BEFORE THE
NEW YORK STATE
PUBLIC SERVICE COMMISSION

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Joint Petition of IBERDROLA, S.A.,
Energy East Corporation, RGS Energy Group, Inc.,
Green Acquisition Capital, Inc.,
New York State Electric & Gas Corporation and Rochester Gas and Electric Corporation for Approval of the Acquisition of Energy East Corporation by IBERDROLA, S.A.
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Case 07-M-0906

REBUTTAL TESTIMONY OF STEVEN M. FETTER

January 31, 2008

STEVEN M. FETTER

INTRODUCTION AND BACKGROUND

Q. PLEASE STATE YOUR NAME, TITLE, AND BUSINESS ADDRESS.

A. My name is Steven M. Fetter. I am President of Regulation UnFettered. My business address is 1489 W. Warm Springs Rd., Suite 110, Henderson, NV 89014.

Q. ON WHOSE BEHALF ARE YOU TESTIFYING?

A. I am testifying on behalf of Iberdrola S.A., which I shall refer to as "Iberdrola" or the "Company".

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am President of Regulation UnFettered, a utility advisory firm I started in April 2002. Prior to that, I was employed by Fitch, Inc. ("Fitch"), a credit rating agency based in New York and London. Prior to that, I served as Chairman of the Michigan Public Service Commission ("Michigan PSC").

Q. WHAT IS YOUR EDUCATIONAL BACKGROUND?

A. I graduated with high honors from the University of Michigan with an A.B. in Communications in 1974. I graduated from the University of Michigan Law School with a J.D. in 1979.

Q. PLEASE BRIEFLY DESCRIBE YOUR ROLE AS PRESIDENT OF REGULATION UNFETTERED.

A. I formed a utility advisory firm to use my financial, regulatory, legislative, and legal expertise to aid the deliberations of regulators, legislative bodies, and the courts, and to assist them in evaluating regulatory issues. My clients include investor-owned, municipal and international electric, natural gas and water utilities, state public utility commissions and consumer advocates, non-utility energy suppliers, international financial services and consulting firms, and investors.

Q. WHAT WAS YOUR ROLE DURING YOUR EMPLOYMENT WITH FITCH?

A. I was Group Head and Managing Director of the Global Power Group within Fitch. In that role, I served as group manager of the combined 18-person New York and Chicago utility team. I was originally hired to interpret the impact of regulatory and legislative developments on utility credit ratings, a responsibility I continued to have throughout my tenure at the rating agency. In April 2002, I left Fitch to start Regulation UnFettered.

Q. HOW LONG WERE YOU EMPLOYED BY FITCH?

A. I was employed by Fitch from October 1993 until April 2002. In addition, Fitch retained me as a consultant for a period of approximately six months shortly after I resigned.

Q. HOW DOES YOUR EXPERIENCE RELATE TO YOUR TESTIMONY IN THIS PROCEEDING?

A. My experience as a Commissioner on the Michigan PSC and my subsequent professional experience analyzing the U.S. electric and natural gas sectors – in jurisdictions involved in restructuring activity as well as those still following a traditional regulated path – have given me solid insight into the importance of a regulator's role in setting rates, determining appropriate terms and conditions of service for all regulated utilities, and considering issues related to utility mergers and acquisitions. These are the factors that enter into the process of utility credit analysis and formulation of individual company credit ratings. It is a well-established fact that a utility's credit ratings have a significant impact as to whether that utility will be able to raise capital on a timely basis and upon favorable terms.

Q. HAVE YOU PREVIOUSLY SPONSORED TESTIMONY BEFORE REGULATORY AND LEGISLATIVE BODIES?

A. Since 1990, I have on numerous occasions testified before the U.S. Senate, the U.S. House of Representatives, the Federal Energy Regulatory Commission, and various state legislative and regulatory bodies on the subjects of credit risk within the utility sector, electric and natural gas utility restructuring, fuel and other energy adjustment mechanisms, utility mergers and acquisitions, utility securitization bonds, and nuclear energy. With regard to approval of utility mergers, I have previously testified on that issue on behalf of Cinergy Corporation, Cincinnati Gas & Electric Company, and Union Light, Heat and Power Company in their merger with Duke Energy Corporation before the Indiana Utility Regulatory Commission (in Case No. 42873), the Public Utilities

Commission of Ohio (in Case Nos. 05-732-EL-MER and 05-733-EL-AAM), and the Kentucky Public Service Commission (in Case No. 2005-00228).

My full educational and professional background is presented in Exhibit ___ (SMF-1).

Q. DOES YOUR TESTIMONY ADDRESS STAFF'S RESPONSES TO INFORMATION REQUESTS RELATED TO THE STAFF POLICY PANEL'S DIRECT TESTIMONY ADDRESSING THE ISSUES DISCUSSED IN YOUR TESTIMONY?

A. Yes. I have received and reviewed several responses by Staff to information requests related to the Staff Policy Panel's direct testimony and have specifically addressed some of the responses in my rebuttal testimony. However, additional analysis will be required to review and possibly specifically address many of Staff's responses as there was insufficient time to complete my review in the time provided to submit my testimony. I further note that in certain responses, Staff has indicated that it intends to revise certain exhibits and I reserve the right to modify my rebuttal testimony at hearing to address any changes to Staff's exhibits.

Q. ARE YOU SPONSORING ANY EXHIBITS?

A. Yes. In addition to my first exhibit, which is my educational and professional background, I sponsor the following: Exhibit __ (SMF-2) is an S&P Research publication entitled “U.S. Electric Utility Companies, Strongest to Weakest”;

Exhibit __ (SMF-3) is an S&P research report entitled "U.S. Utilities Ratings Analysis Now Portrayed in the S&P Corporate Ratings Matrix"; Exhibit ___ (SMF-4) is a Moody's report entitled "Moody's downgrades Iberdrola to A3/P-2; Stable outlook"; Exhibit __(SMF-5) contains a copy of certain interrogatory responses referenced in this testimony; and Exhibit ___ (SMF-6) is an S&P Research Report entitled "Energy East Corp.," November 16, 2007.

EXECUTIVE SUMMARY

Q. WHAT IS THE PURPOSE OF YOUR REBUTTAL TESTIMONY?

A. I have reviewed the prepared testimony of the New York Public Service Commission Staff Policy Panel ("Staff", "Policy Panel" or "PP") and will rebut the following views expressed by those individuals:

a) "Credit ratings are snapshots of a company's existing circumstances and by nature are subject to change when a company's circumstances inevitably change," (PP at 151), and that "S&P has put NYSEG and RG&E on watch for a downgrade if the transaction is completed." (PP at 167-168);

b) that reports by S&P and Moody's support the Policy Panel's belief that: "it is unlikely that the Company can sustain an "A" rating….Moreover,…the capital structure of Iberdrola is not consistent with an "A" rating currently and any increase in its leverage will make a downgrade or multiple downgrades more likely," (PP at 151–162), and that Iberdrola's latest strategic plan, including an extensive capital investment program, could lead to Iberdrola's ratings being downgraded, (PP at 163);

c) that Iberdrola's financial standing could make it more difficult for NYSEG and RG&E "to raise capital in the financial markets at reasonable terms," (PP at 164-165), and that S&P has "indicated specifically that bond rating downgrades for NYSEG and RG&E are likely if the transaction is approved." (PP at 167-168);

d) that "the Commission should insist on…ring fencing conditions" as a condition of approval of the merger, (PP at 174);

e) that "the investment community [has] rendered an assessment on Iberdrola's affect on NYSEG and RG&E" because NYSEG "issued debt 225 basis points above 10-year treasuries" while other companies issued debt at lower spreads (approximately 30 basis points lower compared to such treasuries), and the reasons the Policy Panel provides for the discrepancy in those spreads, (PP at 175-178);

f) the presence of Goodwill at Iberdrola as "an impediment to [Iberdrola's] credit quality," (PP at 179-193); and

g) the Policy Panel's discomfort with Iberdrola's capital structure and its potential impacts on ratemaking and credit ratings, (PP at 194-210).

