

## SPECIAL COMMENT

# Regulatory Frameworks – Ratings and Credit Quality for Investor-Owned Utilities

## Evaluating a Utility's Regulatory Framework

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**Summary**

The framework in which a regulated utility operates is typically one of its most significant credit considerations. The regulatory structure and its general framework is a primary consideration that differentiates the industry from most other corporate sectors.

The characteristics of a utility's regulatory framework represents one of four factors that are considered, within the context of [Moody's Regulated Electric and Gas Utilities Rating Methodology](#), published August 2009, (the Rating Methodology) to determine its rating. This Special Comment discusses our scoring criteria on that first factor.

A key consideration in our analysis is the degree to which a utility's regulator has the ability to independently regulate within the context of its legal, legislative or political environment.

We also examine how developed the utility's regulatory framework is; the decision making track record of its regulators; the utility's business model; and its regulators' openness to alternative rate mechanisms that help assure timely cost recovery.

We also evaluate patterns of regulatory contentiousness, which is often driven by political intervention at some level, in an effort to develop a view toward regulatory bias. This is one of the more challenging aspects to our analysis, since political intervention often occurs quickly and unexpectedly. Ultimately, we look to evaluate how the act of balancing a utility's appropriate cost of service and return on investment with consumer's ability and willingness to pay may change over time. Today's economic turmoil appears to be having some implications for this assessment in selected jurisdictions.

In the U.S., the vast majority of utilities operate within state regulatory frameworks that are reasonably transparent and well developed where regulators generally strive for a fair balance in establishing rates that assure reliable service at a reasonable cost to ratepayers while allowing a utility a fair opportunity to earn a reasonable return. However, assessing this balance is a complex procedure, and frequently involves a subjective assessment on our part. While most utilities in the U.S. score within the Baa range on the regulatory framework factor, indicating relatively solid support from a credit perspective – there are a few notable exceptions.

In Asia, with the exception of Hong Kong, Singapore and Japan, the regulatory framework is generally less transparent, and regulators may be under political pressure to reduce or maintain rates. In Europe, utilities that fall under the subject Rating Methodology, do so either because their regulatory and market development has taken place somewhat later than other countries within the EU<sup>1</sup>, or because they are somewhat isolated and have received an exemption to the EU Electricity Directive. In Canada, the provincial regulatory frameworks are well developed, transparent and predictable, and most utilities score in the A range on the regulatory framework factor. In Latin America, regulatory frameworks vary with some being stable and transparent while other are constantly shifting and prone to political intervention.

It is important to note that our evaluation of a utility's regulatory framework is company specific, and that the score assigned for Factor 1 considers management's ability, over time, to cultivate supportive regulatory relationships.

## Introduction

When evaluating the credit quality of a utility, the degree of support that it may depend on from its regulators is typically one of Moody's most significant considerations. The regulatory framework is also the prime factor in differentiating the industry from most other corporate sectors. This is partly due to the fact that a typical utility provides services that are essential to our way of life and to our economy, namely the delivery of electricity and/or natural gas. Utilities typically do not compete with other companies for the ability to provide these services, although some highly structured pockets of competitive retail "supply" of electricity have been introduced across the U.S. As a monopoly, the activities of a utility are usually conducted within a legislatively mandated oversight framework – where the national, provincial or state regulatory commissions – can review costs associated with the need to provide consistently safe and reliable service, plus provide a reasonable profit. Consequently, a utility's total, over-all revenue requirements and the rates associated with generating those revenues, are important considerations in evaluating this factor.

As the revenues set by the regulator are a primary component of a utility's cash flow, the utility's ability to obtain predictable and supportive treatment within its regulatory framework is one of the most significant factors in assessing a utility's credit quality. The regulatory framework generally provides more certainty around a utility's cash flow and typically allows the company to operate with significantly less cushion in its cash flow metrics than comparably rated companies in other industrial sectors.

In situations where the regulatory framework is less supportive, or is more contentious, a utility's credit quality can deteriorate rapidly. Because of the regulatory safety net, defaults are rare in this sector, as compared with most industrial companies. However, there have been seven major investor owned utility defaults in the United States over the last 50 years, five of which resulted in Chapter 11 bankruptcy filings. In five of the defaults, a dispute with regulators regarding an insufficient or delayed response to a request for financial relief associated with the recovery of costs and/or capital investment in utility plant is generally cited as a primary driver that led to growing financial pressure, credit rating downgrades and, in most cases, the eventual filing for bankruptcy.

<sup>1</sup> The EU Electricity Directive of 1999 ("the Directive") ushered in a period of liberalisation of generation and supply prices and hence most European vertically integrated utilities are covered under the Unregulated Utility and Power Companies Methodology

In our Regulated Electric and Gas Utilities Ratings Methodology, published August 2009, (the Rating Methodology) the importance of regulatory influence is emphasized by the 50% weighting<sup>2</sup> ascribed to various statutory and regulatory provisions when determining a utility's credit quality. Factor 1, Regulatory Framework, the first of four key factors, is ascribed a 25% weighting and considers the general regulatory and political environment under which a utility operates and the overall business position of a utility within that regulatory environment. Factor 2, Ability to Recover Costs and Earn Returns, is also ascribed a 25% weighting and addresses in a more specific manner the ability of an individual utility to recover its costs and earn a fair return on invested capital.

