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Regulatory Policy and

Financial Impact

Steven M. Fetter

Union Electric Co.

Supplemental Direct

Testimony

GR-99-315

August 20, 2004

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO. GR-99-315

SUPPLEMENTAL DIRECT TESTIMONY

OF

STEVEN M. FETTER

ON

BEHALF OF

UNION ELECTRIC COMPANY

d/b/a AmerenUE

St. Louis, Missouri

August, 2004

Exhibit No. 143
Case No(s). GR-99-315
Date 9-22-04 **Rptr** TS

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1 **SUPPLEMENTAL DIRECT TESTIMONY**
2 **OF**
3 **STEVEN M. FETTER**
4 **CASE NO. GR-99-315**

5 **I. INTRODUCTION**

6 **Q. Please state your name and business address.**

7 A. My name is Steven M. Fetter, and my business address is P.O. Box 475,
8 Rumson, New Jersey 07760.

9 **Q. By whom are you employed and in what capacity?**

10 A. I am President of Regulation UnFettered, an energy advisory firm I started
11 in April 2002. Prior to that, I was employed by Fitch, Inc. ("Fitch"), a credit rating
12 agency based in New York and London, as Group Head and Managing Director of the
13 Global Power Group. Prior to my time at Fitch, I served as Chairman of the Michigan
14 Public Service Commission.

15 **Q. Please briefly describe your role as president of Regulation**
16 **UnFettered.**

17 A. I formed an energy advisory firm to use my financial, regulatory,
18 legislative and legal expertise to aid the deliberations of regulators, legislative bodies, and
19 the courts, and to assist them in evaluating regulatory issues. My clients include electric
20 and gas utilities, a non-utility energy supplier, international financial services and
21 consulting firms, and investors.

1 **Q. Please briefly describe Fitch's business during your tenure there.**

2 A. Fitch is the third largest full service credit rating agency in the United
3 States and the largest European rating agency. It is one of four Nationally Recognized
4 Statistical Rating Organizations recognized by the U.S. Securities and Exchange
5 Commission. It is also recognized by the U.S. Department of Labor, state bank and thrift
6 regulators, and the National Association of Insurance Commissioners. Fitch performs
7 credit ratings of corporate obligations, asset-backed transactions, and government and
8 municipal debt. While fees are paid by bond issuer clients, Fitch views its true clients to
9 be bond investors. Accordingly, bond ratings represent Fitch's independent judgment
10 based upon financial data provided by the bond issuer as well as additional quantitative
11 and qualitative information gathered from third-party sources. During my tenure, Fitch
12 merged with IBCA, Ltd. of London, Duff & Phelps of Chicago, and Thomson Bankwatch
13 of New York.

14 **Q. What was your role during your employment with Fitch?**

15 A. As Group Head and Managing Director of the Global Power Group within
16 Fitch, I served as group manager of the combined 18-person New York and Chicago
17 Utility Team. I also was responsible for interpreting the impact of regulatory and
18 legislative developments on utility credit ratings. In early April 2002, I left Fitch to start
19 Regulation UnFettered.

20 **Q. How long were you employed by Fitch?**

21 A. I was employed by Fitch from October 1993 until April 2002. In addition,
22 Fitch retained me as a consultant shortly after I resigned.

1 **Q. Please describe your service on the Michigan Public Service**
2 **Commission.**

3 A. I was appointed as a Commissioner to the three-member Michigan
4 Commission in October 1987 by Democratic Governor James Blanchard. In January
5 1991, I was promoted to Chairman by incoming Republican Governor John Engler, who
6 reappointed me in July 1993.

