

State of Florida



SPECIFIED CONFIDENTIAL

# Public Service Commission

-M-E-M-O-R-A-N-D-U-M-

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**DATE:** September 3, 2002  
**TO:** Martha Brown, Office of the General Counsel  
**FROM:** Tim Devlin, Division of Economic Regulation *TJD*  
**RE:** Docket Nos. 020262-EI and 020263-EI - Florida Power & Light Company

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Attached is the Direct Testimony of Andrew L. Maurey to be filed in the above-referenced dockets. Please note document contains **CONFIDENTIAL** information.

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*declas 12/27/05*  
DOCUMENT NUMBER-DATE

09294 SEP-30

FPSC-COMMISSION CLERK

DOCKET NO. 020262-EI - Petition to Determine the Need for an Electrical Power Plant in Martin County by Florida Power & Light Company

DOCKET NO. 020263-EI - Petition to Determine the Need for an Electrical Power Plant in Manatee County by Florida Power & Light Company

WITNESS: Direct Testimony of Andrew L. Maurey, Appearing on Behalf of Staff

DATE FILED: September 3, 2002

*MR 12.27.05*  
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DOCUMENT NUMBER-DATE

09294 SEP-38

FPSC-COMMISSION CLERK

DIRECT TESTIMONY OF ANDREW L. MAUREY

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**Q. Please state your name, occupation, and business address.**

A. My name is Andrew L. Maurey. I am employed by the Florida Public Service Commission (FPSC or Commission) as the Public Utilities Supervisor of the Finance and Tax Section in the Division of Economic Regulation. My business address is 2540 Shumard Oak Boulevard, Tallahassee, Florida, 32399-0850.

**Q. Please summarize your educational background.**

A. I graduated Magna Cum Laude from Florida State University in 1983 with a Bachelor of Science degree in Finance. I was elected a member of the Beta Gamma Sigma honor society. While with the First National Bank and Trust Company of Naples, I completed course work for and received American Institute of Banking diplomas in Foundations of Banking and Commercial Banking. In 1988, I received a Master of Business Administration degree from Florida State University.

**Q. Please summarize your business experience.**

A. After receiving my Bachelor's degree in 1983, I accepted a position as a credit analyst and commercial loan representative in the commercial loan department of the First National Bank and Trust Company of Naples. Upon successfully completing the holding company management training program, my responsibilities included performing credit analysis, loan review, and other assigned duties in the commercial loan department.

In 1986, I accepted a position as a regulatory analyst with the Hospital Cost Containment Board. In this position, my duties included

1 analyzing and evaluating financial statements and operating budgets of  
2 investor-owned and not-for-profit hospitals for regulatory compliance.

3 Upon receiving my Master's degree in 1988, I accepted a regulatory  
4 analyst position with the Florida Public Service Commission. My duties  
5 included analyzing financial and economic market information regarding  
6 the cost of capital and other finance-related issues.

7 In 1991, I was promoted to Regulatory Analyst Supervisor of the  
8 Finance Section. I was promoted to Public Utilities Supervisor of the  
9 Finance Section in 1994. As part of the agency reorganization in 2000,  
10 I assumed responsibility for the expanded Finance and Tax Section. In  
11 my current position, my primary responsibilities are advising the  
12 Commission on financial and economic matters regarding utility cost of  
13 capital and other finance-related issues.

14 **Q. Are you a member of any professional organizations?**

15 **A.** Yes. I am a member of the Society of Utility and Regulatory Financial  
16 Analysts (SURFA). I have served on the Board of Directors and as the  
17 Vice President of the organization. My current term as President of  
18 SURFA runs through April 2004. I was awarded the professional  
19 designation Certified Rate of Return Analyst (CRRRA) by SURFA in 1992.  
20 This designation is awarded based upon education, experience, and the  
21 successful completion of a written examination.

22 **Q. Have you previously testified before the Commission?**

23 **A.** Yes. I have testified on the appropriate return on equity as well as  
24 other cost of capital related issues before this Commission. In  
25 addition, as a member of Commission staff, I have participated in a wide



1 range of regulatory proceedings.

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

3 A. The purpose of my testimony is to present an independent analysis of the  
4 reasonableness of the financial assumptions used in the determination  
5 of the total cost of the Florida Power & Light Company (FPL or the  
6 Company) self-build options and the equity penalty adjustment proposed  
7 by FPL in the evaluation of proposals submitted in response to the  
8 Company's Request for Proposals (RFP).

9 **Q. Please summarize your conclusions regarding the issues you have**  
10 **addressed in your testimony in this proceeding.**

11 A. I have reviewed FPL's financial assumptions reported in Appendix I of  
12 FPL's revised need determination filing as well as the supporting  
13 documentation the Company has provided in response to discovery requests  
14 regarding these assumptions. Based upon this analysis, I recommend that  
15 the financial assumptions proffered by FPL are reasonable for purposes  
16 of this proceeding.

17 I have also reviewed information relating to the equity penalty  
18 adjustment FPL has proposed be recognized for purposes of evaluating  
19 non-FPL proposals submitted in response to the Company's RFP. Included  
20 among this information is Company and intervener testimony and  
21 supporting documentation, credit rating agency and investment banking  
22 reports, and regulatory orders issued by this Commission. Based upon  
23 this analysis, I disagree with the imputation of an equity penalty as  
24 proposed by FPL for purposes of this proceeding. As I discuss in more  
25 detail later in my testimony, I believe the relative risk faced by FPL

1 with respect to purchased power is exaggerated. I believe FPL is  
2 attempting to take a portion of Standard & Poor's (S&P) consolidated  
3 credit assessment methodology and use it for a purpose it was never  
4 intended. In addition, since FPL has not made any similar adjustments  
5 to insulate its ratepayers from the effects of other factors identified  
6 by the investment community as having as much if not a more significant  
7 impact on the Company's financial position, I believe that this  
8 adjustment is discretionary on FPL's part and not compelled by the  
9 Company's current financial position.

#### 10 FINANCIAL ASSUMPTIONS

- 11 **Q. What cost of capital inputs does FPL assume in the determination of the**  
12 **total cost of the Company's self-build option?**
- 13 **A.** As reported in Appendix I of its revised need determination filing, FPL  
14 has assumed that the incremental capital expenditures associated with  
15 the generation projects for the 2005-6 capacity need will be financed  
16 with debt and equity to maintain "adjusted" capitalization ratios of 45%  
17 debt and 55% equity. The Company is assuming a 7.4% cost of debt and  
18 an 11.7% cost of equity.
- 19 **Q. What actual equity ratio corresponds to the "adjusted" equity ratio of**  
20 **55% referenced in the Company's filing?**
- 21 **A.** Presently, an adjusted equity ratio of 55% equates to an actual equity  
22 ratio of approximately 63% for this Company.
- 23 **Q. What is the difference between an actual equity ratio and an adjusted**  
24 **equity ratio?**
- 25 **A.** The actual equity ratio is the level of equity capitalization that

1 actually exists on a company's books. This is the level of equity that  
2 is reported in the financial statements filed with the Securities and  
3 Exchange Commission (SEC), in the Annual Report to Shareholders provided  
4 to investors, and in the monthly surveillance reports filed with the  
5 Commission. With respect to the Commission, all capital costs that are  
6 prudently incurred by a company and ultimately recovered from ratepayers  
7 are based upon calculations that recognize the actual level of equity.

8 The adjusted equity ratio is a factor developed by S&P for use in  
9 its consolidated credit assessment methodology. S&P converts the  
10 actual equity ratio to an adjusted equity ratio to use as a measure,  
11 along with several other factors, to assess the relative level of  
12 bondholder protection. The adjusted equity ratio does not appear in SEC  
13 filings or in the Annual Report to Shareholders. The adjusted equity  
14 ratio is not used by the investment community or regulators to determine  
15 actual costs.

16 **Q. How do FPL's financial assumptions for purposes of its need**  
17 **determination compare with the financial assumptions reported in the**  
18 **filings in its recently settled rate case?**

19 **A.** While not exactly the same, the Company's financial assumptions for  
20 purposes of its need determination are reasonably comparable to the  
21 financial assumptions reported in the filings for purposes of its rate  
22 case, which was resolved by Order No. PSC-02-0501-AS-EI, issued April  
23 11, 2002.

24 **Q. Are FPL's financial assumptions reasonable?**

25 **A.** Based upon a review of FPL's financial assumptions and the supporting

1 | documentation the Company has provided, it appears that the assumptions  
2 | reported in Appendix I of the Company's revised need determination  
3 | filing are reasonable.

4 | THE FPL EQUITY PENALTY PROPOSAL

5 | **Q. What is an "equity penalty"?**

6 | A. As proposed by FPL for purposes of this proceeding, an equity penalty  
7 | is the term used to identify the adjustment the Company has made to the  
8 | total cost of each non-FPL proposal submitted in response to the  
9 | Company's RFP.

10 | **Q. What is FPL's rationale for incorporating an equity penalty in the  
11 | evaluation process of outside proposals?**

12 | A. According to FPL witness Avera, the equity penalty adjustment is  
13 | necessary to account for the impact additional purchased power contracts  
14 | would have on FPL's financial position. Witness Avera testifies that,  
15 | because the investment community regards purchased power contracts as  
16 | off-balance sheet obligations that increase the financial leverage of  
17 | the purchaser, utilities must offset purchased power obligations with  
18 | increased equity to maintain bond ratings and financial flexibility.  
19 | The equity penalty adjustment is "the method FPL has used to account for  
20 | these impacts in its economic evaluation of capacity alternatives  
21 | submitted in response to its Supplemental Request for Proposals  
22 | (Supplemental RFP)." [FPL Witness Avera Testimony, p. 4]

23 | **Q. Has the concept of an equity penalty been previously considered by the  
24 | FPSC?**

25 | A. Yes. The equity penalty concept was first raised in the need

1 determination filing of Florida Power Corporation (FPC) in Docket No.  
2 910759-EI. In that case, the hearing officer found:

3 Florida Power's contention that further purchased  
4 power will have a negative effect upon its planning  
5 and operating flexibility did not impact my decision  
6 regarding the "buy vs. build" issues in this case.  
7 I am also not persuaded by the contention that  
8 further purchased power creates a substantial risk of  
9 a negative impact on Florida Power's credit rating.  
10 Florida Power has not demonstrated that it will  
11 experience a downgrade in its credit rating if it  
12 purchases more power. ...

13  
14 I find that increased reliance on this source of  
15 power does not have to portend lower credit ratings.  
16 (Ex. 7, p. 5) Just because a utility increases its  
17 reliance on purchased power does not mean that debt  
18 protection measures will deteriorate and a downgrade  
19 is imminent. In many cases, various qualitative  
20 factors may outweigh the quantitative factors. (Tr.  
21 236-7; Ex. 12, p. 7) ...

22  
23 I recognize that purchased power is not without  
24 risks, just as constructing one's own power plant  
25 contains risks. However, I also recognize that it is

1 generally not possible to point to an increased  
2 reliance on purchased power as the sole reason for a  
3 change in credit rating. (Tr. 176) ...

4  
5 In light of the fact that Florida Power has steadily  
6 improved its financial protection measures since its last  
7 growth cycle, I find Florida Power's claim that additional  
8 purchased power commitments would result in a credit  
9 downgrade to be exaggerated.

10 [Order No. 25805, February 25, 1992, Docket No. 910759-EI, pp. 42-43]

11 The equity penalty concept was next raised in the need  
12 determination petition filed jointly by FPL and Cypress Energy Partners  
13 in Docket No. 920520-EQ. While the equity penalty concept was discussed  
14 in the testimony and exhibits sponsored by certain FPL witnesses in that  
15 case, an equity penalty adjustment was not made to the cost of the  
16 Cypress Project during the evaluation process. [Exhibit ALM-9]

17 The equity penalty concept was raised again in Docket No. 990249-  
18 EG involving FPL's petition for approval of a standard offer contract.  
19 In that case the Commission found:

20 We recognize the effect that purchased power  
21 contracts have on the utility's financial ratios as  
22 calculated by S&P. To be consistent with the terms  
23 of the Stipulation approved in Order No. PSC-99-0519-  
24 AS-EI which allows for the recovery of the "equity  
25 adjustment" through base rates, we approve FPL's

1 adjustment to its standard offer contract to  
2 recognize the effect of purchased power contracts and  
3 to avoid possible double recovery. However, while we  
4 are approving FPL's request in the instant case due  
5 to the unique circumstances surrounding FPL's  
6 Stipulation, the broader policy issue of who should  
7 bear the incremental cost of additional equity to  
8 compensate for purchased power contracts has not been  
9 addressed.

10 [Order No. PSC-1713-TRG-EG, September 2, 1999, Docket No. 990249-EG, pp.  
11 9-10]

12 Finally, the equity penalty concept was raised by FPC in its need  
13 determination filing in Docket No. 001064-EI. While the Commission  
14 recognized FPC's consideration of the equity penalty concept with the  
15 same qualifying language from Order No. PSC-1713-TRF-EG cited above, it  
16 was noted in Order No. PSC-01-0029-FOF-EI that the equity penalty was  
17 not a significant issue for the Panda proposal because the cumulative  
18 present worth revenue requirement (CPWRR) of the FPC-proposed unit was  
19 less than the CPWRR of the Panda-proposed unit without recognition of  
20 an equity penalty. [Order No. PSC-01-0029-FOF-EI, January 5, 2001,  
21 Docket No. 001064-EI, pp. 10-11]

22 **Q. Are any of these cases directly on point with the instant case?**

23 A. No. In none of these previous cases has the equity penalty concept been  
24 relied upon to the extent it has been in the instant case to justify the  
25 cost-effectiveness of the utility's self-build option. In Docket No.

1 910759-EI, FPC did not propose the Commission recognize an actual  
2 adjustment for purposes of evaluating alternative proposals. Instead  
3 FPC offered the equity penalty concept as an argument to support its  
4 position that, because of its existing level of purchased power, it was  
5 simply not possible for additional purchased power to be more cost  
6 effective than the utility's proposed self-build options due to credit  
7 rating concerns.

8 In Docket No. 920520-EQ, FPL admitted that it did not recognize  
9 an equity penalty adjustment for purposes of the evaluation process.  
10 The final order disposing of that docket made no mention of the equity  
11 penalty concept. [Order No. PSC-92-1355-FOF-EQ, November 23, 1992,  
12 Docket No. 920520-EQ]

13 In Docket No. 990249-EG, the issue was not whether it was  
14 appropriate to recognize an equity penalty adjustment in the evaluation  
15 of capacity alternatives from outside parties, but rather, whether it  
16 was appropriate to reduce the standard offer price FPL paid QFs and  
17 other small cogeneration power producers for power. Instead of an  
18 adjustment designed to increase the cost of non-FPL proposals, the  
19 equity penalty concept was used to reduce the price FPL paid for power  
20 under the standard offer contract approved in that docket.