TABLE 1

### Regulated Electric and Gas Utility Rating Methodology

#### KEY RATING FACTORS AND WEIGHTINGS

- |  |
|--|
| 1. Regulatory Framework – 25%                      |
| 2. Ability to Recover Costs and Earn Returns – 25% |
| 3. Diversification – 10%                           |
| 4. Financial Strength and Liquidity – 40%          |

Factors 1 and 2 are inter-related in numerous ways. For example, whereas Factor 2 evaluates a company's specific success at earning returns and generating adequate, predictable cash flows, possibly as a result of its use of recovery mechanisms, such as those for fuel and purchased power, environmental, renewable or other expenses, Factor 1 considers, among other things, the regulator's demonstrated willingness to authorize a use of enhanced recovery mechanisms and to provide an ability for the company to earn adequate returns. This Special Comment discusses how we calculate a utility's score for Factor 1 - Regulatory Framework. (The current Factor 1 scoring for the operating utilities in our rated universe is shown in Appendix A). These Factor 1 scores provide an indication of our current thinking. The scores are not intended to be static; they continue to be monitored and modified as warranted to reflect changing conditions and circumstances. In addition, when applied within the context of the Rating Methodology framework grid, the scores shown in Appendix A may be further modified by the use of a "strong" or "weak" designation.

### What are the characteristics of a utility's regulatory framework?

In evaluating a utility's regulatory framework, we consider such things as the regulatory body's independence; its legislative or political environment; the extent of the regulatory framework's development; its track record for predictable, stable decisions; the utility's business model; and the openness of the regulators to alternative rate mechanisms that tend to provide additional assurance of timely cost recovery and the ability to earn a return on invested capital.

### Regulatory Independence

A key consideration in assessing Factor 1 is the degree to which the regulator has the ability to act as an unbiased arbiter over the facts in the record, and base its decisions on the existing laws and statutory decisions. Today, balancing the sometimes conflicting goals of assuring a reliable supply of reasonably priced electricity or natural gas; assuring the long-term financial health of the utilities it regulates; and authorizing rate increases within a given state or region is increasingly viewed as challenging.

<sup>2</sup> The factor weightings shown in the rating methodology grid are approximate. The actual weight given to a factor in our assessment of an issuer's credit quality may differ based on the issuer's circumstances, and the scoring grid does not include every consideration that determines a rating.

We look to see if the regulator consistently strives to achieve balance, between the investor and the consumer in assessing the utility's rate request, or substantially denies the rate request by acting perhaps in a manner more akin to a consumer advocate.

We also evaluate the impact of outside political influence on the regulatory process, where a legislature or a governor can revise, amend or restructure certain provisions associated with the traditional, vertically integrated electric utility framework. Political influence works in many ways, from utility sponsored legislation on the positive side to wholesale reductions to recovery on the negative side.

The majority of utilities in the rated universe of the Rating Methodology are considered to have average exposure to regulator independence, meaning their regulators generally try to take the middle path. There are a few notable exceptions, for example, in Indonesia, or in Argentina where the politicization of the regulatory relationship tends to be a dominant factor in assigning a score to the regulatory framework factor.

### **National and local regulation**

When a utility's revenues are determined by a single national regulator, within a well developed and transparent framework, Moody's generally views the framework as being more independent, less susceptible to local political influence and more supportive of long-term utility credit quality than state regulation. The difference in risk reflects our view that national regulation tends to be more transparent and sometimes even formulaic, and less exposed to significant political or consumer intervention. This tendency is best exemplified in markets that are large, well developed, and relatively transparent; such as the U.K or Japan.

In smaller markets, national regulators may also be susceptible to local pressure. In Asia, each country has one regulator, but with the exception of Hong Kong, Singapore and Japan, the regulatory framework is generally less transparent, and in some countries, the regulators are under political pressure to maintain or reduce rates.<sup>3</sup> The economic recession of the past few years has also put pressure on national regulators in Central and Eastern Europe as well.

In Latin America, the regulatory frameworks vary from one country to another, in some countries, such as Chile, utility regulatory frameworks have been in place for an extended period, and are quite transparent; for others, such as in Argentina, the frameworks are constantly shifting and subject to political influence, while in Brazil the frameworks are more developed but still evolving. Federally regulated utilities in Argentina, which serve the most densely populated areas of the country, tend to be more subject to public scrutiny than the local, smaller utilities in the interior of the country. As a result, regionally regulated utilities have been favored by rate increases more often and in a more timely manner than federally regulated utilities.

In Canada, the provincial regulatory frameworks are well developed, transparent and predictable. In addition, Canadian utilities generally have not pursued diversification strategies and have limited exposure to unregulated activities at affiliates or holding companies. We view Canada's business and regulatory environments as being more supportive than many of those in the U.S. Accordingly, most utilities in Canada score in the A range on the regulatory framework factor.

<sup>3</sup> For example, there has been limited tariff increases in Indonesia for the past few years and Malaysia kept its rates unchanged from 1999 to 2006.

We would be likely to assign a score of Aaa or Aa for a utility's regulatory framework factor in jurisdictions where regulators are likely to take extraordinary action to support a failing company,<sup>4</sup> or where a utility can set rates independently, like the U.S. owned Tennessee Valley Authority. Additionally, U.S.-based transmission companies, which enjoy formulaic federally regulated rates determined by the Federal Energy Regulatory Commission (FERC), but do not see extraordinary supportive action from their regulator, are currently scored in the Aa range because of the transparent and predictable characteristics of that framework.

### U.S. Transmission Regulation

In an effort to encourage investment in the aging U.S. transmission infrastructure, the FERC established a transparent and supportive approach to establishing rates for significant transmission projects. Elements of this approach include:

- » Authorized returns on invested capital that are generally higher than those awarded by state regulators;
- » An ability to earn a cash return on construction work in progress;
- » An ability to recover abandonment costs;
- » A significant equity component is allowed in capital structures and companies have the ability to utilize double-leverage;
- » No rate hearings required to adjust rates;
- » Rates reset annually via established formula, assuring timely recovery of actual costs and return on investment;
- » The rate formula may be forward looking.

In our opinion, state-regulated investor-owned U.S. utilities carry higher regulatory risk than utilities with rates regulated entirely by FERC. The U.S. market is highly fragmented: many utilities are exposed to overlapping or unclear regulatory jurisdictions, and to volatile power prices. And since state regulation is far more local, it can become political - particularly when significant rate increases are proposed. Currently, all state regulated U.S. investor-owned utilities receive scores that range from "A" to "Ba" for the regulatory framework factor.