CREDIT RATINGS OVERVIEW

Q. WHAT CREDIT RATINGS DO IBERDROLA, ENERGY EAST AND ITS REGULATED UTILITY SUBSIDIARIES CURRENTLY HOLD?

A. Iberdrola's current corporate (senior unsecured) credit ratings are "A-" from Standard & Poor's ("S&P") and the equivalent "A3" from Moody's. Both ratings have a Stable outlook. These ratings equate to mid-level investment-grade ratings. Fitch's issuer default rating for Iberdrola is 'A' with a Negative outlook. Energy East and its regulated subsidiaries, NYSEG and RG&E, currently hold corporate credit ratings of "BBB+" from S&P. At Moody's, Energy East holds a senior unsecured rating of "Baa2", while NYSEG and RG&E are rated at "Baa1". These ratings have a Negative outlook at both S&P and Moody's. At Fitch, Energy East's issuer default rating is 'BBB' with a Stable outlook; NYSEG is at 'BBB' with a Negative outlook; and RG&E is at 'BBB-' with a Stable outlook. The ratings of Energy East and its subsidiaries equate to low-to-mid-level investment-grade ratings.

Q. PLEASE GENERALLY DESCRIBE THE CREDIT RATINGS PROCESS.

A. Credit ratings reflect a credit rating agency's independent judgment of the general creditworthiness of an obligor or the creditworthiness of a specific debt instrument. While credit ratings are important to both debt and equity investors for a variety of reasons, their most important purpose is to communicate to investors the financial strength of a company or the underlying credit quality of a particular debt security issued by that company. Credit rating determinations are made through a committee process involving individuals with knowledge of a company, its industry, and its regulatory environment.

Corporate credit ratings analysis considers both qualitative and quantitative factors to assess the financial and business risks of fixed-income issuers. A credit rating is an indication of an issuer's ability to service its debt, both principal and interest, on a timely basis. It also at times incorporates some consideration of ultimate recovery of investment in case of default or insolvency.

Q. CAN YOU PROVIDE A BRIEF DISCUSSION ON WHY CREDIT RATINGS ARE IMPORTANT FOR REGULATED UTILITIES AND THEIR CUSTOMERS?

A. Yes. It is a well-established fact that a utility's credit ratings have a significant impact as to whether that utility will be able to raise capital on a timely basis and upon reasonable terms. As respected economist Charles F. Phillips stated in his treatise on utility regulation:

> Bond ratings are important for at least four reasons: (1) they are used by investors in determining the quality of debt investment; (2) they are used in determining the breadth of the market, since some large institutional investors are prohibited from investing in the lower grades; (3) **they determine, in part, the cost of new debt, since both the interest charges on new debt and the degree of difficulty**

> **in marketing new issues tend to rise as the rating decreases**; and (4) they have an indirect bearing on the status of a utility's stock and on its acceptance in the market.[1] [Emphasis supplied.]

Thus, the lower a regulated utility's credit rating, the more the utility will have to pay to raise funds from debt and equity investors to carry out its capital-intensive operations. In turn, the ratemaking process factors the cost of capital for both debt and equity into the rates that consumers are required to pay. Thus, a utility with strong credit ratings is not only able to access the capital markets on a timely basis at reasonable rates, it also is able to share the benefit from those attractive interest rate levels with customers since cost of capital gets factored into utility rates.

Q. PLEASE DESCRIBE THE QUALITATIVE FACTORS USED BY THE RATING AGENCIES IN RATING UTILITY COMPANIES.

A. The most important qualitative factors include regulation, management and business strategy (including management's transparency, credibility, and ability to deliver upon its commitments), and access to energy, gas and fuel supply with recovery of associated costs.

Q. PLEASE EXPLAIN YOUR THOUGHTS ON THE IMPORTANCE OF REGULATION WITHIN THE CREDIT RATINGS PROCESS?

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[1] C.J. Phillips, Pub. Utils. Reports, Inc., *The Regulation of Public Utilities*, *Theory and Practice* at 250 (1993). *See also* Public Utilities Reports Guide: "Finance," Pub. Utils. Reports, Inc. at 6-7 ("Generally, the higher the rating of the bond, the better the access to capital markets and the lower the interest to be paid.").

A. Regulation is a key factor in assessing the credit profile of a utility because a state public utility commission determines retail rate levels (recoverable expenses including depreciation and operations and maintenance, fuel cost recovery, and return on investment), the terms and conditions of service, and, in a case like this, the future structure of the utilities within its regulatory jurisdiction.

Since the mid-1990s when many states, including New York, introduced industry restructuring plans and opportunity for greater competition, regulation has become an even more important factor as the nature of a utility's responsibilities in providing energy services to customers has undergone dramatic change. In some states, industry restructuring was the result of plans formulated by the state legislature. In other states, the regulators, rather than the legislators, have determined the nature and pace of restructuring, or whether it would occur at all.

This situation thus affects utility investors' decisions because, before major investors will be willing to put forward substantial sums of money, they will want to gain comfort that regulators understand the economic requirements and the financial and operational risks of a rapidly changing industry and that their decision-making will be fair and will have a significant degree of predictability.

For these reasons, rating agencies look for the consistent application of sound economic regulatory principles by the commissions. If a regulatory body were to encourage a company to make investments based upon an expectation of the opportunity to earn a reasonable return, and then did not apply regulatory principles in a manner consistent with such expectations, investor interest in providing funds to such utility would decline, debt ratings would likely suffer, and the utility's cost of capital would increase.

Q. IN VIEW OF THE INDUSTRY CHANGES AND EVENTS DETAILED ABOVE, DO THE ACTIONS OF UTILITY REGULATORS TODAY DRAW EVEN MORE ATTENTION FROM THE FINANCIAL COMMUNITY?

A. Yes, without a doubt. Regulation has always garnered the attention of Wall Street, but, years ago, seemingly only during the days leading up to a commission's rate case decision. This began to change around the time that Fitch hired me in 1993 to serve in the role of regulatory analyst and assess regulatory, legislative and political factors that could affect a utility's financial strength. When California announced its ultimately ill-fated restructuring plan in 1994, the entire financial community, especially the rating agencies, took much greater notice of regulators and how they carried out their responsibilities, not only with regard to rate-setting, but even more importantly the manner in which they undertook to change the way the entire utility industry had operated for over 100 years.