21 Finally, while in Docket No. 001064-EI FPC did propose that the  
22 equity penalty be recognized in a manner similar to the way FPL is  
23 proposing it be used in this case, FPC's proposal to recognize the  
24 equity penalty was not subject to careful financial analysis because it  
25 was not a material issue in that case.



1 Q. What precedence do you believe these decisions hold for the instant  
2 case?

3 A. The Commission Orders speak for themselves. I believe these decisions  
4 indicate the Commission has taken a case-by-case approach regarding the  
5 applicability of the equity penalty concept. Consequently, I believe  
6 the Commission should consider the reasonableness of FPL's decision to  
7 make an equity penalty adjustment in this proceeding based upon the  
8 evidence presented in this record.

9 STANDARD & POOR'S APPROACH

10 Q. Please explain how S&P incorporates off-balance sheet (OBS) obligations  
11 into its analysis of electric utility capitalization ratios.

12 A. The primary OBS obligations for electric utilities are purchased power  
13 contracts. Because the benefits and risks of purchased power contracts  
14 depend on a range of factors, S&P conducts both a qualitative and  
15 quantitative analysis of these contracts for purposes of assessing the  
16 level of debt protection measures available to bond holders.

17 The qualitative analysis focuses on the nature of the contracts.  
18 These features include whether the contract is a take-or-pay obligation  
19 or a take-and-pay obligation; whether the power is economical and  
20 needed; whether there are performance standards; how much discretion the  
21 utility has over maintenance and dispatch; whether the contract was  
22 preapproved by regulators; and whether there is a recovery clause for  
23 capacity and fuel payments. An assessment of these factors results in  
24 the assignment of a risk factor which is later used in the quantitative  
25 analysis.

1           In the quantitative analysis, S&P calculates the present value of  
2 future capacity payments discounted at 10%. The 10% is used as a proxy  
3 for the utility's weighted average cost of capital. S&P then multiplies  
4 the present value amount by the risk factor determined in the  
5 qualitative analysis to estimate the OBS obligation. The risk factor  
6 assigned to FPL's existing purchased power contracts ranges from 10% to  
7 40%.

8           The estimated OBS obligation is added to the balance sheet as  
9 additional debt and an interest component is added to the income  
10 statement. Coverage and debt-to-capital ratios are then recalculated  
11 to reflect the imputed debt and benchmark comparisons for the credit  
12 rating are made using the adjusted ratios.

13 **Q. Does S&P recommend regulators recognize its adjusted ratios for rate**  
14 **making purposes?**

15 **A.** No, it does not. S&P does not take official positions in regulatory  
16 proceedings, nor does it make recommendations on how state regulatory  
17 commissions should interpret or respond to its rating pronouncements.  
18 As demonstrated by the Company's response to Staff Second Set of  
19 Interrogatories Nos. 26 and 35 attached as Exhibit ALM-8, there is no  
20 indication the equity penalty concept has been recognized by other state  
21 regulatory commissions nor is there any evidence that this concept is  
22 applied when FPL or its affiliated companies participate in RFPs to sell  
23 power to other investor-owned utilities in other states. With the  
24 exception of Order No. PSC-01-0029-FOF-EI discussed earlier in my  
25 testimony, none of the other state commission orders provided by the

1 Company in response to staff's production of documents request make any  
2 mention of the equity penalty concept. [See Staff Second Set of PODs,  
3 Request No. 10]

4 It is also important to recognize that S&P's constituents are bond  
5 holders. The interests of ratepayers and shareholders are not of  
6 specific concern to S&P. While at times the interests of bond holders,  
7 shareholders, and utility ratepayers are in line, there are other times  
8 when their interests are mutually exclusive. S&P does not judge what  
9 companies or the state regulatory commissions do. S&P simply analyzes  
10 what has occurred along with a prospective view of what it expects to  
11 occur and renders a decision regarding how these actions impact the  
12 consolidated entity's financial measures in terms of bond holder  
13 protection.

14 **Q. Please discuss your understanding of how S&P assigns corporate credit**  
15 **ratings for utility holding companies and their respective operating**  
16 **companies (electric utilities).**

17 **A.** S&P assigns a corporate credit rating based on the risk of default of  
18 the consolidated entity. In the absence of structural or proscriptive  
19 measures to insulate the individual business units, all subsidiaries are  
20 assigned the same corporate credit rating as the holding company. On  
21 September 26, 2001, S&P lowered its rating on FPL from double A minus  
22 (AA-) to A. In discussing the rationale for the downgrade, S&P stated  
23 that:

24 Driving factors in the current ratings determination  
25 include increasing business risk for the consolidated

1 enterprise attributable to the growing non-regulated  
2 independent power producer (IPP) portfolio,  
3 regulatory challenges in Florida, and an aggressive  
4 financing plan and declining credit protection  
5 measures. . . . Furthermore, as FPL Group's earnings  
6 mix and capital expenditure requirements shift toward  
7 non-regulated businesses, the consolidated business  
8 profile becomes riskier, requiring greater cash flows  
9 and credit protection measures.

10 [Exhibit ALM-10]

11 Q. Isn't it true that in the report cited above S&P also referenced FPL's  
12 reliance on nuclear facilities and purchased power agreements for  
13 certain percentages of its load and the uncertainty over the outcome of  
14 its rate case settled earlier this year as factors which challenged  
15 FPL's credit profile?

16 A. Yes. S&P noted that FPL's credit profile reflects an above average  
17 business position that is supported by competitive residential and  
18 commercial rates, operational efficiency, increasing energy sales due  
19 to additional customers and increased usage, and well-run generating  
20 facilities. It also noted that these positive attributes are partially  
21 offset by the utility's reliance on nuclear facilities and purchased  
22 power for certain percentages of its load and the uncertainty over the  
23 outcome of its rate case.

24 But I believe a distinction should be made between costs that are  
25 appropriately borne by ratepayers and costs that more appropriately

1 should be borne by shareholders. The cost of maintaining a relatively  
2 high equity ratio to compensate for risk factors that are relevant to  
3 the provision of regulated electric service, such as the risk associated  
4 with a company's generating mix, are appropriately recovered from  
5 ratepayers. The cost of maintaining a relatively high equity ratio to  
6 compensate for risk factors that are irrelevant to regulated operations,  
7 such as the additional cash flow requirements placed on the holding  
8 company to compensate for the increasing risk profile of the  
9 consolidated entity related to its increasing investment in higher-risk,  
10 non-regulated operations, should not be recovered from ratepayers but  
11 rather should be borne by the shareholders.

12 FPL is adamant that this adjustment is a necessary response to  
13 address S&P's concern regarding purchased power to protect ratepayers  
14 from higher total revenue requirements over the long run. I believe it  
15 is revealing that the Company does not assign the same degree of  
16 significance to the concerns expressed by S&P regarding the risk to the  
17 utility, and therefore by extension to its ratepayers, arising from the  
18 non-regulated activities of the holding company.

19 **Q. How does S&P characterize the Florida Commission's regulation with**  
20 **respect to the issue of purchased power contracts?**

21 **A.** S&P views the Commission's regulation of electric utilities in Florida  
22 as supportive. S&P recognizes that the Commission allows full recovery  
23 of capacity payments associated with these contracts through the  
24 capacity cost recovery clause as well as full recovery of energy  
25 payments through the fuel cost recovery clause. In addition, S&P

1 specifically acknowledges the Commission's approval of the recovery of  
2 buy-out costs associated with the termination of select purchased power  
3 contracts as supportive regulation.

4 **Q. Will FPL's corporate credit rating be downgraded if the Company enters**  
5 **additional purchased power contracts?**

6 A. If FPL's corporate credit rating is downgraded at some future date, it  
7 will not be as a direct result of the Company entering into pre-  
8 approved, cost-effective purchased power contracts. Purchased power  
9 obligations are only one factor in the rating agency's evaluation, and  
10 to a degree these obligations can be absorbed in the credit quality  
11 assessment. It is generally recognized that coverage and capitalization  
12 ratios may move somewhat within ranges without impacting the credit  
13 quality of the company. While ratios are helpful in broadly defining  
14 a company's position relative to rating categories, S&P is careful to  
15 point out that ratios are not intended to be hurdles or prerequisites  
16 that must be achieved to attain a specific debt rating. In its 2001  
17 Corporate Credit Rating Criteria, S&P noted that risk-adjusted ratio  
18 (G)uidelines are not meant to be precise. Rather,  
19 they are intended to convey ranges that characterize  
20 levels of credit quality as represented by the rating  
21 categories. Obviously, strengths evidenced in one  
22 financial measure can offset, or balance, weakness in  
23 another.

24 [Exhibit ALM-11]

25 Moreover, as shown on Table II.B.4.1 on page 14 of its revised

1 need determination filing, FPL's reliance on purchased power will  
2 significantly decline over the next eight years. From a total Summer  
3 2002 level of 2403 MW, the amount of purchased power drops to 1757 MW  
4 in Summer 2005, to 1310 MW by Summer 2007, and to 382 MW by Summer 2010.  
5 To a certain extent two years out, and definitely five years out, from  
6 the expected completion date for this identified capacity need, new  
7 cost-effective purchased power agreements would be replacing existing  
8 contracts that would have ended.

9 In addition, as part of its ongoing construction program, FPL is  
10 in the process of adding approximately 2,000 MW of net new utility-owned  
11 capacity in 2002 and 2003 at its Fort Myers and Sanford sites. [See  
12 Staff Second Set of PODs, Request No. 17, Salomon Smith Barney, April  
13 23, 2002, bates p. 00114544]

14 Finally, it is well documented that FPL has one of the highest  
15 equity ratios in the country. In its rate case, the Company  
16 characterized this level of equity as necessary to compensate for its  
17 reliance on purchased power, among other factors. This actual level of  
18 equity equates to an adjusted equity ratio that is in the upper quartile  
19 of electric utilities [Exhibit ALM-1] and is above the top of the  
20 implied target range for an A rating. [Exhibit ALM-2]

21 The combination of a relatively high equity ratio, the addition  
22 of new utility-owned capacity, and the expiration of existing purchased  
23 power contracts puts the Company in a strong position to balance the  
24 incremental risk associated with adding the capacity contemplated in  
25 this proceeding, regardless of whether the most cost-effective option

1 is to build or buy.

2           However, it is important to note that, while a utility may have  
3 ratios on a stand-alone basis that would support a particular rating,  
4 S&P looks at the company's financial position on a consolidated basis.  
5 When S&P downgraded FPL from AA- to A in the fall of 2001, it  
6 specifically noted that FPL Group's stated intention to expand its non-  
7 regulated generation business will require the firm to strengthen its  
8 consolidated credit protection measures to maintain the A rating. In  
9 an investment banking report dated July 2, 2001 provided in response to  
10 Staff First Set of Production of Documents Request No. 1, analysts at  
11 Merrill Lynch noted, begin confidential

12           FPL's best case is to lay the groundwork and begin an  
13 investor and agency communication campaign to ensure a "soft  
14 landing" for the evolving ratings.

15           Given the current "negative watch" on FPL's credit rating,  
16 coupled with regulatory uncertainty and FPL's growth plans,  
17 FPL should lay the groundwork for a "soft landing" to a BBB  
18 "high" rating.

19           Merrill Lynch believes that, given the projections provided  
20 by FPL, a BBB "high" rating for FPL Group is both optimal  
21 and achievable.

22           FPL Group's ability to achieve and sustain a BBB "high"  
23 rating is highly desirable, viewed by market as an  
24 attractive/high credit rating.

25           In the absence of insulation, a BBB/BBB+ utility is



1                   defensible to regulators given the new posture of the staff  
2                   and PSC.

3                   Comparable rating to other integrated utilities that combine  
4                   high growth and credit quality.

5                   Additionally, FPL Group's ability to achieve and sustain a  
6                   BBB "high" rating is important for the success of FPL's non-  
7                   regulated energy business.

8                   [Confidential Document No. 15004, Docket No. 001148-EI]

9                   Additional investment banking reports from Lehman Brothers and  
10                  Salomon Smith Barney show that it is the external funding requirements  
11                  associated with the planned expansion of non-regulated operations, not  
12                  the capital spending plans of the utility, that are exerting the  
13                  greatest pressure on FPL Group's consolidated credit protection  
14                  measures. Exhibit ALM-3 shows that while cash flow as a percentage of  
15                  capital expenditures for the utility is consistently in excess of 120%  
16                  over the 5 year planning horizon, cash flow from non-regulated  
17                  operations represents a fraction of its projected capital expenditures  
18                  over the same period. This means that the capital expenditures for the  
19                  utility are primarily funded through internally generated funds while  
20                  the capital expenditures for the non-regulated business are primarily  
21                  funded through external borrowing. This exhibit, along with the  
22                  comments from the investment banking reports it is based on,  
23                  demonstrates that it is the significant requirement for external funding  
24                  to finance growth of non-regulated operations, not the capital spending  
25                  associated with the utility, which is exerting downward pressure on the

1 consolidated entity's credit rating. Based on S&P's consolidated credit  
2 assessment methodology and the absence of structural or proscriptive  
3 measures to insulate the utility, any downgrade of the credit rating of  
4 the holding company due to the significant need for external funding to  
5 finance the growth of the non-regulated business will result in a  
6 downgrade of the credit rating of the utility. end confidential

7 [Confidential Document No. 15004, Docket No. 001148-EI, Staff First Set  
8 of PODs, Request No. 1, Docket Nos. 020262-EI and 020263-EI]

9 The important point to take from this discussion is that no single  
10 factor can be looked at in isolation. As noted earlier in my testimony,  
11 there is no S&P mandate that Florida or any other state regulatory  
12 commission incorporate its credit rating criteria in their decisions.  
13 Moreover, it would be inappropriate to make an adjustment to compensate  
14 for one factor, such as the equity penalty adjustment proposed by the  
15 Company in this proceeding, while at the same time completely ignoring  
16 other factors identified by the investment community as placing even  
17 greater stress on the Company's financial position, such as the  
18 significant degree of debt leverage used to finance non-regulated growth  
19 by other affiliates of the utility.

20 **Q. Can the impact of these other factors on a company's corporate credit  
21 rating be observed?**

22 **A.** Yes. In order to test the relevance of the position that purchased  
23 power has a significant impact on a utility's corporate credit rating,  
24 I requested a statistical analysis be performed on a group of companies  
25 determined to be comparable in risk to FPL. This analysis revealed that

1 other factors, such as the actual equity ratio at the holding company  
2 level and the relative level of holding company revenue derived from  
3 non-regulated operations, are both significant determinants of a  
4 utility's corporate credit rating. In fact, this analysis demonstrates  
5 that the degree of financial leverage at the holding company level  
6 statistically has a greater impact on a utility's corporate credit  
7 rating than the utility-specific equity ratio adjusted for the impact  
8 of purchased power contracts. Exhibit ALM-4 shows the results of this  
9 statistical analysis.

