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November 3, 2011

Ms. Ann Cole, Commission Clerk
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee FL 32399-0850



A SOUTHERN COMPANY

COMMISSION
CLERK

NOV - 4 PM 12: 14

RECEIVED FPSC

VIA HAND DELIVERY

RE: Docket No. 110318-EI ^{* 138} (88)

Dear Ms. Cole:

Enclosed for official filing on behalf of Gulf Power Company (Gulf) in the above referenced docket are an original and fifteen (15) copies of the Rebuttal Testimony and Exhibits of the following Gulf Witnesses:

- R. Scott Teel 08150-11
- James H. Vander Weide, Ph.D 08151-11
- Michael J. Vilbert, Ph.D. 08152-11
- Rhonda J. Alexander 08153-11
- Raymond W. Grove 08154-11
- P. Bernard Jacob 08155-11
- P. Chris Caldwell 08156-11
- R. Scott Moore 08157-11
- Constance J. Erickson 08158-11
- Margaret D. Neyman 08159-11
- James I. Thompson 08160-11
- Richard J. McMillan 08161-11
- Stacy R. Kilcoyne 08162-11
- David J. Wathen 08163-11
- J. Terry Deason 08164-11

Sincerely,

Susan D. Ritenour

- 5 COM
- 1 APA
- 5 ECR
- 1 GCL
- 1 MAD
- 1 SRC
- ADM
- OPC
- CLK
- 1 Ct Rpr

Enclosures

cc: Beggs & Lane
Jeffrey A. Stone, Esq.

DOCUMENT NUMBER-DATE

* DOCKET # CORRECTED + INITIALED 08150 NOV-4 =
BY FAITH GRIDLEY

FPSC-COMMISSION CLERK

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

IN RE: Petition for Increase in Rates)
by Gulf Power Company)
)
)
_____)

Docket No. 110138-EI

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true copy of the foregoing was furnished by overnight delivery the 4th day of November, 2011, on the following:

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**BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION**

DOCKET NO. 110138-EI

**REBUTTAL TESTIMONY AND EXHIBIT
OF
R. SCOTT TEEL**



DOCUMENT NUMBER-DATE

08150 NOV-4 =

FPSC-COMMISSION CLERK

1 GULF POWER COMPANY

2 Before the Florida Public Service Commission
3 Rebuttal Testimony and Exhibit of
4 R. Scott Teel
5 Docket No. 110138-EI
6 In Support of Rate Relief
7 Date of Filing: November 4, 2011

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

9 A. My name is Scott Teel. My business address is One Energy Place,
10 Pensacola, FL 32520, and I am Vice President and Chief Financial Officer
11 (CFO) of Gulf Power Company (Gulf or the Company).

12 Q. Did you file direct testimony in this docket?

13 A. Yes.

14 Q. What is the purpose of your rebuttal testimony?

15 A. The purpose of my testimony is to demonstrate that the return on equity
16 recommended by Federal Executive Agencies (FEA) witness Gorman is
17 not supportive of Gulf's credit ratings. I also respond to a statement by
18 Office of Public Counsel (OPC) witness Dismukes regarding the benefits
19 non-regulated affiliates of Gulf Power receive from their association with
20 the regulated operating companies.

21 Q. Are you sponsoring any rebuttal exhibits?

22 A. Yes. I am sponsoring Exhibit RST-2, consisting of Schedules 1, 2 and 3.
23 Exhibit RST-2 was prepared under my supervision and direction, and the
24

25

1 information contained in that exhibit is true and correct to the best of my
2 knowledge and belief.

3

4 Q. Do you agree with Mr. Gorman's evaluation of the effect of his
5 recommended return on equity of 9.75% on Gulf Power's bond ratings?

6 A. No. Based on his analysis of financial credit metrics utilized by Standard
7 & Poor's, Mr. Gorman concludes that his recommended return on equity
8 would be supportive of an investment grade bond rating and Gulf's
9 "current 'BBB' bond rating." [Gorman at 41] Mr. Gorman uses the wrong
10 credit ratings as the basis of his analysis, and his analysis is too limited to
11 reach any conclusions regarding the effect his recommended return on
12 equity would have on Gulf's credit ratings.