7 **Q. Please describe your other prior professional experience.**

8 A. From October 1979 until March 1982, I was employed as an appellate
9 litigation attorney for the National Labor Relations Board in Washington, D.C. From
10 March 1982 through January 1983, I served as assistant legal counsel to Michigan
11 Governor William Milliken. From January 1983 until August 1985, I began as legal
12 counsel within the Michigan Senate and later was appointed Senate Majority General
13 Counsel. From August 1985 until October 1987, I started as executive assistant to the
14 Deputy Under Secretary at the U.S. Department of Labor in Washington, D.C. and later
15 was Acting Associate Deputy Under Secretary of Labor. As I previously stated, I served
16 on the Michigan Commission from 1987 until 1993, and in October 1993 I was hired by
17 Fitch (then known as "Fitch Investors Service") in New York to be Senior Vice President
18 and Director of Regulatory and Government Affairs. In 1995, I was selected to be Group
19 Manager of the Global Power Group; in 1998, I was promoted to Managing Director of
20 the Group; and in 2000, I was promoted to Group Head and Managing Director. In
21 February 2002, I was appointed to the Board of Directors of CH Energy Group, Inc., the
22 parent company of Central Hudson Gas & Electric in Poughkeepsie, New York. I
23 currently serve as Chairman of the Audit Committee.

1 During my time on the Michigan Commission, I served as Chairman of
2 the Board of Directors of the National Regulatory Research Institute ("NRRI") at Ohio
3 State University, the regulatory research arm of the 51 state and District of Columbia
4 public utility commissions. Last year I was appointed by the President of the National
5 Association of Regulatory Utility Commissioners ("NARUC") to serve as a public
6 member of the NRRI Board – the 20-member board includes ten state public utility
7 commissioners. I have also served on the Keystone Center Energy Board, after having
8 participated in the Keystone Center Dialogues on Financial Markets and Energy Trading,
9 and on Regional Transmission Organizations.

10 I also have served as an adjunct professor of legislation at American
11 University's Washington College of Law. In addition, I have been a member of the
12 following organizations: the NARUC Executive, Natural Gas, and International Relations
13 Committees; the Steering Committee of the U.S. Environmental Protection Agency /
14 State of Michigan Relative Risk Analysis Project; the Federal Energy Regulatory
15 Commission ("FERC") Task Force on Natural Gas Deliverability; and the International
16 Advisory Council of Eisenhower Fellowships. In 1991, I traveled to Japan as an
17 Eisenhower Fellow to study the Japanese utility structure, and, in 1992, I was a NARUC
18 Fellow at the Kennedy School of Government.

19 **Q. Have you previously sponsored testimony before regulatory or**
20 **legislative bodies?**

21 **A.**Since 1990, I have on numerous occasions testified before the U.S. Senate,
22 the U.S. House of Representatives, federal courts and various state legislative and

1 regulatory bodies on the subjects of credit risk within the utility sector, electric utility
2 restructuring, utility securitization bonds, and nuclear energy.

3 **Q. What is your educational background?**

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

7 **II. SUMMARY**

8 **Q. What is the purpose of your testimony in this proceeding?**

9 A. In this testimony, I discuss the issue of net salvage value as a component
10 of depreciation allowances and offer my opinion as to the appropriate means for those
11 costs to be recovered. I offer my views based upon my experience as chairman of a state
12 utility commission and head of the utility ratings practice at a major credit rating agency.
13 From both a regulatory policy viewpoint and a capital markets perspective, the best way
14 to provide recovery of net salvage costs is during the useful life of the relevant asset,
15 collected from the customers who receive the benefit of that asset. This represents the
16 essence of intergenerational equity, a goal that regulators should strive to achieve through
17 their policy determinations.

18 Further, I discuss the downside of a regulatory policy (as proposed by
19 Staff) that awaits the end of the useful life of an asset before seeking recovery of that
20 asset's net salvage costs from later customers who did not and will not receive the benefit
21 provided by that asset during its service life. I find that such an approach, which
22 systematically severs cost responsibility from benefits, is not sound regulatory policy. It
23 goes against the concept of intergenerational equity as it knowingly cross-subsidizes

1 current ratepayers by deferring a substantial portion of the retirement obligations
2 associated with current assets to future customers who are no longer served by these
3 assets. In some cases Staff's approach compounds the cross-subsidy problem by
4 lowering rates now to amortize past depreciation reserve "over-collections" accrued
5 under the standard method.

