpoors.com

## Issuer Ranking:

# U.S. Regulated Electric Utilities, Strongest To Weakest

Standard & Poor's Ratings Services expanded its business risk/financial matrix to better communicate our analytic opinions to the global credit market. Please see the May 27, 2009 article published on RatingsDirect titled "Criteria /Methodology: Business Risk/Financial Risk Matrix Expanded."

The following list contains Standard & Poor's ratings, outlooks, and business and financial profiles for companies with a primary regulated electric utility focus. This list reflects the current ratings and outlooks as of April 1, 2010. The rankings in each rating/outlook grouping (e.g., BBB+/Stable/--) are based on relative business risk.

A Standard & Poor's rating outlook assesses the potential direction of an issuer's long-term debt rating over the intermediate to longer term. In determining a rating outlook, we consider any changes in the economic and/or fundamental business conditions. An outlook is not necessarily a precursor of a rating change or future CreditWatch action. "Positive" indicates that we may raise a rating; "negative" means we may lower a rating; "stable" indicates that ratings will not likely change; and "developing" means we may raise or lower ratings.

We characterize utility business profiles as "excellent," "strong," "satisfactory," "fair," "weak," or "vulnerable" under the credit ratings methodology applied to all rated corporate entities at Standard & Poor's. To determine a utility's business profile, Standard & Poor's analyzes the following qualitative business or operating characteristics: markets and service area economy; competitive position; fuel and power supply; operations; asset concentration; regulation; and management. Issuer credit ratings, shown as long-term rating/outlook or CreditWatch/short-term rating, are local and foreign currency unless otherwise noted. A dash (--) indicates not rated.

For the related industry report card, please see "Industry Report Card: U.S. Regulated Electric Utilities Head Into 2010 With Familiar Concerns" published Dec. 28, 2009 on RatingsDirect.

### U.S. Regulated Electric Utilities

Company	Corporate credit rating*	Business profile	Financial profile
Madison Gas & Electric Co.	AA-/Stable/A-1+	Excellent	Intermediate
American Transmission Co.	A+/Stable/A-1	Excellent	Intermediate
Midwest Independent Transmission System Operator Inc.	A+/Stable/--	Excellent	Intermediate
NSTAR Electric Co.	A+/Stable/A-1	Excellent	Intermediate
NSTAR Gas Co.	A+/Stable/--	Excellent	Intermediate
NSTAR	A+/Stable/A-1	Excellent	Intermediate
California Independent System Operator Corp.	A/Stable/--	Excellent	Intermediate
KeySpan Energy Delivery Long Island	A/Stable/--	Excellent	Intermediate
KeySpan Energy Delivery New York	A/Stable/--	Excellent	Intermediate
Northern Natural Gas Co.	A/Stable/--	Excellent	Intermediate
Alabama Power Co.	A/Stable/A-1	Excellent	Intermediate
Georgia Power Co.	A/Stable/A-1	Excellent	Intermediate
Mississippi Power Co.	A/Stable/A-1	Excellent	Intermediate

*Issuer Ranking: U.S. Regulated Electric Utilities, Strongest To Weakest*

<b>U.S. Regulated Electric Utilities (cont.)</b>			
Gulf Power Co.	A/Stable/A-1	Excellent	Intermediate
Southern Co.	A/Stable/A-1	Excellent	Intermediate
Central Hudson Gas & Electric Corp.	A/Stable/--	Excellent	Significant
San Diego Gas & Electric Co.	A/Negative/A-1	Excellent	Intermediate
Duke Energy Indiana Inc.	A-/Positive/A-2	Excellent	Significant
Duke Energy Carolinas LLC	A-/Positive/A-2	Excellent	Significant
Duke Energy Ohio Inc.	A-/Positive/A-2	Excellent	Significant
Duke Energy Kentucky Inc.	A-/Positive/--	Excellent	Significant
Northern States Power Wisconsin	A-/Positive/--	Excellent	Intermediate
Cinergy Corp.	A-/Positive/A-2	Excellent	Significant
Duke Energy Corp.	A-/Positive/A-2	Excellent	Significant
Massachusetts Electric Co.	A-/Stable/A-2	Excellent	Significant
Narragansett Electric Co.	A-/Stable/A-2	Excellent	Significant
New England Power Co.	A-/Stable/A-2	Excellent	Significant
Connecticut Natural Gas Corp.	A-/Stable/--	Excellent	Intermediate
Southern Connecticut Gas Co.	A-/Stable/--	Excellent	Intermediate
Consolidated Edison Co. of New York Inc.	A-/Stable/A-2	Excellent	Significant
Orange and Rockland Utilities Inc.	A-/Stable/A-2	Excellent	Significant
Rockland Electric Co.	A-/Stable/--	Excellent	Significant
Virginia Electric & Power Co.	A-/Stable/A-2	Excellent	Significant
Florida Power & Light Co.	A-/Stable/A-2	Excellent	Intermediate
Dayton Power & Light Co.	A-/Stable/--	Excellent	Intermediate
Wisconsin Power & Light Co.	A-/Stable/A-2	Excellent	Intermediate
Wisconsin Gas LLC	A-/Stable/A-2	Excellent	Significant
Wisconsin Electric Power Co.	A-/Stable/A-2	Excellent	Significant
Wisconsin Public Service Corp.	A-/Stable/A-2	Excellent	Significant
Southern Indiana Gas & Electric Co.	A-/Stable/--	Excellent	Intermediate
Niagara Mohawk Power Corp.	A-/Stable/A-2	Excellent	Significant
Consolidated Edison Inc.	A-/Stable/A-2	Excellent	Significant
National Grid USA	A-/Stable/A-2	Excellent	Significant
PacifiCorp	A-/Stable/A-2	Excellent	Significant
DPL Inc.	A-/Stable/--	Excellent	Intermediate
MidAmerican Energy Co.	A-/Stable/A-2	Excellent	Significant
Dominion Resources Inc.	A-/Stable/A-2	Excellent	Significant
FPL Group Inc.	A-/Stable/--	Strong	Intermediate
Iberdrola USA	A-/Stable/A-2	Excellent	Aggressive
PPL Electric Utilities Corp.	A-/Negative/A-2	Excellent	Significant
Public Service Co. of Colorado	BBB+/Positive/A-2	Excellent	Significant
Northern States Power Co.	BBB+/Positive/A-2	Excellent	Significant
Southwestern Public Service Co.	BBB+/Positive/A-2	Excellent	Significant
Xcel Energy Inc.	BBB+/Positive/A-2	Excellent	Significant
Oncor Electric Delivery Co. LLC	BBB+/Stable/--	Excellent	Significant
Public Service Co. of North Carolina Inc.	BBB+/Stable/A-2	Excellent	Aggressive

Issuer Ranking: U.S. Regulated Electric Utilities, Strongest To Weakest

<b>U.S. Regulated Electric Utilities (cont.)</b>			
Southern California Edison Co.	BBB+/Stable/A-2	Excellent	Significant
Pacific Gas & Electric Co.	BBB+/Stable/A-2	Excellent	Significant
Peoples Gas Light & Coke Co. (The)	BBB+/Stable/A-2	Excellent	Significant
North Shore Gas Co.	BBB+/Stable/--	Excellent	Significant
Peoples Energy Corp.	BBB+/Stable/--	Excellent	Significant
Baltimore Gas & Electric Co.	BBB+/Stable/A-2	Excellent	Aggressive
The Berkshire Gas Co.	BBB+/Stable/--	Excellent	Aggressive
Central Maine Power Co.	BBB+/Stable/--	Excellent	Aggressive
South Carolina Electric & Gas Co.	BBB+/Stable/A-2	Excellent	Aggressive
Kentucky Utilities Co.	BBB+/Stable/A-2	Excellent	Aggressive
Louisville Gas & Electric Co.	BBB+/Stable/--	Excellent	Aggressive
Oklahoma Gas & Electric Co.	BBB+/Stable/A-2	Excellent	Significant
Interstate Power & Light Co.	BBB+/Stable/A-2	Excellent	Significant
New York State Electric & Gas Corp.	BBB+/Stable/A-2	Excellent	Aggressive
Wisconsin Energy Corp.	BBB+/Stable/A-2	Excellent	Aggressive
MidAmerican Energy Holdings Co.	BBB+/Stable/--	Excellent	Aggressive
SCANA Corp.	BBB+/Stable/--	Excellent	Aggressive
Alliant Energy Corp.	BBB+/Stable/A-2	Excellent	Significant
PG&E Corp.	BBB+/Stable/--	Excellent	Significant
E.ON U.S. LLC	BBB+/Stable/--	Excellent	Aggressive
Montana-Dakota Utilities Co.	BBB+/Stable/--	Strong	Intermediate
OGE Energy Corp.	BBB+/Stable/A-2	Strong	Significant
Integrus Energy Group Inc.	BBB+/Stable/A-2	Strong	Significant
Enogex LLC	BBB+/Stable/--	Fair	Significant
Florida Power Corp. d/b/a Progress Energy Florida Inc.	BBB+/Negative/A-2	Excellent	Aggressive
Carolina Power & Light Co. d/b/a Progress Energy Carolinas Inc.	BBB+/Negative/A-2	Excellent	Aggressive
Progress Energy Inc.	BBB+/Negative/A-2	Excellent	Aggressive
ALLETE Inc.	BBB+/Negative/A-2	Strong	Significant
International Transmission Co.	BBB/Stable/--	Excellent	Aggressive
ITC Holdings Corp.	BBB/Stable/--	Excellent	Aggressive
ITC Midwest LLC	BBB/Stable/--	Excellent	Aggressive
Michigan Electric Transmission Co	BBB/Stable/--	Excellent	Aggressive
Public Service Electric & Gas Co.	BBB/Stable/A-2	Excellent	Significant
PECO Energy Co.	BBB/Stable/A-2	Excellent	Significant
Commonwealth Edison Co.	BBB/Stable/A-2	Excellent	Significant
Tampa Electric Co.	BBB/Stable/A-2	Excellent	Aggressive
AEP Texas Central Co	BBB/Stable/--	Excellent	Aggressive
AEP Texas North Co	BBB/Stable/--	Excellent	Aggressive
Yankee Gas Services Co.	BBB/Stable/--	Excellent	Aggressive
United Illuminating Co. (The)	BBB/Stable/--	Excellent	Aggressive
UIL Holdings Corp.	BBB/Stable/--	Excellent	Aggressive
Connecticut Light & Power Co.	BBB/Stable/--	Excellent	Aggressive
Public Service Co. of New Hampshire	BBB/Stable/--	Excellent	Aggressive

*Issuer Ranking: U.S. Regulated Electric Utilities, Strongest To Weakest*

<b>U.S. Regulated Electric Utilities (cont.)</b>			
Columbus Southern Power Co.	BBB/Stable/--	Excellent	Aggressive
Ohio Power Co.	BBB/Stable/--	Excellent	Aggressive
Appalachian Power Co.	BBB/Stable/--	Excellent	Aggressive
NorthWestern Corp.	BBB/Stable/--	Excellent	Aggressive
Western Massachusetts Electric Co.	BBB/Stable/--	Excellent	Aggressive
Atlantic City Electric Co.	BBB/Stable/A-2	Excellent	Significant
Potomac Electric Power Co.	BBB/Stable/A-2	Excellent	Significant
Delmarva Power & Light Co.	BBB/Stable/A-2	Excellent	Significant
Green Mountain Power Corp.	BBB/Stable/--	Excellent	Aggressive
Kentucky Power Co.	BBB/Stable/--	Excellent	Aggressive
Public Service Co. of Oklahoma	BBB/Stable/--	Excellent	Aggressive
Southwestern Electric Power Co.	BBB/Stable/--	Excellent	Aggressive
Cleco Power LLC	BBB/Stable/--	Excellent	Aggressive
Entergy Arkansas Inc.	BBB/Stable/--	Excellent	Significant
Entergy Louisiana LLC	BBB/Stable/--	Excellent	Significant
Entergy Mississippi Inc.	BBB/Stable/--	Excellent	Significant
Entergy Gulf States Louisiana LLC	BBB/Stable/--	Excellent	Significant
Entergy Texas Inc.	BBB/Stable/--	Excellent	Significant
Rochester Gas & Electric Corp.	BBB/Stable/--	Excellent	Aggressive
Idaho Power Co.	BBB/Stable/A-2	Excellent	Aggressive
TECO Energy Inc.	BBB/Stable/--	Excellent	Aggressive
Puget Sound Energy Inc.	BBB/Stable/A-2	Excellent	Aggressive
Northeast Utilities	BBB/Stable/--	Excellent	Aggressive
American Electric Power Co. Inc.	BBB/Stable/A-2	Excellent	Aggressive
Cleco Corp.	BBB/Stable/--	Excellent	Aggressive
IDACORP Inc.	BBB/Stable/A-2	Excellent	Aggressive
El Paso Electric Co.	BBB/Stable/--	Excellent	Aggressive
System Energy Resources Inc.	BBB/Stable/--	Excellent	Aggressive
Michigan Consolidated Gas Co.	BBB/Stable/A-2	Strong	Significant
Indiana Michigan Power Co.	BBB/Stable/--	Strong	Aggressive
Portland General Electric Co.	BBB/Stable/A-2	Strong	Significant
Detroit Edison Co.	BBB/Stable/A-2	Strong	Significant
DTE Energy Co.	BBB/Stable/A-2	Strong	Significant
Entergy Corp.	BBB/Stable/--	Strong	Significant
PEPCO Holdings Inc.	BBB/Stable/A-2	Strong	Significant
CenterPoint Energy Houston Electric LLC	BBB/Negative/--	Excellent	Aggressive
Kansas City Power & Light Co.	BBB/Negative/A-3	Excellent	Aggressive
KCP&L Greater Missouri Operations Co.	BBB/Negative/--	Excellent	Aggressive
Great Plains Energy Inc.	BBB/Negative/--	Excellent	Aggressive
CenterPoint Energy Inc.	BBB/Negative/A-3	Excellent	Aggressive
CenterPoint Energy Resources Corp.	BBB/Negative/A-3	Excellent	Aggressive
Hawaiian Electric Co. Inc.	BBB/Negative/A-3	Strong	Significant
Hawaiian Electric Industries Inc.	BBB/Negative/A-3	Strong	Significant