S&P highlighted how the changing dynamics within the electric utility industry that I reference above have elevated the importance of regulation to the financial community:

> In recent years, [S&P's] emphasis on the decisions by state commissions has been less pronounced simply because so many

> jurisdictions have been working through multiyear restructuring transition periods. During this time, rates were frequently frozen, and companies and customers have been adjusting (albeit with limited success) to the opportunity that customers have to choose alternate power suppliers. But the confluence of the approaching end of these transition periods and the growing need in certain regions of the country for significant resource additions is quickly returning the regulatory arena to center stage. In assessing the regulatory environment in which a utility operates, [S&P's] analysis is guided by certain principles, most prominently consistency and predictability, as well as efficiency and timeliness. For a regulatory scheme to be considered supportive of credit quality, commissions must limit uncertainty in the recovery of a utility's investment. They must also eliminate, or at least greatly reduce, the issue of rate-case lag that may prove detrimental if a utility needs rate relief.[2]

Q. COULD YOU PLEASE DESCRIBE THE QUANTITATIVE FACTORS USED BY THE RATING AGENCIES?

A. Yes. Financial performance continues to be a very important element in credit rating analysis. Credit rating agencies and fixed-income analysts utilize analytical ratios to understand the credit profile of a utility, with S&P publicly explaining the three

[2] S&P Research: "U.S. Utility Regulation Returns to Center Stage," April 14, 2005.

financial measures that it views as most important in its analysis of utility companies: Funds from Operations ("FFO") Interest Coverage; Funds from Operations / Total Debt; and Total Debt / Total Capital. While all three ratios are important, S&P has noted the agency's greater emphasis on cash flow measures, or the first two ratios: "Cash flow analysis is the single most critical aspect of all credit rating decisions."[3] Thus, as I address further below, the ratio most emphasized by the Staff Policy Panel -- Total Debt / Total Capital -- is the ratio given least emphasis by the rating agencies themselves. I note that rating agencies may adjust these key ratios to reflect imputed debt and interest-like fixed charges flowing from purchased power agreements and certain other off-balance sheet obligations.[4]

Building upon those key ratios, S&P has been the most explicit of the three major rating agencies in explaining how it views the interplay between quantitative and qualitative factors. As part of its utility credit rating process, S&P arrives at a "Business Risk Profile" designation that it considers in concert with its "Financial Risk Profile." Financial Risk is assessed based upon indicative ratios for the three key credit measures cited above; the weaker the Business Risk Profile designation, the stronger the financial ratios must be in order to support an investment-grade rating.

Q. WHAT DOES S&P'S BUSINESS RISK PROFILE DESIGNATION REFLECT?

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[3] S&P Research: "A Closer Look at Ratings Methodology," November 13, 2006.
[4] ***See, e.g.***, S&P Research: "Standard & Poor's Methodology for Imputing Debt for U.S. Utilities' Power Purchase Agreements," May 7, 2007.

A. The Business Risk Profile designation reflects S&P's assessment of qualitative factors such as regulation, markets, operations, competitiveness, and management. Interestingly, on November 30, 2007, S&P announced that it had inserted utility companies into its longstanding "Corporate Ratings" matrix, and that this new framework superseded its prior "Utility Financial Targets" matrix.[5] Thus, while previously S&P had measured business profiles on a '1' (meaning very strong) to '10' (meaning very weak) scale, going forward S&P will rank business risk as 'Excellent', 'Strong', 'Satisfactory', 'Weak', or 'Vulnerable'. However, it is important to note that S&P stated in its recent report announcing the change that "Regulated utilities and holding companies that are utility-focused virtually always fall in the upper range ("Excellent" or "Strong") of business risk profiles."[6] Thus, analysts using this new matrix will be faced with the seemingly anomalous situation that a utility designated as 'Strong' (or the second highest of the five business risk profile rankings) will actually reside within the lower half of all U.S utility business risk profiles, basically at a below average level. Similarly, under S&P's new framework, Financial Risk Profiles will be designated as 'Minimal', 'Modest',

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[5] The Policy Panel makes frequent reference (at pp. 154, 191, 199 and 266) to S&P's Research: "New Business Profile Scores Assigned for U.S. Utility and Power Companies; Financial Guidelines Revised," June 2, 2004. However, that research report and "Utility Financial Targets" matrix has been superseded by S&P Research: "U.S. Utilities Ratings Analysis Now Portrayed in the S&P Corporate Ratings Matrix," November 30, 2007, with a modified methodology process as explained in the text above. This report is attached hereto as Exhibit __ (SMF-2).

[6] S&P Research: "U.S. Utilities Ratings Analysis Now Portrayed in the S&P Corporate Ratings Matrix," November 30, 2007. This report is attached hereto as Exhibit ___ (SMF-3).

'Intermediate', 'Aggressive', or 'Highly Leveraged', words that are not necessarily accurate descriptions of the strategies adopted by regulated utilities or the actions taken by their regulators.

Q. WHY IS S&P'S METHODOLOGY MEANINGFUL TO YOU?

A. I believe that S&P's methodology helps facilitate a general understanding of how a credit rating agency carries out the process of formulating a credit rating and the factors that go into such a determination.[7]

<u>REBUTTAL OF POLICY PANEL TESTIMONY</u>

Q. THE POLICY PANEL DESCRIBES CREDIT RATINGS AS "SNAPSHOTS OF A COMPANY'S EXISTING CIRCUMSTANCES" (PP AT 151) AND THAT S&P HAS PUT NYSEG AND RG&E ON WATCH FOR A DOWNGRADE IF THE TRANSACTION IS COMPLETED. IS THE PANEL ACCURATE IN ITS DESCRIPTIONS?

A. No, it is not. The Policy Panel professes to speak for how the financial community and the credit rating agencies will view Iberdrola, NYSEG and RG&E once the merger is consummated, but its understanding of the workings of credit rating agencies is deeply flawed.

[7] I focus here on S&P's ratings methodology, as opposed to those at Moody's or Fitch, due to the greater transparency of S&P's ratings process owing to its explanation of the methodology and how it is implemented in published reports. ***See, e.g.***, S&P Research: "U.S. Utilities Ratings Analysis Now Portrayed in the S&P Corporate Ratings Matrix," November 30, 2007, and S&P Research: "U.S. Electric Utility Companies, Strongest to Weakest," November 30, 2007. For a comparison, see Moody's Research: "Rating Methodology: Global Regulated Electric Utilities," March 2005.