We also acknowledge that a utility's operations are subject to regulation on numerous fronts, including operational safety and environmental controls. In these cases, federally or nationally imposed regulation, that does not consider local conditions, may create additional uncertainty or may result in a disproportionate impact for individual utilities.

### Political tendencies

When a utility's rate setting process is exposed to significant political interference, its rate-case outcomes become less predictable, often resulting in reduced expectations for cash flow stability, and in many instances introducing a long-term period of contentiousness. Utilities with a history of politically charged rate proceedings will tend to score in the ranges of either Ba or B on the regulatory framework factor. We have observed that while utilities may ultimately prevail through legal

<sup>4</sup> This tends to be the case for utilities in Japan.

challenges, the process can take years to complete, and in most cases, the damage to credit quality will have already occurred.

In evaluating the potential for political interference in the U.S., we look beyond the method of commissioner selection (elected versus appointed). In our view, all regulation is political, so we do not differentiate in a significant manner how the commissioners got on the commission. In states where voters elect their regulatory commissioners, it might seem that consumer oriented political intervention - or a bias toward appearing to do everything possible to minimize rate increases, would be a heavy factor in rate case outcomes. In fact, while this is often the case, we have not found it to consistently be true.

Utilities in Arizona and New Mexico, where commissions are elected, have tended to experience protracted and highly publicized rate proceedings; as a result, utilities in these jurisdictions currently receive regulatory framework scores in the Ba range. Yet in numerous states with elected commissions such as Alabama, Georgia, North Dakota and South Dakota, utilities have not had a history of lengthy or politically charged rate proceedings. Many utilities in these states receive regulatory framework scores in the A range. It should be noted that a utility often represents one of the largest publicly-traded companies headquartered within a particular state that also employs a significant amount of the population with reasonably good jobs, is usually ascribed a substantial property tax bill and is often a very generous contributor to local charities.

On the other hand, the most significant recent examples of negative political intervention that posed a severe threat to utility credit has occurred within regulatory jurisdictions where commissioners were appointed, but their ability to act independently was impaired by the actions of politicians. We have seen this happen in recent years for utilities operating in Illinois and Maryland, which are now scored Ba on regulatory framework, but scored in the B range or lower amid threats of continued rate freezes or caps.

Utilities in California, which also has an appointed commission, faced extreme political opposition during the energy crisis of 2001-2002. Some of these utilities ultimately defaulted. This history is a key consideration in the score assigned to the regulatory framework for these companies; although for the past several years, the regulatory treatment for utilities in California has been among the more credit supportive observed for U.S. utilities, and until recently, their scores on Factor 1- Regulatory Framework remained within the Baa range. Currently, they are scored in the A category. In Florida, where the commission is appointed, utilities have historically experienced very supportive rate decisions, and those utilities had historically received scores in the A range. However, recent interventions by the Governor in the rate proceedings for Florida Power & Light and Progress Energy Florida - including the appointment of new commissioners in the midst of rate proceedings have contributed to our reassessment of this rating factor for these companies, resulting in lower regulatory framework scores for Factor 1 in the Baa range.

Outside of the U.S., utilities in Argentina provide a clear example of regulatory environments that are currently subject to a significant amount of political interference. Initially, ENARGAS was established as an independent agency to administer and enforce the Gas Act and applicable regulations for the gas distribution industry, including the tariff setting and periodic tariff review mechanisms. However, following the 2001-02 crisis, on July 2003 the Argentine government created a new agency (UNIREN or Agency to Renegotiate Public Utilities Contracts) to develop a common regulatory framework for all utilities and to renegotiate their tariffs. In addition, since May 2007 ENARGAS has been under an intervention decreed by the President, who appointed an official (or "Interventor") to be in charge of the agency. Therefore, many of the ENARGAS' technical duties are subject to political interference and as a consequence the regulatory framework is not transparent and highly unpredictable. As an

example, Metrogas, an Argentine regulated LDC, has not been able to adjust its tariffs in over ten years, which has led to a severe deterioration of the company's economic and financial situation. On June 17, 2010, the company filed for reorganization under Argentine law.

In some instances, political or legislative actions can, in fact, be supportive of utility credit quality – putting forth additional rate mechanisms or tools for state commissions to consider, or legislating specific time frames for rate decisions. Such actions generally offer the opportunity for a utility to receive more supportive treatment from its regulators, but they generally also require regulatory follow-through; and are typically not intended to impede the regulator's ability to balance the utility's need to recover its costs and earn a return with the desire to maintain reasonable rates. As a result, credit supportive legislative actions are generally less likely to immediately affect a utility's Regulatory Framework score.

### Some political interventions have hurt utilities' credit quality

- » When Illinois was preparing to fully transition to electric market rates for generation in 2006 and 2007, several bills were proposed that would re-freeze the electric rates for the state's primary utilities that had just come off a 10-year rate freeze. The bill's legislative progress caused considerable rate uncertainty – particularly since the regulator, the Illinois Commerce Commission, had already sanctioned power supply auctions for power procurement and approved rate phase-in plans. We considered the significant potential impact on utility cash flow as a major threat to credit quality which ultimately resulted in ratings downgrades to below investment grade for each of the Illinois transmission and distribution companies.

An August 2007 settlement avoided a more severe negative impact on the utilities' rates and credit ratings, and more recent regulatory proceedings have been concluded without direct political interference. However, this experience suggests the future possibility of political or consumer backlash if significant rate increases become necessary again. Moreover, the utilities' continued relationship with unregulated generation affiliates remains unchanged which was a primary motivation, in Moody's opinion, for the political pushback to transitioning to market rates for generation.