13

14 Q. What are investment grade bond ratings?

15 A. Ratings in the BBB category and higher for Standard & Poor's and Fitch,
16 and ratings in the Baa category and higher for Moody's are considered
17 investment grade. Schedule 5 of Exhibit RST-1 to my direct testimony
18 depicts the ratings scales of each of the three agencies.

19

20 Q. What are Gulf's current bond ratings?

21 A. Contrary to Mr. Gorman's statement, Gulf does not have a BBB rating.
22 Standard & Poor's rates Gulf Power's long-term debt as A, while Fitch and
23 Moody's ratings are A and A3, respectively. Schedule 4 of Exhibit RST-1
24 to my direct testimony depicts Gulf Power's current credit ratings.

25

1 Q. What credit ratings does Gulf target?

2 A. Gulf targets A ratings for its long-term debt, specifically A ratings by
3 Standard and Poor's and Fitch, and A2 by Moody's. Gulf targets
4 equivalent ratings for its short-term debt, A-1 by Standard & Poor's and F1
5 by Fitch. Moody's does not rate Gulf Power's short-term debt.

6

7 Q. Does an investment grade rating meet Gulf's target?

8 A. No. The thresholds for an investment grade rating are BBB- for Standard
9 & Poor's and Fitch, and Baa3 for Moody's. These ratings fall well below
10 Gulf's target ratings.

11

12 Q. Is it necessary to maintain Gulf's targeted ratings?

13 A. Yes. As explained in more detail in my direct testimony, maintaining these
14 targeted ratings is critical for Gulf and its customers. Strong credit ratings
15 ensure access to capital even during troubled financial markets and allow
16 Gulf to provide reliable service to its customers at the lowest financing
17 costs possible.

18

19 Q. Is Mr. Gorman's evaluation of the potential impact of his recommended
20 rate of return on Gulf's credit ratings complete?

21 A. No. Mr. Gorman's evaluation is limited to only one of the three credit
22 rating agencies. More importantly, it does not consider all of the qualitative
23 factors which are key drivers of a utility's credit ratings. Most notably, Mr.
24 Gorman does not consider the impact his recommended rate of return

25

1 could have on the rating agencies' assessment of the regulatory
2 environment in Florida.

3
4 Q. Is the regulatory environment an important consideration of the rating
5 agencies?

6 A. Yes. All three of the major credit rating agencies place significant
7 importance on a utility's regulatory environment. Moody's credit opinion
8 on Gulf Power dated August 13, 2010, issued when Moody's downgraded
9 Gulf's long-term debt rating from A2 to A3, cites the "recently perceived
10 decline in utility's political and regulatory environment" as a rating driver.
11 See Schedule 7 of Exhibit RST-1 to my direct testimony for a copy of this
12 credit opinion.

13
14 In its report on Gulf Power dated October 5, 2010, Fitch states the
15 "continuation of strong regulatory support is important for Gulf to maintain
16 its credit quality and current ratings." See Schedule 8 of Exhibit RST-1 to
17 my direct testimony for a copy of this credit opinion.

18
19 Standard & Poor's, in its March 11, 2010 report entitled "Assessing U.S.
20 Utility Regulatory Environments," states:

21 [T]he assessment of regulatory risk is perhaps the most
22 important factor in Standard & Poor's Ratings Services'
23 analysis of a U.S. regulated, investor-owned utility's
24 business risk. Each of the other four factors we examine—
25 markets, operations, competitiveness, and management —

1 can affect the quality of the regulation a utility experiences,
2 but we believe the fundamental regulatory environment in
3 the jurisdictions in which a utility operates often influences
4 credit quality the most.

5 See Schedule 1 of my rebuttal Exhibit RST-2 for a copy of this report.

6

7 Q. How could Mr. Gorman's recommended rate of return affect assessments
8 of the regulatory environment?

9 A. The rate of return is an important factor in the assessment of the
10 regulatory environment. Fitch explicitly cites "below-average allowed
11 return on equity" in recent decisions in Florida in its report on Gulf Power,
12 dated October 5, 2010. Standard & Poor's, in its report "Key Credit
13 Factors: Business And Financial Risks In The Investor-Owned Utilities
14 Industry", issued on November 26, 2008, states the "[E]valuation of
15 regulation focuses on the ability of regulation to provide utilities with the
16 opportunity to generate cash flow and earnings quality and stability
17 adequate to: meet investment needs; service debt and maintain a
18 satisfactory rating profile; and generate a competitive rate of return to
19 investors." See Schedule 8 of Exhibit RST-1 to my direct testimony for a
20 copy of Fitch's credit opinion. A copy of the Standard & Poor's report is
21 attached as Schedule 2 of my rebuttal Exhibit RST-2.