6 I conclude by discussing why these types of depreciation issues are also
7 important to the Wall Street financial community, and how the choice of a non-
8 mainstream path regarding depreciation allowances for net salvage costs can have a
9 negative effect on a utility's equity value and credit ratings.

10 **III. DISCUSSION**

11 **Q. Can you explain what is meant by the concept of net salvage value?**

12 **A.** A useful starting point for exploring the concept of net salvage value is
13 consideration of four key definitions in the federal Uniform System of Accounts
14 ("USOA"), which, as the USOA has been adopted by Missouri, applies to both the
15 electric and natural gas utilities under this Commission's jurisdiction. While the
16 Commission may, under certain circumstances, deviate from the USOA accounting
17 requirements, such deviations should not be a common occurrence, given that the USOA
18 is a time-tested best practices standard for cost of service accounting.

19 Within these mandatory accounting requirements for Missouri
20 jurisdictional utilities, "service value" is defined as "the difference between original cost
21 and net salvage value of electric plant." "Depreciation" is defined, in relevant part, as
22 "the loss in service value not restored by current maintenance, incurred in connection
23 with the consumption or prospective retirement of electric plant in the course of service

1 from causes which are known to be in current operation[, including] wear and tear,
2 decay, actions of the elements, inadequacy, obsolescence, changes in the art, changes in
3 demand and requirements of public authorities.” “Service life” is defined, in relevant
4 part, as “the time between the date electric plant is includible in electric plant in
5 service...and the date of its retirement.” Finally, “net salvage value” is defined as “the
6 salvage value of property retired less the cost of removal.” If the cost of removal exceeds
7 the salvage value of the retired property, net salvage value would be a negative number
8 (i.e., a cost). I note that the definitions within the gas portion of the USOA are similar in
9 language and intent as these electric provisions.

10 General Instruction 22 of the USOA (Part 101) brings these definitions
11 together in its explanation of how “depreciation accounting” should be carried out:
12 “Utilities must use percentage rates of depreciation that are based on a method of
13 depreciation that allocates in a systematic and rational manner the service value of
14 depreciable property [i.e. “the difference between original cost and net salvage value”] to
15 the service life of the property.”

16 Under these provisions, it is clear that the USOA requires that net salvage
17 value be allocated during the service life of the asset in question, rather than awaiting
18 post-retirement review and approval. Indeed, General Instruction 11 of the USOA directs
19 that a gas utility “is required to keep its accounts on the accrual basis.” I note that
20 NARUC, in its “Public Utility Depreciation Practices” (August 1996), has endorsed the
21 view taken by the USOA. Accordingly, it makes sense that almost every state public
22 utility commission follows this policy of allocating net salvage costs during the useful
23 life of the asset.

1 **Q. Can you share more fully what other commissions have done with this**
2 **issue?**

3 A. Yes. First, during my tenure as Chairman of the Michigan Public Service
4 Commission and since that time, the Michigan Commission's position has been to spread
5 net salvage costs over the useful life of the relevant asset. Moreover, as discussed in the
6 testimony of Laclede Gas Company and AmerenUE witness William Stout, this is the
7 view that has been followed by almost every state utility commission in the country.
8 Indeed, the Indiana Utility Regulatory Commission recently offered a comprehensive
9 explanation of the rationale that underlies this position in its decision in a PSI Energy,
10 Inc. rate case:

11 We believe that there is a sound basis for the traditional approach on this
12 issue that is utilized by a majority of states. Utilizing historical averages
13 as an item to be expensed to current customers means that these customers
14 will be paying for salvage costs at levels that may not be sufficient. That
15 means that the next generation of customers will be paying for salvage
16 costs related to facilities from which they may never have received
17 service. The use of best estimates of future salvage costs addresses this
18 inequity. Moreover, use of historical averages for dismantling costs does
19 not take into account the current configuration of PSI's system with regard
20 to its production, transmission, distribution and general facilities.
21 Facilities in service 40-50 years ago did not take into account the
22 significantly enhanced customer base that PSI now serves, nor the current
23 configuration of PSI's facilities that serve these customers. It seems
24 appropriate to utilize best cost estimates for net salvage values taking into
25 account specific facilities now serving PSI's customers in developing
26 depreciation rates that today's customers should pay. Accordingly, we
27 find that the use of historical averages for net salvage values with regard
28 to transmission, distribution and general plant for the purpose of
29 expensing them outside the context of the depreciation determination
30 should be, and hereby is, rejected. PSI Energy, Inc., 2004 Ind. PUC
31 LEXIS 150, pp. 200-201 (May 18, 2004) (notes omitted).