- » Maryland also experienced a significantly politicized regulatory environment in 2006-2008 as its move towards electric retail competition became a major legislative and gubernatorial issue and was exacerbated by a potential acquisition of Constellation's Baltimore Gas & Electric Company (BG&E) utility subsidiary by Florida based FPL Group. New legislation produced significant uncertainty regarding electric utilities' ability to recover their increased costs for fuel and purchased power which ultimately resulted in significant deferrals and required refunds. Importantly, this legislation was passed after the Maryland Public Service Commission (MPSC) had already approved a plan that provided a more moderate deferral of rate increases. The legislature also voted to replace the full slate of MPSC commissioners - a highly unusual event.

During this time, the ratings of BG&E were downgraded by a total of three notches and remain at that level today. A spring 2008 settlement led to legislation that essentially resolved all issues; but not without a significant sustained reduction in BG&E's expected cash flow credit metrics. This relatively recent past experience, leads us to believe future political intervention cannot be entirely ruled out.

### ... while others have been supportive

- » In Georgia, South Carolina and Florida, legislation has been enacted that permits utilities to earn a cash return on construction work in progress on nuclear plants. Moody's views this type of legislation positively as the resulting mechanisms provide support for a utility cash flows and credit metrics while significant construction is underway, and they also tend to reduce the potential for future rate shock.
- » Michigan passed legislation in 2008 designed to reduce rate lag and encourage utility investment. In its 2009 and 2010 implementation of the legislation, the Michigan Public Service Commission appeared, in our opinion, to apply the legislation as intended; however, they also appeared to carefully balance the utilities' cost recovery needs with a need to minimize rate increases in a struggling economy. Such legislation has been a primary factor in the financial performance of the state's investor-owned utilities, given the severe economic contraction throughout the state.

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## Level of Development of the Regulatory Framework

Utilities that are operating within regulatory frameworks that are not well defined, or are relatively new, such as Eskom Holdings in South Africa, Israel Electric Corporation in Israel, Empresa Electrica de Guatemala S.A in Guatemala, and PLN in Indonesia will tend to receive lower regulatory framework scores, since a lack of development and track record reduces the level of predictability of rating outcomes and cash flow.

In Argentina, although a reasonable regulatory framework was established during the 1990's, and worked relatively well for almost 10 years, it was followed by a period of constant change of rules with very little support for the utilities' cost recovery requirements. In fact, for the past ten years, the majority of companies have been operating with frozen tariffs while costs continue to escalate. As a result of this high level of regulatory uncertainty and political intervention in the rate setting mechanism, the regulatory framework score for Factor 1 for all utilities in Argentina is in the B range.

Utilities in Brazil operate under a regulatory model that is well developed but with a relatively limited track record. The framework was implemented in 2004, and has generally evolved in a manner that has been supportive of utility investment and credit quality. Structural enhancements have included more efficient methods of power procurement, expansion of the national grid, centralization of long term energy planning, and increased thermoelectric capacity. Recognizing these improvements, in 2008 the regulatory framework score improved to Ba from B. However, the federal regulator is not fully independent of political pressure, and currently there is a fair amount of uncertainty surrounding the potential renewal or revocation of some utility concessions. As a result, the Factor 1 score for utilities in Brazil remains in the Ba range.

In certain instances, a utility's regulatory framework score could be tempered by the uncertain effects of policy changes (such as a transition to competition), or the implementation of new laws. As discussed above, Michigan in 2008 passed legislation enabling the Public Service Commission to give above-average support to its utilities - something which has proven to be beneficial in the current economic downturn. Even so, the improved regulatory environment is still relatively new and our concern about the sustainability of utility support in a continued weak economy holds Michigan utilities' regulatory framework scores in the Baa range.

Turnover among state regulatory commissioners may also increase the uncertainty surrounding rate case decisions. New commissioners often face challenges in quickly coming up to speed on complicated rate issues and obviously lack an established track record. Turnover that results from political intervention in opposition to rate increases, as we recently saw in Florida, is highly likely to have a negative impact on a utility's regulatory framework score.

### Considerations within European Markets

The European utilities that fall under the Regulated Electric and Gas Utilities Rating Methodology, do so either because their regulatory and market development has taken place somewhat later than other countries within the EU or where they exist within isolated regimes where significant competition would be hard to achieve (such as the Portuguese regions of Azores and Madeira)<sup>5</sup> and hence have received an exemption to the Directive.

The regulatory frameworks that have been implemented in Central and East European (CEE) countries tend on the one hand to have benefited in the first place from the adaptation, albeit with some modifications, of the already well-established UK regulatory framework. However as the CEE utility markets have been historically rather fragmented, with varying speeds of liberalisation, the full application of a well defined, transparent and consistent regulatory mechanism does vary from region to region. The common factor affecting our evaluation of regulatory regimes in CEE is their short track record compared to the more established regulatory regimes in Western Europe.

In addition, the economic recession of the past two years, revealed a greater-than-expected political influence over the decisions of regulatory bodies even in the more developed CEE countries such as Poland or Slovakia. The adverse economic impacts of the recession raised the political pressures on regulatory regimes not only in the regions with historically highly politically-influenced regulation such as in South East Europe, but also resulted in increasingly politically and socially motivated decisions of historically more consistent and transparent regulatory regimes in Central Europe. Whilst certain regulatory decisions, such as the price cap established by the Slovak regulatory office across most of the regulated sectors or the reluctance of the Polish regulator to adjust tariffs during gas price hikes, have to be seen in the context of the extreme commodity price volatility recorded over the 2008-09 period, it appears that the independence of CEE regulatory regimes from political influence is still fragile and together with short track records prevents a high score on Factor 1.

### Predictability and Stability

Utilities accustomed to fairly stable and predictable rate-proceeding outcomes tend to receive higher regulatory framework scores. This is heavily linked to the degree of a regulator's independence and how developed its framework is, but for utilities whose scores are not dominated by these factors, regulatory treatment over time may be a differentiating factor.

Regulation affects utility credit quality most directly by establishing prices (rates) for the electricity, gas and related services that the utility provides (revenue requirements), and by determining the authorized return on a utility's investment, as well as the authorized return to shareholders. In evaluating a utility's regulatory framework, we consider whether it has consistently been given rate increases that provides it an opportunity to recover its expenses and actually earn a rate of return in line with shareholder expectations.