Q. PLEASE EXPLAIN THE FLAWS IN THE POLICY PANEL'S DISCUSSION OF CREDIT RATINGS?

A. Credit ratings are not, as the Policy Panel asserts, snapshots in time. Both S&P and Moody's publish definitions of their ratings, and related outlooks and watch status. S&P's definitions are as follows:

> A Standard & Poor's rating evaluates default risk over the life of a debt issue, incorporating an assessment of all future events to the extent they are known or can be anticipated. But we also recognize the potential for future performance to differ from initial expectations. Rating outlooks and CreditWatch listings address this possibility by focusing on the scenarios that could result in a rating change.
>
> Ratings appear on CreditWatch when an event or deviation from an expected trend has occurred or is expected, and additional information is necessary to take a rating action…. A listing does not mean a rating change is inevitable…
>
> A rating outlook is assigned to all long-term debt issuers and assesses the potential for a rating change. Outlooks have a longer time frame than CreditWatch listings – typically, two years – and incorporate trend or risks

> with less certain implications for credit quality. An outlook is not necessarily a precursor of a rating change or a CreditWatch listing…
>
> CreditWatch designations and outlooks may be "positive," which indicates a rating may be raised, or "negative," which indicates a rating may be lowered…"Stable" is the outlook assigned when ratings likely will not be changed, but it should not be confused with expected stability of the company's financial performance…
>
> Issuer ratings…focus entirely on the default risk of the entity. Long-term issue ratings also take into account risks pertaining to loss-given-default…both the issuer and issue rating definitions are expressed in terms of default risk, which refers to the capacity and willingness of the obligor to meet its financial commitments on time, in accordance with the terms of the obligation.[8]

Q. HOW DOES S&P DEFINE THE RATING CATEGORIES AT ISSUE WITHIN THIS PROCEEDING: "A" AND "BBB"?

A. S&P defines those categories as follows:

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[8] S&P Research: "Corporate Ratings Criteria – Standard & Poor's Role in the Financial Markets; Ratings Definitions; The Rating Process," March 9, 2006.

> 'A': An obligation rated 'A' is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher rated categories. However, the obligor's capacity to meet its financial commitment on the obligation is still strong.
>
> 'BBB': An obligation rated 'BBB' exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation.[9]

Q. DOES MOODY'S VIEW THE SITUATION SIMILARLY?

A. Yes, it does. Moody's states that:

> Long-term obligation ratings are opinions of the relative credit risk of fixed-income obligations with an original maturity of one year or more. They address the possibility that a financial obligation will not be honored as promised…
>
> Issuer Ratings are opinions of the ability of entities to honor senior unsecured financial obligations and contracts.

[9] *Id.*

> A Moody's rating outlook is an opinion regarding the likely direction of an issuer's rating over the medium term. Where assigned, rating outlooks fall into the following four categories: Positive, Negative, Stable, and Developing….
>
> Moody's uses the Watchlist to indicate that a rating is under review for possible change in the short-term.[10]

Q. AND HOW DOES MOODY'S DEFINE THE 'A' AND 'BBB' CATEGORIES?

A. Moody's defines them as:

> "Obligations rated A are considered upper-medium grade and are subject to low credit risk."

and

> "Obligations rated Baa are subject to moderate credit risk. They are considered medium-grade and as such may possess certain speculative characteristics."[11]

Q. BASED UPON THOSE DEFINITIONS, WHAT DO YOU GLEAN FROM THE POLICY PANEL'S COMMENTS NOTED ABOVE?

A. It is clear that S&P and Moody's do not view their credit rating determinations as "snapshots" of an existing moment in time, and this is confirmed by my experience

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[10] "Moody's Rating Symbols and Definitions," March 2007.

[11] *Id.*

as head of the utility ratings practice at Fitch. When assigning a rating, we would convene a rating committee, consider both qualitative and quantitative factors (including financial forecasts), and come to our best judgment as to the appropriate rating for a security until its maturity. As noted, at the time of assignment of a rating, an outlook is provided to indicate the potential direction of a rating's movement during the medium-term, usually two to three years. If an unforeseen event were to occur that could affect the rating during the near-term (usually six to twelve months), then a Watch designation is assigned, usually with the likely direction of rating movement indicated.

Q. IS IT THE S&P NEGATIVE "*WATCH*" DESIGNATION ON NYSEG AND RG&E THAT THE POLICY PANEL IS CONCERNED ABOUT?

A. It would appear that that is what is troubling the Policy Panel (*see, e.g.*, PP at 167), but such concerns are misplaced. Both NYSEG and RG&E currently have Negative *outlooks* assigned to their ratings by S&P and Moody's, not, as Staff appears to indicate, Negative Watch designations.[12] This would signal *potential* negative movement over a two to three year horizon – a time period that is likely to be well beyond when the Commission decides whether to approve this merger or not. The Policy Panel concedes (PP at 167) that the Negative "watches" (which should be "outlooks") relate to both the regulatory climate within New York State relating to

[12] In some parts of their testimony, the Policy Panel seems to confuse a negative "outlook" with a negative "watch". *Compare* PP at 158 (referring correctly to a negative "outlook") *with* PP at 167 (referring to a "watch for a downgrade").

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NYSEG and RG&E, along with the Commission's consideration of the Iberdrola – Energy East merger. In view of the assignment of a (medium-term) outlook rather than a (near-term) Watch designation, I believe the Negative outlook relates primarily to the regulatory climate within the state as it pertains to Energy East and its subsidiaries over the next few years, supplemented by issues that have arisen of late related to the regulatory review of the merger (rather than the merits of the transaction itself). It is no coincidence that the rating agencies put these Negative outlooks in place in September 2006, following the issuance of the Commission's electric rate decision for NYSEG. As described below, the August 2006 rate order precipitated these Negative outlooks.

Q. THE POLICY PANEL INDICATES THAT S&P AND MOODY'S REPORTS POINT TO A LIKELY DOWNGRADE OF IBERDROLA OUT OF THE 'A' CATEGORY, WITH THE POTENTIAL FOR MULTIPLE DOWNGRADES. IS THIS WHAT THE REPORTS SAY?

A. No, they do not. The Policy Panel misinterprets the S&P and Moody's reports by focusing only on the risks cited by the rating agencies in their reports, without balancing them against the positive aspects of Iberdrola cited in those same reports. This one-sided interpretation of the S&P and Moody's reports is not an appropriate basis upon which to conclude that the subject transaction will be harmful. Every utility faces risks – to consider only negative factors provides a skewed perspective about a company and leads one to make inaccurate assumptions about credit ratings, as has happened here. Rating agencies deliberate over all qualitative and quantitative factors relevant to a company's credit ratings, and then publish credit ratings and factors supporting those determinations to provide investors, other interested parties, and the general public with full information about those ratings. A rating agency speaks through its publicly disseminated press releases and reports.

Q. IS THERE ANY MERIT TO THE POLICY PANEL'S CONTENTION (PP AT 159) THAT, BY THE STANDARDS OF AN S&P REPORT (EXHIBIT PP-17), IBERDROLA'S PRO FORMA DEBT RATIO IMPLIES A 'BBB' BOND RATING?