<b>U.S. Regulated Electric Utilities (cont.)</b>			
Westar Energy Inc.	BBB-/Positive/--	Excellent	Aggressive
Kansas Gas & Electric Co.	BBB-/Positive/--	Excellent	Aggressive
Avista Corp.	BBB-/Positive/A-3	Excellent	Aggressive
Jersey Central Power & Light Co.	BBB-/Stable/--	Excellent	Aggressive
Potomac Edison Co.	BBB-/Stable/--	Excellent	Aggressive
West Penn Power Co.	BBB-/Stable/--	Excellent	Aggressive
Monongahela Power Co.	BBB-/Stable/--	Excellent	Aggressive
Metropolitan Edison Co.	BBB-/Stable/--	Excellent	Aggressive
Pennsylvania Electric Co.	BBB-/Stable/--	Excellent	Aggressive
Cleveland Electric Illuminating Co.	BBB-/Stable/--	Excellent	Aggressive
Ohio Edison Co.	BBB-/Stable/A-2	Excellent	Aggressive
Pennsylvania Power Co.	BBB-/Stable/--	Excellent	Aggressive
Toledo Edison Co.	BBB-/Stable/--	Excellent	Aggressive
Duquesne Light Co.	BBB-/Stable/--	Excellent	Aggressive
Duquesne Light Holdings Inc.	BBB-/Stable/--	Excellent	Aggressive
Central Illinois Public Service Co.	BBB-/Stable/--	Excellent	Significant
Illinois Power Co.	BBB-/Stable/--	Excellent	Significant
Indianapolis Power & Light Co.	BBB-/Stable/--	Excellent	Highly leveraged
IPALCO Enterprises Inc.	BBB-/Stable/--	Excellent	Highly leveraged
Consumers Energy Co.	BBB-/Stable/--	Excellent	Aggressive
Union Electric Co. d/b/a AmerenUE	BBB-/Stable/A-3	Excellent	Significant
Black Hills Power Inc.	BBB-/Stable/--	Excellent	Significant
Otter Tail Power Company	BBB-/Stable/--	Excellent	Significant
Empire District Electric Co.	BBB-/Stable/A-3	Excellent	Aggressive
CMS Energy Corp.	BBB-/Stable/A-3	Excellent	Aggressive
Northern Indiana Public Service Co.	BBB-/Stable/--	Excellent	Aggressive
Entergy New Orleans Inc.	BBB-/Stable/--	Strong	Significant
Arizona Public Service Co.	BBB-/Stable/A-3	Strong	Significant
Central Illinois Light Co.	BBB-/Stable/--	Strong	Significant
CILCORP Inc.	BBB-/Stable/--	Strong	Significant
Edison International	BBB-/Stable/--	Strong	Aggressive
FirstEnergy Corp.	BBB-/Stable/--	Strong	Aggressive
Pinnacle West Capital Corp.	BBB-/Stable/A-3	Strong	Significant
Allegheny Energy Inc.	BBB-/Stable/--	Strong	Aggressive
Ohio Valley Electric Corp.	BBB-/Stable/--	Strong	Aggressive
Ameren Corp.	BBB-/Stable/A-3	Satisfactory	Significant
Black Hills Corp.	BBB-/Stable/--	Satisfactory	Significant
Otter Tail Corp.	BBB-/Stable/--	Satisfactory	Significant
FirstEnergy Solutions Corp.	BBB-/Stable/--	Satisfactory	Aggressive
Puget Energy Inc.	BB+/Stable/--	Excellent	Aggressive
Tucson Electric Power Co.	BB+/Stable/B-2	Strong	Highly leveraged
Nevada Power Co.	BB/Stable/--	Excellent	Highly leveraged
Sierra Pacific Power Co.	BB/Stable/--	Excellent	Highly leveraged

*Issuer Ranking: U.S. Regulated Electric Utilities, Strongest To Weakest*

<b>U.S. Regulated Electric Utilities (cont.)</b>			
NV Energy Inc.	BB/Stable/B-2	Excellent	Highly leveraged
Texas-New Mexico Power Co.	BB-/Stable/--	Strong	Aggressive
Public Service Co. of New Mexico	BB-/Stable/--	Strong	Aggressive
PNM Resources Inc.	BB-/Stable/--	Satisfactory	Aggressive

\*Ratings as of April 1, 2010.



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The McGraw-Hill Companies

# Rating Methodology

# Moody's Global Infrastructure Finance

August 2009

## Regulated Electric and Gas Utilities

### Summary

This rating methodology provides guidance on Moody's approach to assigning credit ratings to electric and gas utility companies worldwide whose credit profile is influenced to a large degree by the presence of regulation. It replaces the Global Regulated Electric Utilities methodology published in March 2005 and the North American Regulated Gas Distribution Industry (Local Distribution Companies) methodology published in October 2006. While reflecting similar core principles as these previous methodologies, this updated framework incorporates refinements that better reflect the changing dynamics of the regulated electric and gas industry and the way Moody's applies its industry methodologies.

The goal of this rating methodology is to assist investors, issuers, and other interested parties in understanding how Moody's arrives at company-specific ratings, what factors we consider most important for this sector, and how these factors map to specific rating outcomes. Our objective is for users of this methodology to be able to estimate a company's ratings (senior unsecured ratings for investment-grade issuers and Corporate Family Ratings for speculative-grade issuers) within two alpha-numeric rating notches.

Regulated electric and gas companies are a diverse universe in terms of business model (ranging from vertically integrated to unbundled generation, transmission and/or distribution entities) and regulatory environment (ranging from stable and predictable regulatory regimes to those that are less developed or undergoing significant change). In seeking to differentiate credit risk among the companies in this sector, Moody's analysis focuses on four key rating factors that are central to the assignment of ratings for companies in the sector. The four key rating factors encompass nine specific elements (or sub-factors), each of which map to specific letter ratings (see Appendix A). The four factors are as follows:

1. Regulatory Framework
2. Ability to Recover Costs and Earn Returns
3. Diversification
4. Financial Strength and Liquidity

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### Analyst Contacts:

New York 1.212.553.1653

**Michael G. Haggarty**  
Vice President - Senior Credit Officer

**Mitchell Moss**  
Associate Analyst

**W. Larry Hess**  
Team Managing Director

**Thomas Keller**  
Group Managing Director

**Bart Oosterveld**  
Chief Credit Officer, Public, Project & Infrastructure Finance

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## Regulated Electric and Gas Utilities

This methodology pertains to regulated electric and gas utilities and excludes regulated electric and gas networks (companies primarily engaged in the transmission and/or distribution of electricity and/or natural gas that do not serve retail customers) and unregulated utilities and power companies, which are covered by separate rating methodologies. Municipal utilities and electric cooperatives are also excluded and covered by separate rating methodologies.

In Appendix A of this methodology, we have included a detailed rating grid for the companies covered by the methodology. For each company, the grid maps each of these key rating factors and shows an indicated alpha-numeric rating based on the results from the overall combination of the factors (see Appendix B). We note, however, that many companies will not match each dimension of the analytical framework laid out in the rating grid exactly and that from time to time a company's performance on a particular rating factor may fall outside the expected range for a company at its rating level. These companies are categorized as "outliers" for that rating factor. We discuss some of the reasons for these outliers in this methodology as well as in published credit opinions and other company-specific analysis.

The purpose of the rating grid is to provide a reference tool that can be used to approximate credit profiles within the regulated electric and gas utility sector. The grid provides summarized guidance on the factors that are generally most important in assigning ratings to the sector. While the factors and sub-factors within the grid are designed to capture the fundamental rating drivers for the sector, this grid does not include every rating consideration and does not fit every business model equally. Therefore, we outline additional considerations that may be appropriate to apply in addition to the four rating factors. Moody's also assesses other rating factors that are common across all industries, such as event risk, off-balance sheet risk, legal structure, corporate governance, and management experience and credibility. Furthermore, most of our sub-factor mapping uses historical financial results to illustrate the grid while our ratings also consider forward looking expectations. As such, the grid-indicated rating is not expected to always match the actual rating of each company. The text of the rating methodology provides insights on the key rating considerations that are not represented in the grid, as well as the circumstances in which the rating effect for a factor might be significantly different from the weight indicated in the grid.

Readers should also note that this methodology does not attempt to provide an exhaustive list of every factor that can be relevant to a utility's ratings. For example, our analysis covers factors that are common across all industries (such as coverage metrics, debt leverage, and liquidity) as well as factors that can be meaningful on a company or industry specific basis (such as regulation, capital expenditure needs, or carbon exposure).

This publication includes the following sections:

- **About the Rated Universe:** An overview of the regulated electric and gas industries
- **About the Rating Methodology:** A description of our rating methodology, including a detailed explanation of each of the key factors that drive ratings
- **Assumptions and Limitations:** Comments on the rating methodology's assumptions and limitations, including a discussion of other rating considerations that are not included in the grid

In the appendices, we also provide tables that illustrate the application of the methodology grid to 30 representative electric and gas utility companies with explanatory comments on some of the more significant differences between the grid-implied rating and our actual rating (Appendix C). We also provide definitions of key ratios (Appendix D), an industry overview (Appendix E) and a discussion of the key issues facing the industry over the intermediate term (Appendix F) and regional considerations (Appendix G).

## About the Rated Universe

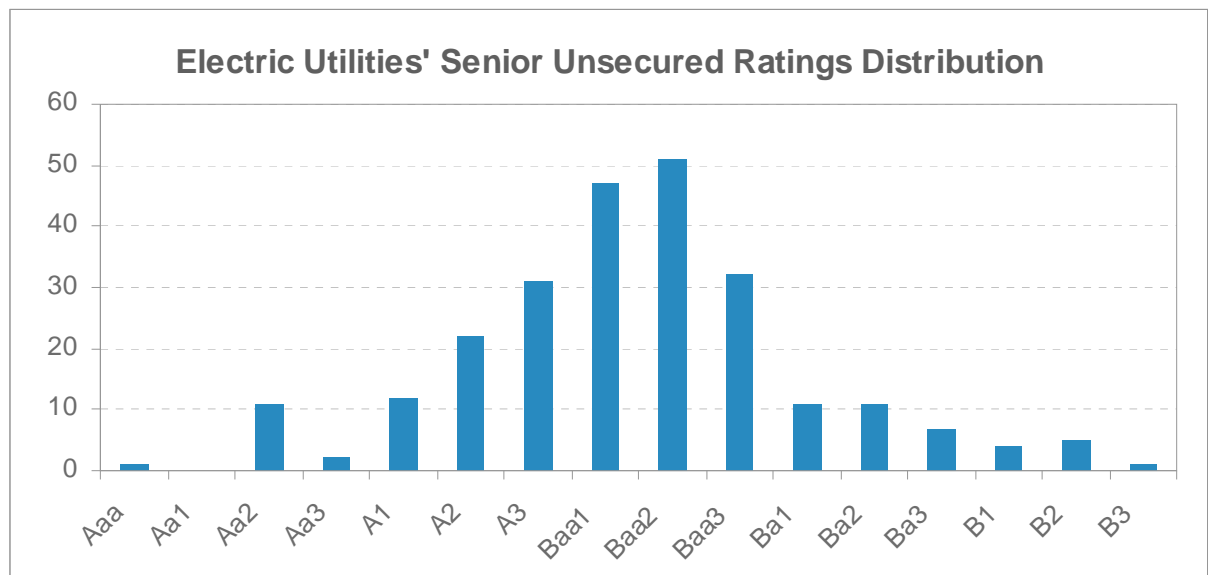
The rating methodology covers investor-owned and commercially oriented government owned companies worldwide that are engaged in the production, transmission, distribution and/or sale of electricity and/or natural gas. It covers a wide variety of companies active in the sector, including vertically integrated utilities, transmission and distribution companies, some U.S. transmission-only companies, and local gas distribution companies (LDCs). For the LDCs, we note that this methodology is concerned principally with operating utilities regulated by their local jurisdictions and not with gas companies that have significant non-utility

## Regulated Electric and Gas Utilities

businesses<sup>1</sup>. In addition, this methodology includes both holding companies as well as operating companies. For holding companies, actual ratings may be lower than methodology grid-implied ratings due to the structural subordination of the holding company debt to the operating company debt. In order for a utility to be covered by this methodology, the company must be an investor-owned or commercially oriented government owned entity and be subject to some degree of government regulation or oversight. This methodology excludes regulated electric and gas networks, electric generating companies<sup>2</sup> and independent power producers operating predominantly in unregulated power markets, municipally owned utilities, electric cooperative utilities, and power projects, which are covered in separate rating methodologies.

The rated universe includes approximately 250 entities that are either utility operating companies or a parent holding company with one or more utility company subsidiaries that operate predominantly in the electric and gas utility business. They account for about US\$650 billion of total outstanding long-term debt instruments. In general, ratings used in this methodology are the Senior Unsecured ("SU") rating for investment grade companies, the Corporate Family Rating ("CFR") for non-investment grade companies, and the Baseline Credit Assessment ("BCA") for Government Related Issuers (GRI). A subset of 30 of these entities is included in the methodology, representing a sampling of the universe to which this methodology applies.

Geographically, this methodology covers companies in the Americas, Europe, Middle East, Africa, Japan, and the Asia/Pacific region. The ratings spectrum for the sector ranges from Aaa to B3, with the actual rating distribution of the issuers included (both holding companies and operating companies) shown on the following table:



Although all of these companies are affected to some degree by government regulation or oversight, country-by-country regulatory differences and cultural and economic characteristics are also important credit considerations. There is little consistency in the approach and application of regulatory frameworks around the world. Some regulatory frameworks are highly supportive of the utilities in their jurisdictions, in some cases offering implied sovereign support to ensure reliability of electric supply. Other regulatory frameworks are less supportive, more unpredictable or affected by political influence that can increase uncertainty and negatively affect overall credit quality.

<sup>1</sup> These companies are assessed under the rating methodology "North American Diversified Natural Gas Transmission and Distribution Companies", March 2007.

<sup>2</sup> The six Korean generation companies are included in this methodology as they are subject to regulation and Moody's views them and their 100% parent and sole off-taker KEPCO on a consolidated basis. The Brazilian generation companies are included as they are also subject to regulatory intervention.