10 **Q. Has S&P commented on the credit rating impact on FPL resulting from the**  
11 **level of risk associated with FPL Group's growing portfolio of higher-**  
12 **risk, non-regulated investments?**

13 **A.** Yes. In an S&P report dated September 27, 2001, S&P noted,  
14 Credit quality for Florida Power & Light Co., the utility  
15 operating company of FPL Group, Inc., reflects the unit's  
16 steady and reliable cash flow attributes, tempered by the  
17 parent's growing portfolio of higher-risk, non-regulated  
18 investments, principally in independent power projects.

19 [ALM-12]

20 In addition, in an S&P report issued January 18, 2002, titled  
21 "U.S. Utilities' Credit Quality Displayed Steep Decline in 2001;  
22 Negative Trend Likely to Continue," S&P categorized its September 2001  
23 downgrade of FPL under the heading,

24 The following downgrades can be traced to investments in  
25 higher-risk non-regulated businesses and weakening credit

1 fundamentals.

2 [ALM-13]

3 Finally, in an S&P report issued June 20, 2002, S&P noted,  
4 Credit quality for FPL Group is characterized by the  
5 activities of its operating utility, Florida Power  
6 and Light and its growing portfolio of higher-risk,  
7 non-regulated investments, mainly in independent  
8 power projects. Ratings for FPL Group and its  
9 affiliates incorporate increasing business risk for  
10 the consolidated enterprise, attributable to the  
11 growing non-regulated, independent power producer  
12 portfolio, an aggressive financing plan, and the  
13 decline in credit protection measures.

14  
15 Standard and Poor's expects to review FPL's strategy  
16 and financial plans for its regulated and non-  
17 regulated segments with a focus on its rapidly  
18 growing and aggressive strategy in the competitive  
19 energy business. The review's outcome could result  
20 in a ratings affirmation or a downgrade.

21 [ALM-14]

22 **Q. Have any other credit rating agencies commented on the link between the**  
23 **credit rating of the utility and the activities of the holding company?**

24 **A. Yes.** In a Moody's Investors Service (Moody's) report dated April 16,  
25 2002, Moody's stated,

1 Because parent FPL Group guarantees the obligations  
2 of FPL Group Capital, increased leverage at the  
3 subsidiary puts pressure on all the rated entities  
4 within the FPL Group, including Florida Power and  
5 Light, its operating utility subsidiary.

6 [ALM-15]

7 Q. Has FPL made any adjustments to compensate for the impact the higher-  
8 risk, non-regulated investments and the greater reliance on debt  
9 leverage at the FPL Group level places on the Utility's corporate credit  
10 rating and financial flexibility?

11 A. Other than maintaining an equity ratio well above the average for the  
12 industry, I'm not aware of any specific adjustments FPL has made to  
13 insulate its ratepayers from the pressure higher-risk investments and  
14 increased leverage at the holding company have placed on the financial  
15 position of the utility.

16 REBUTTAL OF FPL WITNESSES AVERA AND DEWHURST

17 Q. Have you reviewed FPL witness Avera's testimony filed in this  
18 proceeding?

19 A. Yes.

20 Q. Have you reviewed FPL witness Dewhurst's testimony filed in this  
21 proceeding?

22 A. Yes.

23 Q. Do you agree with their recommendations regarding the need to assign an  
24 equity penalty to the cost of non-FPL proposals for purposes of  
25 comparing these proposals to FPL's self-build option?

1 A. No.

2 **Q. What are the factors these witnesses offer as justification for FPL's**  
3 **proposed equity penalty adjustment?**

4 A. Witnesses Avera and Dewhurst both cite the implied financial impact of  
5 imputed debt associated with purchased power contracts as justification  
6 for making this adjustment.

7 **Q. Do you disagree that S&P considers a utility's reliance on purchased**  
8 **power contracts when it evaluates its financial position?**

9 A. Not at all. My testimony is that, with ratepayers already bearing the  
10 cost of supporting one of the highest equity ratios in the country, the  
11 Company already has the equity cushion to balance the incremental risk  
12 associated with this factor. In addition, as I have discussed earlier  
13 in my testimony, there are other factors identified by S&P that have a  
14 significant impact on FPL's financial flexibility and corporate credit  
15 rating that are not being specifically addressed by the Company.

16 **Q. How does FPL's actual equity ratio compare with the equity ratios of**  
17 **other electric utilities which rely on purchased power?**

18 A. Exhibit ALM-1 shows the equity ratios for a group of utilities  
19 comparable in risk with FPL. These ratios are based upon financial  
20 statements filed with the SEC for the period ended December 31, 2001.

21 Exhibit ALM-5 shows the relative percentage of fuel mix for each  
22 of the companies in FPL's peer group. For the period ended December 31,  
23 2001, FPL relied upon purchased power for 20% of its capacity. For the  
24 same period, ten of the companies in the index relied on purchased power  
25 for a greater percentage of their supply. Pinnacle West supported its

1 30% purchased power level with a 49% equity ratio. NSTAR, which sold  
2 all of its fossil plants in 1998 and all of its nuclear plants in 1999,  
3 and DQE, Inc., which sold all of its generating assets in 2000, rely on  
4 purchased power for 100% of their supply. NSTAR has an equity ratio of  
5 40%. DQE has an equity ratio of 32%. Relative to these companies, a  
6 64% equity ratio compares very favorably and demonstrates that FPL  
7 already has more than enough equity capitalization to compensate for the  
8 level of risk perceived to be associated with reliance on purchased  
9 power. The fact that FPL's existing reliance on purchased power will  
10 decline significantly over the next eight years combined with the  
11 continuous addition of new utility-owned capacity erodes the credibility  
12 of the Company's argument that it needs an equity penalty adjustment for  
13 purposes of this proceeding.

14 **Q. On page 14 of his testimony, witness Avera refers to an article from the**  
15 **Wall Street Journal which he asserts indicates that credit rating**  
16 **agencies are closely scrutinizing the debt levels on power company**  
17 **balance sheets. Do you agree with his assertion?**

18 **A.** Yes, but only in the most broadest of interpretations of the article.  
19 While the title, *Rating Agencies Crack Down on Utilities*, sounds  
20 alarming, a careful reading reveals the actual subjects of the article  
21 are companies in the energy marketing, trading, and IPP business.  
22 [Exhibit ALM-16] The article is off point with respect to public  
23 utilities. Several of the companies mentioned by name in this article  
24 are also listed as genco (generating company) competitors of FPL Energy  
25 in the July 3, 2001, Salomon Smith Barney report cited earlier. Four

1 of the companies. Allegheny Energy Supply, Calpine, Dynegy, and NRG,  
2 have below investment grade credit ratings.

3 The call for improved balance sheets relates to unregulated energy  
4 companies with 30-35% equity ratios, not regulated utilities with equity  
5 ratios in the mid to high 50s. Rather than confirm the reasonableness  
6 of FPL's capital structure policies, this article implies that FPL Group  
7 is ignoring the message from the capital markets and rating agencies  
8 that it needs to use a greater relative level of equity to fund its non-  
9 regulated operations, currently at 20%. [Exhibit ALM-6] It is also  
10 further indication that responding to these types of comments from the  
11 investment community is discretionary on the part of the Company.

12 **Q. Witness Avera offers several quotes from S&P articles intended to**  
13 **support his position regarding the risks associated with purchased**  
14 **power. Do these same articles address the risk associated with the**  
15 **building of new capacity?**

16 **A.** Yes. On page 7 of his direct testimony, witness Avera offers a quote  
17 from the May 24, 1993 issue of S&P CreditWeek. In that same article,  
18 S&P states:

19 Buying power may be the best choice for a utility  
20 that faces increasing demand. Moreover, purchasing  
21 may be the least risky course. The benefits of  
22 purchasing can be quite compelling. For example,  
23 utilities that purchase avoid the risks of  
24 significant construction cost overruns or that the  
25 plant might never be finished at all. They also may



1 avoid the associated financial stress caused by  
2 regulatory lag typical in building programs.

3  
4 In addition, utilities that purchase power  
5 avoid risking substantial capital. There are many  
6 examples of utilities that have failed to earn a full  
7 return on and of capital employed to build a plant.  
8 Furthermore, purchased power may contribute to fuel  
9 supply diversity and flexibility, and may be cheaper,  
10 at least over the short run. Utilities that meet  
11 demand expectations with a portfolio of supply-side  
12 options also may be better able to adapt to future  
13 demand uncertainty, given the specter of retail  
14 transmission access.

15 [Exhibit ALM-17]

16 The point of this discussion is to rebut the Company's presumption  
17 that purchasing power is risky and building new capacity is not. S&P  
18 makes it clear that regardless of whether a utility builds or buys,  
19 adding capacity means incurring risk.

20 Q. The implication of the Company witnesses' testimony appears to be that  
21 if the equity penalty adjustment is not recognized in this proceeding,  
22 it will send a signal to the capital markets that the Commission has  
23 become less supportive of the financial integrity of the companies  
24 subject to its jurisdiction. Do you agree?

25 A. No. As I mentioned earlier, the investment community and the rating

1 agencies both view the regulation in Florida as fair and supportive.  
2 It is the Commission's statutory responsibility to balance the interests  
3 of ratepayers and shareholders. When a situation warrants, this  
4 Commission will make adjustments to the Company's filing. A Commission  
5 decision to hold the utility to a balanced approach in the RFP process  
6 will not undermine the investment community and rating agencies' view  
7 that the Florida Commission is supportive of the financial integrity of  
8 the companies under its jurisdiction.

9 An example of this continuing support can be found in the level  
10 of financial stability this Commission provides companies through the  
11 use of various recovery clauses. Exhibit ALM-7 shows the relative  
12 percentages of expenses and revenues recovered through the various  
13 clauses for each of the four investor-owned electric utilities in the  
14 state. As this exhibit shows, this Commission allowed for the recovery  
15 of 43%, 46%, and 54% of FPL's expenses in 1999, 2000, and 2001,  
16 respectively. This exhibit also shows that 38%, 40%, and 48% of FPL's  
17 revenues in 1999, 2000, and 2001, respectively, were recovered through  
18 various clauses. For 2001, this means that only 52% of FPL's revenues  
19 were subject to recovery through base rates. When nearly half a  
20 company's revenues and more than half its expenses are recovered dollar  
21 for dollar through clauses, its variability in earnings is significantly  
22 reduced relative to companies without such recovery mechanisms. Lower  
23 variability in earnings reduces FPL's risk and is further evidence that  
24 this Commission supports the financial integrity of Florida utilities.

25 Q. Please summarize your conclusions regarding the equity penalty testimony

1 proffered by witnesses Avera and Dewhurst in this proceeding.

2 A. For the reasons outlined above, I believe these witnesses are taking a  
3 portion of S&P's consolidated credit assessment methodology out of  
4 context and are attempting to use it for a purpose it was never  
5 intended.

6 SUMMARY

7 Q. Please summarize your recommendation regarding the financial  
8 assumptions.

9 A. Based upon my analysis of FPL's financial assumptions reported in  
10 Appendix I of FPL's revised need determination filing, I recommend that  
11 these assumptions are reasonable for purposes of this proceeding.

12 Q. Please summarize your recommendation regarding the recognition of an  
13 equity penalty adjustment for purposes of this proceeding.

14 A. Based upon my analysis of the information relating to the equity penalty  
15 adjustment FPL has proposed be recognized for purposes of evaluating  
16 non-FPL proposals submitted in response to the Company's RFP, I disagree  
17 with the imputation of an equity penalty for purposes of this  
18 proceeding.

19 Q. Does this conclude your testimony?

20 A. Yes.

21

22

23

24

25

**Utilities**

**Quartiles-Equity Ratio**

**Top:**

Florida Power & Light Co.	64.19%
Union Light Heat & Power Co.	63.02%
Dayton Power & Light Co.	62.41%
Mississippi Power Co.	57.63%
Tampa Electric Co.	55.78%
Florida Power Corporation	54.67%
Northern State Power Wisconsin	54.08%
Georgia Power Co.	52.15%
Cleco Corporate & Power LLC	50.88%
Southwestern Public Service Co.	50.62%
South Carolina Electric & Gas Co.	50.42%

**Middle-top:**

Hawaiian Electric Co. Inc.	50.26%
Central Power & light Co.	50.07%
TXU Electric Co.	50.00%
Columbus Southern Power Co.	49.68%
Ohio Power Co.	49.08%
Arizona Public Service Co.	48.92%
West Texas Utilities Co.	48.71%
Cincinnati Gas & Electric Co.	48.20%
Southwestern Electric Power Co.	47.57%
Public Service Co. of Oklahoma	47.47%
Gulf Power Co.	47.44%

**Middle-bottom:**

Public Service Co. of Colorado	46.74%
Boston Edison Co.	46.33%
Carolina Power & Light	46.11%
Alabama Power Co.	44.83%
Potomac Edison Co.	44.74%
Southern Indiana Gas & Electric Co.	44.10%
Northern Indiana Public Service Co.	43.91%
Virginia Electric & Power Co.	43.38%
Savannah Electric & Power Co.	43.05%
Kentucky Power Co.	42.53%
Appalachian Power Co.	41.55%

**Bottom:**

Monogahela Power Co.	41.08%
PSI Energy Inc.	39.78%
Idaho Power Co.	38.64%
West Penn Power Co.	38.42%
Kansas City Power & Light Co.	37.92%
Consumers Energy Co.	33.28%
Indiana Michigan Power Co.	33.27%
Detroit Edison Co.	32.90%
Duquesne Light Co.	31.68%
Public Service Electric & Gas Co.	28.73%

**Quartiles- Adjusted Equity Ratio**

**Top:**

Dayton Power & Light Co.	62.41%
Mississippi Power Co.	57.59%
Union Light Heat & Power Co.	56.86%
Florida Power & Light Co.	56.16%
Tampa Electric Co.	54.66%
Northern State Power Wisconsin	54.08%
Cleco Corporate & Power LLC	50.88%
South Carolina Electric & Gas Co.	50.42%
Central Power & light Co.	49.94%
Southwestern Public Service Co.	49.72%
Columbus Southern Power Co.	49.44%

**Middle-top:**

Georgia Power Co.	49.39%
TXU Electric Co.	48.86%
West Texas Utilities Co.	48.71%
Florida Power Corporation	48.62%
Southwestern Electric Power Co.	47.57%
Public Service Co. of Oklahoma	47.47%
Gulf Power Co.	47.44%
Hawaiian Electric Co. Inc.	46.76%
Cincinnati Gas & Electric Co.	45.74%
Potomac Edison Co.	44.74%
Arizona Public Service Co.	44.32%