32 The Indiana Commission also explained its views about depreciation of
33 generating stations; these policies provide guidance for the appropriate depreciation
34 treatment of mass property accounts at issue in this proceeding:

1 This Commission can either find that current customers should pay a share
2 of dismantling costs, which will not be incurred for a number of years, or,
3 in the alternative, conclude that these costs should be passed on to a future
4 generation of customers. **This Commission does not believe that the**
5 **latter alternative constitutes sound regulatory policy, or is based on**
6 **sound ratemaking principles.** Current customers are receiving service
7 from PSI's generation facilities. A part of the costs of those facilities is
8 dismantlement upon retirement. Therefore, we do not believe it would be
9 appropriate for the Company to backload the dismantlement costs for
10 future ratepayers to pay when the facilities associated with these costs are
11 providing service to current customers. Rather, we find it is appropriate
12 that these costs be shared by all customers that received service from PSI's
13 generation facilities. Accordingly, this Commission finds that
14 dismantlement costs are properly included in determining the depreciation
15 rates approved in this cause. PSI Energy, Inc., 2004 Ind. PUC LEXIS
16 150, pp. 196-197 (May 18, 2004) (**emphasis supplied**).

17 **Q. Do you see problems with a policy of waiting until after retirement of**
18 **an asset for consideration of net salvage value ?**

19 A. Yes I do. First, it runs counter to the general ratemaking principle (and the
20 USOA principle) that customers should be responsible for the costs related to the service
21 they receive. If recovery of the net salvage costs of assets currently used to serve
22 customers is deferred to future customers, as is the case under Staff's proposed approach,
23 it also creates uncertainty for both customers and investors with regard to the ultimate
24 treatment of these deferred costs. From a customer's perspective, flowing through all the
25 costs of retirement of utility property over a short period of time after the assets have
26 been retired could result in rate volatility and rate shock, potentially stressing the ability
27 of some customers to meet their rate obligations, or, as it relates to the business
28 community, possibly affecting business prospects of some companies. From an
29 investor's perspective, investors and rating agencies would have to carry their concerns
30 about ultimate recovery by the utility for many years. The uncertainty and risk that

1 accompanies such delay and lack of clarity usually ends up putting pressure on a utility's
2 equity price and credit ratings.

3 A further negative byproduct of depreciation allowances that are not
4 correlated with net salvage costs over the service life of an asset is the impact such a
5 policy has on utility cash flow. Cash flow measures are the most important ratios relied
6 upon by credit rating agencies because they are the best predictors of a utility's ability to
7 meet its debt obligations on a timely basis. In addition, strong cash flow supports a
8 utility's ability to finance ongoing infrastructure enhancement under reasonable terms
9 and on a timely basis. Regulatory policy that sets depreciation allowances inconsistent
10 with industry norms can impair a utility's ability to attract capital on favorable terms
11 within both the debt and equity markets.

12 **Q. But how can consumers be protected from changes in plant**
13 **retirement timing or cost if the revenue is going into the utility's hands during the**
14 **useful life of the plant, prior to its actual retirement?**

15 A. For all utilities, depreciation accounting is based on initial capital cost as
16 well as projections of service life and net salvage value (salvage value less cost of
17 removal). If over time, new and better information is gained to help predict these
18 projected factors, modifications or mid-term adjustments can be made (and often are
19 made based upon periodic depreciation studies) to ensure consistency of depreciation
20 allowances with the new data.