## Regulated Electric and Gas Utilities

### About this Rating Methodology

Moody's approach to rating companies in the regulated electric and gas utility sector, as outlined in this rating methodology, incorporates the following steps:

#### 1. Identification of the Key Rating Factors

In general, Moody's rating committees for the regulated electric and gas utility sector focus on a number of key rating factors which we identify and quantify in this methodology. A change in one or more of these factors, depending on its weighting, is likely to influence a utility's overall business and financial risk. We have identified the following four key rating factors and nine sub-factors when assigning ratings to regulated electric and gas utility issuers:

Rating Factor / Sub-Factor Weighting - Regulated Utilities			
Broad Rating Factors	Broad Rating Factor Weighting	Rating Sub-Factor	Sub-Factor Weighting
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 pre-WC + Interest/ Interest	7.5%
		CFO pre-WC / Debt	7.5%
		CFO pre-WC - Dividends / Debt	7.5%
		Debt/Capitalization or Debt / Regulated Asset Value	7.5%
<b>Total</b>	<b>100%</b>		<b>100%</b>

\*10% weight for issuers that lack generation; \*\*0% weight for issuers that lack generation

These factors are critical to the analysis of regulated electric and gas utilities and, in most cases, can be benchmarked across the industry. The discussion begins with a review of each factor and an explanation of its importance to the rating.

#### 2. Measurement of the Key Rating Factors

We next explain the elements we consider and the metrics we use to measure relative performance on each of the four factors. Some of these measures are quantitative in nature and can be specifically defined. However, for other factors, qualitative judgment or observation is necessary to determine the appropriate rating category.

Moody's ratings are forward looking and attempt to rate through the industry's characteristic volatility, which can be caused by weather variations, fuel or commodity price changes, cost deferrals, or reasonable delays in regulatory recovery. The rating process also makes extensive use of historic financial statements. Historic results help us understand the pattern of a utility's financial and operating performance and how a utility compares to its peers. While rating committees and the rating process use both historical and projected financial results, this document makes use only of historic data, and does so solely for illustrative purposes. All financial measures incorporate Moody's standard adjustments to income statement, cash flow statement, and balance sheet amounts for (among other things) underfunded pension obligations and operating leases.

#### 3. Mapping Factors to Rating Categories

After identifying the measurement criteria for each factor, we match the performance of each factor and sub-factor to one of Moody's broad rating categories (Aaa, Aa, A, Baa, Ba, and B). In this report, we provide a

## Regulated Electric and Gas Utilities

range or description for each of the measurement criteria. For example, we specify what level of CFO pre-WC plus Interest/Interest is generally acceptable for an A credit versus a Baa credit, etc.

### 4. Mapping Issuers to the Grid and Discussion of Grid Outliers

For each factor and sub-factor, we provide a table showing how a subset of the companies covered by the methodology maps within the specific factors and sub-factors. We recognize that any given company may perform higher or lower on a given factor than its actual rating level will otherwise indicate. These companies are identified as "outliers" for that factor. A company whose performance is two or more broad rating categories higher than its rating is deemed a positive outlier for that factor. A company whose performance is two or more broad rating categories below is deemed a negative outlier. We also discuss the general reasons for such outliers for each factor.

### 5. Discussion of Assumptions, Limitations and Other Rating Considerations

This section discusses limitations in the use of the grid to map against actual ratings as well as limitations and key assumptions that pertain to the overall rating methodology.

### 6. Determining the Overall Grid-Indicated Rating

To determine the overall rating, each of the factors and sub-factors is converted into a numeric value based on the following scale:

#### Ratings Scale

Aaa	Aa	A	Baa	Ba	B
1	3	6	9	12	15

Each sub-factor's numeric value is multiplied by an assigned weight and then summed to produce a composite weighted-average score. The total sum of the factors is then mapped to the ranges specified in the table below, and the indicated alpha-numeric rating is determined based on where the total score falls within the ranges.

#### Factor Numerics

Composite Rating	
Indicated Rating	Aggregate Weighted Factor Score
Aaa	< 1.5
Aa1	1.5 < 2.5
Aa2	2.5 < 3.5
Aa3	3.5 < 4.5
A1	4.5 < 5.5
A2	5.5 < 6.5
A3	6.5 < 7.5
Baa1	7.5 < 8.5
Baa2	8.5 < 9.5
Baa3	9.5 < 10.5
Ba1	10.5 < 11.5
Ba2	11.5 < 12.5
Ba3	12.5 < 13.5
B1	13.5 < 14.5
B2	14.5 < 15.5
B3	15.5 < 16.5

## Regulated Electric and Gas Utilities

For example, an issuer with a composite weighting factor score of 8.2 would have a Baa1 grid-indicated rating. We use a similar procedure to derive the grid-indicated ratings in the tables embedded in the discussion of each of the four broad rating categories.

### The Key Rating Factors

Moody's analysis of electric and gas utilities focuses on four broad factors:

1. Regulatory Framework
2. Ability to Recover Costs and Earn Returns
3. Diversification
4. Financial Strength and Liquidity

#### Rating Factor 1: Regulatory Framework (25%)

##### *Why it Matters*

For a regulated utility, the predictability and supportiveness of the regulatory framework in which it operates is a key credit consideration and the one that differentiates the industry from most other corporate sectors. The most direct and obvious way that regulation affects utility credit quality is through the establishment of prices or rates for the electricity, gas and related services provided (revenue requirements) and by determining a return on a utility's investment, or shareholder return. The latter is largely addressed in Factor 2, Ability to Recover Cost and Earn Returns, discussed below. However, in addition to rate setting, there are numerous other less visible or more subtle ways that regulatory decisions can affect a utility's business position. These can include the regulators' ability to pre-approve recovery of investments for new generation, transmission or distribution; to allow the inclusion of generation asset purchases in utility rate bases; to oversee and ultimately approve utility mergers and acquisitions; to approve fuel and purchased power recovery; and to institute or increase ring-fencing provisions.

##### *How We Measure It for the Grid*

For a regulated utility company, we consider the characteristics of the regulatory environment in which it operates. These include how developed the regulatory framework is; its track record for predictability and stability in terms of decision making; and the strength of the regulator's authority over utility regulatory issues. A utility operating in a stable, reliable, and highly predictable regulatory environment will be scored higher on this factor than a utility operating in a regulatory environment that exhibits a high degree of uncertainty or unpredictability. Those utilities operating in a less developed regulatory framework or one that is characterized by a high degree of political intervention in the regulatory process will receive the lowest scores on this factor. Consideration is given to the substance of any regulatory ring fencing provisions, including restrictions on dividends; restrictions on capital expenditures and investments; separate financing provisions; separate legal structures; and limits on the ability of the regulated entity to support its parent company in times of financial distress. The criteria for each rating category are outlined in the factor description within the rating grid.

For regulated electric utilities with some unregulated operations, consideration will be given to the competitive and business position of these unregulated operations<sup>3</sup>. Moody's views unregulated operations that have minimal or limited competition, large market shares, and statutorily protected monopoly positions as having substantially less risk than those with smaller market shares or in highly competitive environments. Those businesses with the latter characteristics usually face a higher likelihood of losing customers, revenues, or market share. For electric utilities with a significant amount of such unregulated operations, a lower score could be assigned to this factor than would be if the utility had solely regulated operations.

Moody's views the regulatory risk of U.S. utilities as being higher in most cases than that of utilities located in some other developed countries, including Japan, Australia, and Canada. The difference in risk reflects our view that individual state regulation is less predictable than national regulation; a highly fragmented market in the U.S. results in stronger competition in wholesale power markets; U.S. fuel and power markets are more

<sup>3</sup> For diversified gas companies, the "North American Diversified Natural Gas Transmission and Distribution Company" rating methodology is applied.

## Regulated Electric and Gas Utilities

volatile; there is a low likelihood of extraordinary political action to support a failing company in the U.S.; holding company structures limit regulatory oversight; and overlapping or unclear regulatory jurisdictions characterize the U.S. market. As a result, no U.S. utilities, except for transmission companies subject to federal regulation, score higher than a single A in this factor.

The scores for this factor replace the classifications we had been using to assess a utility's regulatory framework, namely, the Supportiveness of Regulatory Environment (SRE) framework, outlined in our previous rating methodology (Global Regulated Electric Utilities, March 2005), which we are phasing out. Generally speaking, an SRE 1 score from our previous methodology would roughly equate to Aaa or Aa ratings in this methodology; an SRE 2 score to A or high Baa; an SRE 3 score to low Baa or Ba, and an SRE 4 score to a B. For U.S. and Canadian LDCs, this factor corresponds to the "Regulatory Support" and "Ring-fencing" factors in our previous methodology (North American Regulated Gas Distribution, October 2006).

### Factor 1 – Regulatory Framework (25%)

Aaa	Aa	A	Baa	Ba	B
Regulatory framework is fully developed, has a long-track record of being predictable and stable, and is highly supportive of utilities. Utility regulatory body is a highly rated sovereign or strong independent regulator with unquestioned authority over utility regulation that is national in scope.	Regulatory framework is fully developed, has been mostly predictable and stable in recent years, and is mostly supportive of utilities. Utility regulatory body is a sovereign, sovereign agency, provincial, or independent regulator with authority over most utility regulation that is national in scope.	Regulatory framework is fully developed, has above average predictability and reliability, although is sometimes less supportive of utilities. Utility regulatory body may be a state commission or national, state, provincial or independent regulator.	Regulatory framework is a) well-developed, with evidence of some inconsistency or unpredictability in the way framework has been applied, or framework is new and untested, but based on well-developed and established precedents, or b) jurisdiction has history of independent and transparent regulation in other sectors. Regulatory environment may sometimes be challenging and politically charged.	Regulatory framework is developed, but there is a high degree of inconsistency or unpredictability in the way the framework has been applied. Regulatory environment is consistently challenging and politically charged. There has been a history of difficult or less supportive regulatory decisions, or regulatory authority has been or may be challenged or eroded by political or legislative action.	Regulatory framework is less developed, is unclear, is undergoing substantial change or has a history of being unpredictable or adverse to utilities. Utility regulatory body lacks a consistent track record or appears unsupportive, uncertain, or highly unpredictable. May be high risk of nationalization or other significant government intervention in utility operations or markets.

### Rating Factor 2: Ability to Recover Costs and Earn Returns (25%)

#### *Why It Matters*

Unlike Factor 1, which considers the general regulatory framework under which a utility operates and the overall business position of a utility within that regulatory framework, this factor addresses in a more specific manner the ability of an individual utility to recover its costs and earn a return. The ability to recover prudently incurred costs in a timely manner is perhaps the single most important credit consideration for regulated utilities as the lack of timely recovery of such costs has caused financial stress for utilities on several occasions. For example, in four of the six major investor-owned utility bankruptcies in the United States over the last 50 years, regulatory disputes culminated in insufficient or delayed rate relief for the recovery of costs and/or capital investment in utility plant. The reluctance to provide rate relief reflected regulatory commission concerns about the impact of large rate increases on customers as well as debate about the appropriateness of the relief being sought by the utility and views of imprudence. Currently, the utility industry's sizable capital expenditure requirements for infrastructure needs will create a growing and ongoing need for rate relief for recovery of these expenditures at a time when the global economy has slowed.

#### *How We Measure It for the Grid*

For regulated utilities, the criteria we consider include the statutory protections that are in place to insure full and timely recovery of prudently incurred costs. In its strongest form, these statutory protections provide unquestioned recovery and preclude any possibility of legal or political challenges to rate increases or cost recovery mechanisms. Historically, there should be little evidence of regulatory disallowances or delays to



## Regulated Electric and Gas Utilities

rate increases or cost recovery. These statutory protections are most often found in strongly supportive and protected regulatory environments such as Japan, for example, where the utilities in that country receive a score of Aa for this factor.

More typically, however, and as is characteristic of most utilities in the U.S., the ability to recover costs and earn authorized returns is less certain and subject to public and sometimes political scrutiny. Where automatic cost recovery or pass-through provisions exist and where there have been only limited instances of regulatory challenges or delays in cost recovery, a utility would likely receive a score of A for this factor. Where there may be a greater tendency for a regulator to challenge cost recovery or some history of regulators disallowing or delaying some costs, a utility would likely receive a Baa rating for this factor. Where there are no automatic cost recovery provisions, a history of unfavorable rate decisions, a politically charged regulatory environment, or a highly uncertain cost recovery environment, lower scores for this factor would apply.

For regulated electric utilities that have some unregulated operations, we assess the likelihood that the utility will be able to pass on costs of its unregulated businesses to unregulated customers. Among the criteria we use to judge this factor include the number and types of different businesses the company is in; its market share in these businesses; whether there are significant barriers to entry for new competitors; and the degree to which the utility is vertically integrated. Those utilities with several businesses with large market shares are generally in a better position to pass on their costs to unregulated customers. Those utilities that have lower market shares in their unregulated activities or are in businesses with few barriers to entry will likely be more at risk in passing on costs, and thus would receive lower scores. A high proportion of unregulated businesses or a higher risk of passing on costs to unregulated customers could result in a lower score for this factor than would apply if the business was completely regulated.

For U.S. and Canadian LDCs, this factor addresses the “Sustainable Profitability” and “Regulatory Support” assessments in the previous LDC rating methodology. While LDCs’ authorized returns are comparable to those for their electric counterparts, the smaller, more mature LDCs tend to face less regulatory challenges. Purchased Gas Adjustment mechanisms are the norm and they have made strides in implementing alternative rate designs that decouple revenues from volumes sold.

### Factor 2 – Ability to Recover Costs and Earn Returns (25%)

Aaa	Aa	A	Baa	Ba	B
Rate/tariff formula allows unquestioned full and timely cost recovery, with statutory provisions in place to preclude any possibility of challenges to rate increases or cost recovery mechanisms.	Rate/tariff formula generally allows full and timely cost recovery. Fair return on all investments. Minimal challenges by regulators to companies’ cost assumptions; consistent track record of meeting efficiency tests.	Rate/tariff reviews and cost recovery outcomes are fairly predictable (with automatic fuel and purchased power recovery provisions in place where applicable), with a generally fair return on investments. Limited instances of regulatory challenges; although efficiency tests may be more challenging; limited delays to rate or tariff increases or cost recovery.	Rate/tariff reviews and cost recovery outcomes are usually predictable, although application of tariff formula may be relatively unclear or untested. Potentially greater tendency for regulatory intervention, or greater disallowance (e.g. challenging efficiency assumptions) or delaying of some costs (even where automatic fuel and purchased power recovery provisions are applicable).	Rate/tariff reviews and cost recovery outcomes are inconsistent, with some history of unfavorable regulatory decisions or unwillingness by regulators to make timely rate changes to address market volatility or higher fuel or purchased power costs. AND/OR Tariff formula may not take into account all cost components; investment are not clearly or fairly remunerated.	Difficult or highly uncertain rate and cost recovery outcomes. Regulators may engage in second-guessing of spending decisions or deny rate increases or cost recovery needed by utilities to fund ongoing operations, or high likelihood of politically motivated interference in the rate/tariff review process. AND/OR Tariff formula may not cover return on investments, only cash operating costs may be remunerated.