**Middle-bottom:**

Carolina Power & Light	44.28%
Alabama Power Co.	44.23%
Southern Indiana Gas & Electric Co.	44.10%
Northern Indiana Public Service Co.	43.26%
Public Service Co. of Colorado	42.99%
Savannah Electric & Power Co.	42.69%
Kentucky Power Co.	42.52%
Appalachian Power Co.	41.50%
Ohio Power Co.	41.99%
Monogahela Power Co.	39.94%
Virginia Electric & Power Co.	39.15%

**Bottom:**

Idaho Power Co.	38.21%
PSI Energy Inc.	38.14%
West Penn Power Co.	37.34%
Boston Edison Co.	36.51%
Kansas City Power & Light Co.	35.97%
Detroit Edison Co.	32.65%
Duquesne Light Co.	31.23%
Consumers Energy Co.	28.93%
Public Service Electric & Gas Co.	28.73%
Indiana Michigan Power Co.	25.27%

Florida Power & Light Company  
ELECTRIC UTILITY INDEX  
For 12 months ended Dec. 31, 2001  
(\$millions)

Exhibit ALM-1  
Page 2 of 2

	(1)	(2)	(2)	(2)	(2)	(3)	(4)	(5)
Company Name	Bond	STD	LTD	Pref. Stock	Common Equity	OBS DEBT	Equity Ratio	Adj. Equity Ratio
1 Appalachian Power Co.	A-	\$80.0	\$1,476.6	\$28.7	\$1,126.7	\$3.1	41.55%	41.50%
2 Central Power & Light Co.	A-	\$265.0	\$988.8	\$142.2	\$1,400.1	\$7.5	50.07%	49.94%
3 Columbus Southern Power Co.	A-	\$220.5	\$571.3	\$10.0	\$791.5	\$7.5	49.68%	49.44%
4 Indiana Michigan Power Co.	A-	\$340.0	\$1,312.1	\$73.7	\$860.6	\$818.6	33.27%	25.27%
5 Kentucky Power Co.	A-	\$95.0	\$251.1	\$0.0	\$256.1	\$0.2	42.53%	42.52%
6 Ohio Power Co.	A-	\$0.0	\$1,203.8	\$25.5	\$1,184.8	\$407.8	49.08%	41.99%
7 Public Service Co. of Oklahoma	A-	\$106.0	\$345.1	\$80.3	\$480.2	\$0.0	47.47%	47.47%
8 Southwestern Electric Power Co.	A-	\$150.6	\$494.7	\$114.7	\$689.6	\$0.0	47.57%	47.57%
9 West Texas Utilities Co.	A-	\$35.0	\$221.0	\$2.5	\$245.4	\$0.0	48.71%	48.71%
10 Cleco Corporate & Power LLC	BBB+	\$88.7	\$310.5	\$0.0	\$413.5	\$0.0	50.88%	50.88%
11 Dayton Power & Light Co.	BBB+	\$0.0	\$666.6	\$22.9	\$1,144.9	\$0.0	62.41%	62.41%
12 Duquesne Light Co.	BBB+	\$0.0	\$1,061.1	\$74.5	\$526.7	\$23.9	31.68%	31.23%
13 Detroit Edison Co.	BBB+	\$215.0	\$4,798.0	\$0.0	\$2,458.0	\$57.0	32.90%	32.65%
14 Florida Power & Light Co.	A	\$232.0	\$2,579.0	\$226.0	\$5,444.0	\$1,213.3	64.19%	56.16%
15 Idaho Power Co.	A+	\$309.1	\$802.2	\$104.4	\$765.6	\$22.4	38.64%	38.21%
16 Boston Edison Co.	A	\$0.0	\$1,065.7	\$43.0	\$956.9	\$555.6	46.33%	36.51%
17 Arizona Public Service Co.	BBB+	\$296.6	\$1,949.1	\$0.0	\$2,150.7	\$456.4	48.92%	44.32%
18 Alabama Power Co.	A	\$15.4	\$3,742.3	\$317.5	\$3,310.9	\$100.0	44.83%	44.23%
19 Georgia Power Co.	A	\$1,059.2	\$2,961.7	\$14.6	\$4,397.5	\$470.9	52.15%	49.39%
20 Gulf Power Co.	A	\$87.3	\$467.8	\$4.2	\$504.9	\$0.0	47.44%	47.44%
21 Mississippi Power Co.	A	\$96.0	\$233.8	\$31.8	\$491.7	\$0.5	57.63%	57.59%
22 Savannah Electric & Power Co.	A	\$33.3	\$160.7	\$40.0	\$176.9	\$3.5	43.05%	42.69%
23 Tampa Electric Co.	A	\$405.1	\$880.9	\$0.0	\$1,622.4	\$59.5	55.78%	54.66%
24 Florida Power Corporation	BBB+	\$32.0	\$1,619.3	\$33.5	\$2,031.6	\$462.4	54.67%	48.62%
25 Carolina Power & Light	BBB+	\$600.0	\$2,958.9	\$59.3	\$3,095.5	\$276.8	46.11%	44.28%
26 Monogahela Power Co.	A+	\$44.8	\$784.3	\$74.0	\$629.6	\$43.9	41.08%	39.94%
27 Potomac Edison Co.	A+	\$57.6	\$415.8	\$0.0	\$383.3	\$0.0	44.74%	44.74%
28 West Penn Power Co.	A+	\$103.8	\$574.6	\$0.0	\$423.3	\$31.9	38.42%	37.34%
29 Northern State Power Wisconsin	A	\$34.6	\$313.1	\$0.0	\$409.5	\$0.0	54.08%	54.08%
30 Public Service Co. of Colorado	A-	\$608.6	\$1,465.1	\$194.0	\$1,990.1	\$371.8	46.74%	42.99%
31 Southwestern Public Service Co.	A-	\$0.0	\$725.4	\$100.0	\$846.0	\$30.2	50.62%	49.72%
32 PSI Energy Inc.	A-	\$593.9	\$1,325.1	\$42.3	\$1,295.5	\$140.0	39.78%	38.14%
33 Union Light Heat & Power Co.	A-	\$26.4	\$74.6	\$0.0	\$172.2	\$29.6	63.02%	56.86%
34 Cincinnati Gas & Electric Co.	A-	\$740.9	\$1,105.3	\$20.5	\$1,737.1	\$194.1	48.20%	45.74%
35 Consumers Energy Co.	BBB-	\$673.0	\$2,472.0	\$564.0	\$1,850.0	\$836.0	33.28%	28.93%
36 Virginia Electric & Power Co.	A	\$970.9	\$3,704.4	\$384.0	\$3,876.4	\$965.3	43.38%	39.15%
37 Northern Indiana Public Service Co.	BBB	\$394.4	\$843.1	\$86.1	\$1,036.3	\$35.6	43.91%	43.26%
38 TXU Electric Co.	BBB+	\$899.0	\$5,586.0	\$136.0	\$6,622.0	\$311.0	50.00%	48.86%
39 Hawaiian Electric Co. Inc.	BBB+	\$49.0	\$685.0	\$134.0	\$877.0	\$130.4	50.26%	46.76%
40 Kansas City Power & Light Co.	A-	\$309.8	\$758.9	\$150.0	\$744.4	\$106.5	37.92%	35.97%
41 Public Service Electric & Gas Co.	A-	\$668.0	\$4,977.0	\$235.0	\$2,370.0	\$0.0	28.73%	28.73%
42 South Carolina Electric & Gas Co.	A	\$193.0	\$1,412.0	\$116.0	\$1,750.0	\$0.0	50.42%	50.42%
43 Southern Indiana Gas & Electric Co.	A-	\$81.5	\$341.2	\$0.5	\$333.8	\$0.0	44.10%	44.10%
						Simple Average	46.42%	44.45%
						Weighted Average	45.80%	43.35%

(1) Standard & Poor's Ratings Direct (online: [www.standardandpoors.com/ratingsdirect](http://www.standardandpoors.com/ratingsdirect))  
(2) SEC 10-K  
(3) Standard & Poor's Balance Sheet Statistics for Electric Utilities for 2000  
(4) E/R = CE / CE+PS+LTD+STD  
(5) Adjusted E/R = CE / CE+PS+LTD+STD+OBS

Florida Power & Light Company  
 S&P Risk-Adjusted Financial Targets

	<u>A</u>	<u>BBB</u>
Total Debt / Total Capital (%)	46-50	53-57
Implied Equity Ratio (%)	50-54	43-47

Source: S&P Corporate Rating Criteria 2001, page 58 (S&P Ratings Direct, [www.standardandpoors.com/ratingsdirect](http://www.standardandpoors.com/ratingsdirect))

Florida Power & Light Company  
 Capital Expenditures

FP&L Predominately Funds Capex with Operating Cash Flow (1)

(\$ in millions)	2001	2002	2003	2004	2005
<i>Uses</i>					
FP&L Capital Expenditures	\$1,240	\$1,069	\$946	\$908	\$817
Dividend to FPL Group	<u>383</u>	<u>596</u>	<u>528</u>	<u>701</u>	<u>647</u>
<b>Total Uses</b>	<b>\$1,623</b>	<b>\$1,665</b>	<b>\$1,474</b>	<b>\$1,609</b>	<b>\$1,464</b>
<i>Sources</i>					
FP&L Cash Flow	\$1,509	\$1,468	\$1,493	\$1,530	\$1,451
FP&L Debt Issuances	114	197	0	60	13
Excess Funds from Previous Years	<u>0</u>	<u>0</u>	<u>0</u>	<u>19</u>	<u>0</u>
<b>Total Sources</b>	<b>\$1,623</b>	<b>\$1,665</b>	<b>\$1,493</b>	<b>\$1,609</b>	<b>\$1,464</b>
<b>Cash Flow as a % of Capital Expenditures</b>	<b>121.7%</b>	<b>137.3%</b>	<b>157.8%</b>	<b>168.5%</b>	<b>177.6%</b>

FPL Energy Predominately Funds Capex with External Funding (2)

(\$ in millions)	2001	2002	2003	2004	2005
FPL Energy Capital Spending*	\$1,595	\$2,407	\$1,720	\$1,400	\$725
Internal Cash Flow	<u>271</u>	<u>302</u>	<u>463</u>	<u>706</u>	<u>905</u>
External Funding	\$1,324	\$2,105	\$1,257	\$694	\$(180)
<b>Cash Flow as a % of Capital Expenditures</b>	<b>17.0%</b>	<b>12.5%</b>	<b>26.9%</b>	<b>50.4%</b>	<b>124.8%</b>

\* Excludes synthetic lease expenditures and funding.

Sources:

- (1) FPL response to Staff First Set of PODs Request #1, Lehman Brothers Report, July 3, 2001, p. 22.
- (2) FPL response to Staff First Set of PODs Request #1, Salomon Smith Barney Report, July 3, 2001, p. 11.

Florida Power & Light Company  
 Summary  
 For 12 months ended Dec. 31, 2000

Exhibit ALM-4

Company Name	Holding Co. Name	Utility Bond Rating	Num. Bond Rating	Actual Equity Ratio	Adj. Equity Ratio	Holding Co. Equity Ratio	Holding Co. Rev. from Non-Reg
Florida Power & Light Co.	FPL Group	AA-	3	59.94%	52.37%	50.76%	10.18%
Idaho Power Co.	IDACORP	A+	4	43.26%	42.72%	42.08%	72.06%
South Carolina Electric & Gas Co.	SCANA	A	5	50.89%	50.89%	37.03%	31.78%
Alabama Power Co.	Southern Co.	A	5	39.63%	39.14%	46.69%	5.38%
Georgia Power Co.	Southern Co.	A	5	53.04%	50.10%	46.69%	5.38%
Gulf Power Co.	Southern Co.	A	5	50.84%	50.84%	46.69%	5.38%
Mississippi Power Co.	Southern Co.	A	5	45.84%	45.82%	46.69%	5.38%
Savannah Electric & Power Co.	Southern Co.	A	5	42.89%	42.53%	46.69%	5.38%
Tampa Electric Co.	TECO Energy	A	5	57.36%	56.04%	34.05%	33.88%
Southern Indiana Gas & Electric Co.	Vectren Corp.	A	5	49.16%	49.16%	33.34%	29.93%
Public Service Co. of Colorado	Xcel Energy	A-	6	47.78%	43.74%	35.15%	19.01%
Southwestern Public Service Co.	Xcel Energy	A-	6	42.88%	42.16%	35.15%	19.01%

SUMMARY OUTPUT

Regression Statistics

Multiple R	0.883551832233011
R Square	0.78066384024231
Adjusted R Square	0.698412780333177
Standard Error	0.435470306822217
Observations	12

ANOVA

	df	SS	MS
Regression	3	5.39959156167598	1.79986385389199
Residual	8	1.51707510499069	0.189634388123836
Total	11	6.91666666666667	

	Coefficients	Standard Error	t Stat
Intercept	13.1948958187889	1.70964199818338	7.71792915289248
X Variable 1	-6.30532418271881	2.57323214459797	-2.45035186427143
X Variable 2	-11.481658422656	2.37662308128308	-4.83108092026831
X Variable 3	-2.53657770680474	0.757807793051563	-3.34725735214516

where: Y = Bond Rating

X1 = Equity Penalty Adjusted Equity Ratio

X2 = Utility Holding Company Equity Ratio

X3 = % of Holding Company Revenues derived from non-regulated operations.