Requested and authorized rates of return (ROEs) have trended downward over the last two decades, from about 12-13% in the early 1990s to the 10%-10.5% range more recently. Much of the decrease has stemmed from falling interest rates, but some of the decline may be attributed to other mechanisms put in place to ensure timely recovery and reduce risk (see next section). In evaluating the

<sup>5</sup> In this instance, they are subject to well-established Portuguese regulation under Entidade Reguladora dos Serviços Energéticos, where we apply a Baa to the Regulatory Framework

predictability of cash flows, we are concerned less with the awarded ROE, which has a tendency to become a headline, than the overall collective rate outcome, including the authorized base rate increase, the impact of any approved enhanced recovery mechanisms such as riders or trackers, and the implications for future cash flows. We observe that the amount of regulatory lag can be a contributing factor to a utility not being able to earn their authorized rate of return. From a credit perspective, while we are also less concerned with shareholder returns, we do observe that those companies that earn at or near their authorized rate of return tend to produce more predictable cash flows; and those companies that are not able to earn their authorized return tend to produce relatively weaker cash flow credit metrics.

The past two years have seen a tremendous amount of electric rate case activity, with rate increases generally coming in at slightly more than 50% of the requested amount. In prior years, when there was less activity, awards tended to be closer to 40%. Gas rate case awards, which have tended to be less politically contentious, have come in more consistently around 50%. While history tells us it is unlikely a utility would be awarded the full amount of its requested increase, companies that manage their regulatory relationships in a way that allows them to consistently achieve awards that provide an opportunity to earn a fair rate of return, would be more likely to receive an above average regulatory framework factor score.

Utilities that have received unwelcome surprises from regulators, with awards significantly lower than anticipated or less than enough to generally maintain or improve credit metrics, are likely to have a lower regulatory framework score. For example, the outlook of Consolidated Edison Company of New York (CECONY) was revised to negative and its ratings were ultimately downgraded following a change in our view of CECONY's historical relationship with its regulator and the extent to which we could expect future rate actions to be supportive of credit quality. In 2008, CECONY received a rate increase that was only about 35% of its requested amount, premised on a 9.1% ROE, which was significantly below the average ROE of 10% or so that was then typical for transmission and distribution utilities in other regulatory environments.

### Alternative Rate Making Mechanisms

Another key aspect of a utility's regulatory framework is the regulator's openness to policies that could ease rate lag. Such policies could include the tendency for its rate cases to be settled rather than litigated over a protracted period, the use of interim rates and/or forward test years.

Other mechanisms are designed to assure cost recovery and give utilities the chance to earn allowed rates of return. These include such things as, pre-approval of recovery of investments for new generation, transmission or distribution; the inclusion of construction work in progress (CWIP) in utility rate bases; the existence of attrition revenues which provide cash returns on construction expenditures, the inclusion of riders or trackers for specific investments or expenses; and the design and administration of mechanisms that allow the recovery of prudently incurred costs for fuel and purchased power.

Where rate design reduces or eliminates the utility's exposure to fluctuations in gas or electricity consumption that can be caused by weather, economic conditions, gas or power costs or legislative or regulatory conservation requirements, the utility is likely to enjoy more stable revenue and cash flow than would otherwise be the case. This form of rate design, known as decoupling, tends to lower a utility's business risk and could contribute to higher scoring on Factor 1.

Although the impact of these factors on any given utility is considered more specifically when assigning scores to the second of the four factors utilized to determine utility credit quality, the ability to recover costs and earn returns, and as described more fully in Moody's Special Comment on Cost Recovery Provisions dated June 2010, to the extent these mechanisms have been a consistent part of the regulatory framework for some time it would also be considered positively when assigning a score to the regulatory framework factor.

### A Utility's Business Model Could Affect Regulatory Framework Score

In evaluating the regulatory framework we also consider a utility's business model and its impact on its relationship with its regulators. We consider the amount and type of unregulated activity that a company may be engaged in as well as the nature of its regulated operations.

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

We also consider the degree to which a utility might be indirectly exposed to unregulated business risks by virtue of the ownership of such businesses by affiliates or parent holding companies. We will consider the tendency of parent companies to pursue diversification strategies which, in the absence of effective ring-fencing mechanisms, could expose the regulated utility to increased financial risk. Historically, holding company diversification into unregulated, and sometimes unrelated, business lines and into international markets has had generally negative credit consequences for regulated utility subsidiaries.

We also evaluate the nature of the utility's regulated businesses. Local Gas Distribution Companies sometimes referred to as LDCs, are generally considered to have lower business risk than electric utilities. These utilities tend to almost universally have mechanisms in place that pass the commodity cost of gas directly to their customers, tend to have capital expenditure plans that are more consistent than electric utilities, reducing the need for large sudden rate increases; and tend to have less contentious issues with their regulators. Decoupling, a concept designed to protect a utility from the risk of declining usage, has become more prevalent in recent years as regulators have sought to encourage energy efficiency, and is currently much more prevalent in gas utilities. Therefore, LDCs could receive higher scores on the regulatory framework factor than electric utilities operating within the same jurisdiction.

In jurisdictions that have deregulated power generation activities, utilities have been left with only a delivery obligation, giving them - in theory - a lower business risk profile as they are not exposed to the costs and operating risks associated with power production. However, in many deregulated markets, the utility maintains a provider of last resort (POLR) obligation, and may be subject to rate caps or freezes that do not always allow the full timely recovery of costs for power purchased or hedged to meet their POLR obligations. A utility that provides only transmission and distribution services, and truly has no exposure to retail customers, is viewed as having a lower business risk profile and its regulatory framework would likely score above average. This is true for the majority of the transmission and distribution utilities operating in Texas, the Factor 1 scores for these companies are

in the A range. Conversely, utilities with significant POLR and under-recovery risk tend to score below average.