21 Drawing an analogy to the careers of all of us involved in this proceeding,
22 the inability to know with absolute precision future annual income, length of career, or
23 retirement income needs adjusted for inflation is not a reason to forgo putting aside cash

1 now for that eventuality. Rather, with the encouragement of the government and
2 employers, most employees begin saving for retirement on their first day of work, with
3 modifications about retirement planning expectations and needs subject to interim
4 adjustment throughout their working lives. Depreciation planning should be no different.

5 Even more significant is that as the depreciation reserve grows, the
6 utility's rate base goes down. Because rates include an allowed return on rate base,
7 customers get the benefit of the accrual of the depreciation reserve by paying less in rates
8 based upon a lower rate base. Conversely, deferral of net salvage amounts results in
9 inflated rate base and cost of service, thus increasing utility rates in the long run, and
10 damaging the economic viability of the service territory.

11 The reduction in rate base through accrual in the depreciation reserve
12 provides full protection for customers against over-accruals within the account, because
13 customers effectively earn the utility's authorized return on rate base until the excess
14 funds have been trued-up. Ultimately, the funds in the depreciation reserve are used for
15 the benefit of those customers who paid in – by covering the net salvage costs associated
16 with retirement of utility property that produced and delivered electricity during their
17 ratepayer lives. Because the depreciation reserve also effectively acts as a “balancing”
18 account, customers ultimately will have paid no more (and no less) than the actually-
19 incurred net salvage costs. Mr. Lyon's testimony discusses these safeguards in greater
20 detail from an accounting perspective.

21 Ironically, Staff's approach may also create an additional cross-subsidy to
22 current customers at the expense of past consumers. I have already explained how future
23 customers will have to pay net salvage costs at the time of plant retirement, but past

1 customers have also already paid into the depreciation reserve amounts forecasted to be
2 necessary for plant retirement. If those amounts, collected previously under the standard
3 method, are now required to be amortized to lower current rates, today's customers will
4 effectively enjoy subsidies from both past and future consumers.

5 **Q. Turning to your experience as head of the utility ratings practice at**
6 **Fitch, are rating agencies concerned about the types of issues under consideration in**
7 **this case?**

8 A. Yes they are, for any of a number of reasons. First, credit rating agencies
9 track closely the likelihood that a regulated utility will receive appropriate recovery for
10 prudent expenditures made – both with regard to capital additions as well as operations
11 and maintenance. To the extent that depreciation expense, including net salvage value, is
12 aligned closely to the customers receiving the benefit of the capital asset and collected
13 during the asset's useful life, rating agencies gain greater comfort. It is when collection
14 of these costs is removed from contemporaneous recovery and left for later calculation,
15 determination, and potential recovery that red flags are raised.

16 Second, cash flow has evolved to be the most important financial measure
17 relied upon by the credit rating agencies in determining utility bond ratings. To the
18 extent that a state commission departs from mainstream depreciation practices in a way
19 that negatively impacts cash flow, rating agencies will not look favorably on such
20 policies and, as I explain below, will likely reflect those concerns within a particular
21 utility's credit ratings.

22 A third analytical factor considered by the rating agencies is concern about
23 rate shock on a utility's customer base – that could compromise their ability to pay, or, as

1 it relates to business climate, compromise companies' willingness to pay. Of even
2 greater concern to investors, of course, would be refusal by a regulatory body to allow
3 rates to go up substantially, notwithstanding the prudent nature of the funds expended by
4 the regulated utility. In my view, deferral of net salvage value of utility property
5 currently used to serve customers to the time of its removal increases the potential that
6 full recovery may be compromised due to unrelated regulatory considerations, including
7 the possibility that regulatory lag could even tarnish "full" recovery that was delayed and
8 came at a later time.

9 The importance of depreciation issues to credit rating agencies is shown
10 by Standard & Poor's response to a Missouri Public Service Commission ("MPSC")
11 order in an Empire District Electric Co. proceeding in 2002. In that case, the MPSC
12 lowered depreciation allowances when it adopted a Commission Staff position that did
13 not allow net salvage value to be collected during the useful life of Empire's plant
14 property, but rather deferred recovery to the end of the assets' lives. While lowering
15 Empire's corporate credit rating to 'BBB' from 'A-' and revising the company's outlook
16 to 'Negative,' S&P specifically highlighted Missouri regulation's "low plant depreciation
17 allowances" as one of the key financial factors leading to the highly unusual two-notch
18 downgrade of significant consequence to the company. ("S&P Research: Ratings on
19 Empire District Electric Co. Lowered to 'BBB'; Outlook Revised to Stable," July 2,
20 2002.)