A. No, there is not. The Staff Policy Panel has taken one ratings criterion, the Total Debt / Total Capital ratio, and elevated it to become, in Staff's view, the sole relevant criterion for credit ratings -- an approach that is manifestly contrary to the multiple criteria that credit ratings agencies carefully weigh and examine before assigning a rating (in this case, for example, Iberdrola's 'A-' rating from S&P). As I discussed above, S&P has explained that (i) Funds from Operations ("FFO") Interest Coverage and (ii) Funds from Operations / Total Debt are the two most important financial measures used to rate companies' debt which, of course, explains why Iberdrola is not and should not, as Staff suggests, be rated 'BBB'. Iberdrola has coverage ratios commensurate with an 'A' category rating.[13]

[13] *See* S&P Research Update: "Spain's Iberdrola Affirmed at 'A-/A-2' on IPO Completion; L-T Off Watch; Outlook Stable," December 13, 2007 ("The IPO proceeds will finance this growth

Interestingly, under its new methodology (announced in November 2007), S&P has classified NYSEG and RG&E as having Excellent business profiles and Aggressive financial profiles.[14] Under that updated methodology, S&P equates such profiles with a 'BBB' rating.[15]

Q. PLEASE DESCRIBE FURTHER YOUR ANALYSIS OF THE S&P AND MOODY'S REPORTS AS THEY PERTAIN TO THE POTENTIAL FOR A FURTHER CREDIT RATING DOWNGRADE OF IBERDROLA?

A**.** A review of the most recent public pronouncements by S&P and Moody's on Iberdrola presents a very different picture than the one presented in the Policy Panel's testimony. On December 13, 2007, S&P affirmed its 'A-' corporate credit rating on Iberdrola, removing it from Negative CreditWatch, and assigning a Stable outlook. The rating action followed upon successful completion of the IPO of

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and are key to maintaining credit metrics that are consistent with an 'A-' rating….Credit metrics should remain in line with the levels indicated."). The report is attached as an exhibit to the Joint Petitioners' Policy Panel. *See also* Moody's Investors Service: "Moody's downgrades Iberdrola to A3/P-2; Stable outlook," December 12, 2007 ("Moody's expects Iberdrola's ratios to be positioned at the low end of the expected range for an A3 rating for a company with this business risk profile…these ratios are anticipated to improve gradually."). This report is attached hereto as Exhibit ___ (SMF-4).

[14] *See* Exhibit ___ (SMF-2) (S&P Research: "U.S. Electric Utility Companies, Strongest to Weakest").

[15] *See* Exhibit ___ (SMF-3) (S&P Research: "U.S. Utilities Ratings Analysis Now Portrayed in the S&P Corporate Ratings Matrix").

Iberdrola Renovables, with the proceeds slated to secure the Company's financial profile during the period of its new strategic capital investment plan (2008-2010).[16]

Unlike the Policy Panel's testimony, S&P detailed the balance between positive and negative rating factors:

> The ratings reflect Iberdrola's strong position as one of Spain's dominant vertically integrated electricity utilities and the regulated and quasiregulated nature of its electricity distribution and renewable operations, respectively, which together contribute about 40% of EBITDA and provide cash flow stability and predictability. They also reflect the group's increased earnings diversity – both geographic and operational – through the acquisition of Scottish Power…
>
> These strengths are offset by increasing competitive pressure in the Spanish electricity market, Iberdrola's exposure to electricity price volatility, and the group's weaker capital structure resulting from the Scottish Power deal. In addition, Iberdrola must now face the challenge of integrating the acquired business.

[16] S&P Research Update: "Spain's Iberdrola Affirmed at 'A-/A-2' on IPO Completion; L-T Rating Off Watch; Outlook Stable," December 13, 2007.

> Iberdrola is one of the world's largest energy companies…Over the next three years, Iberdrola will undertake a large investment program of 24.2 billion euros…Renewable energy will represent the core of the group's future growth, and accounts for about 50% of expected organic investments. The IPO proceeds will finance this growth and are key to maintaining credit metrics that are consistent with an 'A-' rating.[17]

Q. HOW DOES S&P VIEW THE BALANCE BETWEEN POSITIVE AND NEGATIVE FACTORS?

A. S&P assigned a Stable outlook to Iberdrola's ratings. The agency explained its conclusion:

> The stable outlook reflects [S&P's] expectations that Iberdrola will focus on consolidating its operations and that its management will be consistent with its commitment to strengthen the group's capital structure. Credit metrics should remain in line with the levels indicated. The ratings could be lowered if credit metrics are weaker than anticipated because of lower profit margins, large acquisitions, or a more aggressive dividend policy. Changes to the regulatory framework for renewable energies (rate-of-return reduction, elimination of tax credits) would also have a negative impact on the rating. An upgrade is unlikely in the short term.[18]

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[17] *Id.*

[18] *Id.*

All in all, S&P, through its assignment of a Stable outlook, sees relative stability for Iberdrola's ratings over the next couple of years, at rating levels above those of Energy East.

Q. HOW DO THE MOODY'S REPORTS DESCRIBE IBERDROLA'S CURRENT SITUATION?

A. In very similar fashion. On December 12, 2007, Moody's downgraded Iberdrola from an 'A2' rating to 'A3'. In doing so, Moody's stated that the downgrade incorporated "the partly debt-funded acquisition of Scottish Power in April 2007; the recently announced IPO of Iberdrola's renewables subsidiary…; and an ambitious investment strategy for 2008-2010 [that includes] the expected acquisition of Energy East Corporation…, subject to regulatory approvals."[19] On December 13, 2007, Moody's published a report on Iberdrola, citing the Company's business strengths and weaknesses, and, like S&P, emphasized several positive aspects of the business profile of Iberdrola while affirming a Stable outlook:

> Iberdrola's A3/P-2 ratings reflect Moody's overall low/medium assessment of Iberdrola's business risk for an electric utility, following the recent corporate actions and taking into account its revised strategic plan. This risk assessment reflects the significantly increased scale of the group, its

[19] *See* Exhibit ___ (SMF-4) ("Moody's downgrades Iberdrola to A3/P-2; Stable outlook").

geographic spread and diversification of risks, particularly those of regulation, generation pricing and fuel technology…

Nonetheless, this risk assessment factors a degree of integration and execution risk as the company has expanded into new markets in which it has had less prior experience, and, in addition, the group has ambitious growth targets which may not be achieved if operating conditions become more difficult…

Iberdrola is well-placed to make good progress given its size, scale and diversified exposure to fairly favourable regimes in Iberia, the UK and US. It has long-term agreements with a range of turbine manufacturers; an experienced team in the development of sites and management of operations which should help offset key risks that include the speed at which the pipeline can be processed given possible delays in receiving permissions and/or accessing equipment; possible regulatory change; construction risk and weather conditions…

Ambitious growth targets in the UK may be challenged by competitive activity and there are a number of regulatory and political challenges in Spain as the electricity system is transitioning only gradually to a fully

> liberalized market. Overall, commodity and generation pricing risks remain the most volatile component of the group's portfolio although these are somewhat limited by the vertical hedge of the UK and Spanish operations and the various hedging and risk-mitigating techniques Iberdrola employs.[20]

Q. HOW DOES MOODY'S VIEW THE BALANCE BETWEEN POSITIVE AND NEGATIVE FACTORS?

A. Moody's assigned a Stable outlook to Iberdrola, explaining that:

> The rating outlook is stable although Iberdrola's ratios are expected to be positioned at the low end of the rating range for the A3 rating category applied for its business risk… Should the company fail to achieve growth targeted, or should negative regulatory or pricing developments affect the company, then pressure could develop on these ratios. Nonetheless, Moody's believes the company is committed to an A3 rating and that it would consider means at its disposal to reinforce its financial position if necessary.[21]

The 'A3' rating is equivalent to S&P's 'A-' rating, and Moody's has matched S&P's Stable outlook, signifying relative stability for the medium term.