## Regulated Electric and Gas Utilities

### Rating Factor 3 - Diversification (10%)

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#### *Why It Matters*

Diversification of overall business operations helps to mitigate the risk that any one part of the company will have a severe negative impact on cash flow and credit quality. In general, a balance among several different businesses, geographic regions, regulatory regimes, generating plants, or fuel sources will diminish concentration risk and reduce the risk that a company will experience a sudden or rapid deterioration in its overall creditworthiness because of an adverse development specific to any one part of its operations.

#### *How We Measure It For the Grid*

For transmission and distribution utilities, local gas distribution companies, and other companies without significant generation, the key criterion we use is the diversity of their operations among various markets, geographic regions or regulatory regimes. For these utilities, the first set of criteria, labeled market diversification, account for the full 10% weighting for this factor. A predominately T&D utility with a high degree of diversification in terms of market and/or regulatory regime is less likely to be affected by adverse or unexpected developments in any one of these markets or regimes, and thus will receive the highest scores for this factor. Smaller T&D utilities operating in a limited market area or under the jurisdiction of a single regulatory regime will score lower on the factor, with those that are concentrated in an emerging market or riskier environment receiving the lowest scores.

For vertically integrated utilities with generation, the diversification factor is broadened to include not only the criteria discussed above, but also takes into consideration the diversity of their generating assets and the type of fuel sources which they rely on. An additional but somewhat related consideration is the degree to which the utility is exposed to (or insulated from) commodity price changes. A utility with a highly diversified fleet of generating assets using different types of fuels is generally better able to withstand changes in the price of a particular fuel or additional costs required for particular assets, such as more stringent environmental compliance requirements, and thus would receive a higher rating for this sub-factor. Those utilities with more limited diversification or that are more reliant on a single type of generation and fuel source (measured by energy produced) will be scored lower on this sub-factor. Similarly, those utilities with a high reliance on coal and other carbon emitting generating resources will be scored lower on this factor due to their vulnerability to potential carbon regulations and accompanying carbon costs.

Generally, only the largest vertically integrated utilities or transmission companies with substantial operations that are multinational or national in scope, or whose operations encompass a substantial region within a single country, will receive scores in the highest Aaa or Aa categories for this factor. In the U.S., most of the largest multi-state or multi-regional utilities are scored in the A category, most of the larger single state utilities are scored Baa, and smaller utilities operating in a single state or within a single city are scored Ba. A utility may also be scored higher if it is a combination electric and gas utility, which enhances diversification.

The diversification factor was not included in the previous North American LDC methodology. Most LDCs are small and tend to have little geographic and regulatory diversity. However, they tend to be highly stable due to their customer base and margins that comprise primarily of a large number of residential and small commercial customers that are captive to the utility. This customer composition tends to result in a more stable operating performance than those that have concentrations in certain industrial customers that are prone to cyclicity or to bypassing the LDC to obtain gas directly from a pipeline. Pure LDCs are scored under the "Market Position" sub-factor for a full 100% under this factor. As with transmission and distribution utilities, no scores are given for "Fuel/Generation Diversification" as this sub-factor would not be applicable.

## Regulated Electric and Gas Utilities

## Factor 3: Diversification (10%)

	Aaa	Aa	A	Baa	Ba	B	Sub-Factor Weighting
Market Position	A high degree of multinational/regional diversification in terms of market and/or regulatory regime.	Material operations in more than three nations or geographic regions providing diversification of market and/or regulatory regime.	Material operations in two or three states, nations, or geographic regions and exhibits some diversification of market and/or regulatory regime.	Operates in a single state, nation, or economic region with low volatility with some concentration of market and/or regulatory regime.	Operates in a limited market area with material concentration in market and/or regulatory regime.	Operates in a single market which may be an emerging market or riskier environment, with high concentration risk.	5% *
	For LDCs, extremely low reliance on industrial customers and/or exceptionally large residential and commercial customer base and well above average growth.	For LDCs, very low reliance on industrial customers and/or very large residential and commercial customer base with very high growth.	For LDCs, low reliance on industrial customers and/or high residential and commercial customer base with high growth.	For LDCs, moderate reliance on industrial customers in defensive sectors, moderate residential and customer base.	For LDCs, high reliance on industrial customers in somewhat cyclical sectors, small residential and commercial customer base.	For LDCs, very high reliance on industrial customers in cyclical sectors, very small residential and commercial customer base.	
Generation and Fuel Diversity	A high degree of diversification in terms of generation and/or fuel source, well insulated from commodity price changes, no generation concentration, or 0-20% of generation from carbon fuels.	Some diversification in terms of generation and/or fuel source, affected only minimally by commodity price changes, little generation concentration, or 20-40% of generation from carbon fuels.	May have some concentration in one particular type of generation or fuel source, although mostly diversified, modest exposure to commodity price changes, or 40-55% of generation from carbon fuels.	Some reliance on a single type of generation or fuel source, limited diversification, moderate exposure to commodity prices, or 55-70% of generation from carbon fuels.	Operates with little diversification in terms of generation and/or fuel source, high exposure to commodity price changes, or 70-85% of generation from carbon fuels.	High concentration in a single type of generation or highly reliant on a single fuel source, little diversification, may be exposed to commodity price shocks, or 85-100% of generation from carbon fuels.	5% **

\*10% weight for issuers that lack generation \*\*0% weight for issuers that lack generation

## Rating Factor 4 – Financial Strength and Liquidity (40%)

## Why It Matters

Since most electric and gas utilities are highly capital intensive, financial strength and liquidity are key credit factors supporting their long-term viability. Financial strength and liquidity are also important to the maintenance of good relationships with regulators, to assure adequate regulatory responsiveness to rate increase requests and for cost recovery, and to avoid the need for sudden or unexpected rate increases to avoid financial problems. Financial strength is also important due to the ongoing need to invest in generation, transmission, and distribution assets that often require substantial amounts of debt financing. Utilities are among the largest debt issuers in the world and typically require consistent access to the capital markets to assure adequate sources of funding and to maintain financial flexibility.

Although ratio analysis is a helpful way of comparing one company's performance to that of another, no single financial ratio can adequately convey the relative credit strength of these highly diverse companies. The relative strength of a company's financial ratios must take into consideration the level of business risk associated with the more qualitative factors in the methodology. *Companies with a lower business risk can have weaker credit metrics than those with higher business risk for the same rating category.*

## Regulated Electric and Gas Utilities

Given the long-term nature of many of the capital intensive projects undertaken in the industry and the need to obtain regulatory recovery over an often multi-year time period, it is important to analyze both a utility's historical financial performance as well as its prospective future performance, which may be different from the historic measures. Scores under this factor may be higher or lower than what might be expected from historical results, depending on our view of expected future performance.

### *How We Measure It For the Grid*

In addition to assigning a score for a utility's overall liquidity position and relative access to funding sources and the capital markets, we have identified four key core ratios that we consider the most useful in the analysis of regulated electric and gas utilities. The four ratios are the following:

- Cash from Operations (CFO) pre-Working Capital Plus Interest / Interest
- Cash from Operations (CFO) pre-Working Capital / Debt
- Cash from Operations (CFO) pre-Working Capital – Dividends / Debt
- Debt/Capitalization or Debt / Regulated Asset Value (RAV)

The use of Debt / Capitalization or Debt / Regulated Asset Value will depend largely on the regulatory regime in which the utility operates, as explained below. These credit metrics incorporate all of the standard adjustments applied by Moody's when analyzing financial statements, including adjustments for certain types of off-balance sheet financings and certain other reclassifications in the income statement and cash flow statement.

These cash flow based ratios replace the earnings based metrics in the previous "North American Local Gas Distribution Company" rating methodology, reducing the impact on the grid results from non-cash items, such as pension expense.

The ratio calculations utilized and published for the companies covered by this methodology (including the 30 representative electric and gas utility companies highlighted) are historical three-year averages for the years 2006-2008. Three-year averages are used in part to smooth out some of the year to year volatility in financial performance and financial statement ratios.

### **Measurement Criteria**

#### **Liquidity**

Liquidity analysis is a key element in the financial analysis of electric and gas utilities and encompasses a company's ability to generate cash from internal sources, as well as the availability of external sources of financings to supplement these internal sources. Sources of funds are compared to a company's cash needs and other obligations over the next twelve months. The highest "Aaa" and "Aa" scores under this sub-factor would be assigned to those utilities that are financially robust under all or virtually all scenarios, with little to no need for external funding and with unquestioned or superior access to the capital markets. Most utilities, however, receive more moderate scores of between "A" and "Baa" in this sub-factor as most need to rely to some degree on external funding sources to finance capital expenditures and meet other capital needs. Below investment grade scores on the sub-factor are assigned to utilities with weak liquidity or those that rely heavily on debt to finance investments.

#### **CFO pre-Working Capital Plus Interest/Interest or Cash Flow Interest Coverage**

The cash flow interest coverage ratio is a basic measure of a utility's ability to cover the cost of its borrowed capital and is an important analytical tool in this highly capital intensive industry. The numerator in the ratio calculation is a measure of cash flow excluding working capital movements plus interest expense, which can vary in significance depending on the utility. The use of CFO pre-WC is more comprehensive than Funds from Operations (FFO) under U.S. Generally Accepted Accounting Principles (GAAP) since it also captures the changes in long-term regulatory assets and liabilities. However, under International Financial Reporting Standards (IFRS), the two measures are essentially the same. The denominator in the ratio calculation is interest expense, which incorporates our standard adjustments to interest expense, such as including

## Regulated Electric and Gas Utilities

capitalized interest and re-classifying the interest component of operating lease rental expense. In Brazil, the cash interest amount is adjusted by the variation of non-cash financial expenses derived from foreign exchange and inflation denominated debt.

### **CFO pre-Working Capital / Debt**

This metric measures the cash generating ability of a utility compared to the aggregate level of debt on the balance sheet. This ratio is useful in comparing utilities, many of which maintain a significant amount of leverage in their capital structure. The debt calculation takes into consideration Moody's standard adjustments to balance sheet debt, such as for operating leases, underfunded pension liabilities, basket-adjusted hybrids, guarantees, and other debt-like items.

### **CFO pre-Working Capital – Dividends / Debt**

This ratio is a measure of financial leverage as well as an indicator of the strength of a utility's cash flow after dividend payments are made. Dividend obligations of utilities are often substantial and can affect the ability of a utility to cover its debt obligations. The higher the level of retained cash flow relative to a utility's debt, the more cash the utility has to support its capital expenditure program. Moody's expects that even the financially strongest utilities will need to issue debt on a regular basis to maintain a target capital structure if their asset bases are growing. If a utility with an expanding asset base funds all of its capital expenditures with internally generated cash flow then, in the extreme, the utility's debt to capitalization will trend toward zero.

### **Debt/Capitalization or Debt/Regulated Asset Value or RAV**

This ratio is a traditional measure of leverage and can be a useful way to gauge a utility's overall financial flexibility in light of its overall debt load. High debt to capitalization levels are not only an indicator of higher interest obligations, but can also limit the ability of a utility to raise additional financing if needed and can lead to leverage covenant violations in bank credit facilities or other financing agreements. The denominator of the debt / capitalization ratio includes Moody's standard adjustments, the most important of which for some utilities is the inclusion of deferred taxes in capitalization, which tempers the impact of our debt adjustment.

While debt/capitalization is used predominantly in the Americas, other regions may use a variation of this ratio, namely, debt/regulated asset value or RAV ratio. The regulated asset base is comprised of the physical assets that are used to provide regulated distribution services and the RAV represents the value on which the utility is permitted to earn a return. RAV can be calculated in various ways, using different rules that can be revised periodically, depending on the regulatory regime. Where RAV is calculated using consistent rules (i.e. Australia and Japan), debt/RAV is viewed as superior to debt / capitalization as a credit measure and will be used for this sub-factor. Where RAV does not exist (i.e. North America and most Asian countries) or the method of calculation is subject to arbitrary or unpredictable revisions, we use debt/capitalization.

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## Factor 4: Financial Strength, Liquidity and Key Financial Metrics (40%)

	Aaa	Aa	A	Baa	Ba	B	Sub-Factor Weighting
Liquidity	Financially robust under all scenarios with no need for external funding, unquestioned access to the capital markets, and excellent liquidity.	Financially robust under virtually all scenarios with little to no need for external funding, superior access to the capital markets, and very strong liquidity.	Financially strong under most scenarios with some reliance on external funding, solid access to the capital markets, and strong liquidity.	Some reliance on external funding and liquidity is more likely to be affected by external events, good access to the capital markets, and adequate liquidity under most scenarios.	Weak liquidity with more susceptibility to external shocks or unexpected events. Significant reliance on debt funding. Bank financing may be secured and there may be limited headroom under covenants.	Very weak liquidity with limited ability to withstand external shocks or unexpected events. Must use debt to finance investments. Bank financing is normally secured and there may be a high likelihood of breaching one or more covenants.	10%
CFO pre-WC + Interest/Interest	> 8.0x	6.0x - 8.0x	4.5x - 6.0x	2.7x - 4.5x	1.5x - 2.7x	< 1.5x	7.5%
CFO pre-WC/Debt	> 40%	30% - 40%	22% - 30%	13% - 22%	5% - 13%	< 5%	7.5%
CFO pre-WC - Dividends/Debt	> 35%	25% - 35%	17% - 25%	9% - 17%	0% - 9%	< 0%	7.5%
Debt/Capitalization	< 25%	25% - 35%	35% - 45%	45% - 55%	55% - 65%	> 65%	7.5%
Debt/RAV	< 30%	30% - 45%	45% - 60%	60% - 75%	75% - 90%	> 90%	7.5%

## Rating Methodology Assumptions and Limitations, and other Rating Considerations

The rating methodology grid incorporates a trade-off between simplicity that enhances transparency and greater complexity that would enable the grid to map more closely to actual ratings. The four rating factors in the grid do not constitute an exhaustive treatment of all of the considerations that are important for ratings of companies in the regulated electric and gas utility sector. In addition, our ratings incorporate expectations for future performance, while the financial information that is used to illustrate the mapping in the grid is mainly historical. In some cases, our expectations for future performance may be impacted by confidential information that we cannot publish. In other cases, we estimate future results based upon past performance, industry trends, and other factors. In either case, we acknowledge that estimating future performance is subject to the risk of substantial inaccuracy.