Year 2001

2001

Company		Coal	Gas	Oil	Nuclear	Purchased	Hydro	Other
Allegheny Energy	(4)	0%	26%	1%	0%	67%	1%	6%
American Electric Power	(2)	68%	22%	0%	8%	**	0%	2%
Cinergy Corp.	(4)	93%	0%	0%	0%	**	1%	6%
Cleco Corp.	(2)	33%	27%	0%	0%	40%	0%	0%
CMS Energy Corp.	(2)	46%	0%	0%	6%	46%	0%	2%
DPL Inc.	(4)	68%	0%	0%	0%	**	0%	32%
DQE	(3)	0%	0%	0%	0%	100%	0%	0%
DTE	(4)	71%	0%	0%	15%	13%	0%	0%
Dominion Resources	(3)	40%	0%	5%	31%	21%	0%	3%
FPL Group	(3)	6%	24%	26%	24%	20%	0%	0%
Hawaiian Elec.	(1)	0%	0%	76%	0%	24%	0%	0%
IDACORP Inc.	(1)	(b)	(b)	(b)	(b)	(c)	34%	(c)
Great Plains (KC Power & Light)	(2)	65%	0%	0%	26%	6%	0%	0%
MDU Resources Group, Inc.	(1)	75%	(g)	(g)	0%	24%	0%	0%
NiSource Inc.	(2)	92%	0%	0%	0%	7%	0%	1%
NSTAR	(3)	0%	0%	0%	0%	100%	0%	0%
Pinnacle West Capital	(1)	36%	10%	0%	24%	30%	0%	0%
Progress Energy	(4)	0%	0%	0%	28%	15%	0%	57% (d)
Public Serv. Enterprise Group	(3)	24%	9%	1%	60%	0%	0%	6%
SCANA	(3)	71%	0%	0%	21%	4%	4%	0%
Southern Co.	(3)	68%	(e)	(e)	15%	6%	3%	0%
TECO Energy	(3)	100%	0%	0%	0%	0%	0%	0%
TXU Corp.	(2)	37%	(a)	(a)	17%	13%	0%	0%
Vectren Corp.	(2)	0%	73%	0%	0%	**	0%	27%
Xcel Energy Inc.	(1)	50%	(f)	(f)	11%	27%	0%	2%
Simple Average		43%	7%	5%	11%	22%	2%	13%

- (1) Value Line edition 11, May 17, 2002
- (2) Value Line edition 5, April 5, 2002
- (3) Value Line edition 1, June 7, 2002
- (4) Company's 2001 Annual Report

\*\* No purchased power reported in fuel mix but incurred purchased power costs

- (a) gas & oil 33%
- (b) thermal 46%
- (c) purchased power & other 20%
- (d) steam 50%; combustion turbines 6.8%
- (e) gas & oil 8%
- (f) gas & oil 10%
- (g) gas & oil 1%

Florida Power & Light Company  
Capitalization Ratios

	Ratios					
	December 31, 1999		December 31, 2000		December 31, 2001	
FPL	Amount	% age	Amount	% age	Amount	% age
Short-term Debt	94,000	1.3%	560,000	6.6%	232,000	2.7%
Long-term Debt	2,203,885	30.1%	2,641,252	31.2%	2,578,238	30.4%
Preferred Stock	226,250	3.1%	226,250	2.7%	226,250	2.7%
Common Equity	4,792,763	65.5%	5,032,430	59.5%	5,444,139	64.2%
Total Capitalization	7,316,898	100.00%	8,459,932	100.00%	8,480,627	100.00%

	Ratios					
	December 31, 1999		December 31, 2000		December 31, 2001	
FPL Group Capital, Inc.	Amount	% age	Amount	% age	Amount	% age
Short-term Debt	245,200	9.2%	598,413	20.4%	1,750,406	34.3%
Long-term Debt	1,399,463		1,399,592	47.7%	2,311,436	45.3%
Preferred Stock	0	0.0%	0	0.0%	0	0.0%
Common Equity	1,012,540	38.1%	935,036	31.9%	1,040,405	20.4%
Total Capitalization	2,657,203	100.00%	2,933,041	100.00%	5,102,247	100.00%

	Ratios					
	December 31, 1999		December 31, 2000		December 31, 2001	
FPL Group, Inc.	Amount	% age	Amount	% age	Amount	% age
Short-term Debt	339,200	3.6%	1,158,413	10.5%	1,982,406	15.1%
Long-term Debt	3,603,348	37.8%	4,040,844	36.7%	4,889,675	37.3%
Preferred Stock	226,250	2.4%	226,250	2.1%	226,250	1.7%
Common Equity	5,370,142	56.3%	5,593,408	50.8%	6,015,069	45.9%
Total Capitalization	9,538,940	100.00%				

Sources: Staff First Set of Interrogatories No. 1

Florida Power & Light Company  
 Percentage of Revenues and Expenses  
 Passed Through Recovery Clauses

	<u>Revenues</u>			
	<u>Florida Power &amp; Light Company</u>	<u>Florida Power Corporation</u>	<u>Tampa Electric Company</u>	<u>Gulf Power Company</u>
2001	48%	45%	41%	39%
2000	40%	45%	39%	35%
1999	38%	43%	34%	33%

	<u>Expenses</u>			
	<u>Florida Power &amp; Light Company</u>	<u>Florida Power Corporation</u>	<u>Tampa Electric Company</u>	<u>Gulf Power Company</u>
2001	54%	52%	47%	27%
2000	46%	50%	45%	24%
1999	43%	49%	40%	37%

Sources: December Rate of Return Surveillance Reports, percentage of revenues and expenses recovered through PSC approved recovery clauses.

**Florida Power & Light Company**  
**Docket No. 020262-EI & 020263-EI**  
**Staff's Second Set of Interrogatories (Amended Petition)**  
**Interrogatory No. 26**  
**Page 1 of 1**

**Q.**

At page 17 of his direct testimony, Alan Taylor states that he has seen the "equity penalty concept" incorporated in other solicitations both inside and outside Florida. Provide a list of all the cases Witness Taylor has participated in where the presiding regulatory commission has recognized the use of an "equity penalty" adjustment in the evaluation process of outside power supply proposals. For purposes of this response, please list the regulatory commission, the company involved, the date and number of the final order, and the amount of the "equity penalty" recognized.

**A.**

Mr. Taylor has seen equity penalties incorporated into two other solicitations that were reviewed by four state commissions in the following proceedings:

Florida Public Service Commission, Florida Power Corporation, Docket No. 001064-EI (Petition for determination of need for Hines Unit 2 Power Plant by Florida Power Corporation), January 5, 2001, Order NO. PSC-01-0029-FOF-EI, no specific amount of equity penalty was recognized in the order.

Illinois Commerce Commission, MidAmerican Energy Company, Docket 00-0197 (Petition for Determination Pursuant to Section 32(k)(2)(A) of the Public Utility Holding Company Act and Consent to a Contract with an Affiliated Interest pursuant to Section 7-101(3) of the Public Utilities Act), Commission Order dated July 6, 2000, no specific amount of equity penalty was recognized in the order.

Iowa Utilities Board, MidAmerican Energy Company, Docket SPU-00-4 (Petition for Determinations Pursuant to Section 32(k)(2)(A) of the Public Utility Holding Company Act and Approval of an Affiliate Transaction), Final Decision and Order issued June 26, 2000, no specific amount of equity penalty was recognized in the order.

South Dakota Public Utilities Commission, MidAmerican Energy Company, Docket EL00-006 (Application for Determinations Pursuant to Section 32(k)(2)(A) of the Public Utility Holding Company Act), Order Reciting Commission Determinations issued June 28, 2000, no specific amount of equity penalty was recognized in the order.

Florida Power & Light Company  
Docket No. 020262-EI & 020263-EI  
Staff's Second Set of Interrogatories (Amended Petition)  
Interrogatory No. 35  
Page 1 of 1

**Q.**

Provide a list of all contracts entered into by FPL, FPL Energy, or any other FPL Group affiliate to sell power to another utility during the last 3 years. For each contract, cite the name of the purchasing utility, the size of the contract (MW), the term of the contract, and indicate the amount of equity penalty, if any, that was added to the price of FPL's bid in the purchasing utility's evaluation process.

**A.**

FPL does not have knowledge of the information requested regarding FPL Energy or other FPL Group affiliates. FPL maintains its prior objection to providing such information regarding its affiliates. FPL also objects on the ground that even if FPL had such information regarding its affiliates, it would be highly sensitive, proprietary information which should not be disclosed to its affiliates' competitors, several of which are interveners in this proceeding. As to FPL, the following information is applicable:

Contract	1
Purchasing Utility	Utilities Commission-City of New Smyrna Beach
Contract Quantity	Variable by Month/Year - 0 MW - 38 MW
Contract Term	March 1, 2000 - April 30, 2002
Amount of Equity Penalty	N/A *
Contract	2
Purchasing Utility	FMPA
Contract Quantity	75 MW
Contract Term	June 1, 2002 - October 31, 2007
Amount of Equity Penalty	N/A *

\* Note: These contracts were the result of private, bilateral negotiations between FPL and the purchasing utility. Any information about an equity penalty would not have been disclosed by the purchasing utility.

RECEIVED  
Commission  
JUN 29 1992  
ELECTRIC AND GAS

**BEFORE THE  
FLORIDA PUBLIC SERVICE COMMISSION**

**DOCKET NOS. 920520-EQ AND  
920648-EQ**

**CYPRESS ENERGY PROJECT**

**FLORIDA POWER & LIGHT COMPANY  
JUNE 26, 1992**

**DIRECT TESTIMONY OF:  
S. S. WATERS**

DOCUMENT NUMBER-DATE

06869 JUN 26 1992

FPSC-RECORDS/REPORTING

1       **Q.    What costs of the Cypress Project are included in these analyses?**

2       A.    All contractual obligations, including capacity, O&M and energy payments  
3           based on the final contract between FPL and Cypress, are included. The  
4           capacity costs include interconnection costs while the O&M costs include  
5           payments to Cypress for acquisition of SO<sub>2</sub> allowances required by the  
6           Clean Air Act. These costs are detailed in Dr. Sim's testimony.

7

8       **Q.    Do these analyses include a cost for the equity penalty associated**  
9           **with FPL's decision to purchase power from the Cypress Project?**

10      A.    No. The equity penalty was quantified by FPL after the evaluation process  
11           described by Dr. Sim in this testimony and will be applied to future power  
12           purchase evaluations. The equity penalty associated with the Cypress  
13           Project represents an additional cost to FPL of approximately \$73 million,  
14           NPV, \$1991. This additional cost reduces the savings of the Cypress  
15           Project to \$71 million versus the pulverized coal plan using base  
16           assumptions and \$96 million versus the combined cycle plan using the  
17           lower oil and gas price sensitivity assumptions. Even with this equity  
18           penalty, the Cypress project remains the most cost effective alternative  
19           available to FPL.

20

21      **Q.    How did FPL determine the cost of the credit impact (equity penalty)**  
22           **of the Cypress contract?**

23      A.    FPL utilized the methodology which Standard & Poors (S&P) has used in  
24           adjusting FPL's financial ratios to reflect the credit impact of its purchase



**Andrew Maurey**

**From:** SandPUtil@StandardAndPoors.Com  
**Sent:** Wednesday, September 26, 2001 11:50 AM  
**To:** AMAUREY@PSC.STATE.FL.US  
**Subject:** Ratings On FPL Group and Affiliates Are Lowered; Off CreditWatch



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### **Ratings On FPL Group and Affiliates Are Lowered; Off CreditWatch**

John W Whitlock, New York (1) 212-438-7678; Jodi E Hecht, New  
York (1) 212-438-2019

NEW YORK (Standard & Poor's) Sept. 26, 2001--Standard & Poor's today lowered its ratings on FPL Group Inc. and its affiliates Florida Power & Light Co. and FPL Group Capital Inc. and removed the entities from CreditWatch (see list below), where they were placed with negative implications on July 31, 2000. The rating action reflects Standard & Poor's comprehensive review of FPL Group's strategic direction after the termination of its merger agreement with Entergy Corp., as well as the risk assessment and cash flow potential of FPL Group as a stand-alone entity. Driving factors in the current ratings determination include increasing business risk for the consolidated enterprise attributable to the growing nonregulated independent power producer (IPP) portfolio, regulatory challenges in Florida, and an aggressive financing plan and declining credit protection measures. The potential for ratings stability at current levels is predicated on favorable resolution of regulatory issues at Florida Power & Light, adequate risk mitigation for the IPP activities, and sufficient consolidated cash flow accretion consistent with the financial targets of the single-'A' rating category.



The outlook is negative.

FPL Group's credit quality is supported by the activities of its operating utility, Florida Power & Light. Florida Power & Light's credit profile reflects an above-average business position that is supported by competitive residential and commercial rates (less than the average for Florida), operational efficiency (operations and management expenses at around 1 cent per kWh), increasing energy sales due to additional customers and increased usage, and well-run generating facilities (above 90% availability). These factors are offset by the utility's reliance on nuclear facilities for 26% of load and another 14% from long-term, above-market purchased-power agreements. The utility's revenue-sharing mechanism (instead of traditional ROE regulation) allows Florida Power & Light to receive the benefit of operational efficiencies while providing a refund mechanism to the customer when sales exceed prescribed levels. In addition, the utility's financial profile is strained by intensive capital spending related to increased generation and distribution requirements necessary to meet growing customer demand while maintaining a PSC mandated reserve margin above 20%.

Currently, Florida Power & Light is preparing for a base rate proceeding which will extend into 2002, absent a negotiated settlement. Ultimate resolution of this rate matter may affect consolidated credit quality dependent on the level of allowed revenues, the recovery of costs and the affect on cash flow. Although restructuring momentum has slowed in Florida, the debate over opening Florida's wholesale generation market to competition, which was originally proposed by the Governor, remains under discussion causing additional uncertainty. In addition, contention between the Florida Public Service Commission and the FERC about the formation of a regional transmission organization for Florida creates additional uncertainty for all of the Florida utilities regarding this portion of the business.

FPL Group's business profile reflects the growing portfolio of higher-risk nonregulated investments, principally in independent power projects. Furthermore, as FPL Group's earnings mix and capital expenditure requirements shift further toward nonregulated businesses, the consolidated business profile becomes riskier, requiring greater cash flows and credit protection measures.

The portfolio of nonregulated electric power generation holdings is in several regions, including New England, the Mid-Atlantic, West Coast, and the Southwest. The firm expects to have about 5,000 net MW in operation by year-end 2001 and plans to add an additional 5,000 MW by 2003. The potential for an economic downturn and the possibility of additional capacity coming on line in some of the regions that FPL Group has targeted highlight some of Standard & Poor's concerns has about this high-risk business line. FPL Group has mitigated some of the inherent risk related to volatile prices and demand by selling a majority of its output from its facilities to creditworthy utilities under long-term contracts. ✓

The IPP financing strategy utilizing greater amounts of nonrecourse debt and the continued sales of power under contracts will be important to sustaining current ratings for the FPL family.

This includes prudent and conservative balance-sheet management including an ability and willingness to issue common equity.

On a consolidated basis, cash flow potential will need to be realized to offset the level of risk being undertaken. Specifically, adjusted funds from operations (FFO) interest coverage of about 5 times and FFO to total debt of 35% is targeted. In addition, debt to total capital below 50% is expected.