Q. IN ITS RESPONSE TO REQUEST FOR INFORMATION IBER/EE IR NO. 27 (EXHIBIT __ (SMF-5), THE POLICY PANEL NOTES THAT IBERDROLA

[20] Moody's Global Credit Research: "Credit Opinion: Iberdrola S.A.," December 13, 2007 (attached as an exhibit to the Joint Petitioners' Policy Panel).
[21] *Id.*

CURRENTLY HAS A "CREDIT DEFAULT SWAP-IMPLIED" CREDIT RATING OF Baa1 AND A "DEFAULT PREDICTOR-IMPLIED" CREDIT RATING OF Baa2, BOTH ASSIGNED BY MOODY'S. DOES THIS MEAN THAT IBERDROLA'S MOODY'S CREDIT RATINGS EQUATE TO EITHER Baa1 OR Baa2?

A. No, Iberdrola's Moody's credit ratings do not. Moody's has explained that such implied ratings are *not* an input into credit ratings decisions themselves, but rather are functions of comparing its assigned credit ratings to measures calculated as a result of bond and swap market trading levels and certain financial accounting ratios – all for the purpose of providing the investor with as much raw data as the rating agency can. Moody's itself clearly distances the process of assigning its credit ratings from the numerical calculations underlying the two implied "ratings" identified by Staff:

> **For bond-implied ratings and credit default swap-implied ratings, gaps and movements of one or two notches are generally not significant** for several reasons. First, one notch differences are often attributable to "rounding error." At some point, a cutoff must be made for what constitutes, for instance, an A2 credit. For credits close to this cutoff, small fluctuations in market pricing could drive the market implied rating in line with Moody's rating one day and away from it the next.

Second, the spreads used to infer bond-implied ratings or credit default swap-implied ratings may be influenced by non-credit factors, such as liquidity risk.

Third, in many cases, credit spreads and credit default swap spreads are representative indicative quotes that may be an imperfect indicator of a security's likely trading price….

Moody's analysts use these tools to identify where there are material and systematic gaps between our ratings and the ratings implied by market data or financial accounting ratios. **They use them to inform themselves of how their opinions differ from those held by the broader market or those generated by purely quantitative models, so that they are prepared to clearly articulate the reasons for those differences to market participants. Market implied ratings are not, however, an "input" into their rating decisions.**

Market-based measures are inherently volatile and produce many false positives and false negatives. We remain committed to producing opinions that look beyond each day's news to provide much more stable, although equally predictive, measures of long-term credit risk. [Emphasis supplied.][22]

Thus, far from pointing to the direction that Iberdrola's credit ratings will be going, the two implied "ratings" identified by the Policy Panel are either insignificant indicators or have led the Moody's analysts to look even more closely at the factors leading the agency to assign an 'A3' rating to Iberdola with a Stable outlook.

Q. THE POLICY PANEL EXPRESSED CONCERN THAT IBERDROLA'S EXTENSIVE CAPITAL INVESTMENT PROGRAM COULD LEAD TO A DOWNGRADE OR MULTIPLE DOWNGRADES (*SEE, E.G.,* PP AT 169). CAN YOU ADDRESS ITS CONCERN?

A. As can be seen in the rating agency reports cited above, S&P and Moody's have fully incorporated Iberdrola's strategic plan into their current ratings and outlooks. It is my understanding that Iberdrola has consistently stated its commitment to maintaining an 'A' category rating before and after announcement of its strategic investment plan. The Company's recent steps show that it has strong ability to access the capital markets when necessary, and, indeed, Iberdrola has already issued the equity needed to finance the acquisition of Energy East, as well as concluding a successful IPO that will provide the bulk of the funding needed for the strategic plan.

[22] Moody's Products and Services: "Market Implied Ratings: Frequently Asked Questions," September 2006.

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What should be clear is that, if Iberdrola is able to continue its strong past performance and maintain its commitment to having an 'A' category rating, both of which the rating agencies believe the Company can do, S&P and Moody's do not see that the capital investment plan will threaten the stability of Iberdrola's current credit rating level.

Q. THE POLICY PANEL WARNS THAT IBERDROLA'S FINANCIAL STANDING COULD HARM NYSEG'S AND RG&E'S ACCESS TO THE CAPITAL MARKETS AND THAT S&P HAS INDICATED THAT RATING DOWNGRADES ARE LIKELY FOR NYSEG AND RG&E IF THE MERGER IS APPROVED (PP AT 167-168). COULD YOU ADDRESS THESE COMMENTS?

A. Yes. First, when the merger was announced, both S&P and Moody's affirmed their ratings on Energy East, NYSEG, and RG&E and maintained the existing Negative outlooks -- thus, there was *no change* to the companies' ratings following the transaction's announcement. Second, Iberdrola's 'A-/A3' ratings are higher than those of Energy East at 'BBB+/Baa2' and its subsidiaries at 'BBB+/Baa1'. When you factor in Iberdrola's Stable outlook versus Energy East's and its subsidiaries' Negative outlooks, investors are looking at basically a one-and-a-half notch rating differential between Iberdrola and NYSEG/RG&E and a one-and-a-half to two-and-a-half notch difference between Iberdrola and Energy East. Such differential in ratings is significant. Indeed, in view of Iberdrola's stated commitment to maintain its rating status in the 'A' category, the greater likelihood is that once the merger has been approved and a successful transition has concluded, the affiliation with the 'A-' rated Iberdrola might allow Energy East, NYSEG and RG&E to escape their Negative outlooks and potentially improve their ratings to Iberdrola's level. S&P described such a situation in its 2005 "Corporate Ratings Criteria:"

> A weak entity owned by a strong parent usually – although not always – will enjoy a stronger rating than it would on a standalone basis. Assuming the parent has the ability to support its subsidiary during a period of financial stress, the spectrum of possibilities still ranges from ratings equalization at one extreme to very little or no help from the parent's credit strength at the other. The greater the gap to be bridged, the more evidence of support is necessary."[23]

Here, it is important to note that Iberdrola's cash flow coverages are markedly stronger than those of Energy East. For example, for 2006, Iberdrola's FFO interest coverage was 3.9x compared to Energy East at 2.7x. Iberdrola's FFO/Total Debt ratio was 18.5% as compared to Energy East at 14.2%. These

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[23] S&P Research: "Corporate Ratings Criteria: Rating Methodology," June 9, 2005. *See also* Moody's Credit Opinion: "Energy East Corporation," December 26, 2007 ("Moreover, if Iberdrola is successful in acquiring EEC and then takes aggressive steps to reduce structural subordination by lowering or eliminating debt at the EEC and/or other operating company levels, then such a strategy could at least help stabilize the outlook for EEC and the rated subsidiaries within the current EEC family. Indeed, depending on the magnitude, such steps might even contribute to higher ratings for some of the lower rated entities in the current EEC family (i.e. those with senior unsecured debt rated Baa1 or lower.").

differences are significant and could serve to support improved ratings at Energy East.[24]

Turning to the Policy Panel's following comment about S&P's intentions (PP at 167-168):

> Q. Have either credit agency indicated specifically that bond rating downgrades for NYSEG and RG&E are likely if the transaction is approved?
>
> A. Yes, Exhibit __ (PP-4) contains two reports from S&P, one for NYSEG and the one for RG&E. These reports express concern over the financial metrics, i.e., the high debt leverage; Iberdrola would exhibit as the ultimate parent of NYSEG and RG&E. These reports also expressed some concern over the last NYSEG rate decision, which lowered the Company's rates. As a result of these concerns and others, S&P has put NYSEG and RG&E on watch for a downgrade if the transaction is completed.