In choosing metrics for this rating methodology grid, we did not include certain important factors that are common to all companies in any industry, such as the quality and experience of management, assessments of corporate governance, financial controls, and the quality of financial reporting and information disclosure. The assessment of these factors can be highly subjective and ranking them by rating category in a grid would in some cases suggest too much precision in the relative ranking of particular issuers against all other issuers that are rated in various industry sectors.

Ratings may include additional factors that are difficult to quantify or that only have a meaningful effect in differentiating credit quality in some cases. Such factors include environmental obligations, nuclear decommissioning trust obligations, financial controls, and emerging market risk, where ratings might be

## Regulated Electric and Gas Utilities

constrained by the uncertainties associated with the local operating, political and economic environment, including possible government interference.

Actual assigned ratings may also reflect circumstances in which the weighting of a particular factor will be different from the weighting suggested by the grid. For example, although Factors 1 and 2 address regulation and cost recovery, in some instances the effect of a company's financial strength and liquidity in Factor 4 will be given greater consideration in an assigned rating than what is indicated by the weighting in the grid.

### Conclusion: Summary of the Grid-Indicated Rating Outcomes

For the 30 representative utilities highlighted, the methodology grid-indicated ratings map to current assigned ratings as follows (see Appendix B for the details):

- 30% or 9 companies map to their assigned rating
- 50% or 15 companies have grid-indicated ratings that are within one alpha-numeric notch of their assigned rating
- 20% or 6 companies have grid-indicated ratings that are within two alpha-numeric notches of their assigned rating

#### Grid-Indicated Rating Outcomes

Map to Assigned Rating	Map to Within One Notch	Map to Within Two Notches
American Electric Power Company, Inc.	Cemig Distribuicao S.A.	Duke Energy Corporation
Arizona Public Service Company	Consolidated Edison Company of New York	Eesti Energia AS
CLP Holdings Limited	Dominion Resources, Inc.	Eskom Holdings Ltd
Consumers Energy Company	EDP - Energias do Brasil S.A.	Korea Electric Power Corporation
Florida Power & Light Company	Emera Incorporated	Northern Illinois Gas Company
PG&E Corporation	The Empire District Electric Company	Tokyo Electric Power Company
Piedmont Natural Gas Company, Inc.	FirstEnergy Corp.	
The Southern Company	Indianapolis Power & Light Company	
Xcel Energy Inc.	Kyushu Electric Power Company	
	Oklahoma Gas and Electric Co.	
	PECO Energy Company	
	Progress Energy Carolinas, Inc.	
	Southern California Edison Company	
	Westar Energy, Inc.	
	Wisconsin Power and Light Company	

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Appendix A: Regulated Electric and Gas Utilities Methodology Factor Grid

Factor 1: Regulatory Framework

Weighting: 25%	Aaa	Aa	A	Baa	Ba	B	Sub-Factor Weighting
	Regulatory framework is fully developed, has a long-track record of being predictable and stable, and is highly supportive of utilities. Utility regulatory body is a highly rated sovereign or strong independent regulator with unquestioned authority over utility regulation that is national in scope.	Regulatory framework is fully developed, has been mostly predictable and stable in recent years, and is mostly supportive of utilities. Utility regulatory body is a sovereign, sovereign agency, provincial, or independent regulator with authority over most utility regulation that is national in scope.	Regulatory framework is fully developed, has above average predictability and reliability, although is sometimes less supportive of utilities. Utility regulatory body may be a state commission or national, state, provincial or independent regulator.	Regulatory framework is a) well-developed, with evidence of some inconsistency or unpredictability in the way framework has been applied, or framework is new and untested, but based on well-developed and established precedents, or b) jurisdiction has history of independent and transparent regulation in other sectors. Regulatory environment may sometimes be challenging and politically charged.	Regulatory framework is developed, but there is a high degree of inconsistency or unpredictability in the way the framework has been applied. Regulatory environment is consistently challenging and politically charged. There has been a history of difficult or less supportive regulatory decisions, or regulatory authority has been or may be challenged or eroded by political or legislative action.	Regulatory framework is less developed, is unclear, is undergoing substantial change or has a history of being unpredictable or adverse to utilities. Utility regulatory body lacks a consistent track record or appears unsupportive, uncertain, or highly unpredictable. May be high risk of nationalization or other significant government intervention in utility operations or markets.	25%

Factor 2: Ability to Recover Costs and Earn Returns

Weighting: 25%	Aaa	Aa	A	Baa	Ba	B	Sub-Factor Weighting
	Rate/tariff formula allows unquestioned full and timely cost recovery, with statutory provisions in place to preclude any possibility of challenges to rate increases or cost recovery mechanisms.	Rate/tariff formula generally allows full and timely cost recovery. Fair return on all investments. Minimal challenges by regulators to companies' cost assumptions; consistent track record of meeting efficiency tests.	Rate/tariff reviews and cost recovery outcomes are fairly predictable (with automatic fuel and purchased power recovery provisions in place where applicable), with a generally fair return on investments. Limited instances of regulatory challenges; although efficiency tests may be more challenging; limited delays to rate or tariff increases or cost recovery.	Rate/tariff reviews and cost recovery outcomes are usually predictable, although application of tariff formula may be relatively unclear or untested. Potentially greater tendency for regulatory intervention, or greater disallowance (e.g. challenging efficiency assumptions) or delaying of some costs (even where automatic fuel and purchased power recovery provisions are applicable).	Rate/tariff reviews and cost recovery outcomes are inconsistent, with some history of unfavorable regulatory decisions or unwillingness by regulators to make timely rate changes to address market volatility or higher fuel or purchased power costs. AND/OR Tariff formula may not take into account all cost components; investment are not clearly or fairly remunerated.	Difficult or highly uncertain rate and cost recovery outcomes. Regulators may engage in second-guessing of spending decisions or deny rate increases or cost recovery needed by utilities to fund ongoing operations, or high likelihood of politically motivated interference in the rate/tariff review process. AND/OR Tariff formula may not cover return on investments, only cash operating costs may be remunerated.	25%



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## Factor 3: Diversification

Weighting: 10%	Aaa	Aa	A	Baa	Ba	B	Sub-Factor Weighting
Market Position	A high degree of multinational/regional diversification in terms of market and/or regulatory regime.	Material operations in more than three nations or geographic regions providing diversification of market and/or regulatory regime.	Material operations in two or three states, nations, or geographic regions and exhibits some diversification of market and/or regulatory regime.	Operates in a single state, nation, or economic region with low volatility with some concentration of market and/or regulatory regime.	Operates in a limited market area with material concentration in market and/or regulatory regime.	Operates in a single market which may be an emerging market or riskier environment, with high concentration risk.	5% *
	For LDCs, extremely low reliance on industrial customers and/or exceptionally large residential and commercial customer base and well above average growth.	For LDCs, very low reliance on industrial customers and/or very large residential and commercial customer base with very high growth.	For LDCs, low reliance on industrial customers and/or high residential and commercial customer base with high growth.	For LDCs, moderate reliance on industrial customers in defensive sectors, moderate residential and customer base.	For LDCs, high reliance on industrial customers in somewhat cyclical sectors, small residential and commercial customer base.	For LDCs, very high reliance on industrial customers in cyclical sectors, very small residential and commercial customer base.	
Generation and Fuel Diversity	A high degree of diversification in terms of generation and/or fuel source, well insulated from commodity price changes, no generation concentration, or 0-20% of generation from carbon fuels.	Some diversification in terms of generation and/or fuel source, affected only minimally by commodity price changes, little generation concentration, or 20-40% of generation from carbon fuels.	May have some concentration in one particular type of generation or fuel source, although mostly diversified, modest exposure to commodity price changes, or 40-55% of generation from carbon fuels.	Some reliance on a single type of generation or fuel source, limited diversification, moderate exposure to commodity prices, or 55-70% of generation from carbon fuels.	Operates with little diversification in terms of generation and/or fuel source, high exposure to commodity price changes, or 70-85% of generation from carbon fuels.	High concentration in a single type of generation or highly reliant on a single fuel source, little diversification, may be exposed to commodity price shocks, or 85-100% of generation from carbon fuels.	5% **

\*10% weight for issuers that lack generation \*\*0% weight for issuers that lack generation

## Regulated Electric and Gas Utilities

## Factor 4: Financial Strength, Liquidity and Key Financial Metrics

Weighting: 40%	Aaa	Aa	A	Baa	Ba	B	Sub-Factor Weighting
Liquidity	Financially robust under all scenarios with no need for external funding, unquestioned access to the capital markets, and excellent liquidity.	Financially robust under virtually all scenarios with little to no need for external funding, superior access to the capital markets, and very strong liquidity.	Financially strong under most scenarios with some reliance on external funding, solid access to the capital markets, and strong liquidity.	Some reliance on external funding and liquidity is more likely to be affected by external events, good access to the capital markets, and adequate liquidity under most scenarios.	Weak liquidity with more susceptibility to external shocks or unexpected events. Significant reliance on debt funding. Bank financing may be secured and there may be limited headroom under covenants.	Very weak liquidity with limited ability to withstand external shocks or unexpected events. Must use debt to finance investments. Bank financing is normally secured and there may be a high likelihood of breaching one or more covenants.	10%
CFO pre-WC + Interest/ Interest	> 8.0x	6.0x - 8.0x	4.5x - 6.0x	2.7x - 4.5x	1.5x - 2.7x	< 1.5x	7.5%
CFO pre-WC/ Debt	> 40%	30% - 40%	22% - 30%	13% - 22%	5% - 13%	< 5%	7.5%
CFO pre-WC - Dividends/ Debt	> 35%	25% - 35%	17% - 25%	9% - 17%	0% - 9%	< 0%	7.5%
Debt/ Capitalization	< 25%	25% - 35%	35% - 45%	45% - 55%	55% - 65%	> 65%	7.5%
Debt/RAV	< 30%	30% - 45%	45% - 60%	60% - 75%	75% - 90%	> 90%	7.5%

## Regulated Electric and Gas Utilities

## Appendix B: Methodology Grid-Indicated Ratings

		Factor 1: Regulatory Framework	Factor 2: Returns and Cost Recovery	Factor 3: Diversification		Factor 4: Financial Strength								
Sub-Factor Weights		25%	25%	5%	5%	10%	7.5%	7.5%	7.5%	7.5%	7.5%	7.5%		
	Current Rating/BCA	Indicated Rating	Regulatory Supportiveness	Rate Adjustment and Cost Recovery Mechanisms	Indicated Factor 3 Rating	Market Position	Fuel or Generation Diversification	Indicated Factor 4 Rating	Liquidity	3 Year Average CFO pre-WC + Interest/ Interest	3 Year Average CFO pre-WC / Debt	3 Year Average CFO pre- W/C - Dividends / Debt	3 Year Average Debt / Cap or Debt/RAV	
Kyushu Electric Power Company, Incorporated	Aa2	Aa3	Aaa	Aa	Aa	A	Aaa	A	Aa	Aa		Ba	Ba	Baa
Tokyo Electric Power Company, Incorporated	Aa2	A1	Aaa	Aa	Aa	A	Aaa	Baa	Aa	A		Ba	Ba	Ba
Eesti Energia AS	A1/[8]	A3	Baa	Baa	B	B	B	Aa	Baa	Aaa	Aaa	Aaa	Aa	
Florida Power & Light Company	A1	A1	A	A	Baa	Baa	Baa	Aa	A	Aa	Aa	Aa	A	
Korea Electric Power Corporation	A2/[6]	Baa1	Baa	Baa	Baa	Baa	A	A	Baa	Aa	A	A	A	
CLP Holdings Limited	A2	A2	A	A	A	A	A	A	A	Aa	A	Baa	A	
Northern Illinois Gas Company	A2	Baa1	Baa	Baa	A	A	N/A	Baa	Baa	A	A	Baa	Baa	
Oklahoma Gas and Electric Company	A2	A3	Baa	A	Baa	Baa	Baa	A	A	A	A	A	A	
Wisconsin Power and Light Company	A2	A3	A	A	Baa	Baa	Baa	A	Baa	A	A	Baa	A	
Consolidated Edison Company of New York	A3	Baa1	Baa	A	Baa	Baa	N/A	Baa	A	Baa	Baa	Ba	A	
PECO Energy Company	A3	Baa1	Baa	Baa	Baa	Baa	N/A	A	A	A	A	Baa	Baa	
Piedmont Natural Gas Company, Inc.	A3	A3	A	A	A	A	N/A	Baa	Baa	A	Baa	Baa	Baa	
Progress Energy Carolinas, Inc.	A3	A2	A	A	Baa	Baa	A	A	Baa	A	A	A	Baa	
Southern California Edison Company	A3	Baa1	Baa	Baa	Baa	Baa	A	A	A	A	A	A	Baa	
The Southern Company	A3	A3	A	A	Baa	A	Ba	Baa	A	A	Baa	Baa	Baa	
PG&E Corporation	Baa1	Baa1	Baa	Baa	A	Baa	Aa	Baa	Baa	A	A	A	Baa	
Xcel Energy Inc.	Baa1	Baa1	Baa	A	A	A	A	Baa	Baa	Baa	Baa	Baa	Baa	
American Electric Power Company, Inc.	Baa2	Baa2	Baa	Baa	Baa	A	Ba	Baa	Baa	Baa	Baa	Baa	Ba	