Vertically integrated electric utilities are generally considered to have higher business risk than T&D utilities due to the risks associated with generation including fuel price and volume, operational and environmental risks. Among utilities with generation, those with significant exposure to fossil fuels, particularly coal, are typically viewed as having higher risk due to uncertainty as to the timing and amount of capital expenditures required to comply with further anticipated restrictions on environmental emissions including carbon dioxide, mercury, sulfur dioxide and nitrogen oxides.

### Regulatory Framework Score is Utility Specific

It is important to note that our evaluation of a utility's regulatory framework is company specific, considering each company's experience and track record at cultivating supportive regulatory relationships and operating within its framework. Although utilities operating within the same framework will tend to have similar Factor 1 scores, it is possible to have deviations based on actual experience. For example:

In Florida, a historically supportive environment, Progress Energy Florida, Inc. and Florida Power & Light's recent sizeable rate increase requests, which were proposed against a backdrop of a significantly weakened economy, resulted in an unprecedented (for Florida) amount of political intervention, and rate increases that were severely limited, or denied. As a result, we have lowered the Factor 1 score for these companies to Baa from A. This does not necessarily mean that we would automatically lower the regulatory framework scores for all utilities in Florida to the same degree. Gulf Power Company, for example, which has not filed for a base rate increase in several years and is not expected to do so over the near term, is insulated to some extent from the current, perhaps temporarily deteriorated, political and regulatory environment in the state.

In Virginia, a regulatory environment also historically viewed as supportive, legislation passed in 2007 essentially to re-regulate the electric industry has impacted utilities differently. Virginia Electric and Power Company (VEPCO), in March received commission approval of a unanimous settlement agreement, which included a base rate ROE of 11.9%. The settlement resulted in no change in VEPCO's base rates (but did require significant refunds and rate credits); however, it also allows VEPCO to adjust rates via rider mechanisms for various transmission, generation and efficiency investments. As a result, cash flows are expected to remain adequate and VEPCO's Factor 1 score is currently A. On the other hand, in 2008 the commission rejected Appalachian Power Company's (APCO) proposed construction of an integrated gas combined cycle plant, and associated request for a premium ROE. In APCO's pending rate case, staff is recommending an increase of approximately \$40 million, while a new state law resulted in the suspension of a \$154 million interim increase put in place in December. APCO also has operations in West Virginia and its score on Factor 1 is currently Baa. Allegheny Energy Inc.'s Potomac Edison Company (PEC) had substantial difficulty recovering its increased costs for fuel and purchase power post a June 2007 expiration of a fixed rate contract with its affiliate. Recovery was not authorized until 2008, and was implemented, subject to caps, in July 2009. On June 1<sup>st</sup>, PEC completed the sale of its Virginia operations to two electric cooperatives.

A utility's treatment within its regulatory framework, and our assessment of its Factor 1 score, often may have less to do with the regulator and much to do with the company and their cultivation of the regulatory relationship. It is entirely possible for a company to improve upon its regulatory relationships via open communication and negotiation toward the shared goals of providing reliable service at a reasonable cost. For example, regulatory relationships within PacifiCorp's numerous

jurisdictions have generally all improved since its 2006 acquisition by MidAmerican Energy Holdings, Inc. as the company focused on understanding the needs and concerns of the regulators and other constituents within each state that it operates.

### Other Considerations

On a company-specific basis, we would also evaluate factors such as the regulator's ability to oversee and ultimately approve utility mergers and acquisitions or their ability to encourage or require investments in renewable resources or energy efficiency. Environmental regulations, such as carbon capture or renewable portfolio standards could affect the regulatory framework score, particularly if they are especially onerous, for example in the U.S. southeast where renewable resources are limited. Nevertheless, these mandates are complex, usually have voluntary alternatives or offset provisions and can simply be re-legislated in the future which typically does not make these requirements a material credit issue at this time.

We also look at the substance of any regulatory or legal ring fencing provisions, including restrictions on dividends, capital expenditures and investments; separate financing provisions and/or legal structures; and limits on the ability of the regulated entity's ability to support its parent in times of financial distress. At any given time, depending on the circumstances facing the company, these may become contributing factors in determining the Factor 1 score.

### Conclusion

A utility's regulatory framework is a key consideration in determining its credit quality - accounting for a significant 25% weighting - when we evaluate a utility's credit rating within the framework of our Rating Methodology.

When evaluating a utility's regulatory framework we consider such things as the independence of the regulatory body; the legislative or political environment; how developed the regulatory framework is; the regulator's track record for predictability and stability in terms of decision making; the business model of the utility; and the regulator's openness to consider alternative rate mechanisms.

Most of the utilities we rate operate in environments where regulators strive for a fair balance between assuring reliable customer service at a reasonable cost, while allowing a utility to earn a reasonable return. These companies generally score around the mid-Baa range.

Meanwhile, unusual regulatory conditions can affect a utility's credit rating for better or worse. Utilities operating in regulatory environments with a history of independent decision making and generally supportive regulatory actions receive the highest regulatory framework scores; generally within the A to Aa ranges - while those operating in environments prone to political pressure receive the lowest scores, generally within the B to Ba ranges.