22

23

24 As discussed in my direct testimony, both Moody's and Fitch have
25 expressed concerns about the regulatory environment in Florida. While

1 Fitch “expects the regulatory climate in Florida to slowly return to normal
2 after this election year and as the state’s economy slowly begins to
3 recover,” Moody’s recognized the “Florida Public Service Commission is
4 entering a period of substantial uncertainty...”

5
6 More recently, in its report dated August 12, 2011, Moody’s states that
7 “the political and regulatory environment for investor-owned utilities in
8 Florida has largely stabilized”; however, they did not upgrade their score
9 of Baa for Regulatory Framework, the qualitative factor providing 25% of
10 the weighting for their credit ratings. This score was downgraded
11 following recent rate case decisions, citing the state as being “substantially
12 less supportive of credit quality than it had been previously.”

13
14 Moody’s notes that “Gulf Power’s base rate case will also be the first one
15 to be addressed by a newly constituted FPSC and may give an indication
16 of the future direction of utility regulation in Florida.” Moody’s also cites
17 an unsupportive outcome in this case as a factor that could lead to
18 another downgrade. See Schedule 3 of my rebuttal Exhibit RST-2 for a
19 copy of this report.

20
21 An authorized rate of return below the return required by investors would
22 increase the concerns of the ratings agencies about the regulatory
23 environment in Florida.

24
25

1 Q. Are you aware of any other assessments of the regulatory environment in
2 Florida?

3 A. Yes. Regulatory Research Associates (RRA) rates the various states on
4 their regulatory climate. In its August 2011 release, RRA noted that
5 Florida historically had been one of the most stable and constructive state
6 regulatory environments from an investor viewpoint. It cited the recent
7 FP&L and Progress rate decisions in early 2010 as factors that led it to
8 lower its regulatory assessment of the Commission by two steps on its
9 rating scale, from the middle of the "Above Average" range to the top of
10 the "Average" range.

11
12 Q. Will Mr. Gorman's recommended return on equity be supportive of Gulf's
13 targeted credit ratings?

14 A. No. Mr. Gorman's recommended rate of return would be detrimental to
15 the rating agencies' assessment of Gulf Power's regulatory environment, a
16 key factor in determining credit ratings. This could heighten the risk of a
17 downgrade that would adversely affect Gulf's customers by making it more
18 difficult or more costly for Gulf to access the capital markets to support the
19 investment required to continue to provide them with reliable service.

20
21 Q. Ms. Dismukes' testimony may be interpreted to state that Southern
22 Company's non-regulated affiliates receive benefits to their credit ratings
23 from being associated with the regulated operating companies. Is this
24 correct?

25

1 A. No. Southern Power Company (SPC) is the only non-regulated affiliate of
2 Southern Company that is rated by the credit rating agencies. None of the
3 rating agencies incorporate Southern Company, or its subsidiaries, into
4 their ratings of SPC. SPC is evaluated and rated independently of both
5 the parent company and the core regulated electric utility companies.

6

7 Q. Please summarize your rebuttal testimony.

8 A. Mr. Gorman's conclusion that his recommended rate of return would be
9 supportive of an investment grade bond rating and allow Gulf to maintain
10 "its current BBB utility bond rating" is wrong for several reasons. First, he
11 is mistaken about Gulf's current credit ratings and considers an
12 investment grade rating a sufficient rating. Second, his opinion relies
13 solely on an analysis of financial metrics and considers only one of the
14 three credit rating agencies. Third, and most importantly, he does not
15 consider the qualitative impact on Gulf's credit ratings of a regulatory
16 decision which awarded Gulf only his recommended return on equity.

17

18 Additionally, I clarify that the credit rating agencies, in their assessment of
19 Southern Power, Gulf's non-regulated affiliate, do not consider its
20 affiliation with Gulf and its regulated sister companies.