21 Similarly, on August 6, 2002, Moody's downgraded the senior secured
22 ratings of Laclede Gas Co. two notches (from A1 to A3), reflecting unease about the
23 company's "difficulty ... in restoring its operating coverages and financial leverage to its

1 historical levels.” The reason given by the rating agency for its concern included
2 pendency of “a court appeal of the MPSC’s decision relative to the calculation of
3 Laclede’s depreciation rates.” Earlier, on March 8, 2002, Moody’s had placed Laclede’s
4 senior secured rating (Aa3 at that time) on Negative outlook, reflecting in part pendency
5 of an MPSC proceeding considering “certain financial and accounting matters affecting
6 Laclede’s operating cash flows [including] depreciation methodologies.”

7 **Q. How do the types of concerns expressed by S&P and Moody’s enter**
8 **into the credit ratings process?**

9 A. Regulation is a key factor in assessing the credit profile of a utility.
10 Because state public utility commissions determine rate levels (recoverable expenses
11 including depreciation and operations and maintenance, fuel cost recovery, and return on
12 investment) and the terms and conditions of service, assessment of regulatory policies,
13 utility commission orders and the overall industry marketplace are particularly important
14 in determining a utility’s credit profile.

15 How a particular state utility commission is perceived by Wall Street
16 affects utility investment decisions because, before major energy investors will be willing
17 to put forward substantial sums of money, they will want to gain comfort that regulators
18 understand the economic requirements and the financial and operational risks of the
19 evolving utility industry and that their decision-making will be fair and will have a
20 significant degree of predictability.

21 Thus, rating agencies look for the consistent application of sound
22 economic regulatory principles by the commissions. If, for example, a regulatory body
23 were to encourage a company to make investments based upon an expectation of the

1 opportunity to earn a reasonable return, and then did not apply regulatory principles in a
2 manner consistent with such expectations, investor interest in providing funds to such
3 utility would decline, debt ratings would likely suffer, and the utility's cost of capital
4 would increase.

5 **Q. Do you see any parallels with that example in Missouri?**

6 A. Yes I do. I think these are the types of concerns rating agencies would
7 have about Missouri regulation if the depreciation policies going forward diverged from
8 the mainstream of state commissions around the country. Indeed, two years after its two-
9 notch downgrade of Empire District, S&P continues to note that a "challenging
10 regulatory environment tempers the strengths of Empire's business profile [including the
11 MPSC's] low depreciation allowances." ("S&P Research Summary: Empire District
12 Electric Co.," July 13, 2004.)

13 Significantly, if the Missouri Commission were to support the Staff
14 position in this case, the rating agencies would make an assessment of the reasons for the
15 decision and determine whether they supported modifying their current view of the state
16 regulatory environment further downward. This assessment could have unfavorable
17 credit rating implications, not only for Laclede, but potentially for all utilities subject to
18 the rate making authority of the Missouri PSC.

19 **Q. Earlier you mentioned the importance of utility cash flow to the rating**
20 **agencies.**

21 A. Yes, as I discussed, depreciation allowances play a critical role in the
22 provision of cash flow to utilities. Cash flow is also the financial measure that currently
23 carries the greatest weight within the credit rating process. I was Group Manager of the

1 Fitch utilities ratings practice when the firm laid out its criteria for electric distribution
2 utilities, emphasizing that Fitch's "financial analysis is cash flow-oriented but also
3 incorporates traditional accrual accounting measures." ("Electric Distribution Credit
4 Criteria," Fitch Special Report, October 7, 1999.) That same orientation carries over to
5 the entire utility sector – in addition to electric distribution utilities, to integrated electric
6 and gas utilities and generators as well – and is still the primary factor in Fitch's credit
7 rating analysis today.

