CREDIT AND CAPITAL ISSUES AFFECTING THE ELECTRIC POWER INDUSTRY

FERC TECHNICAL CONFERENCE

Garry Brown, Chairman, New York State Public Service Commission & Chairman, Committee on Electricity, National Association of Regulatory Utility Commissioners — January 13, 2009

Good afternoon and thank you for the opportunity to address this important conference. Today, I will be speaking to you as both Chairman of the New York State Public Service Commission and as Chairman of the NARUC Committee on Electricity.

As you may know, the New York Commission is responsible for setting rates and ensuring adequate electric service is provided by New York's utilities. The NARUC Committee's role is to develop and advance policies that promote reliable, adequate, and affordable supply of electricity. Through strong collaboration with the Federal Energy Regulatory Commission and related Federal agencies, the Committee also seeks ways to improve the quality and effectiveness of regulation through education, cooperation, and exchange of information.

We have just heard from a number of experts representing investors and various electric power industry participants. It is quite evident that there are many challenges facing the industry as a whole.

At the outset, I want to note that it is typically the responsibility of State utility regulators to assure that the state's electric utilities provided safe and reliable service at a reasonable price. This requires utilities to make investments, some of which are very substantial. Utilities generally desire certainty from regulators that they can recover their investments including a reasonable return.

With that said, it is important to recognize the economic realities of a recession and expect utilities to take a hard look at their capital programs with an eye toward prioritizing. This not only reduces utility exposure to the volatile financial markets but also helps to relieve upward pressure on rates to end-use customers caused by an increase in the utility asset investment base (rate base). For example, those projects that are essential to safety and reliability must go forward while those that are discretionary and can be deferred should be evaluated on a case by case basis as to whether customers are best served by going forward with the projects at this time.

I note that there are several potential drivers of utility investment on the horizon — transmission and distribution upgrades due to aging infrastructure and to meet new needs, requirements to create a smart grid, energy efficiency investments, renewable energy mandates, and, in some parts of the country, capital for new power plant construction. These potential investments will require billions of dollars to support.

Large capital programs such as the ones noted make it very important that electric utilities continue to have access to the financial markets, and regulatory policies should support utilities' ability to raise capital.

Speaking parochially from a New York perspective our policies over the years, while not always viewed by some as investor-friendly, have nonetheless resulted in no New York electric utility currently being rated less than BBB+ (Con Edison, Orange & Rockland, Central Hudson, are in the A category while NYSEG and Rochester Gas & Electric are BBB+).

In the last two months, New York electric utilities have raised about $800 million in the markets — ($600 million for Con Edison, $150 million for Rochester Gas & Electric, and about $50 million for Central Hudson.) Thus, our utilities have been able to raise capital even in these difficult financial times. That said, however, the interest costs associated with new utility debt issues has been extremely high relative to yields on comparable treasury securities.

I should note that there is a clear relationship between a utility's bond rating and its ability to borrow at a reasonable cost, especially in times of economic distress as we are now facing.

For example, in New York, we have, for many years, considered the question of what the most cost effective electric utility bond rating is for ratepayers. While the Commission has never formally stated a particular policy, I think most experts would say that over the last 15 years the answer probably was some place in the BBB-A range, depending on the assumptions employed in the analysis. While this may be a good answer over the long run, it flies in the face of current reality.

Given current economic realities, 100-200 basis point premiums on the yield for BBB debt over A debt may indicate that A is cheaper to ratepayers now. The policy question for utilities and regulators to grapple with is how long the current situation will continue and how often we can expect similar situations in the future.

While there is a large difference between A and BBB, there is an even brighter line between Investment Grade (BBB-/Baa3 bond ratings by S&P/Moody's and higher) and non-Investment Grade (Junk) (BB+/Ba1 and lower). The cost of issuing non-investment grade debt, assuming the market is receptive to it, has in some cases been hundreds of basis points over the yield on investment grade securities. To me this suggests that you do not want to be rated at the lower end of the BBB range because an unexpected shock could move you outside the investment grade range.

Now turning to implications of the current financial environment on market players, I think you will hear from the Short-Term Electricity Markets panel shortly concerns regarding the need to tighten up credit requirements to reduce the risk of default in the markets.

For example, in New York, the rules for extending credit by NYISO are largely based on lagging data, such as ratings and prior financial statements that may not adequately capture the potential for the type of rapid financial deterioration that we've been seeing. While the cost of market defaults will ultimately be paid by consumers, the costs of potential remedies to avoid defaults, such as reducing load-serving entities unsecured credit lines or requiring accelerated cash payments, will also be born by consumers. It is therefore incumbent upon both State and Federal regulators to ensure that these rules provide balance and that the entities that administer these markets have the tools and ability to react quickly to changing conditions.

Anecdotally, we have heard that the current environment is leading to difficulties in raising capital for investors in certain renewable projects. Many states have RPS goals in place. Some of the projects rely partly on state and federal funding. If the current financial situation continues to persist, there may be an impact on the achievement of RPS goals. Regulators may need to consider how their funding for renewables should be changed to help achieve RPS goals.

Clearly, we are in uncharted waters. There remains a significant concern that some might try to use this opportunity to achieve other goals. We need to be diligent to ensure that what actions we might take today are indeed the best decision to ensure the safety and reliability of the electric power industry.

We regulators need to ask tough, pointed questions. We need to be watchful. Asking questions does not mean we are not supportive; it means we as regulators must continue to recognize that our primary responsibility is to ensure safety and reliability at just and reasonable rates.