21

22 Q. Does that conclude your testimony?

23 A. Yes.

24

25

AFFIDAVIT

STATE OF FLORIDA)
)
COUNTY OF ESCAMBIA)

Docket No. 110138-EI

Before me the undersigned authority, personally appeared Richard Scott Teel, who being first duly sworn, deposes, and says that he is the Vice President and Chief Financial Officer of Gulf Power Company, a Florida corporation, that the foregoing is true and correct to the best of his knowledge, information, and belief. He is personally known to me.

The signed original affidavit is attached to the original testimony on file with the FPSC.

s/ _____
Richard Scott Teel
Vice President and Chief Financial Officer

Sworn to and subscribed before me this _____ day of _____,
2011.

Notary Public, State of Florida at Large
Commission No. _____
My Commission Expires _____

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March 11, 2010

Assessing U.S. Utility Regulatory Environments

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08150 NOV-4 = 11/04 2009

FPSC-COMMISSION CLERK

Assessing U.S. Utility Regulatory Environments

(Editor's Note: For our latest comments on regulated utility subsidiaries, please see "Methodology: Differentiating The Issuer Credit Ratings Of A Regulated Utility Subsidiary And Its Parent," published March 11, 2010, on RatingsDirect.)

The assessment of regulatory risk is perhaps the most important factor in Standard & Poor's Ratings Services' analysis of a U.S. regulated, investor-owned utility's business risk. Each of the other four factors we examine--markets, operations, competitiveness, and management--can affect the quality of the regulation a utility experiences, but we believe the fundamental regulatory environment in the jurisdictions in which a utility operates often influences credit quality the most. In our credit analysis, we evaluate regulatory risk on a company-specific basis. A utility management's skill in managing regulatory risk can in many cases overcome a difficult regulatory environment. Conversely, other companies can experience greater regulatory risk even with supportive regulatory regimes if management fails to devote the necessary time and resources to the important task of managing regulatory risk. Operating in a state with a regulatory structure that is conducive to maintaining credit quality will improve the chances for a utility to successfully negotiate the regulatory maze.

This commentary discusses our views on what constitutes a favorable regulatory climate. We then use those factors to create assessments of the regulatory environments in states that regulate the electric and gas utilities that we rate. (See the table at the end of this article.) Our intention is to provide a common base for our own analysis of regulatory risk and to better communicate to investors, issuers, and regulators how various elements of regulation can affect credit quality. The exercise is also expected to enhance our ability to evaluate management by highlighting instances where our opinion of a company's regulatory risk diverges significantly from the fundamental quality of the regulatory jurisdictions where it operates.

The assessments of relevant jurisdictions are based on quantitative and qualitative factors. Importantly, we make our assessments from a credit perspective. We plan to update them annually or when significant events occur that have an important impact on the regulatory climate in a particular jurisdiction. The new regulatory assessment information augments the methodology applied to regulated utilities today.

Our introduction of these regulatory assessments coincides with what we view as the increasing influence of regulatory matters on the rated utilities' risk profiles and greater credit market awareness of the importance of understanding the regulatory process. Our goal in explaining our views on regulatory practices and policies and their effect on Standard & Poor's analysis of the credit quality of utilities is to provide additional transparency to the market.

Background

State utility regulation is almost as old as credit ratings. Standard & Poor's predecessor, Standard Statistics Bureau, was formed in 1906, and the first state utility commissions, as we know them today, appeared in 1907. Regulation has always been a factor in Standard & Poor's analysis of utility ratings, but its importance to our analysis has shifted with industry trends over time.

Before the 1970s, regulators presided for the most part over stable or decreasing rates as economic growth, rising consumption, and economies of scale drove costs down. The advent of inflation, rising and volatile fuel costs, and

Assessing U.S. Utility Regulatory Environments

nuclear power missteps led to higher rates and, in our view, greater regulatory influence on credit quality during the 1980s. Restructuring in the natural gas and then the electric industries marked the 1990s and the first years of the new millennium, and the importance of regulatory issues in our analysis again started to subside. In our view, we are now in another era of increasing and unstable costs and some semblance of a return to traditional utility regulation. Consequently, the quality of regulation is at the forefront of our analysis of utility creditworthiness.

We have historically focused on regulatory risk on a company-specific basis. Nothing in what follows will change that approach. Utility commissions regulate diverse industries and adopt different approaches to different types of businesses. Treatment of utilities within the same industry can vary significantly in the same jurisdiction. The quality of the regulation experienced by a company is often the product of the company's management and business strategy as much as its regulators. The regulatory climate assessments only serve as a baseline of our opinion on the fundamental attitude of a jurisdiction toward the credit quality of the utilities in that state, and they are the starting point for Standard & Poor's analysis of the regulatory risk of each rated utility. Our goal is to achieve greater consistency and continuity in utility ratings.