OUTLOOK: NEGATIVE

The negative outlook for FPL Group and its affiliates reflects the uncertainty tied to the current regulatory proceedings and the potential for decreased revenues and cash flow at Florida Power & Light, which could affect key coverage ratios. In addition, FPL Group's stated intention to expand its nonregulated generation business, will challenge the firm to strengthen consolidated credit-protection measures to maintain the existing ratings profile. Successful resolution of these issues could lead to ratings stability. ✓

RATINGS LOWERED AND REMOVED FROM CREDITWATCH

	TO	FROM
FPL Group Inc.		
Corporate credit rating	A	AA-
Senior unsecured debt	A-	A+
Florida Power & Light Co.		
Corporate credit rating	A/A-1	AA-/A-1+
Commercial paper	A-1	A-1+
Senior secured debt	A	AA-
Preferred stock	BBB+	A
FPL Group Capital Inc.		
Long-term corporate credit rating	A	AA-

RATINGS AFFIRMED

FPL Group Capital Inc.		
Short-term corporate credit rating	A-1	
Commercial paper	A-1	

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## Ratio Guidelines

Risk-adjusted ratio guidelines depict the role that financial ratios play in Standard & Poor's rating process, since financial ratios are viewed in the context of a firm's business risk. A company with a stronger competitive position, more favorable business prospects, and more predictable cash flows can afford to undertake added financial risk while maintaining the same credit rating.

The guidelines displayed in the matrices make explicit the linkage between financial ratios and levels of business risk. For example, consider a U.S. industrial—which includes manufacturing, service, and transportation sectors—with an *average* business risk profile. Cash flow coverage of 60% would indicate an 'A' rating. If a company were *below average*, it would need about 85% cash flow coverage to qualify for the same rating. Similarly, for the 'A' category, a firm that has an *above-average* business risk profile could tolerate about 40%

leverage and an average firm only 30%. The matrices also show that a company with only an *average* business position could not aspire to an 'AAA' rating, even if its financial ratios were extremely conservative.

Ratio medians that Standard & Poor's has been publishing for more than a decade are merely statistical composites. They are not rating benchmarks, precisely because they gloss over the critical link between a company's financial risk and its business risk. Medians are based on historical performance, while Standard & Poor's risk-adjusted guidelines refer to expected future performance.

Guidelines are not meant to be precise. Rather, they are intended to convey ranges that characterize levels of credit quality as represented by the rating categories. Obviously, strengths evidenced in one financial measure can offset, or balance, relative weakness in another.

■ STANDARD & POOR'S

**U.S. UTILITIES**

**Funds from Operations/Total Debt Guidelines (%)**

Company business risk profile		—Rating category—					
		AAA	AA	A	BBB	BB	B
Well-above-average business position	1	23	18	15	10	5	—
	2	29	23	19	14	9	—
Above average	3	35	29	23	17	12	7
	4	40	34	28	21	15	9
Average	5	46	37	30	24	18	11
	6	53	43	35	27	19	13
Below average	7	63	52	42	31	21	14
	8	75	61	49	35	23	15
Well below average	9	—	—	57	41	27	17
	10	—	—	69	50	34	22

**Total Debt/Capitalization (%)**

Company business risk profile		—Rating category—					
		AAA	AA	A	BBB	BB	B
Well-above-average business position	1	47	53	58	64	70	—
	2	43	49	54	60	66	—
Above average	3	39	45	50	57	64	70
	4	35	41	46	53	61	68
Average	5	33	39	44	51	59	67
	6	30	36	43	50	57	65
Below average	7	27	34	41	49	56	64
	8	23	31	39	47	55	62
Well below average	9	—	—	35	43	51	58
	10	—	—	29	37	43	50

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	<b>Rationale</b>

- Table of Contents
- Rationale
  - Outlook
  - Current Ratings

Credit quality for Florida Power & Light Co., the utility operating company of FPL Group Inc., reflects the unit's steady and reliable cash flow attributes, tempered by the parent's growing portfolio of higher-risk, nonregulated investments, principally in independent power projects.

Current ratings for FPL Group and its affiliates incorporate increasing business risk for the consolidated enterprise attributable to the growing nonregulated independent power producer (IPP) portfolio, regulatory challenges in Florida, an aggressive financing plan, and declining credit protection measures. The potential for ratings stability at current levels is predicated on favorable resolution of regulatory issues at Florida Power & Light, adequate risk mitigation for the IPP activities, and sufficient consolidated cash flow accretion consistent with the financial targets of the 'A' rating category.

Florida Power & Light's credit profile reflects an above-average business position that is supported by competitive residential and commercial rates (less than the average for Florida), operational efficiency (operations and management expenses at around one cent per kWh), increasing energy sales due to additional customers and increased usage, and well-run generating facilities (above 90% availability). These factors are offset by the utility's reliance on nuclear facilities for 26% of load and another 14% from long-term, above-market purchased-power agreements. The utility's revenue-sharing mechanism (instead of traditional ROE regulation) allows Florida Power & Light to receive the benefit of operational efficiencies while providing a refund mechanism to the customer when sales exceed prescribed levels. In addition, the utility's financial profile is strained by intensive capital spending related to increased generation and distribution requirements necessary to meet growing customer demand while maintaining a Florida PSC mandated reserve margin above 20%.

Florida Power & Light is preparing for a base rate proceeding that will extend into 2002, absent a negotiated settlement. Ultimate resolution of this rate matter may affect consolidated credit quality dependent on the level of allowed revenues, the recovery of costs and the affect on cash flow. Although restructuring momentum has slowed in Florida, the debate over opening Florida's wholesale generation market to competition, which was originally proposed by the Governor, remains under discussion causing additional uncertainty. In addition, contention between the Florida Public Service Commission and the FERC about the formation of a regional transmission organization for Florida creates additional uncertainty for all of the Florida utilities regarding this portion of the business.

Parent FPL Group's portfolio of nonregulated electric power generation holdings is in several regions, including New England, the Mid-Atlantic, West Coast, and the Southwest. The firm expects to have about 5,000 net MW in operation by year-end 2001 and plans to add an additional 5,000 MW by 2003. The potential for an economic downturn and the possibility of additional capacity coming on line in some of the regions that FPL Group has targeted highlight some of Standard & Poor's concerns has about this high-risk business line. FPL Group has mitigated some of the inherent risk related to volatile prices and demand by selling a majority of its output from its facilities to creditworthy utilities under long-term contracts.

On a consolidated basis, cash flow potential will need to be realized to offset the level of risk being undertaken. Specifically, adjusted funds from operations (FFO) interest coverage of about 5 times and FFO to total debt of 35% is targeted. In addition, debt to total capital below 50% is expected.

[↑ back to top](#)

## ■ Outlook

The negative outlook for FPL Group and its affiliates reflects the uncertainty tied to the current regulatory proceedings and the potential for decreased revenues and cash flow at Florida Power & Light, which could affect key coverage ratios. In addition, FPL Group's stated intention to expand its nonregulated generation business, will challenge the firm to strengthen consolidated credit-protection measures to maintain the existing ratings profile. Successful resolution of these issues could lead to ratings stability.

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**Andrew Maurey**

**From:** SandPUtil@StandardAndPoors.Com  
**Sent:** Tuesday, January 22, 2002 11:55 AM  
**To:** AMAUREY@PSC.STATE.FL.US  
**Subject:** U.S. Utilities' Credit Quality Displayed Steep Decline in 2001; Negative Trend Likely to Continue



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### Research:

## U.S. Utilities' Credit Quality Displayed Steep Decline in 2001; Negative Trend Likely to Continue

**Publication Date:** 18-Jan-2002

**Analyst:** Barbara A Eiseman, New York (1) 212-438-7666

The U.S. power industry began 2001 under the dark cloud of the near-total credit collapse of California's two largest electric utilities, and ended with the bankruptcy of Enron Corp., the largest such filing in U.S. history. Sandwiched in between, and far outdistancing the negative ratings trend firmly established in 2000, were 81 downgrades of utility holding companies and operating companies, contrasted with only 29 upgrades. In the fourth quarter alone, Standard & Poor's recorded 51 rating actions—44 downgrades and seven upgrades. In addition, Standard & Poor's revised numerous outlooks to negative, and significantly increased its CreditWatch listings. In 2000, there were 85 rating changes (65 downgrades, 20 upgrades), as well as a substantial rise in CreditWatch listings and outlook changes, mostly to negative.

Although many familiar themes dominated the overall credit picture, Enron's fall to noninvestment grade and ultimately to 'D' alone accounted for 15 downgrades in fourth-quarter 2001, while the California energy and liquidity crisis led to several downgrades on PG&E Corp., Edison International, and their affiliates earlier in the year. Pacific Gas & Electric Co.'s and Southern California Edison Co.'s corporate credit ratings were dropped to 'D' when they defaulted on their financial obligations in first-quarter 2001. The negative credit momentum experienced during the year can also be traced to increasing business risk related to investments outside the traditional regulated utility business, eroding bondholder protection fundamentals, mergers and acquisitions, unsympathetic regulatory arenas, and corporate restructuring efforts. These trends, in turn, reflect companies' strategies to deal with an increasingly competitive market, while also seeking to enhance shareholder value in this more uncertain environment.



acquisition of Global Energy Marketing, a commodity trading operation. In addition, Standard & Poor's now treats AE Supply analytically more as a stand-alone entity in light of recent industry trends and Allegheny Energy's announcement of a potential IPO of AE Supply, which the parent has since postponed indefinitely.

Reduced creditworthiness for Southwestern Energy Co. and WPS Resources Corp. and its subsidiary Wisconsin Public Service Corp. was attributable mainly to weakening financial measures.

The ratings of United Water New Jersey and United Waterworks were lowered as a consequence of the downgrade of their ultimate parent, Suez S.A.

Some rating changes resulted from mergers and acquisitions:

Massachusetts Electric Co., Narragansett Electric Co., and New England Power Co. experienced lower ratings owing to the pending acquisition of Niagara Mohawk Power Corp. by parent National Grid Group PLC.

Northwestern Corp. saw its ratings lowered due to its soon-to-be-completed, debt-financed acquisition of Montana Power Co.'s transmission and distribution assets.

Credit deterioration for Vectren Corp and its operating subsidiaries Indiana Gas Co. Inc., Southern Indiana Gas & Electric Co., Vectren Energy Delivery of Ohio Inc., Vectren Enterprises Corp., and Vectren Utility Holdings Inc. can be traced to erosion in the company's consolidated financial position following the acquisition of Dayton Power & Light Co.'s gas assets (Vectren Energy of Ohio) for \$465 million. The incremental debt associated with the transaction, combined with the lack of improvement in the gas company's performance and delayed merger synergies, has caused Vectren's financial position to be weaker than expected at the time of the merger.

The ratings on GPU Inc. and its subsidiaries Jersey Central Power & Light Co., Metropolitan Edison Co., and Pennsylvania Electric Co. were lowered after their acquisition by FirstEnergy Corp. Because Standard & Poor's considers all the domestic operating utilities as core, and because none benefits from any structural or regulatory insulation, the default risks are indistinguishable, and the same corporate credit rating is accorded to each.

The ratings of MCN Energy Group Inc. (now known as DTE Enterprises) and its subsidiary Michigan Consolidated Gas Co. were cut, reflecting MCN Energy Group's imminent merger with DTE Energy Co. The ratings reflect Standard & Poor's view that the default risk of each entity within the consolidated DTE Energy family is the same.

The downgrade on IPALCO Enterprises Inc. and its subsidiary Indianapolis Power & Light Co. can be traced to the acquisition of IPALCO by lower-rated AES Corp. In most circumstances, Standard & Poor's will not rate a wholly owned subsidiary higher than the rating of the parent. However, exceptions can be made on the basis of the cumulative value provided by such enhancements as structural protections, covenants, a pledge of stock, and an independent director. IPALCO has amended its charter to include such insulation, providing Standard & Poor's with sufficient comfort to separate the corporate credit ratings of AES and IPALCO/Indiana Power & Light.

The following downgrades can be traced to investments in higher-risk nonregulated businesses and weakening credit fundamentals.

Credit quality erosion for Alliant Energy Corp. and its subsidiaries Alliant Energy Resources Inc., IES Utilities Inc., Interstate Power Co., Iowa Southern Utilities Co., and Wisconsin Power & Light Co. can be attributed to Alliant's expansion into riskier nonregulated areas, which has weakened consolidated financial measures.

Lower ratings for Otter Tail Corp. were a function of increasing business risk resulting from the company's expanding nonregulated business activities.

The ratings of Wisconsin Energy Corp. and its units Wisconsin Electric Power Co. and Wisconsin Gas



Co. were cut due to continued weakening in consolidated financial measures resulting from higher debt leverage, disappointing results from nonregulated businesses, and prospectively higher levels of capital spending.

Lower ratings for Black Hills Power Inc. were tied to Standard & Poor's consolidated rating methodology and reflect the heightened business risk profile from the current and anticipated growth of parent Black Hills Corp's nonregulated business activities through increased debt leverage.

The ratings of OGE Energy Corp. and utility subsidiary Oklahoma Gas & Electric Co. were lowered, reflecting the increased business risk that the growing Enogex Inc., OGE's unregulated subsidiary, creates for the consolidated enterprise. Without any structural or regulatory insulation, the utility's corporate credit rating is the same as the consolidated entity's, reflecting the belief that default risk is the same for the entire organization.

Reduced creditworthiness for FPL Group Inc. and its subsidiary Florida Power & Light Co. reflects Standard & Poor's review of FPL Group's strategic direction after the termination of its merger agreement with Entergy Corp., as well as the risk assessment and cash flow potential of FPL Group as a stand-alone entity. Driving factors in the current ratings determination include increasing business risk for the consolidated enterprise attributable to the growing unregulated independent power producer portfolio, regulatory challenges in Florida, and an aggressive financing plan and declining credit protection measures.

#### Some Credit Improvement

Rating upgrades during the year were mostly attributable to stronger business profiles, improving financial measures, responsive regulation, and industry consolidation.

The ratings of NSTAR and its operating subsidiaries (Boston Edison Co., Commonwealth Electric Co., NSTAR Gas Co., and Cambridge Electric Light Co.), Kinder Morgan Inc., and Reliant Energy Resources Corp. were raised due to improving business and financial profiles. However, the ratings of Kinder Morgan were subsequently placed on CreditWatch with negative implications following the company's announcement that it had entered into an agreement to buy Tejas Gas for \$750 million. The purchase will be initially funded with debt.

Higher ratings for The Williams Cos. Inc. and its subsidiaries, Northwest Pipeline Corp., Texas Gas Transmission Corp., Transcontinental Gas Pipe Line Corp., and Williams Gas Pipelines Central Inc. reflect prospects for financial improvement as the complementary portfolio of energy assets generates a level of earnings and cash flow that will lower debt (excluding nonrecourse debt) to about 50% of capital and maintain cash flow interest coverage in the 4x area—measures that are appropriate for its revised ratings.

The ratings on Northeast Utilities and its affiliates were raised to reflect supportive regulatory decisions that have removed significant uncertainty over the future financial profile of the utilities. Furthermore, corporate restructuring strategies have strengthened the business profile of the individual entities and, accordingly, the consolidated corporation.