## Appendix A: Current Factor 1 scoring for the operating utilities in Moody's rated universe

### Vertically Integrated Utilities

| Aaa                                      | Aa                          | A   | Baa                                       | Ba  | B   |
|--|-----------------------------|---|---|---|---|
| Chubu Electric Power Company, Incorp.    | CLP Power Hong Kong Limited | Alabama Power Company                     | Appalachian Power Company                 | Arizona Public Service Company            | National Power Corporation                  |
| Chugoku Electric Power Company, Incorp.  |                             | ALLETE, Inc.                              | Avista Corp.                              | Cemig Geração e Transmissão               | Power Sector Asset & Liabilities Management |
| Hokkaido Electric Power Company, Incorp. |                             | Duke Energy Carolinas, LLC                | Black Hills Power, Inc.                   | Companhia Energetica de Minas Gerais      | Perusahaan Listrik Negara (P.T.)            |
| Hokuriku Electric Power Company          |                             | FortisBC Inc                              | Central Vermont Public Service Corp.      | Companhia Paranaense de Energia           |   |
| Kansai Electric Power Company, Incorp.   |                             | Georgia Power Company                     | Cleco Power LLC                           | EDP – Energias do Brasil                  |   |
| Kyushu Electric Power Company, Incorp.   |                             | Hydro-Quebec                              | Columbus Southern Power Company           | Empire District Electric Company (The)    |   |
| Okinawa Electric Power Company, Incorp.  |                             | Interstate Power & Light Company          | Consumers Energy Company                  | Empresas Publicas de Medellin E.S.P.      |   |
| Tokyo Electric Power Company, Incorp.    |                             | Madison Gas and Electric Company          | Dayton Power & Light Company              | Eskom Holdings Ltd                        |   |
| Tennessee Valley Authority               |                             | MidAmerican Energy Company                | Detroit Edison Company (The)              | Furnas Centrais Eletricas S.A             |   |
|  |                             | Mississippi Power Company                 | Duke Energy Indiana, Inc.                 | Israel Electric Corporation Limited (The) |   |
|  |                             | Northern States Power Company (Minnesota) | Duke Energy Kentucky, Inc.                | Kansas City Power & Light Company         |   |
|  |                             | Northern States Power Company (Wisconsin) | Duke Energy Ohio, Inc.                    | Light S.A.                                |   |
|  |                             | Otter Tail Power Company                  | Eesti Energia AS                          | Monongahela Power Company                 |   |
|  |                             | Progress Energy Carolinas, Inc.           | EDA - Electricidade dos Acores, S.A.      | NTPC Limited                              |   |
|  |                             | South Carolina Electric & Gas Company     | El Paso Electric Company                  | Public Service Company of New Mexico      |   |
|  |                             | Southern California Edison Company        | Empresa de Electricidade da Madeira, S.A. | Tata Power Company Limited (The)          |   |
|  |                             | Pacific Gas & Electric Company            | Entergy Arkansas, Inc.                    | Tucson Electric Power Company             |   |
|  |                             | San Diego Gas & Electric Company          | Entergy Gulf States Louisiana, LLC        | Union Electric Company                    |   |
|  |                             | Virginia Electric and Power Company       | Entergy Louisiana, LLC                    | UNS Electric                              |   |
|  |                             | Wisconsin Electric Power Company          | Entergy Mississippi, Inc.                 |   |   |
|  |                             | Wisconsin Power and Light Company         | Entergy New Orleans, Inc.                 |   |   |
|  |                             | Wisconsin Public Service Corporation      | Entergy Texas, Inc.                       |   |   |
|  |                             |   | Florida Power & Light Company             |   |   |
|  |                             |   | Green Mountain Power Corporation          |   |   |
|  |                             |   | Gulf Power Company                        |   |   |
|  |                             |   | Hawaiian Electric Company, Inc.           |   |   |
|  |                             |   | Idaho Power Company                       |   |   |
|  |                             |   | Indiana Michigan Power Company            |   |   |
|  |                             |   | Indianapolis Power & Light Company        |   |   |

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## Vertically Integrated Utilities

| Aaa | Aa | A | Baa                                     | Ba | B |
|-----|----|---|---|----|---|
|     |    |   | Kentucky Power Company                  |    |   |
|     |    |   | Kentucky Utilities Co.                  |    |   |
|     |    |   | Korea Electric Power Corporation        |    |   |
|     |    |   | Korea East-West Power Co. Ltd           |    |   |
|     |    |   | Korea Hydro and Nuclear Power Co. Ltd   |    |   |
|     |    |   | Korea Midland Power Co. Ltd             |    |   |
|     |    |   | Korea South-East Power Co. Ltd          |    |   |
|     |    |   | Korea Southern Power Co. Ltd            |    |   |
|     |    |   | Korea Western Power Co. Ltd             |    |   |
|     |    |   | Latvenergo AS                           |    |   |
|     |    |   | Louisville Gas & Electric Company       |    |   |
|     |    |   | Nevada Power Company                    |    |   |
|     |    |   | Northern Indiana Public Service Company |    |   |
|     |    |   | NorthWestern Corporation                |    |   |
|     |    |   | Ohio Power Company                      |    |   |
|     |    |   | Oklahoma Gas & Electric Company         |    |   |
|     |    |   | PacifiCorp                              |    |   |
|     |    |   | Portland General Electric Company       |    |   |
|     |    |   | Progress Energy Florida, Inc.           |    |   |
|     |    |   | Public Service Company of Colorado      |    |   |
|     |    |   | Public Service Company of New Hampshire |    |   |
|     |    |   | Public Service Company of Oklahoma      |    |   |
|     |    |   | Puget Sound Energy, Inc.                |    |   |
|     |    |   | San Diego Gas & Electric Company        |    |   |
|     |    |   | Sierra Pacific Power Company            |    |   |
|     |    |   | Southern Indiana Gas & Electric Company |    |   |
|     |    |   | Southwestern Electric Power Company     |    |   |
|     |    |   | Southwestern Public Service Company     |    |   |
|     |    |   | Tampa Electric Company                  |    |   |
|     |    |   | Tenaga Nasional Berhad                  |    |   |