Assessing Regulatory Jurisdictions

We assess jurisdictions on one basic attribute--the fundamental approach to controlling utility rates--and then in three major categories. The resulting assessments are based primarily on various measures of regulatory risk that are discussed briefly below. With respect to qualitative factors, we look for long-term, historical characteristics of the jurisdiction, as well as transient regulatory and political developments.

The foundation of our opinion of the regulation in a jurisdiction is the degree to which competitive market forces are allowed to influence rates. In order of credit-friendliness, a state will rely either on full cost-based regulation for all components of the utility bill, market-based mechanisms for generation, and (more rarely) retail markets, or a hybrid of the two to control the amount charged and the terms on which that service is offered. It may surprise some to learn that we consider a hybrid setup, which in most cases exists because the transition to some sort of competition has stalled, to harbor more risk for bondholders than a system that is committed to letting market prices set a major part of the customer's bill.

The risk inherent in the market-based model is straightforward: the price for electricity can be more volatile when based on a market than when it is based on embedded costs, and regulators are apt to resist full and timely recovery when changes in generation costs are abrupt and substantial (and perhaps misunderstood). The risks in a hybrid or transitional model are less apparent, but, in our opinion, potentially more significant. First, we consider the uncertainty of the timing of reaching the end state--and what that end state will look like--to be a negative factor from a credit perspective. Second, in some cases, the hybrid model may result in a "lower-of-cost-or-market" approach that allows generation rates to reflect one or the other at different times depending on which one suits ratepayers best. A utility and its bondholders may then face a prolonged period of potential exposure to market risk (the downside) with little or no opportunity to participate in the benefits of competition (the upside of greater returns).

After identifying the fundamental regulatory paradigm, our analysis turns to factors that influence the utility's business risk climate in the jurisdiction. The factors fall into three broad categories: ratemaking, political environment, and financial stability. Broadly speaking, the ratemaking and financial stability factors influence our assessments more than the paradigm and political factors.

Ratemaking Practices And Procedures

The main, and often the most contentious, task of a regulator is to set the rates a utility may charge its customers. We analyze specific rate decisions as part of the surveillance of each utility. Our regulatory assessments focus on the jurisdiction's overall approach to setting rates and the process it uses to conduct and manage base rate filings. Practices pertaining to separate tariff clauses for large expense items are examined in the third category of the analysis (see below). In this part of the assessment, we concentrate on whether established base rates fairly reflect the cost structure of a utility and allow management an opportunity to earn a compensatory return that provides bondholders with a financial cushion that promotes credit quality.

Notably, the analysis does not revolve around "authorized" returns, but rather on actual earned returns. We note the many examples of utilities with healthy authorized returns that, we believe, have no meaningful expectation of actually earning that return because of rate case lag, expense disallowances, etc. Although, in general, the absolute level of financial returns is less important to our analysis than how that return is earned, we recognize that, all else being equal, higher earned returns translate into better credit metrics and a more comfortable equity cushion for bondholders. A regulatory approach that allows utilities the opportunity to consistently earn a reasonable return is a positive factor in our view of credit quality.

The rates of return and capital structures used to generate the revenue requirement in rate proceedings may not be the primary focus of the assessment, but those and other decisions made in the ratemaking process are still noted. We consider those decisions to be potential signals from regulators on their attitude toward credit quality. We believe that the capital structure in particular is a handy and direct indication from the regulator as to whether or not creditworthiness is an important consideration in its deliberations when setting rates. Obviously, any pronouncements from a regulator that explicitly address credit ratings or ratemaking practices that incorporate credit-minded adjustments (e.g., the use of double-leveraged capital structures or off-balance-sheet debt-like obligations) are considered in the Standard & Poor's assessment.

We analyze the issue of "regulatory lag" in a comprehensive manner and not just as a matter of the efficiency of the regulator in completing rate cases. As part of this analysis, we evaluate the timeliness of rate decisions, coupled with an evaluation of the rest year. In addition, we take into account the timing of interim rates, and other practices that affect the appropriateness of rates periodically established by the regulator. We do not view the issue of regulatory lag as an intermittent concern, consequential only during times of acute inflation or rising capital spending, but as a consistent part of our credit analysis. Accordingly, in our regulatory assessments we focus on whether the regulator efficiently prosecutes rate requests and bases its decisions with respect to rate setting on the most current information.