Higher ratings for Bangor Hydro-Electric Co. reflect a measure of implicit support from its Canada-based parent company Emera Inc. It is Standard & Poor's opinion that Bangor Hydro stands to benefit from its association with Emera in terms of financial and managerial support. Although Bangor Hydro forms an important part of Emera's assets and revenues, and is viewed by Emera as a core operation, Standard & Poor's expects to see some tangible measure of support before equalizing the ratings of Bangor Hydro with those of Emera.

Mergers with higher-rated entities led to upgrades on FirstEnergy's operating utilities (Cleveland Electric Illuminating Co., Ohio Edison Co., Pennsylvania Power Co., and Toledo Edison Co.), DTE Energy, and Niagara Mohawk. First Energy acquired GPU, DTE acquired MCN Energy Group, and Niagara Mohawk will be acquired by National Grid Group.



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## Research:

**Summary: FPL Group Inc.**

**Publication date:** 20-Jun-2002

**Credit Analyst:** Jodi E Hecht, New York (1) 212-438-2019

**Credit Rating:** A/Watch Neg/--

### Rationale

Credit quality for FPL Group is characterized by the activities of its operating utility, Florida Power and Light and its growing portfolio of higher-risk, non-regulated investments, mainly in independent power projects. Ratings for FPL Group and its affiliates incorporate increasing business risk for the consolidated enterprise, attributable to the growing non-regulated, independent power producer portfolio, an aggressive financing plan, and the decline in credit-protection measures.

Juno Beach, Fla.-based FPL Group has about \$6.8 billion in outstanding debt. Subsidiaries include Florida Power and Light Co. and FPL Group Capital Inc.

Florida Power and Light serves 3.9 million electric customers along the east coast and southern portions of Florida. The company's credit profile reflects an above-average business position that is supported by competitive residential and commercial rates (less than the average for Florida), operational efficiency (operations and management expenses at around 1 cent per kWh), increasing energy sales due to additional customers and increased usage (customer growth and utilization averaging 2.1% and 3% per year, respectively), and well-run generating facilities (above 90% availability). These factors are offset by the utility's reliance on nuclear facilities for 31% of load and another 12% from long-term, above-market purchased-power agreements. The utility's revenue-sharing mechanism (instead of traditional ROE regulation) allows Florida Power and Light to receive the benefit of operational efficiencies while providing a refund mechanism to the customer when sales exceed prescribed levels. In addition, the utility's financial profile is strained by intensive capital spending related to increased generation and distribution requirements necessary to meet growing customer demand while maintaining a PSC-mandated reserve margin of 20%.

FPL Group Capital is primarily comprised of FPL Energy, the unregulated energy subsidiary, with smaller contributions from FPL Fiber Net. FPL Energy's portfolio of non-regulated electric power generation is located in four regions of the United States, specifically the Northeast, the Mid-Atlantic, West, and Central, which includes Texas. At year-end 2001, the portfolio's primary fuel source was natural gas (46%), followed by wind (28%), oil (15%), hydro (7%), and other (4%). The firm expects to have just under 8,000 net MW in operation by year-end 2002, and plans to increase to just under 12,000 MW by 2003. While all of the wind projects are under long-term contracts, the portfolio remains exposed to volatile prices and demand. Contract coverage drops to below 50% beyond 2003, which is exacerbated by new capacity coming into commercial service.

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The rating was placed on CreditWatch with negative implications on April 18, 2002, following the announcement that the company will purchase an 88% interest in the 1,161 MW Seabrook nuclear power plant. This is the first nuclear plant in FPL's portfolio of non-regulated generating assets. The plant will not have any initial off-take contracts and will be managed as a merchant plant with a series of short-term contracts. FPL Group will thus be exposed to electricity price volatility, although as a low-cost base load plant, high levels of dispatch can be expected. The increased risk is partly balanced by FPL's good track record with operating two nuclear plants in Florida. The Seabrook facility also has a good operating profile.

Standard & Poor's expects to review FPL's strategy and financial plans for its regulated and non-regulated segments with a focus on its rapidly growing and aggressive strategy in the competitive energy business. The review's outcome could result in a ratings affirmation or a downgrade.

[↑ back to top](#)

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Moody's Investors Service

Global Credit Research

Rating Action

16 APR 2002

**Rating Action: Florida Power & Light Company****MOODY'S INVESTORS SERVICE PLACES THE DEBT RATINGS OF FPL GROUP CAPITAL, INC. AND FLORIDA POWER AND LIGHT COMPANY ON REVIEW FOR POSSIBLE DOWNGRADE****Approximately \$7.0 billion of Debt Securities Affected**

Moody's Investors Service has placed the debt ratings of FPL Group Capital, Inc. and Florida Power and Light Company on review for possible downgrade. Moody's has taken this action in response to the higher level of debt incurred at FPL Group Capital to finance its growing unregulated generation portfolio. Consolidated debt to capital at FPL Group has increased from 41% at 12/31/99, to 47% at 12/31/00, and again to 52% at 12/31/01. It will likely increase further as a result of yesterday's announcement that FPL Group will purchase 88.2% of the 1,161 MW Seabrook Nuclear Generation Station for \$836.6 million. The purchase price includes \$516 million for the plant, \$233 million for nuclear decommissioning funds, \$62 million for nuclear fuel, and \$26 million for spare parts. These financial obligations are being undertaken at a time of heightened uncertainty in the merchant generation market overall. Moody's notes that the company did issue \$575 million of equity security units during the first quarter of 2002 and expects to issue approximately \$125 million of equity annually through its employee benefit plans, mitigating the increased leverage to some degree.

Under review are FPL Group Capital's A2 senior unsecured and P-1 commercial paper ratings, Florida Power and Light Company's Aa3 first mortgage bond and senior secured medium term note ratings, A1 issuer rating, and A3 preferred stock rating. Also under review are the ratings for the shelf registrations for the issuance of FPL Group Capital senior unsecured debt, (P)A2; and Florida Power and Light Company senior secured debt, (P)Aa3 and preferred stock, (P)A3. Florida Power and Light Company's P-1 commercial paper rating is confirmed.

Over the last several years, FPL Group Capital has issued nearly \$2.0 billion of debt to finance the growth of independent power projects at its FPL Energy subsidiary. Before the Seabrook purchase, the company had expected to double its unregulated generation portfolio from the current 5,063 MW's to approximately 10,000 MW's by the end of 2003. The Seabrook acquisition will increase the company's current capacity by over 20% and significantly accelerates and broadens this expansion program. It is the first nuclear plant acquired by the company, although the company does operate two well running nuclear plants at its Florida Power and Light subsidiary. The plant was acquired on a fully merchant basis, with no new power purchase agreements between FPL Group and any of the former owners of Seabrook included as part of the transaction. The company intends to contract approximately 75% of the output of its entire Northeast unregulated generation portfolio into the NEPOOL market by the end of 2002.

Because parent FPL Group guarantees the obligations of FPL Group Capital, increased leverage at the subsidiary puts pressure on all the rated entities within the FPL Group, including Florida Power and Light, its operating utility subsidiary. The utility is engaged in a large capital expenditure program of its own to meet capacity needs in Florida and must also manage a four-year \$250 million annual rate reduction approved this month by the Florida Public Service Commission. While the rate settlement reduces regulatory uncertainty and includes incentive-based revenue sharing mechanisms which FP&L can take advantage of, the rate reduction may reduce the utility's traditionally strong coverage ratios going forward.

As part of our review, Moody's plans to meet with senior management and will focus on FPL Group's future independent power project development strategy, its financing plans for both this expansion and for growth needs at Florida Power & Light, and the extent to which the utility can mitigate the negative effects of the rate reduction.

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WEDNESDAY, DECEMBER 19, 2001 C1

# Rating Agencies Crack Down on Utilities

## Hard Line on Debt Jolts Power Industry

### CREDIT MARKETS

By REBECCA SMITH

Staff Reporter of THE WALL STREET JOURNAL

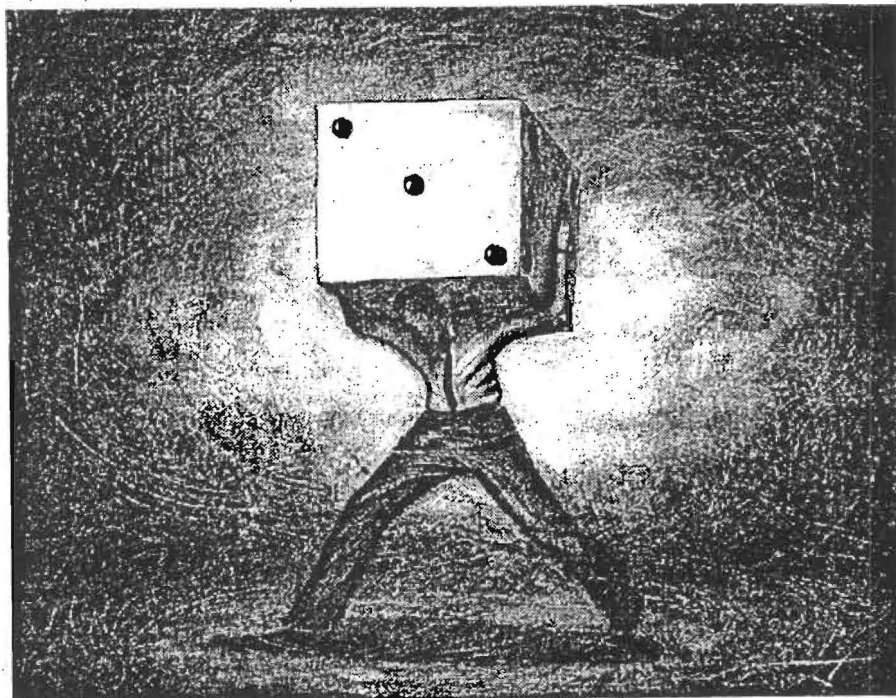
Credit-rating agencies were asleep when California's deregulated energy market imploded. They were slow to act when Enron Corp. plunged, for fear of hastening its demise. Now, they have made an about-face and are being tougher than ever on power companies, telling them to slash debt or else.

Downgrades of Dynegy Inc. and Calpine Corp.—both coming as apparent surprises to the companies' chief executives—function as a shot over the bow of an entire industry that has been borrowing like crazy. Companies involved in energy marketing and trading have to recognize they are in a "confidence-sensitive industry" that can create sudden needs for cash collateral, says John Diaz, energy analyst for Moody's Investors Service Inc.

After Enron's Chapter 11 bankruptcy-court filing early this month, the rating agencies want to see more cash on hand. The message: The market is more worried about risk than it is excited by the prospect of profits from deregulated markets.

Underscoring this new reality, companies on negative credit watch from Standard & Poor's Ratings Group or Moody's include Allegheny Energy Supply, a unit of Allegheny Energy Inc.; Calpine; Duke Energy Trading and Marketing LLC, a unit of Duke Energy Corp.; Dynegy; NRG Energy Inc. and Reliant Resources Inc. Moody's has said it will issue an opinion tomorrow on several of these companies, as well as AES Corp. and Edison Mission Energy, a unit of Edison International.

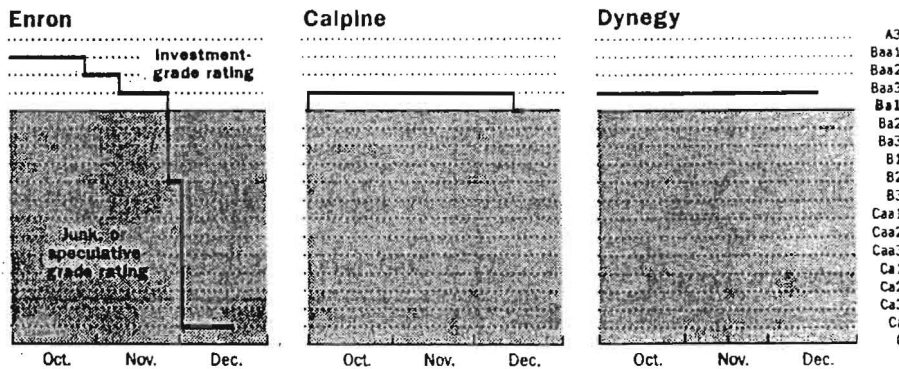
Ratings downgrades make it more difficult and more expensive to borrow money. That is true for all companies. But a low credit rating can be especially troublesome for energy-trading companies because they often operate on slim margins, and a higher borrowing cost can wipe out profits. More important, most energy firms require trading partners to be credit-worthy in order to enter into contracts. A firm that slips can be required to post large amounts of cash collateral that can cause a liquidity "death spiral" such as Enron experienced



Jon Krause

## Slow to Weigh the Risks?

On the heels of its Dec. 3, 2001, downgrade of Enron, Moody's Investors Service has also lowered its ratings on Calpine and Dynegy.



Source: Moody's Investors Service

The speed of Enron's collapse has caused the credit agencies to be more vigilant, reflecting criticism that they have both been slow to sense change and that they have permitted "ratings inflation" during recent years. "I don't know if the problem was grade inflation as much as a willingness to downplay the exposure that was off balance sheet," says Jeffrey Holzschuh, an investment banker for the power industry at Morgan Stanley. "It's not just credit-rating agencies. The whole market was overheated."

At Moody's Mr. Diaz says his agency

now routinely asks companies, "Assume you're downgraded to below investment grade. Do you have sufficient liquidity to run your business?" It is equivalent to asking the average worker, assume you lose your job, do you have enough savings to pay the mortgage? "Companies haven't focused on this possibility at all," he says.

Now, says Alan Spen, a credit analyst at rating agency Fitch Inc., "banks are fearful to put more money into the sector" and it is making credit analysts nervous, as well. The smart companies, he says,

Please Turn to Page C16, Column 3

00115078 ND



# Raters Spark Energy Industry to Rein in Borrowing

## CREDIT MARKETS

*Continued From Page C1*

are the ones that voluntarily "get their balance sheets in line" and then "let the market know they're in charge of their destiny ... since the market clearly has the heebie-jeebies."

It isn't the message energy companies were getting a few months ago. In fact, the ability to borrow heavily was touted as one of the central advantages of the national push toward deregulated power markets since the mid-1990s. Historically, regulated utilities were permitted to borrow only a dollar for every dollar of equity they invested because ratepayers ultimately bore the risk of any failure. But so-called merchant generators of electricity, often affiliated with utilities, could borrow as much as their credit ratings and banks would permit. Calpine, the fastest-growing power-plant builder in the country, has borrowed two dollars from banks and bondholders for each dollar of equity, for instance.

Capital markets are "very fickle" now, says Mr. Holzschuh of Morgan Stanley. "From week to week, the judgments can be different and it's extremely selective."

Nine months ago, the energy business was promoting itself as a colossal "growth story" that could pick up where the dot-com meltdown left off. The price-to-earnings ratios of the stocks of flashier companies in the sector, such as Enron and Calpine, were huge, signaling investor confidence in ever-rising earnings.