Regulated Electric and Gas Utilities

		Factor 1: Regulatory Framework	Factor 2: Returns and Cost Recovery	Factor 3: Diversification			Factor 4: Financial Strength						
Sub-Factor Weights		25%	25%	5%	5%	10%	7.5%	7.5%	7.5%	7.5%			
Current Rating/BCA	Indicated Rating	Regulatory Supportiveness	Rate Adjustment and Cost Recovery Mechanisms	Indicated Factor 3 Rating	Market Position	Fuel or Generation Diversification	Indicated Factor 4 Rating	Liquidity	3 Year Average CFO pre-WC + Interest/Interest	3 Year Average CFO pre-WC / Debt	3 Year Average CFO pre-W/C - Dividends / Debt	3 Year Average Debt / Cap or Debt/RAV	
													Arizona Public Service Company
Consumers Energy Company	Baa2	Baa2	Baa	Baa	Baa	Baa	Baa	Baa	Baa	Baa	Baa	Ba	
Dominion Resources, Inc.	Baa2	Baa1	Baa	A	A	A	A	Baa	Baa	Baa	Ba	Baa	
Duke Energy Corporation	Baa2	A3	Baa	A	Baa	A	Baa	A	Baa	A	A	Baa	
Emera Incorporated	Baa2	Baa1	A	A	Ba	Ba	Ba	Ba	Baa	Baa	Ba	B	
The Empire District Electric Company	Baa2	Baa3	Ba	Baa	Baa	Baa	Baa	Baa	Baa	Baa	Baa	Baa	
Eskom Holdings Ltd	Baa2[13]	Ba1	Ba	Ba	B	Ba	B	Baa	Ba	Ba	A	A	
Indianapolis Power & Light Company	Baa2	Baa1	Baa	A	Ba	Baa	Ba	Baa	Baa	A	A	Baa	
Cemig Distribuição S.A.	Baa3	Baa2	Ba	Ba	Ba	Ba	N/A	A	Baa	Aa	Aaa	Aa	
FirstEnergy Corp.	Baa3	Baa2	Baa	Baa	Baa	A	Baa	Baa	Baa	Baa	Baa	Baa	
Westar Energy, Inc.	Baa3	Baa2	Baa	Baa	Ba	Baa	Ba	Baa	Baa	Baa	Baa	Baa	
EDP - Energias do Brasil S.A.	Ba1	Baa3	Ba	Ba	Baa	Baa	Baa	Baa	Ba	Baa	Aa	A	

Positive Outlier   
 Negative Outlier

## Regulated Electric and Gas Utilities

## Appendix C: Observations and Outliers for Grid Mapping

## Results of Mapping Factor 1

Factor 1: Regulatory Framework		
Factor Weight		25%
	Current Rating /BCA	Regulatory Supportiveness
Kyushu Electric Power Company, Incorporated	Aa2	Aaa
Tokyo Electric Power Company, Incorporated	Aa2	Aaa
Eesti Energia AS	A1/[8]	Baa
Florida Power & Light Company	A1	A
Korea Electric Power Corporation	A2/[6]	Baa
CLP Holdings Limited	A2	A
Northern Illinois Gas Company	A2	Baa
Oklahoma Gas and Electric Company	A2	Baa
Wisconsin Power and Light Company	A2	A
Consolidated Edison Company of New York	A3	Baa
PECO Energy Company	A3	Baa
Piedmont Natural Gas Company, Inc.	A3	A
Progress Energy Carolinas, Inc.	A3	A
Southern California Edison Company	A3	Baa
The Southern Company	A3	A
PG&E Corporation	Baa1	Baa
Xcel Energy Inc.	Baa1	Baa
American Electric Power Company, Inc.	Baa2	Baa
Arizona Public Service Company	Baa2	Ba
Consumers Energy Company	Baa2	Baa
Dominion Resources, Inc.	Baa2	Baa
Duke Energy Corporation	Baa2	Baa
Emera Incorporated	Baa2	A
The Empire District Electric Company	Baa2	Ba
Eskom Holdings Ltd	Baa2/[13]	Ba
Indianapolis Power & Light Company	Baa2	Baa
Cemig Distribuição S.A.	Baa3	Ba
FirstEnergy Corp.	Baa3	Baa
Westar Energy, Inc.	Baa3	Baa
EDP - Energias do Brasil S.A.	Ba1	Ba

**Observations and Outliers**

As a utility's regulatory framework is one of the most important drivers of ratings, there are no outliers for this factor among the 30 issuers highlighted for this methodology.

## Regulated Electric and Gas Utilities

## Results of Mapping Factor 2

## Factor 2: Ability to Recover Costs and Earn Returns

Factor Weight		25%
	Current Rating/BCA	Rate Adjustment and Cost Recovery Mechanisms
Kyushu Electric Power Company, Incorporated	Aa2	Aa
Tokyo Electric Power Company, Incorporated	Aa2	Aa
Eesti Energia AS	A1/[8]	Baa
Florida Power & Light Company	A1	A
Korea Electric Power Corporation	A2/[6]	Baa
CLP Holdings Limited	A2	A
Northern Illinois Gas Company	A2	Baa
Oklahoma Gas and Electric Company	A2	A
Wisconsin Power and Light Company	A2	A
Consolidated Edison Company of New York	A3	A
PECO Energy Company	A3	Baa
Piedmont Natural Gas Company, Inc.	A3	A
Progress Energy Carolinas, Inc.	A3	A
Southern California Edison Company	A3	Baa
The Southern Company	A3	A
PG&E Corporation	Baa1	Baa
Xcel Energy Inc.	Baa1	A
American Electric Power Company, Inc.	Baa2	Baa
Arizona Public Service Company	Baa2	Baa
Consumers Energy Company	Baa2	Baa
Dominion Resources, Inc.	Baa2	A
Duke Energy Corporation	Baa2	A
Emera Incorporated	Baa2	A
The Empire District Electric Company	Baa2	Baa
Eskom Holdings Ltd	Baa2/[13]	Ba
Indianapolis Power & Light Company	Baa2	A
Cemig Distribuição S.A.	Baa3	Ba
FirstEnergy Corp.	Baa3	Baa
Westar Energy, Inc.	Baa3	Baa
EDP - Energias do Brasil S.A.	Ba1	Ba

**Observations and Outliers**

Like Factor 1, Regulatory Framework, the ability to recover costs and earn returns is also an important ratings driver for regulated utilities, and it is not surprising that there are no outliers among the 30 issuers highlighted. For this factor, most of the issuers score exactly at their current rating levels, with the remainder scoring within one notch of their actual rating.

## Regulated Electric and Gas Utilities

## Results of Mapping Factor 3

Factor 3: Diversification				
Sub-Factor Weights			5% *	5% **
	Current Rating/BCA	Indicated Factor 3 Rating	Market Position	Generation and Fuel Diversification
Kyushu Electric Power Company, Incorporated	Aa2	Aa	A	Aaa
Tokyo Electric Power Company, Incorporated	Aa2	Aa	A	Aaa
Eesti Energia AS	A1/[8]	B	B	B
Florida Power & Light Company	A1	Baa	Baa	Baa
Korea Electric Power Corporation	A2/[6]	Baa	Baa	A
CLP Holdings Limited	A2	A	A	A
Northern Illinois Gas Company	A2	A	A	N/A
Oklahoma Gas and Electric Company	A2	Baa	Baa	Baa
Wisconsin Power and Light Company	A2	Baa	Baa	Baa
Consolidated Edison Company of New York	A3	Baa	Baa	N/A
PECO Energy Company	A3	Baa	Baa	N/A
Piedmont Natural Gas Company, Inc.	A3	A	A	N/A
Progress Energy Carolinas, Inc.	A3	Baa	Baa	A
Southern California Edison Company	A3	Baa	Baa	A
The Southern Company	A3	Baa	A	Ba
PG&E Corporation	Baa1	A	Baa	Aa
Xcel Energy Inc.	Baa1	A	A	A
American Electric Power Company, Inc.	Baa2	Baa	A	Ba
Arizona Public Service Company	Baa2	Baa	Baa	Baa
Consumers Energy Company	Baa2	Baa	Baa	Baa
Dominion Resources, Inc.	Baa2	A	A	A
Duke Energy Corporation	Baa2	Baa	A	Baa
Emera Incorporated	Baa2	Ba	Ba	Ba
The Empire District Electric Company	Baa2	Baa	Baa	Baa
Eskom Holdings Ltd	Baa2/[13]	B	Ba	B
Indianapolis Power & Light Company	Baa2	Ba	Baa	Ba
Cemig Distribuição S.A.	Baa3	Ba	Ba	N/A
FirstEnergy Corp.	Baa3	Baa	A	Baa
Westar Energy, Inc.	Baa3	Ba	Baa	Ba
EDP - Energias do Brasil S.A.	Ba1	Baa	Baa	Baa

**Observations and Outliers**

Of the 30 issuers highlighted, there are three outliers, including PG&E Corporation as a positive outlier, due to their high degree of generation diversification and the lack of coal in their generation mix, and both Eesti Energia AS and The Southern Company as negative outliers. As an Estonian vertically integrated dominant electric utility, Eesti Energia is exposed to considerably high concentration risk as it operates in one of the smallest CEE emerging markets. The concentration risk is further worsened by the company's high reliance on one fuel source as its generation is fully based on internationally rare oil shale. Furthermore, as the oil shale generation is relatively CO<sub>2</sub> intensive, Eesti Energia is further exposed to the development of CO<sub>2</sub> allowance prices. The Southern Company is one of the largest coal generating utility systems in the U.S., with a high percentage of its generation from carbon fuels.

## Regulated Electric and Gas Utilities

## Results of Mapping Factor 4

## Factor 4: Financial Strength, Liquidity and Key Financial Metrics

Sub-Factor Weights			10%	7.5%	7.5%	7.5%	7.5%
	Current Rating/BCA	Indicated Factor 4 Rating	Liquidity	3 Year Average CFO pre-WC + Interest/Interest	3 Year Average CFO pre-WC / Debt	3 Year Average CFO pre-WC / Debt	3 Year Average Debt / Cap or Debt/RAV
Kyushu Electric Power Company, Incorporated	Aa2	A	Aa	Aa	Ba	Ba	Baa*
Tokyo Electric Power Company, Incorporated	Aa2	Baa	Aa	A	Ba	Ba	Ba*
Eesti Energia AS	A1/[8]	Aa	Baa	Aaa	Aaa	Aaa	Aa
Florida Power & Light Company	A1	Aa	A	Aa	Aa	Aa	A
Korea Electric Power Corporation	A2/[6]	A	Baa	Aa	A	A	A
CLP Holdings Limited	A2	A	A	Aa	A	Baa	A
Northern Illinois Gas Company	A2	Baa	Baa	A	A	Baa	Baa
Oklahoma Gas and Electric Company	A2	A	A	A	A	A	A
Wisconsin Power and Light Company	A2	A	Baa	A	A	Baa	A
Consolidated Edison Company of New York	A3	Baa	A	Baa	Baa	Ba	A
PECO Energy Company	A3	A	A	A	A	Baa	Baa
Piedmont Natural Gas Company, Inc.	A3	Baa	Baa	A	Baa	Baa	Baa
Progress Energy Carolinas, Inc.	A3	A	Baa	A	A	A	Baa
Southern California Edison Company	A3	A	A	A	A	A	Baa
The Southern Company	A3	Baa	A	A	Baa	Baa	Baa
PG&E Corporation	Baa1	Baa	Baa	A	A	A	Baa
Xcel Energy Inc.	Baa1	Baa	Baa	Baa	Baa	Baa	Baa
American Electric Power Company, Inc.	Baa2	Baa	Baa	Baa	Baa	Baa	Ba
Arizona Public Service Company	Baa2	Baa	Baa	A	Baa	Baa	Baa
Consumers Energy Company	Baa2	Baa	Baa	Baa	Baa	Baa	Ba
Dominion Resources, Inc.	Baa2	Baa	Baa	Baa	Baa	Ba	Baa
Duke Energy Corporation	Baa2	A	Baa	A	A	Baa	A
Emera Incorporated	Baa2	Ba	Baa	Baa	Ba	Baa	B
The Empire District Electric Company	Baa2	Baa	Baa	Baa	Baa	Baa	Baa
Eskom Holdings Ltd	Baa2/[13]	Baa	Ba	Ba	A	A	A
Indianapolis Power & Light Company	Baa2	Baa	Baa	A	A	Baa	Baa
Cemig Distribuição S.A.	Baa3	A	Baa	Aa	Aaa	Aa	Ba
FirstEnergy Corp.	Baa3	Baa	Baa	Baa	Baa	Baa	Ba
Westar Energy, Inc.	Baa3	Baa	Baa	Baa	Baa	Baa	Baa
EDP - Energias do Brasil S.A.	Ba1	Baa	Ba	Baa	Aa	A	A

\*Debt/RAV

Positive Outlier

Negative Outlier



## Regulated Electric and Gas Utilities

### *Observations and Outliers*

This factor takes into account historic financial statements. Historic results help us to understand the pattern of a utility's financial and operating performance and how a utility compares to its peers. While Moody's rating committees and the rating process use both historical and projected financial results, this document makes use only of historic data, and does so solely for illustrative purposes.

While the vast majority of utilities' key financial metrics map fairly closely to their ratings, there are several significant outliers, which generally fall into two broad groups. The first group is composed of negative outliers and include several utilities located in stable and supportive regulatory environments and are characterized by very low business risk. In these cases, the utilities may have lower financial ratios and higher leverage than most peer companies on a global basis, but still maintain higher overall ratings. In short, the certainty provided by regulatory stability and low business risk offsets any risks that may result from lower financial ratios. Examples of such negative outliers on the financial strength factor include most of the major Japanese utilities, including Tokyo Electric Power and Kyushu Electric Power.

The second group of outliers is composed of positive outliers, whereby several financial ratios are stronger than the overall Moody's rating. These include several utilities in Latin America, such as Cemig Distribuicao, EDP-Energias do Brasil, and European Eesti Energia, which exhibit strong financial coverage ratios and low debt levels, but where ratings are constrained by a more difficult regulatory or business environment or a sovereign rating ceiling.