In our view, the prevalence of rate case settlements is not necessarily an important credit consideration. Although the common assumption among market participants seems to be that a settlement must be in the best interest of a utility, we believe this assumption disregards the possibility that management will sometimes make decisions based on its effect on earnings at the expense of cash flow considerations. This does not mean we dismiss the ability of stipulations to reach a fair resolution of difficult matters that help regulators issue timely and constructive rate decisions. It just means that frequent settlements do not, in our view, directly lead to a conclusion that the regulatory environment in a state enhances credit quality.

An important policy-related issue outside of individual rate cases that falls under this part of the assessment is the

regulatory oversight of large capital projects with long lead times that carry out-sized risks to a utility and its bondholders. In our opinion, practices such as legislative or regulatory recognition of the need for pre-approval of such endeavors, periodic reviews that substantively involve the regulator in the progress of the project, and rolling prudence determinations during construction can reduce the general level of risk associated with a utility committing substantial capital well in advance of the rate proceeding that results in the project being placed into rate base. Before committing to such projects, a resource-procurement process that uses objective guidelines to evaluate competing proposals to meet load obligations and keeps the regulator informed and involved in the decisions can, in our view, help to reduce the risk of subsequent disallowances. If the jurisdiction has an Integrated Resource Plan or similar mechanism that includes the participation of many parties and is used to definitively establish the need for new generation, we consider credit risk to be further diminished.

One more factor that we examine in this part of the analysis is whether a jurisdiction employs nontraditional ratemaking practices. Examples of what we may view to be potentially credit-enhancing regulatory mechanisms include weather normalization and incentive ratemaking. We believe that the beneficial effect on credit quality of a tariff clause that smooths out cash flows that can vary with outside influences like weather is self evident. The benefits of incentives incorporated into the regulatory regime may be less clear. Well-designed incentives can be at least credit neutral. A moderate amount of incentives can be credit supportive. We generally view incentive provisions (whether tied to cost control, reliability, or operational performance) as being beneficial for credit quality if they are linked to fair and objective benchmarks. Incentives that lack some or all of those features, such as a plain, long-term rate freeze, can be, in our opinion, detrimental to credit quality.

Political Insulation

The role of politics in utility regulation is often misunderstood. In most jurisdictions, legislatures created regulatory commissions and invested them with the power to set and enforce utility rates and service standards. Regardless of how a regulatory commission is statutorily organized, its function is to set and regulate rates and service standards with due regard not only for the interests of those who advance the capital needed to provide safe and reliable utility service but for other constituents as well. In this regard, bondholders should recognize that the setting of utility rates invariably reflects political as well as economic factors. Therefore, the potential for political considerations to affect utility regulation can be a key determinant when we assess a regulatory jurisdiction.

A primary factor in this part of our assessment is the method of selecting utility commissioners. In some jurisdictions, the governors appoint regulatory commissioners. In others, the same voters who pay utility bills directly elect commissioners. The regulatory risk associated with that model can sometimes be managed, but there is an inherent level of risk in elected regulatory bodies that we reflect in the assessment. Standard & Poor's also analyzes the track record of the involvement of the executive branch or the legislature in utility matters, and the relative visibility of utility issues in the political arena.

The ability of a regulator to deliver sound, fair, and timely rate decisions and set prudent regulatory policies that assist utility managers in managing business and financial risk can be affected by the overall atmosphere that it operates in. The tone can be set by the governor or legislature, the history and tradition of independence accorded to the regulatory body, and the behavior of important constituent groups that intervene in utility proceedings.

Cash Flow Support And Stability

The final set of factors in our assessment of regulatory environments is arguably the most important. The phrase "cash is king" can be overused, but it does highlight an essential part of the credit analysis. A regulatory jurisdiction that recognizes the significance of cash flow in its decision making is one that will appeal to bondholders.

Generating cash is a function of the actions of utility management, but the regulator can supply (or withhold) the tools that can affect the company's essential ability to actually realize the intended level of cash flow.