I earlier discussed the inaccuracy in the Panel's use of the phrase "watch for a downgrade."

Q. DO YOU HAVE OTHER CONCERNS WITH THE STATEMENTS BY STAFF QUOTED ABOVE?

[24] S&P Research: "Iberdrola, S.A.," September 18, 2007 (attached to the Staff Policy Panel as Exhibit __(Policy Panel – 15); S&P Research: "Energy East Corp.," November 14, 2007, attached hereto as Exhibit ___ (SMF-6).

A. Yes. Unfortunately, the Staff, in describing the S&P report, explicitly, or, at a minimum, implicitly misleads the Commission with regard to S&P's placement of a Negative outlook on NYSEG and RG&E. That action did not occur upon announcement of the Iberdrola-Energy East merger on June 26, 2007. Rather that action came almost a year earlier, on August 25, 2006, and was "based on the [NYPSC's] decision to approve a one-year rate plan that reduces [NYSEG's] electric delivery rates by $36.2 million annually starting in January 2007….[a decision that] will pressure credit measures in 2007, which were already expected to be weak for the ratings." S&P concluded, "An outlook revision to stable is not anticipated in the near term, given the need for regulatory relief that is unlikely to occur before 2008."[25]

The announcement of the merger did add nuance to S&P's outlook, but in no way reached the level of a "watch for a downgrade if the transaction is completed." In the November 14, 2007 report cited by the Policy Panel, S&P indicated that:

> The negative outlook indicates that ratings could be lowered one notch depending on Iberdrola's ultimate financing structure for the acquisition. Moreover, potential regulatory outcomes that could hurt cash flow metrics would precipitate lower ratings. Ratings stability at the current level is highly dependent on a balanced capital approach at Energy East, consistent

[25] S&P Research Update: "Energy East and Units Outlook Revised to Negative After New York Regulators Cut Unit's Rates," August 25, 2006.

> cash flow metrics, and supportive regulatory outcomes. Higher ratings are limited by the company's persistent high debt.[26]

Q. DID MOODY'S EXPRESS A VIEW ON THIS QUESTION?

A. Yes, it did. On December 26, 2007, Moody's stated that its Negative outlook on Energy East and its subsidiaries:

> reflects the consolidated financial and operating challenges that exist within the consolidated family. These challenges primarily result from the outcome of the affiliated NYSEG's general rate case in August 2006 plus the uncertainties about whether the modified fixed price option approved earlier this year by the NYPSC for NYSEG's retail electric customers can provide sufficient impetus for overcoming some of these challenges….In addition, the negative outlook recognizes the aforementioned pending transaction with Iberdrola.[27]

Q. HOW DO YOU READ THE COMMENTS FROM S&P AND MOODY'S IN THESE REPORTS?

A. That the clear precipitating event for the Negative outlooks was the August 2006 rate order, and that the rating agencies did not see a potential positive resolution to the problem until another rate proceeding could occur, perhaps by 2008. Already existing financial and operating challenges "primarily result[ing]" from regulatory

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[26] S&P Research: "New York State Electric & Gas Corp.," November 16, 2007.

[27] Moody's Global Credit Research: "Credit Opinion: Energy East Corporation," December 26, 2007.

risks faced by NYSEG in New York continued to be key to the rating agencies' analyses – through that language, Moody's clearly characterizes this as the primary challenge. The Iberdrola-Energy East merger was laid onto this difficult regulatory situation, and, by necessity, has become part of the rating agencies' overall vigilant posture in light of the possible regulatory action associated with this proceeding, as opposed to the business merits of the transaction. But by no means has S&P or Moody's validated the Policy Panel's statement that NYSEG and RG&E are "on watch for a downgrade if the transaction is completed."

Q. WOULD YOU SUPPORT THE POLICY PANEL'S CALL (PP AT 174, 206) FOR THE COMMISSION TO INSIST UPON RING FENCING PROVISIONS AS A CONDITION OF MERGER APPROVAL?

A. I would not support such conditions as part of merger approval here based upon ratings or rating agency reports. While effective ring fencing can isolate the risks of individual subsidiaries in a corporate family, the Commission must be mindful that this can cut both ways. Ring fencing can also concentrate risks within subsidiaries of a corporation. For example, a poor regulatory decision or a decline in sales could leave a subsidiary financially reeling without access to the broader corporate safety net. Basically, a financially strong holding company's ability to support a weaker performing subsidiary could be compromised if strong ring fencing were to be put in place.

Here, Iberdrola is a global leader among electric utilities. It has a wide geographic reach and significant business operational diversity, including substantial experience interacting with regulators and public officeholders. The Company has a stronger credit profile than Energy East, NYSEG and RG&E, and can access the capital markets – both equity and debt – more easily and upon more reasonable terms. Moreover, one major benefit of such a merger would be the ability to tap into an extensive base of management expertise. In view of all of these beneficial characteristics that Iberdrola brings to the table – and the negative side to ring fencing restrictions discussed above, I believe it would be a mistake to create hard and fast rules restricting, if not prohibiting, financial and operational interaction between Iberdrola and Energy East and its subsidiaries.[28]

Q. THE POLICY PANEL STATES THAT "THE INVESTMENT COMMUNITY [HAS] RENDERED AN ASSESSMENT ON IBERDROLA'S AFFECT ON NYSEG AND RG&E" BECAUSE, AS SHOWN ON EXHIBIT PP-19, NYSEG ISSUED DEBT 225 BASIS POINTS ABOVE 10-YEAR TREASURIES ON NOVEMBER 29, 2007, APPROXIMATELY 30 BASIS POINTS HIGHER THAN DEBT ISSUED BY OTHER SIMILAR COMPANIES WITHIN THE SAME TIMEFRAME. DO YOU AGREE WITH THIS ASSESSMENT?

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[28] *See* Fetter, Steve, "Perspective: Don't Fence Me Out," Public Utilities Fortnightly, October 2004 ("Hard-and-fast ring-fencing rules are not the best way to maintain order in the partially deregulated utility sector.").