## Regulated Electric and Gas Utilities

### Appendix D: Definition of Ratios

#### Cash Flow Interest Coverage

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(Cash Flow from Operations – Changes in Working Capital + Interest Expense) / (Interest Expense + Capitalized Interest Expense)

#### CFO pre-WC / Debt

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(Cash Flow from Operations – Changes in Working Capital) / (Total debt + operating lease adjustment + under-funded pension liabilities + basket-adjusted hybrids + securitizations + guarantees + other debt-like items)

#### CFO pre-WC - Dividends / Debt

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(Cash Flow from Operations – Changes in Working Capital – Common and Preferred Dividends) / (Total debt + operating lease adjustment + under-funded pension liabilities + basket-adjusted hybrids + securitizations + guarantees + other debt-like items)

#### Debt / Capitalization or Regulated Asset Value

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(Total debt + operating lease adjustment + under-funded pension liabilities + basket-adjusted hybrids + securitizations + guarantees + other debt-like items) / (Shareholders' equity + minority interest + deferred taxes + goodwill write-off reserve + Total debt + operating lease adjustment + under-funded pension liabilities + basket-adjusted hybrids + securitizations + guarantees + other debt-like items) or RAV

## Regulated Electric and Gas Utilities

### Appendix E: Industry Overview

The electric and gas utility industry consists of companies that are engaged in the generation, transmission, and distribution of electricity and/or natural gas. While many utilities remain vertically integrated with operations in all three segments, others have functionally or legally unbundled these functions due to legislatively mandated market restructuring or other deregulation initiatives and may be engaged in just one or two of these activities.

The **generation** of electricity is the first step in the process of producing and delivering electricity to end use customers and typically the most capital intensive, with the largest portion of the industry's assets consisting of generating plants and related hard assets. Electricity is generated from a variety of fuel sources, including coal, natural gas, or oil; nuclear energy; and renewable sources such as hydro, wind, solar, geothermal, wood, and waste.

**Transmission** is the high voltage transfer of electricity over long distances from its source, usually the location of a generating plant, to substations closer to end use customers in population or industrial centers. Although many utilities own and operate their own transmission systems, there are also several independent transmission companies included in this methodology.

The **distribution** of electricity is the process whereby voltage is reduced and delivered from a high voltage transmission system through smaller wires to the end-users, which consist of industrial, commercial, government, or retail customers of the utility. Most of the utilities covered by this methodology are engaged to some degree in the distribution of electricity through "poles and wires" to their end customers. The distribution of natural gas entails the transport of gas from delivery points along major pipelines to customers in their service territory through distribution pipes.

### Regulation Plays a Major Role in the Industry

Because of the essential nature of the utility's end products (electricity and gas), the public policy implications associated with their provision, the demands for high levels of reliability in their delivery, the monopoly status of most service territories, and the high capital costs associated with its infrastructure, the utility industry is generally subject to a high degree of government regulation and oversight. This regulation can take many forms and may include setting or approving the rates or other cost recovery mechanisms that utilities charge for their services (revenue), determining what costs can be recovered through base rates, authorizing returns that utilities earn on their investments, defining service territories, mandating the level and reliability of electricity and gas service that must be provided and enforcing safety standards. From a credit standpoint, the regulators' ability to set and control rates and returns is perhaps the most important regulatory consideration in determining a rating.

In the U.S., the most important utility regulator for most companies is the individual state agency generally known as the Public Utility Commission or the Public Service Commission. The commissions are comprised of elected or appointed officials in each state who determine, among other things, whether utility expenditures are reasonable and/or prudent and how they should be passed on to consumers through their utility rates. While some states have legislatively mandated certain market restructuring or deregulation initiatives with regard to the generation segment of their electricity markets, the majority of states remain fully regulated, and some states that had deregulated are in the process of "re-regulating" their electricity markets.

The key federal agency governing utilities in the U.S. is the Federal Energy Regulatory Commission (FERC), an independent agency that regulates, among other things, the interstate transmission of electricity and natural gas. The FERC's responsibilities include the approval of rates for the wholesale sale and transmission of electricity on an interstate basis by utilities, power marketers, power pools, power exchanges, and independent system operators. The Energy Policy Act of 2005 increased the FERC's regulatory authority in a wide range of areas including mergers and acquisitions, transmission siting, market practices, price transparency, and regional transmission organizations.

## Regulated Electric and Gas Utilities

In Europe, following the implementation of specific policies relating to the liberalization of energy supply within the European Union (EU), the electric utility sector has been evolving toward a model targeting complete separation between network activities, regulated in light of their monopoly nature, and supply and production of energy, fully liberalized and hence unregulated. As a result of this process, most Western European utilities currently operate either as fully regulated entities in the networks segment, or largely unregulated integrated companies (albeit some may still maintain some regulated network activity), and are therefore excluded from the scope of this methodology. Nevertheless, there are countries in Europe where regulatory evolution and transition to competition remain at an earlier stage (Central and Eastern European countries and the Baltic states in particular) and/or are characterized by the remoteness and isolation of their systems (the islands in the Azores and Madeira regions for example). In these countries, Governments and/or Regulators maintain greater influence on the bulk of the utilities' revenues, thus supporting their inclusion in this methodology.

In Japan, regulation has been an important positive factor supporting utility credit quality. Japan's regulator makes the maintenance of supply its primary policy objective, followed in priority by environmental protection and finally, allowing market conditions to work. This approach preserves the utilities' integrated operations and makes them responsible for final supply to users in the liberalized market. The Japanese government is gradually deregulating the utility industry and expanding the liberalized market. However, the pace of deregulation has been moderate so that the regulator can monitor the risks and the effects on the power companies, especially in the context of generation supply security.

In Australia, stable and predictable regulatory regimes continue to underpin the investment-grade characteristics of the sector. So far, regulators – which operate independently from the governments – have not adopted an aggressive stance to revenues and returns as they seek a balance between: appropriate returns for utilities; ongoing incentives for network investments; and appropriate prices for consumers. The supportiveness of the regimes will become increasingly important over the medium term as the sector undertakes investments to expand network capacity and replace ageing assets to meet rising demand.

In Asia Pacific (ex-Japan), regulation of electric utilities is overseen by government regulatory bodies in their respective countries. As such, the stability and regulatory framework can vary to a large extent by country with a few utilizing automatic cost pass through mechanisms while the majority operate with ad hoc tariff adjustments. However, power security remains a key policy objective and regulators continue to seek to ensure stability in regulatory and operating environments. Such regulatory environments are critical to attracting investments for both privatizations and for funding expanding electricity projects. Reform of the power industry in Asia remains slow paced and competition is well contained. Regulators have shown that they will reform in a prudent manner and allow tariff adjustment to minimize any material negative impact on the credit profiles of their power utilities. Such a supportive approach enhances stability and provides a stable regulatory regime which in turn remains a key driver in supporting the cash flows of Asia Pacific (ex-Japan) utilities.

In Canada, regulation of electric and gas utilities is overseen by independent, quasi-judicial provincial or territorial regulatory bodies. Accordingly, the transparency and stability of regulation and the timeliness of regulatory decisions can vary by jurisdiction. However, generally the regulatory frameworks in each jurisdiction are well established and there is a high expectation of timely recovery of cost and investments. Furthermore, Moody's considers the overall business environment in Canada to be relatively more supportive and less litigious than that of the U.S. Moody's views the supportiveness of the Canadian business and regulatory environments to be positive for regulated utility credit quality and believes that these factors, to some degree, offset the relatively lower ROEs and higher deemed debt components typically allowed by Canadian regulatory bodies for rate-making purposes. As a result of the relatively low ROEs and higher deemed debt levels that are generally characteristic of Canadian utilities, for a given rating category, these entities often have weaker credit metrics than their international peers.

## Regulated Electric and Gas Utilities

In Latin America, there is a perceived lower level of regulatory supportiveness than in other regions. In Argentina, although the generation industry is deregulated, the government continues to intervene in the process of setting prices and tariffs. In addition, collections from sales to the spot market have only been partial and have depended on the government's discretion. Moody's views the current regulatory framework as a relatively high risk factor given the government's interference, the unclear regulations, the lack of support for the companies' profitability, and the lack of incentives for much needed long-term investment. Brazil's power generation companies could also be affected by unfavorable regulatory decisions, since about 75% of its electricity currently goes to the regulated market, but Moody's last year noted improvements in Brazil's regulatory environment, which led to several issuer upgrades. Brazil's regulatory model provides a more supportive environment for acceptable rates of return since the current rules for electric utilities are more transparent and technically driven. Nonetheless, there is a lower assurance of timely recovery of costs and investments in Brazil since the new framework has not yet experienced the stress of high inflation, exchange rate devaluation or electricity rationing. Recent distribution tariff review reductions have typically been in the high-single-digit range, which is considered modest, particularly compared to Moody's rated issuers in El Salvador (14% reduction) and Guatemala (45% reduction) both of which led to downgrades last year. The regulatory framework in Chile, in Moody's opinion, comes closest to the United States in terms of regulatory supportiveness.

## Regulated Electric and Gas Utilities

### Appendix F: Key Rating Issues Over the Intermediate Term

#### Global Climate Change and Environmental Awareness

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Electric and gas utilities will continue to be affected by growing concerns over global climate change and greenhouse gas emissions, which are particularly important in the electricity generation segment which continues to rely on a large number of coal and natural gas fired power plants. There have been significant increases in environmental expenditure estimates among utilities with significant coal fired generation in recent years as policymakers have mandated pollution control measures and emissions limitations in response to public concerns over carbon. These expenditures are likely to continue to increase with the imposition of new and sometimes uncertain requirements with respect to carbon emissions. Utilities may have to implement substantial additional reductions in power plant emissions and could experience progressively higher capital expenditures over the next decade. In the U.S., the planned construction of several new coal plants has been cancelled as a result of opposition from regulators, political leaders, and the public or because cheaper alternatives appeared more compelling due to higher coal plant construction costs.

#### Large Capital Expenditures and Rising Costs for New Generation and Transmission

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While the global recession may have reduced electric demand in certain regions in the short-term, longer-term worldwide demand for electricity is expected to continue to grow and many utilities will incur substantial capital expenditures for new generation, as well as for upgrades and expansions to transmission systems. In the U.S., the Edison Electric Institute projects annual capacity additions among investor-owned utilities to increase to over 15,000 megawatts (MW) in 2009 compared with less than 6,000 MW in 2006. Some of the new plants announced include large, highly capital intensive nuclear plants, which have not been built in the U.S. in many years. In Indonesia, the Fast Track program calls for the addition of 9,000 MW of coal-fired power plants while India plans to build eight ultra-mega power projects (each under 4,000 MW). Similar large nuclear plants are being constructed worldwide in countries as diverse as Bulgaria, China, India, Russia, South Korea, Taiwan and Ukraine. Because of this construction boom, international demand for certain construction materials, plant components and skilled labor has driven up the cost of new nuclear. More recently, the global economic slowdown may relieve some of this cost pressure.

#### Political and Regulatory Risk

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As the utility industry faces higher operating costs, rising environmental compliance expenditures, large capital expenditures for new generation, as well as fuel and commodity price risks, the need for rate relief and other regulatory support will continue to be a key rating factor. In the U.S., political intervention in the regulatory process following particularly large rate increase requests increased risk and negatively affected the credit ratings of utilities in Illinois and Maryland in recent years. In Europe, rising electricity prices two years ago resulted in widespread criticism of utilities in several countries, increasing regulatory and political risk for some of them. In Australia, the transition from state based regulation to a national regulatory framework could pose a moderate level of uncertainty to current regulatory thinking over the longer term. In Asia Pacific (ex-Japan) and Latin America, the governments face political pressure regarding tariff adjustments given their need to balance socio-economic targets and inflationary concerns against the objective of ensuring reliable electricity supply over the long term.

#### Economic and Financial Market Conditions

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Although electric and gas utilities are somewhat resistant (although not immune) to unsettled economic and financial market conditions due partly to the essential nature of the service provided, a protracted or severe recession could negatively affect credit profiles over the intermediate term in several ways. Falling demand for electricity or natural gas could negatively impact margins and debt service protection measures. Poor economic conditions could make it more difficult for regulators to approve needed rate increases or provide timely cost recovery for utilities, resulting in higher cost deferrals and longer regulatory lag. Finally,

## Regulated Electric and Gas Utilities

constrained capital market conditions could severely limit the availability of credit necessary to finance needed capital expenditures, or make such financing plans more expensive.

### Appendix G: Regional and Other Considerations

#### Notching Considerations - Structural Subordination and Holding Company Ratings

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Utility corporate structures often include multiple legal entities within a single consolidated organization under an unregulated parent holding company. The holding company typically has one or more regulated operating subsidiaries and may have one or more unregulated subsidiaries as well. Most utility families issue debt at several of these legal entities within the organizational family including the parent holding company and the utility subsidiaries. In such cases, our approach is to assess each issuer on a standalone basis as well as to evaluate the creditworthiness of the consolidated entity. We also consider the interdependent relationships that may exist among affiliates and the degree to which a management team operates its utility subsidiaries as a system. We then assess the degree of legal and regulatory insulation that exists between the generally lower-risk regulated entities and the generally higher-risk unregulated entities.

The degree of notching (or rating differential) between entities in a single family of companies depends on the degree of insulation that exists between the regulated and unregulated entities, as well as the amount of debt at the holding company in comparison to the consolidated entity. If there is minimal insulation or ring-fencing between the parent and subsidiary and little to no debt at the parent, there is typically a one notch differential between the two to reflect structural subordination of the parent company debt compared to the operating subsidiary debt. If there is substantial insulation between the two and/or debt at the parent company is a material percentage of the overall debt, there could be two or more notches between the ratings of the parent and the subsidiary.

#### U.S. Securitization

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Since the late 1990s, legislatively approved stranded cost and other regulatory asset securitization has become an increasingly utilized financing technique among some investor-owned electric utilities. In its simplest form, a stranded cost securitization isolates and dedicates a stream of cash flow into a separate special purpose entity (SPE). The SPE uses that stream of revenue and cash flow to provide annual debt service for the securitized debt instrument. Securitizations were originally done to reimburse utilities for stranded costs following deregulation, which was primarily related to the actual lower market values of the legacy generation compared to its book value. More recently, securitizations have been done to reimburse utilities for storm restoration costs following two active hurricane seasons in the U.S. in 2004 and 2005, with additional securitizations planned following an active 2008 hurricane season, as well as for environmental equipment. In 2007, Baltimore Gas & Electric used securitization to fund supply cost deferrals. Securitization could also be used to help fund the next generation of nuclear plants to be built in the U.S.