8 S&P agrees with this focus on cash flow, recently stating that the agency
9 "places much emphasis on cash flow protection measures when assessing credit quality"
10 and pays close attention to crucial details "such as a change in the depreciation rate" that
11 would "defer cost recovery into the future" so as to "preserve earnings but weaken cash
12 flow." (See Schedule SMF-1, "S&P Research: A Fresh Look at U.S. Utility Regulation,"
13 January 29, 2004.)

14 For this reason, S&P closely tracks the cash flow effects of a regulatory
15 decision, "especially if it is the result of a full or partial settlement between the parties
16 [since a] common method to achieve the compromise ... is to defer cost recovery into the
17 future, which can preserve earnings but weaken cash flow." S&P's focus on cash flow
18 protection leads it to analyze such rate decisions in great detail "because some that appear
19 to be favorable on the surface can hide the 'bite' that regulators took in the less
20 conspicuous parts of the case, such as a change in the depreciation rate." (See Schedule
21 SMF-1, "S&P Research: A Fresh Look at U.S. Utility Regulation," January 29, 2004.)

22 In view of the rating agencies' close scrutiny of depreciation methodology
23 and heavy reliance on cash flow measures, if regulators were to stray from mainstream

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Steven M. Fetter

1 depreciation accounting policies, there very well can be a negative effect on utilities
2 within that jurisdiction. Clearly, if the depreciation policies lowered a utility's cash flow,
3 that impact would pressure the utility's existing credit ratings, increase the utility's
4 capital costs, and make the utility's day-to-day operations a more difficult task, including
5 potential delay of infrastructure investment necessary to maintain reliability above
6 minimum standards.

7 **Q. Does this conclude your testimony?**

8 **A. Yes, it does.**

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A Fresh Look at U.S. Utility Regulation

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Standard & Poor's Ratings Services has been tracking the ups and downs of utility regulation for years, and in the past year or so has noted the recent upswing in the amount of attention that regulators and their activities are attracting (see, for instance, "State Utility Regulation Coming Back In Vogue," published Oct. 3, 2002, and "U.S. Electricity Regulation Evolves as Transition to Competition Continues," published Sept. 25, 2003). With the renewed and increasing influence that regulators are asserting on the creditworthiness of utilities, especially as many managements scramble back under the protective umbrella of comprehensive regulation, Standard & Poor's offers this primer on how we analyze the effect of regulation on utility credit ratings. The entire range of regulatory actions and inactions is examined, but inevitably it is the analysis of rate case decisions that provides the key indicator of the level of support.

First, however, it is useful to remember the legal status of utility regulatory bodies when developing the basic analytical approach to their activities and decisions. Most utility commissions are, in a legal sense, "creatures of the legislature"; that is, the role they play is essentially legislative and not judicial. The responsibility for setting utility rates and for other various functions is actually that of legislators, but has been delegated to regulators for practical reasons. Thus, despite the trappings of a court (testimony, rules of evidence, administrative law "judges") and a long history of accumulated case law governing their activities, the decision-making process of utility commissioners more often resembles that of legislators, with its emphasis on compromise and political considerations, than that of jurists who weigh evidence, construe the law, follow legal precepts, and the like.

The implication for the analyst is that the behavior of regulators can more often be explained by looking to political factors than to analyzing legal precedents or assessing the arguments of opposing parties. That's why Standard & Poor's analysts spend considerable time meeting with regulators and staff members and accumulating knowledge about the local and regional political climate and its effect on a utility, in addition to analyzing the impact of a particular rate decision or other commission pronouncements. Nevertheless, rate cases, once thought to be obsolete as competition spread across the country, appear to be returning to the forefront again.