A. No, I do not, for the reasons discussed in the rebuttal testimony of the Rate Adjustment Panel.

Q. CAN YOU COMMENT UPON THE POLICY PANEL'S BELIEF THAT THE AMOUNT OF GOODWILL AT IBERDROLA WILL HAVE A NEGATIVE EFFECT ON ITS CREDIT RATINGS?

A. "Goodwill" is the excess price paid over and above book value of tangible assets. Goodwill has been accumulated on Iberdrola's balance sheet in large part from its acquisition of Scottish Power with more to go on its books upon completion of the pending merger with Energy East. Goodwill is subject to an annual impairment test and is subject to possible write-down, as are all assets, whether tangible or intangible. Goodwill occurs when accounting principles do not allow for write-up of an asset to its apparent true value. Rating agencies do not view Goodwill as a primary indicator of the risk profile of a company, and the lack of focus on Goodwill by S&P and Moody's in their reports on the proposed merger bears this out.

Instead, cash flow will be the driver of Iberdrola's ratings, as it will be in the assessment of Goodwill impairment. Accordingly, if Iberdrola is able to maintain its strong operational performance while continuing to properly manage its business risks, which the rating agencies expect it to be able to do, its credit ratings should be stable and the potential for Goodwill impairment should be small. It is only when Goodwill impairment poses a threat to a company's capital structure that rating agencies will focus upon potential negative credit profile effects. The rating agencies have not indicated the need to do so here.

Q: IN ITS RESPONSE TO REQUEST FOR INFORMATION IBER/EE IR NO. 51 (EXHIBIT __ (SMF-5), STAFF STATES THAT "WHILE NOT MENTIONED IN ANY REPORT, STAFF BELIEVES IT IS NOT A COINCIDENCE THAT IBERDROLA'S GOODWILL HAS RISEN AS ITS CREDIT QUALITY HAS DECLINED," AND THEN DESCRIBES THIS HIDDEN MOTIVE IT HAS UNCOVERED AS "EVIDENCE." "THEREFORE," THE STAFF CONCLUDES, "EVIDENCE INDICATES THAT GOODWILL IS PLAYING A ROLE IN THE CREDIT QUALITY DECLINE OF IBERDROLA." DO YOU AGREE WITH THIS CONCLUSION?

A: No, I do not. Rating agencies do not base reported credit ratings on factors that are not mentioned in their reports. They explain the strengths and weaknesses underlying a company's credit ratings as has been fully explored within the agency reports and the testimony in this case. If Goodwill was the driver of a credit profile decline for Iberdrola or any other rated entity, all three rating agencies would mention it, rather than none.

Q: STAFF SUGGESTS THAT GOODWILL BE TREATED AS SIMILAR TO DEBT LEVERAGE (PP AT 255). DO YOU AGREE WITH THIS SUGGESTION?

A: No, I do not. Goodwill is not debt and it should not be treated as such. Goodwill is not included in a rating agencies' calculation of debt leverage,[29] just as it is not included in a regulatory commission's assessment of capital structure as it relates to ratemaking activities. As I stated above, it is only when Goodwill impairment poses a threat to a company's capital structure that rating agencies will focus upon potential negative credit profile effects, though they still do not treat impaired Goodwill as debt.

Q. THE POLICY PANEL'S RATEMAKING AND RATINGS DISCUSSIONS HAVE A HEAVY FOCUS ON IBERDROLA'S CAPITAL STRUCTURE. DO THEIR ARGUMENTS CAUSE CONCERN FOR YOU?

A. I believe that focus is misplaced. First, NYSEG and RG&E will maintain a capital structure that is regulated by the NYPSC. At the same time, these utilities could benefit from the higher credit ratings at Iberdrola. Indeed, over time, all other things being equal, the superior ratings and financial standing of Iberdrola should have a

[29] For example, S&P defines Total Debt to Total Capitalization as "Long-term debt (including amount for operating lease debt equivalent) plus current maturities, commercial paper, and other short-term borrowings" divided by "Long-term debt (including amount for operating lease debt equivalent) plus current maturities, commercial paper, and other short-term borrowings plus shareholders' equity (including preferred stock) plus minority interest." *See* S&P Research: "Corporate Ratings Criteria," 2000. Similarly, Fitch defines "Debt as % of Total Capitalization" as "Total debt (short- and long-term debt), including debt of financing trusts or debt supporting trust preferred securities, plus current portion of long-term debt and capitalized lease obligations" divided by "Total debt (short- and long-term debt), including debt of financing trusts or debt supporting trust preferred securities, plus current portion of long-term debt and capitalized lease obligations plus preferred and preference stock plus common equity." *See* Fitch Research: "U.S. Electric and Gas Financial Peer Study," May 2007.

positive impact on the credit ratings of Energy East and its two regulated subsidiaries.

As for how Iberdrola's capital structure could affect its ratings, I emphasize again that the primary concern of both rating agencies and investors is the ability of an issuer to pay interest and principal when due. As a result, and as explained above, the most important quantitative metrics in the ratings process are cash flow measures that relate directly to such ability to meet financial commitments on a timely basis. Such focus can clearly be seen in the rating agencies' reactions to the NYPSC's August 2006 rate order for NYSEG. The Negative outlooks that were placed on Energy East and its subsidiaries in August 2006 were driven by the cash flow implications of the Commission decision. Energy East's capital structure was unaffected by that rate order, and subsequently, in March 2007, Energy East's capital structure was improved through the issuance of 10 million shares of common equity. Yet the Negative outlooks remain – and the rating agencies remain focused on Energy East's cash flow.

Finally, on December 13, 2007, both S&P and Moody's indicated comfort with Iberdrola's debt level. Moody's stated that steps Iberdrola has taken related to its Scottish Power and Energy East acquisitions, and divestments including its successful IPO "should allow the company to stay within its leverage target of

50%."[30] S&P on that same day said that the proceeds from the IPO "will enable the group to maintain gearing below 50%."[31]

<u>CONCLUSION</u>

Q. DO YOU HAVE CONCLUDING THOUGHTS?

A. Yes. The concept of utility regulation is to provide a surrogate for the competitive market that is not present when a company possesses monopoly or near-monopoly status with regard to an essential good, such as utility service. Based on my experience as a state regulator, it is not the purpose of regulators to step into the shoes of management and make strategic business decisions. Nor is it the role of regulators to usurp the function of the major rating agencies and determine likely rating impacts different than those highlighted by the agencies. The Staff Policy Panel attempts to do both of these things here. The NYPSC should focus on preserving the financial and operational health of the two regulated utilities within its jurisdiction. That decision is easier here than in most cases because Iberdrola has indicated its intent to take the necessary steps to maintain both the financial standing and operational reliability of NYSEG and RG&E on a going forward basis, after the merger has been consummated. Moreover, in addition to that intent, Iberdrola, as one of the most preeminent and

[30] Moody's Global Credit Research: "Credit Opinion: Iberdrola S.A.," December 13, 2007.

[31] S&P Research Update: "Spain's Iberdrola Affirmed at 'A-/A-2' on IPO Completion; L-T Rating Off Watch; Outlook Stable," December 13, 2007.

respected utility holding companies in the world, also possesses the wherewithal to deliver on those promises.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes it does.