Although it often addresses a major credit overhang and provides an immediate source of cash, Moody's treats securitization debt of utilities as being on-credit debt. In calculating balance sheet leverage, Moody's treats the securitization as being fully recourse to the utility as accounting guidelines require the debt to appear on the utility's balance sheet. In looking at cash flow coverages, Moody's analysis focuses on ratios that include the securitized debt in the company's total debt as being the most consistent with the analysis of comparable companies. Securitizations also entail transition or other charges on ratepayer bills that may limit a utility's flexibility to raise rates for other reasons going forward. While our standard published credit ratios include the securitization debt, we also look at the ratios without the securitization debt and cash flow in our analysis, to distinguish this debt and ensure that the benefits of securitization are not ignored.

## Regulated Electric and Gas Utilities

### Strong levels of government ownership in Asia Pacific (ex-Japan) provide rating uplift

Strong levels of government ownership dominate Asia Pacific (ex-Japan) power utilities and remain one of their key rating drivers. The current majority state ownership levels are expected to remain largely unchanged for the near to medium term, thereby providing rating uplift to a majority of the government-owned Asia Pacific (ex-Japan) utilities under the Joint Default Analysis methodology.

### Appendix H: Treatment of Power Purchase Agreements ("PPA's")

Although many utilities own and operate power stations, some have entered into PPAs to source electricity from third parties to satisfy retail demand. The motivation for these PPAs may be one or more of the following: to outsource operating risks to parties more skilled in power station operation, to provide certainty of supply, to reduce balance sheet debt, or to fix the cost of power. While Moody's regards these risk reduction measures positively, some aspects of PPAs may negatively affect the credit of utilities.

Under most PPAs, a utility is obliged to pay a capacity charge to the power station owner (which may be another utility or an Independent Power Producer – IPP); this charge typically covers a portion of the IPP's fixed costs in relation to the power available to the utility. These fixed payments usually help to cover debt service and are made irrespective of whether the utility requires the IPP to generate and deliver power. When the utility requires generation, a further energy charge, to cover the variable costs of the IPP, will also be paid by the utility. Some other similar arrangements are characterized as tolling agreements, or long-term supply contracts, but most have similar features to PPAs and are thus analyzed by Moody's as PPAs.<sup>4</sup>

### Factors determining the treatment of PPAs

Because PPAs have a wide variety of financial and regulatory characteristics, each particular circumstance may be treated differently by Moody's. The most conservative treatment would be to treat the PPA as a debt obligation of the utility as, by paying the capacity charge, the utility is effectively providing the funds to service the debt associated with the power station. At the other end of the continuum, the financial obligations of the utility could also be regarded as an ongoing operating cost, with no long-term capital component recognized. Factors which determine where on the continuum Moody's treats a particular PPA are as follows:

- **Risk management:** An overarching principle is that PPAs have been used by utilities as a risk management tool and Moody's recognizes that this is the fundamental reason for their existence. Thus, Moody's will not automatically penalize utilities for entering into contracts for the purpose of reducing risk associated with power price and availability. Rather, we will look at the aggregate commercial position, evaluating the risk to a utility's purchase and supply obligations. In addition, PPAs are similar to other long-term supply contracts used by other industries and their treatment should not therefore be fundamentally different from that of other contracts of a similar nature.
- **Pass-through capability:** Some utilities have the ability to pass through the cost of purchasing power under PPAs to their customers. As a result, the utility takes no risk that the cost of power is greater than the retail price it will receive. Accordingly Moody's regards these PPA obligations as operating costs with no long-term debt-like attributes. PPAs with no pass-through ability have a greater risk profile for utilities. In some markets, the ability to pass through costs of a PPA is enshrined in the regulatory framework, and in others can be dictated by market dynamics. As a market becomes more competitive, the ability to pass through costs may decrease and, as circumstances change, Moody's treatment of PPA obligations will alter accordingly.
- **Price considerations:** The price of power paid by a utility under a PPA can be substantially below the current spot price of electricity. This will motivate the utility to purchase power from the IPP even if it

<sup>4</sup> When take-or-pay contracts, outsourcing agreements, PPAs and other rights to capacity are accounted for as leases under US GAAP or IFRS, they are treated by Moody's as such for analytical purposes.



## Regulated Electric and Gas Utilities

does not require it for its own customers, and to sell excess electricity in the spot market. This can be a significant source of cash flow for some utilities. On the other hand, utilities that are compelled to pay capacity payments to IPPs when they have no demand for the power or when the spot price is lower than the PPA price will suffer a financial burden. Moody's will particularly focus on PPAs that have mark-to-market losses that may have a material impact on the utility's cash flow.

- **Excess Reserve Capacity:** In some jurisdictions there is substantial reserve capacity and thus a significant probability that the electricity available to a utility under PPAs will not be required by the market. This increases the risk to the utility that capacity payments will need to be made when there is no demand for the power. For example, Tenaga, the major Malaysian utility, purchases a large proportion of its power requirement from IPPs under PPAs. PPA payment totaled 42.0% of its operating costs in FY2008. In a high reserve margin environment existing in Malaysia, capacity payment under these PPAs are a significant burden on Tenaga, and some account must be made for these payments in its financial metrics.
- **Risk-sharing:** Utilities that own power plants bear the associated operational, fuel procurement and other risks. These must be balanced against the financial and liquidity risk of contracting for the purchase of power under a PPA. Moody's will examine on a case-by case basis which of these two sets of risk poses greatest concern from a ratings standpoint.
- **Default provisions:** In most cases, a default under a PPA will not cross-default to the senior facilities of the utility and thus it is inappropriate to add the debt amount of the PPA to senior debt of the entity. The PPA obligations are not senior obligations of the utility as they do not behave in the same way as senior debt. However, it may be appropriate in some circumstances to add the PPA obligation to Moody's debt, in the same way as other off-balance sheet items.<sup>5</sup>
- **Accounting:** From a financial reporting standpoint, very few PPA's have thus far resulted in IPP's being consolidated by the off taker. Similarly, very few PPA's are treated as lease obligations. Due to upcoming accounting rule changes<sup>6</sup>, however, coupled with many contracts being renegotiated and extended over the next several years, we expect to see an increasing number of projects being consolidated or PPA's accounted for as leases on utility financial statements. Many of the factors assessed in the accounting decision are the same as in our analysis, i.e. risk and control. However, our analysis also considers additional factors that the accountants may not, such as the ability to pass through costs. We will consider the rationale behind the accounting decision and compare it to our own analysis and may not necessarily come to the same conclusion as the accountants.

Each of these factors will be weighed by Moody's analysts and a decision will be made as to the importance of the PPA to the risk analysis of the utility.

### Methods of accounting for PPAs in our analysis

According to the weighting and importance of the PPA to each utility and the level of disclosure, Moody's may analytically assess the total debt obligations for the utility using one of the methods discussed below.

- **Operating Cost:** If a utility enters into a PPA for the purpose of providing an assured supply and there is reasonable assurance that regulators will allow the costs to be recovered in regulated rates, Moody's may view the PPA as being most akin to an operating cost. In this circumstance, there most likely will be no imputed adjustment to the debt obligations of the utility. In the event operating costs are consolidated, we will attempt to deconsolidate these costs from a utility's financial statements.
- **Annual Obligation x 6:** In some situations, the PPA obligation may be estimated by multiplying the annual payments by a factor of six (in most cases). This method is sometimes used in the capitalization of operating leases. This method may be used as an approximation where the analyst determines that the obligation is significant but cannot be quantified otherwise due to limited information.

<sup>5</sup> See "The Analysis of Off-Balance Sheet Exposures – A Global Perspective", Rating Methodology, July 2004.

<sup>6</sup> SFAS 167 "Amendments to FASB Interpretation No. 46(r)" will be effective Q1 2010.

## Regulated Electric and Gas Utilities

- **Net Present Value:** Where the analyst has sufficient information, Moody's may add the NPV of the stream of PPA payments to the debt obligations of the utility. The discount rate used will be the cost of capital of the utility.
- **Debt Look-Through:** In some circumstances, where the debt incurred by the IPP is directly related to the off-taking utility, there may be reason to allocate the entire debt (or a proportional part related to share of power dedicated to the utility) of the IPP to that of the utility.
- **Mark-to-Market:** In situations in which Moody's believes that the PPA prices exceed the spot price and thus a liability is arising for the utility, Moody's may use a net mark-to-market method, in which the NPV of the net cost to the utility will be added to its total debt obligations.
- **Consolidation:** In some instances where the IPP is wholly dedicated to the utility, it may be appropriate to consolidate the debt and cash flows of the IPP with that of the utility. Again, if the utility purchases only a portion of the power from the IPP, then that proportion of debt might be consolidated with the utility.

In some circumstances, Moody's will adopt more than one method to estimate the potential obligations imposed by the PPA. This approach recognizes the subjective nature of analyzing agreements that can extend over a long period of time and can have a different credit impact when regulatory or market conditions change. In all methods the Moody's analyst will account for the revenue from the sale of power bought from the IPP. We will focus on the term to maturity of the PPA obligation, the ability to pass through costs and curtail payments, and the materiality of the PPA obligation to the overall cash flows of the utility in assessing the effect of the PPA on the credit of the utility.

## Moody's Related Research

### Industry Outlooks:

- U.S. Regulated Electric Utilities, Six-Month Update, July 2009 (118776)
- U.S. Investor-Owned Electric Utility Sector, January 2009 (113690)
- EMEA Electric and Gas Utilities, November 2008 (112344)
- North American Natural Gas Transmission & Distribution, March 2009 (115150)

### Rating Methodologies:

- Unregulated Utilities and Power Companies, August 2009 (118508)
- Regulated Electric and Gas Networks, August 2009 (118786)

### Special Comments:

- Credit Roadmap for Energy Utilities and Power Companies in the Americas, March 2009 (115514)

*To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.*

## Regulated Electric and Gas Utilities

**Analyst Contacts (continued):**

**London** 44.20.7772.5454

**Raffaella Altamura**  
Analyst

**Monica Merli**  
Team Managing Director

**Hong Kong** 852.3551.3077

**Jennifer Wong**  
Assistant Vice President - Analyst

**Gary Lau**  
Senior Vice President

**Sydney** 61.2.9270.8100

**Clement Chong**  
Vice President – Senior Analyst

**Terry Fanous**  
Senior Vice President

**Brian Cahill**  
Managing Director/Australia

**Tokyo** 81.3.5408.4100

**Kenji Okamoto**  
Vice President – Senior Analyst

Report Number: 118481

Author	Associate Analyst	Production Specialist
Michael G. Haaqartv	Mitchell Moss	Yelena Ponirovskaya

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## Equity Risk Premium - Treasury Bond

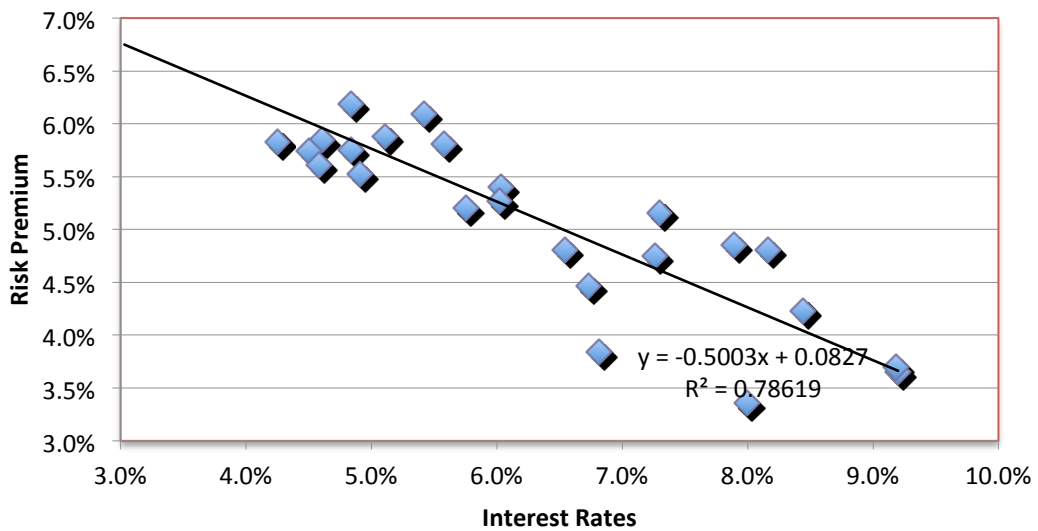
<u>Line</u>	<u>No. of Decisions</u>	<u>Date</u>	<u>Treasury Bond Yield<sup>1</sup></u> (1)	<u>Authorized Nat Gas Returns<sup>2</sup></u> (2)	<u>Indicated Risk Premium</u> (3)
1		1986	7.89%	12.74%	4.9%
2	29	1987	9.20%	12.85%	3.7%
3	31	1988	9.18%	12.88%	3.7%
4	31	1989	8.16%	12.97%	4.8%
5	31	1990	8.44%	12.67%	4.2%
6	35	1991	7.30%	12.46%	5.2%
7	29	1992	7.26%	12.01%	4.8%
8	45	1993	6.54%	11.35%	4.8%
9	28	1994	7.99%	11.35%	3.4%
10	16	1995	6.03%	11.43%	5.4%
11	20	1996	6.73%	11.19%	4.5%
12	13	1997	6.02%	11.29%	5.3%
13	10	1998	5.42%	11.51%	6.1%
14	9	1999	6.82%	10.66%	3.8%
15	12	2000	5.58%	11.39%	5.8%
16	7	2001	5.75%	10.95%	5.2%
17	21	2002	4.84%	11.03%	6.2%
18	25	2003	5.11%	10.99%	5.9%
19	20	2004	4.84%	10.59%	5.8%
20	26	2005	4.61%	10.46%	5.9%
21	16	2006	4.91%	10.43%	5.5%
22	10	2007	4.50%	10.24%	5.7%
23	30	2008	3.03%	10.37%	7.3%
24	29	2009	4.58%	10.19%	5.6%
25	36	2010	4.25%	10.08%	5.8%
27	559	<b>Average</b>	<b>6.2%</b>	<b>11.4%</b>	<b>5.2%</b>

Sources:

<sup>1</sup> Mornistar 2010 Valuation Yearbook Table B-9

<sup>2</sup> SNL (Regulatory Research Associates), *Regulatory Focus*.  
Jan. 86 - Jan. 11

### Risk Premium vs Treasury Bond Yields 1986-2010



IFYIELD = 4.40%  
 THEN RP = 6.21%  
 Ke = 10.61%

### Allowed Risk Premium 2006-2010