The most prominent factor in this part of the analysis is the application of separate tariff provisions for major expenses such as fuel and purchased power. The timely adjustment of rates in response to changing commodity prices and other expenses that are largely out of the control of utility management is a key component of a credit-enhancing regulatory jurisdiction. We analyze the quality of special tariff mechanisms to determine their effectiveness in producing the cash flow stability they are designed to achieve. The frequency of rate adjustments, the ability to quickly react to unusual market volatility, and the control of opportunities to engage in hindsight disallowances of costs could affect the analysis almost as much as whether the tariff provisions exist at all. The record of disallowances plays a part in the regulatory assessment.

The commission's policies and oversight covering hedging activities may also be a factor in this part of the review if a utility has sought regulatory approval. For utilities that attempt to manage commodity risks, we look for a clearly-stated hedging policy and a track record of activity that conforms to that policy. The responsibility for communicating the policy and demonstrating the prudence of the hedging activity rests with the utility, but the initial response to a hedging program and the history of the regulator's treatment of the results of the program could influence our assessment.

Regulators can employ other ratemaking techniques that promote stable cash flows. We consider a commission's decisions on rate design in assessing its attitude on credit quality. For example, we take into account the relative size of the typical monthly customer charge, a decoupling mechanism that severs the direct relationship between revenues and customer usage, or other rate design features that bolster credit quality.

Especially during upswings in the capital expenditure cycle, such as we are experiencing now, a jurisdiction's willingness to support large capital projects with cash during the construction phase is an important aspect of our analysis. This is especially true for ventures with big budgets and long lead times, such as baseload coal-fired or nuclear power plants and high-voltage transmission lines that are susceptible to construction delays. Allowance of a cash return on construction work-in-progress or similar ratemaking methods historically were considered extraordinary measures for use in unusual circumstances, but in today's environment of rising construction costs and possible inflationary pressures, cash flow support could be crucial in maintaining credit quality through the spending program.

Jurisdictional Assessments

The table below shows Standard & Poor's assessments of regulatory jurisdictions. The category titles are designed to communicate one other important point regarding utility regulation and its effect on ratings. All categories are denoted as "credit-supportive". To one degree or another, all U.S. utility regulation sustains credit quality when compared with the rest of corporate ratings at Standard & Poor's. The presence of regulators, no matter where in

Assessing U.S. Utility Regulatory Environments

the spectrum of our assessments, reduces business risk and generally supports all U.S. utility ratings.

Regulatory Jurisdictions For Utilities Among U.S. States				
Most credit supportive	More credit supportive	Credit supportive	Less credit supportive	Least credit supportive
	Alabama	Arkansas	Louisiana	Arizona
	California	Colorado	Maine	Delaware
	Florida	Connecticut	Missouri	Dist. of Columbia
	Georgia	Hawaii	Montana	Illinois
	Indiana	Idaho	New York	Maryland
	Iowa	Kansas	Oklahoma	New Mexico
	South Carolina	Kentucky	Rhode Island	
	Wisconsin	Massachusetts	Texas	
		Michigan	Utah	
		Minnesota	Vermont	
		Mississippi	Washington	
		Nevada	West Virginia	
		New Hampshire	Wyoming	
		New Jersey		
		North Carolina		
		North Dakota		
		Ohio		
		Oregon		
		Pennsylvania		
		South Dakota		
		Virginia		

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November 26, 2008

Criteria | Corporates | Utilities:

Key Credit Factors: Business And Financial Risks In The Investor-Owned Utilities Industry

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(Editor's Note: This criteria article was originally published on Nov. 26, 2008. We are republishing this article following our periodic review completed on Oct. 28, 2010. This article supersedes the articles titled, "Influence Of Regulatory And Policy Decisions On Utility Credit Quality Deepens, Demanding Timely Assessments From Standard & Poor's," published May 15, 2007, and "Keys To Success For U.S. Electricity Transmission And Distribution Companies," published March 11, 2004. Tables 1, 2, and 3 in this article are no longer current. They have been superseded by the table found in "Criteria Methodology: Business Risk/Financial Risk Matrix Expanded," published May 27, 2009. For our latest comments on regulated utility subsidiaries, please see "Methodology: Differentiating The Issuer Credit Ratings Of A Regulated Utility Subsidiary And Its Parent," published March 11, 2010.)