That view started to dim early this year when problems in California's deregulated energy market pushed the state's largest private utility, PG&E Corp.'s Pacific Gas & Electric Co., into bankruptcy court. The jitters turned into panic when Enron collapsed in a shocking six weeks, amid questions over its accounting practices.

Now, there is a heightened sense that "we're the ultimate guardians of financial markets," says Mr. Spen of Fitch. "People are looking to us for a higher degree of guidance since we have special access to inside information about these companies."

Their tougher line is having a big effect. Even companies with stocks trading near their 52-week lows now appear prepared to issue new stock to bolster equity. Dynegy and gas-and-electricity seller El Paso Corp. both say they are willing to take lumps from common shareholders for diluting them rather than risk the wrath of the rating agencies. Executives of Mirant Corp., a recent power-generation spinoff of Atlanta's Southern Co., have been barricaded in their offices preparing to unveil details on the company's capital restructuring later in the week.

All the belt-tightening spells bad news for continued development of the nation's energy infrastructure. Companies that can borrow more money and stretch their dollars, quite simply, can build more plants and equipment. Companies that are increasingly dependent on equity financing—particularly in a bear market—can do less. Already, Dynegy, NRG and others have said they will slow devel-

opment projects. If enough follow, it could put the nation in a tight spot when the recession ends and energy demand surges.

It was a point made in a recent analyst call by Calpine Chairman Pete Cartwright. "We're building a portfolio of the best plants it's possible to build with a working life of 40 years or more," he said, with evident exasperation at souring investor perceptions of his company's health. "America needs this power."

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# STANDARD & POOR'S **CREDITWEEK** EPRINT

THE AUTHORITY ON CREDIT QUALITY MAY 24, 1993

## BUY VERSUS BUILD DEBATE REVISITED

*"Regardless of whether a utility buys or builds, adding capacity means incurring risk."*

The debate over purchased power, or the "buy versus build" controversy, will likely continue to rage as state utility regulators grapple with the implications of the National Energy Policy Act of 1992. As part of this sweeping legislation, state regulators must consider the potential impact on utilities' cost of capital from purchasing power.

Compared with the last baseload construction cycle, which is universally acknowledged to have been a disaster for investor-owned utilities, buying power from others appears substantially less risky than building new capacity. However, the electric utility industry's entire approach to supply-side resource additions has undergone radical transformation, to the point where it is now impossible to generalize about whether utility bondholders are better off if their utility buys or builds. The important thing is that both resource strategies have inherent risks. S&P employs a methodology for evaluating the benefits and risks of purchased power, and for adjusting a purchasing utility's reported financial statements to allow for more meaningful comparisons with traditional utilities.

**Table 1**  
Determining the risk factor

The risk factor chosen is a function of a subjective (not arbitrary) analysis of qualitative risks.

<b>Market</b>	Need for power Economics
<b>Operating</b>	Performance standards Reliability Dispatchability Control over maintenance Flexibility and diversity
<b>Regulatory</b>	Preapproval Regulatory recovery mechanisms Regulatory out clause

### BENEFITS OF PURCHASING POWER

Buying power may be the best choice for a utility that faces increasing demand. Moreover, purchasing may be the least risky course. The benefits of purchasing can be quite compelling. For example, utilities that purchase avoid the risks of significant construction cost overruns or

that the plant might never be finished at all. They also may avoid the associated financial stress caused by regulatory lag typical in building programs.

In addition, utilities that purchase power avoid risking substantial capital. There are many examples of utilities that have failed to earn a full return on and of capital employed to build a plant. Furthermore, purchased power may contribute to fuel-supply diversity and flexibility, and may be cheaper, at least over the short run. Utilities that meet demand expectations with a portfolio of supply-side options also may be better able to adapt to future demand uncertainty, given the specter of retail transmission access.

Nevertheless, in the buy-versus-build debate it is important that appropriate comparisons are made. A properly designed building program may avoid many of the risks associated with the unfortunate baseload program of the 1970s and early 1980s. A utility could:

- Build a plant using a fixed-price, turnkey construction contract;
- Construct with a modular approach, adding small units incrementally as demand expectations solidify;
- Obtain regulatory preapproval;
- Receive a cash return on construction work in progress to ease financing stress; and
- Finance the asset with a large portion of equity, providing a cushion for bondholders.

### PURCHASES ARE NOT RISK-FREE

Regardless of whether a utility buys or builds, adding capacity means incurring risk. To the extent that there are any risks with purchased power, bondholders are directly threatened because there is no equity layer to protect them. Utilities are not compensated for any risks they assume in purchasing power. At best, purchased power is recovered dollar-for-dollar as an operating expense, so there is no markup to reward equity holders for taking risks.

When a utility enters into a long-term purchased power contract with a fixed-cost component, it takes on financial risk. Heavy fixed

**CREDIT COMMENT**

charges reduce a utility's financial flexibility, and long-term contractual arrangements represent—at least in part—off-balance-sheet debt equivalents. Utilities need to take these "financial externalities" into account so that buy and build options are evaluated on a level playing field.

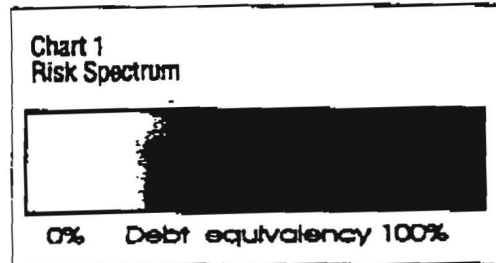
S&P has developed a methodology to quantify this financial risk and adjust financial statements to make traditional utilities and purchasing utilities comparable. S&P's approach is unique because it folds our qualitative analysis into our quantitative methodology. S&P begins by determining the potential off-balance-sheet obligation. This is done by calculating the present value of the capacity payments to be made over the life of the contract, discounted at 10%. The capacity payment is the fixed portion of the purchased power expense. It covers fixed costs, including debt service, depreciation, and a return on equity. S&P is concerned about the total fixed payment, not simply the debt service portion: the utility is obligated to pay the whole amount, not just a part. This means S&P is relatively indifferent to how the nonutility generator is capitalized, except in the extreme case where vast overleveraging threatens the viability of the project.

S&P does not stop with the potential debt equivalent. S&P recognizes that not all obligations have the same characteristics. What is true of other off-balance-sheet liabilities also is true of purchased power: some are more firm and therefore more debt-like than others.

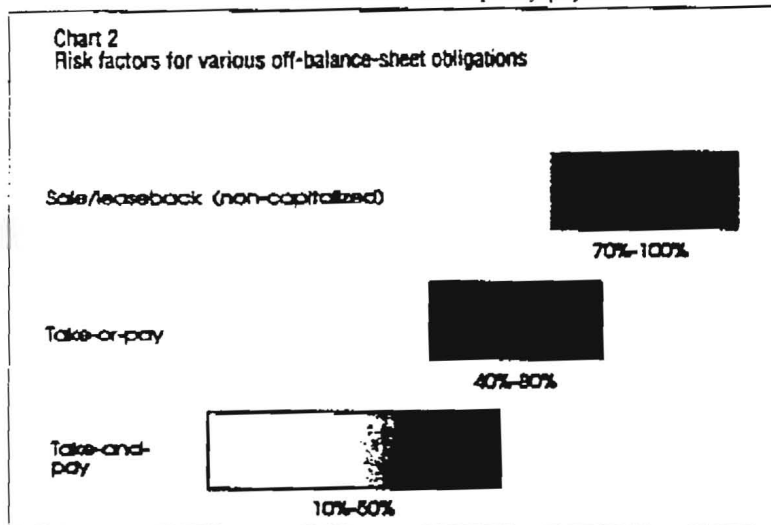
This concept of the difference in the relative debt characteristics of purchased power obligations can be illustrated by using the concept of a risk spectrum (see chart 1). A risk spectrum is simply a range from 0% to 100%. Obligations on the low end of the scale would have fewer debt-like characteristics and would be considered less firm than the obligations judged to fall on the high end of the scale. This spectrum is important because the place where an obligation falls on the scale—what S&P calls the risk factor—will determine what portion of the obligation S&P will add to a utility's reported debt. For example, if S&P determines that the risk factor for an obligation is 20%, S&P adds 20% of the potential debt equivalent to reported debt.

Different off-balance-sheet obligations have different risks (see chart 2, which shows various types of off-balance sheet obligations and where S&P believes they might fall on the risk spectrum scale). Sale/leasebacks of major plants are viewed as the virtual equivalent of debt, due to the strategic importance of these major electric generating facilities and the "hell-or-high-water" nature of the lease commitments.

Obligations under take-or-pay contracts, which are unconditional as to both acceptance and availability of power, are considered quite firm. The extreme case would be a unit-specific purchase of expensive nuclear capacity under a firm take-or-pay arrangement. Here, the risk factor might be as high as 70%-80%. Take-and-pay contracts, which require capacity payments only if power is available, are considered the least debt-like of the three types of obligations listed in chart 2 because take-and-pay capacity payments are conditional. In practice, the risk factors for take-and-pay performance contracts are generally in the 10%-20% range, although some may be as high as 50%.



In virtually all cases, S&P has access to—and utilizes—actual capacity payments. In the rare instance where they are not available or where capacity and energy payments are not broken out—such as in an energy-only contract—S&P will estimate the capacity payment.



**DETERMINING THE RISK FACTOR**

How does S&P determine the risk factor or the place where an obligation falls on the risk spectrum? S&P's assessment of the risk factor reflects our analysis of the risks a utility incurs when purchasing power under contract. This depends on a qualitative analysis of market, operating, and regulatory risks. It also depends on S&P's evaluation of the extent to which these risks are borne by the utility. The analysis is subjective, but not arbitrary (see table 1 for some of the key factors under each broad risk category). Depending on circumstances, the utility may bear substantial risks, or it may have successfully shifted risks to either the ratepayers or to the nonutility generator provider of the power.



**CREDIT COMMENT**

Lower risk factors would be appropriate if:

- The power is economic and needed,
- True performance standards exist,
- A project has operated reliably,
- The utility has a say in the scheduling of maintenance and retains control over dispatch,
- A contract is preapproved by regulators,
- Capacity payments are recovered through a fuel-clause type mechanism, and
- A regulatory out clause passes disallowance risk to the power seller.

The absence of these qualitative risk mitigators would lead toward the higher end of the risk spectrum and a higher risk factor.

**ADJUSTMENTS TO FINANCIAL STATEMENTS**

Once S&P has determined what the risk factor is through a qualitative evaluation, S&P then adjusts the utility's financial statements. The procedure to adjust debt is to take the present value of future capacity payments discounted at 10%. The 10% discount factor was chosen to approximate a utility's average cost of capital. The result—the potential debt equivalent—would be multiplied by the risk factor. That result would be added to the utility's reported debt. To adjust the traditional pretax interest coverage ratio, S&P would take 10% of the adjustment to debt. A typical example of the adjustment process is shown below.

**ABC POWER CO. EXAMPLE**

To illustrate the financial adjustments, consider the hypothetical example of ABC Power Co. buying power from XYZ Cogeneration Venture. Under the terms of the purchased power contract, annual capacity payments made by ABC Power

**Table 2**  
ABC Power Co. adjustment to capital structure  
(Mil. \$ at year-end 1992)

	Original capital structure		Adjusted capital structure	
	\$	%	\$	%
Debt	1,400	54	1,400	49
Adjustment to debt	—	—	265	9
Preferred stock	200	8	200	7
Common equity	1,000	38	1,000	35

start at \$115 million in 1993, rise by \$5 million per year to \$135 million by 1997, and remain fixed through the expiration of the purchased power contract in 2023. The net present value of these obligations over the life of the contract discounted at 10% is \$1.3 billion.

**Table 3**  
ABC Power Co. adjustment to pretax interest coverage  
(Mil. \$ year-end 1992)

	Orig. pretax int. cov.		Adj. pretax int. cov.	
Net income	120		300	
Income taxes	65	300	+27	
Interest expense	115	115	115	2.3x
Pretax available	300		+27	
Interest associated with adjusted debt = \$265 million x 10%				

In the case of XYZ, S&P chose a 20% risk factor, which, when multiplied by the potential debt equivalent, resulted in a figure of \$265 million. The risk factor is chosen based on qualitative analysis of the purchased power contract itself and the extent to which market, operating, and regulatory risks are borne by the utility.

Table 2 shows the adjustment to ABC Power's capital structure. S&P takes \$265 million, which is the net present value of the future capacity payments multiplied by a 20% risk factor, and adds it to ABC Power's actual debt of \$1.4 billion at year-end 1992. As illustrated in table 2, ABC Power's adjusted debt leverage is 58%, up from 54%.

Table 3 illustrates that ABC Power's pretax interest coverage for 1992, without adjusting for off-balance-sheet obligations, was 2.6 times (x), which is calculated by dividing the sum of net income, income taxes, and interest expense by interest expense. To adjust for the XYZ capacity payments, the \$265 million debt adjustment is multiplied by a 10% interest rate to arrive at \$27 million. When this is added to both the numerator and denominator, adjusted pretax interest coverage falls to 2.3x.

**EFFECT ON RATINGS**

The purchased power issue is somewhat complex, but S&P strongly believes that certain purchased power contracts are less risky than others, and that these subtle differences must be factored into the analysis. S&P combines qualitative analysis with the traditional present value approach. The result is an adjustment to debt that is understandable and useful, particularly in the regulatory process, since the adjusted ratios S&P derives are the ones on which S&P ratings are based.

Over the past few years, several ratings have been lowered due to purchased power obligations. In other cases, S&P did not raise ratings. Still others are lower than they might otherwise be owing to purchased power liabilities.

S&P anticipates some rating downgrades of electric utilities over the next couple of years. However, much will depend on how utilities and regulators respond to S&P's analysis.

Utilities can offset purchased power liabilities in several ways, including higher returns on equity or higher equity components in capital structures. Another possibility might be some type of incentive return mechanism.

As competition increases in the electric utility industry, power supply strategies will grow more complex. Consequently, a utility's purchased power obligations must be evaluated in a broader framework than the one this article addresses.

The simple truth is that a utility can build all of its own plants, finance them with a balanced mix of equity and debt, put them into rate base without a disallowance, and still find itself in trouble if its rates are not competitive. Consequently, the buy-

**CREDIT COMMENT**

versus-build debate must be viewed within the larger context of a utility's competitive position.

There are many benefits to purchasing power. Indeed, purchasing may be the least risky strategy, but it is not risk-free. S&P's methodology quantifies the risks by explicitly recognizing the key qualitative factors of markets, operations,

and regulation. S&P analyzes contracts to determine who is taking the risk: the nonutility generator, the utility, or the ratepayer. S&P recognizes that these adjustments must be viewed within the larger context of a utility's competitive position.

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