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## T&amp; D Utilities

| Aa                               | A  | Baa   | Ba   | B                                |
|----------------------------------|--|---|--|----------------------------------|
| Hong Kong and China Gas Co. Ltd  | AEP Texas Central Company                | Atlantic City Electric Company                | AES Eletropaulo                            | Empresa Distribuidora Norte S.A. |
| Oman Power and Water Procur. Co. | AEP Texas North Company                  | Central Hudson Gas & Electric Corporation     | AES El Salvado Trust                       | Empresa Jujena de Energia S.A.   |
|                                  | CenterPoint Energy Houston Electric, LLC | Central Maine Power Company                   | Baltimore Gas and Electric Company         |                                  |
|                                  | FortisAlberta Inc.                       | Cleveland Electric Illuminating Company (The) | Bandeirante Energia S.A.                   |                                  |
|                                  | Hydro One Inc.                           | Connecticut Light and Power Company           | Cemig Distribuição S.A.                    |                                  |
|                                  | Newfoundland Power Inc.                  | Consolidated Edison Company of New York       | Centrais Eletricas do Para S.A.            |                                  |
|                                  | Oncor Electric Delivery Company          | Jersey Central Power & Light Company          | Centrais Eletricas Matogrossenses S.A.     |                                  |
|                                  | Superior Water, Light and Power Company  | Massachusetts Electric Company                | Central Illinois Light Company             |                                  |
|                                  | Texas-New Mexico Power Company           | Metropolitan Edison Company                   | Central Illinois Public Service Company    |                                  |
|                                  |  | Narragansett Electric Company                 | Commonwealth Edison Company                |                                  |
|                                  |  | New England Power Company                     | Comp. de Ener. Eletr. do Est. do Tocantins |                                  |
|                                  |  | New York State Electric and Gas Corporation   | Delmarva Power & Light Company             |                                  |
|                                  |  | Niagara Mohawk Power Corporation              | Duquesne Light Company                     |                                  |
|                                  |  | NSTAR Electric Company                        | Empresa Electrica de Guatemala, S.A.       |                                  |
|                                  |  | Ohio Edison Company                           | Energisa Paraiba-Dist. de Energia S.A.     |                                  |
|                                  |  | Orange and Rockland Utilities, Inc.           | Energisa Sergipe - Dist. de Energia S.A.   |                                  |
|                                  |  | PECO Energy Company                           | Escelsa                                    |                                  |
|                                  |  | Pennsylvania Electric Company                 | GAIL (India) Ltd                           |                                  |
|                                  |  | Pennsylvania Power Company                    | Illinois Power Company                     |                                  |
|                                  |  | PPL Electric Utilities Corporation            | Light Serviços                             |                                  |
|                                  |  | Public Service Electric and Gas Company       | Perusahaan Gas Negara                      |                                  |
|                                  |  | Rochester Gas & Electric Corporation          | Potomac Edison Company (The)               |                                  |
|                                  |  | Toledo Edison Company                         | Potomac Electric Power Company             |                                  |
|                                  |  | United Illuminating Company                   | Rede Energia                               |                                  |
|                                  |  | West Penn Power Company                       | Rio Grande Energia S.A. - RGE              |                                  |
|                                  |  | Western Massachusetts Electric Company        | Towngas China Co. Ltd                      |                                  |
|                                  |  |   | Xinao Gas Holdings Ltd                     |                                  |

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**Transmission Only Utilities**


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**Aa**

American Transmission Company LLC

American Transmission Systems

International Transmission Company

ITC Midwest LLC

Michigan Electric Transmission Company

Trans-Allegheny Interstate Line Company

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**Local Gas Distribution Companies (LDCs)**


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| <b>Aa</b>        | <b>A</b>                                   | <b>Baa</b>                          | <b>Ba</b>                        | <b>B</b>                  |
|------------------|--|-------------------------------------|----------------------------------|---------------------------|
| Terasen Gas Inc. | Atlanta Gas Light Company                  | Bay State Gas Company               | Cia de Gas de Sao Paulo - COMGAS | Camuzzi Gas Pampeana S.A. |
|                  | Piedmont Natural Gas Company, Inc.         | Berkshire Gas Company               | Source Gas LLC                   | Gas Natural Ban S.A.      |
|                  | Public Service Co. of North Carolina, Inc. | Boston Gas Company                  | UNS Gas                          | Metrogas S.A.             |
|                  | Southern California Gas Company            | Brooklyn Union Gas Company          |                                  |                           |
|                  | Terasen Gas (Vancouver Island) Inc.        | Cascade Natural Gas Corp.           |                                  |                           |
|                  | Wisconsin Gas LLC                          | Colonial Gas Company                |                                  |                           |
|                  |  | Connecticut Natural Gas Corporation |                                  |                           |
|                  |  | Indiana Gas Company, Inc.           |                                  |                           |
|                  |  | Laclede Gas Company                 |                                  |                           |
|                  |  | Michigan Consolidated Gas Company   |                                  |                           |
|                  |  | New Jersey Natural Gas Company      |                                  |                           |
|                  |  | North Shore Gas Company             |                                  |                           |
|                  |  | Northern Illinois Gas Company       |                                  |                           |
|                  |  | Northwest Natural Gas Company       |                                  |                           |
|                  |  | Peoples Gas Light and Coke Company  |                                  |                           |
|                  |  | SEMCO Energy, Inc.                  |                                  |                           |
|                  |  | South Jersey Gas Company            |                                  |                           |
|                  |  | Southern Connecticut Gas Company    |                                  |                           |
|                  |  | Southwest Gas Corporation           |                                  |                           |
|                  |  | UGI Utilities, Inc.                 |                                  |                           |
|                  |  | Washington Gas Light Company        |                                  |                           |
|                  |  | Yankee Gas Services Company         |                                  |                           |

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## Moody's Related Research

### Rating Methodologies:

- » [Regulated Electric and Gas Utilities, August 2009 \(118481\)](#)
- » [Unregulated Utilities and Power Companies, August 2009 \(118508\)](#)

### Industry Outlooks:

- » [U.S. Electric Utilities Face Challenges Beyond Near-Term, January 2010 \(121717\)](#)

### Special Comments:

- » [Cost Recovery Provisions Key to Investor Owned Utility Ratings and Credit Quality, June 2010 \(122304\)](#)

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» contacts continued from page 1

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