For major rate cases that can directly affect ratings, the analyst will follow the developments in a rate proceeding from the initial filing. The company's request for rate relief, the local public reaction to the filing, the rebuttals of important parties and intervenors, and the conduct of the hearings are all monitored, assessed, and commented upon, if necessary, as the case proceeds through its schedule. The ability of the commission to render a fair and balanced decision that appropriately considers the interests of all the participants in the process can sometimes be affected by incidents that occur while the case is developing. Standard & Poor's tracks whether the case is drawing a lot of attention, influential parties are staking out extreme positions, or outside events such as upcoming elections are affecting the chances of a rate decision that is consistent with the financial projections the ratings are based on.

Once a decision is reached, Standard & Poor's analyzes its effect on the financial forecast for the company, and also to assess whether the actions and precedents being set by the commission in its decision will have a long-term effect on Standard & Poor's opinion of the regulatory environment in that jurisdiction. The analysis of the rate case fundamentally explores a two-fold question: are the new rates based on a rate of return consistent with the company's ratings, and is the utility being afforded a legitimate opportunity to actually earn that rate of return?

On the former question, the analyst looks to equity returns being authorized for other utilities of the same credit quality, as well as the capital structure employed to arrive at the overall rate of return being used to set rates. On the latter, the test year and all of the adjustments made to the company's filed data are inspected to arrive at the final conclusion. Generally, decisions that feature the most up-to-date information in determining rates, including current test years and all "known-and-measurable" changes, are viewed as providing companies with the best chance to earn a reasonable and cash-rich return.

Importantly, credit analysis also incorporates the cash-flow effect of a decision, especially if it is the result of a full or partial settlement between the parties. A common method to achieve the compromise often sought by the parties or the regulators is to defer cost recovery into the future, which can preserve earnings but weaken cash flow. Standard & Poor's places much emphasis on cash flow protection measures when assessing credit quality, and a rate decision that ostensibly looks favorable for investors can sometimes come at the expense of bondholders. Attention to the details is crucial in analyzing a rate decision because some that appear to be favorable on the surface can hide the "bite" that regulators took in the less conspicuous parts of the case, such as a change in the depreciation rate.

Finally, one of the most important issues affecting ratings may or may not be part of the rate-case process, but is constantly tracked by Standard & Poor's: the recovery of fuel and purchased-power and gas costs. The analysis concentrates on stability of cash flows and the relative certainty of full recovery of these items, the largest expenses for almost all utilities, in arriving at a consensus on the level of a utility's business risk.

The stability that leads to improved credit quality can be supported by legislators and regulators either through rate design or by carving out fuel and commodity expenses and treating them separately from the normal rate case process. Rate design is established as part of a rate-case decision, and can be used to promote stability by allocating a greater percentage of fixed costs for recovery through the standard monthly charge. The more common method is a separate clause in the tariff that fluctuates automatically or near-automatically as commodity costs rise and fall. The presence of a fuel and purchased-power or gas clause that helps a utility manage its exposure to commodity price moves is positive for credit ratings. Not all are created equal, however, and each mechanism is studied to determine how closely it allows for matching of customer rates with expenses.

Many other factors outside the scope of this commentary can play an important part in the overall assessment of the regulatory environment in which a utility operates. Incentive ratemaking, special rate riders to recover extraordinary costs (e.g., environmental compliance), deregulation developments, the degree to which regulation insulates a utility from its parent, legislative initiatives, and other non-ratemaking

considerations can all affect Standard & Poor's opinion of the quality of regulation. The ability of management to control its regulatory risk and the historical attitude of regulators toward the interests of utility bondholders also enter into the analysis. In the end, the regulation of public utilities is the defining element of the industry and is often the determining factor in the ratings of a utility.

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The McGraw-Hill Companies

In the Matter of Laclede Gas Company's Tariff)
to Revise Natural Gas Rate Schedules.)

STATE OF NEW JERSEY)
) ss
COUNTY OF MONMOUTH)

1. My name is Steven M. Fetter. My business address is P.O. Box 475, Rumson, New Jersey 07760. I am President of Regulation UnFettered, an energy advisory firm I started in April 2002.

3. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded are true and correct.

Subscribed and sworn to before me this 19th day of August, 2004.

My commission expires:

LILLIAN PALUMBO
NOTARY PUBLIC OF NEW JERSEY
 Commission Expires 12/21/2006