Standard & Poor's Ratings Services' analytic framework for companies in all sectors, including investor-owned utilities, is divided into two major segments: The first part is the fundamental business risk analysis. This step forms the basis and provides the industry and business contexts for the second segment of the analysis, an in-depth financial risk analysis of the company.

An integrated utility is often a part of a larger holding company structure that also owns other businesses, including unregulated power generation. This fact does not alter how we analyze the regulated utility, but it may affect the ultimate rating outcome because of any higher risk credit drag that the unregulated activities may have on the utility. Such considerations include the freedom and practice of management with respect to shifting cash resources among subsidiaries and the presence of ring-fencing mechanisms that may protect the utility.

Relationship Between Business And Financial Risks

Prior to discussing the specific risk factors we analyze within our framework, it is important to understand how we view the relationship between business and financial risks. Table 1 displays this relationship and its implications for a company's rating.

Criteria | Corporates | Utilities: Key Credit Factors: Business And Financial Risks In The Investor-Owned Utilities

Table 1

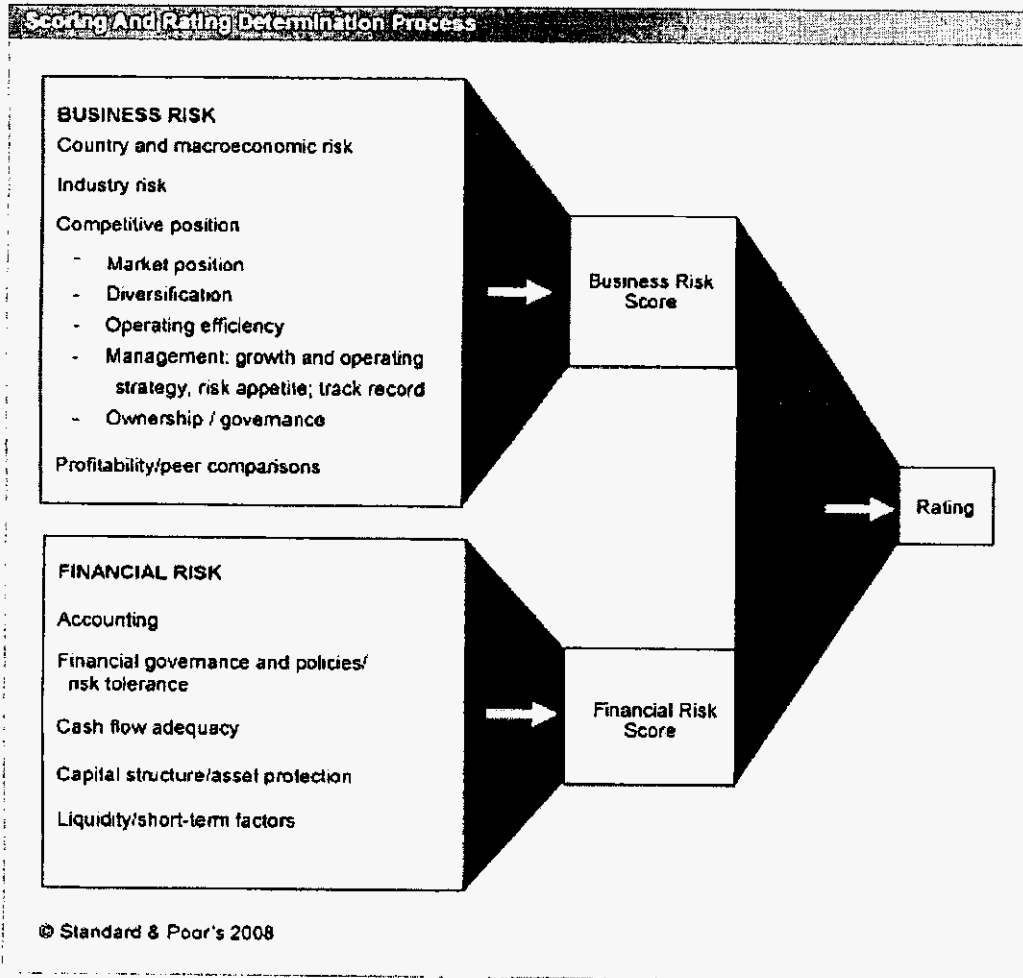
Business And Financial Risk Profile Matrix							
		Financial Risk Profile					
		Minimal	Moderate	Intermediate	Aggressive	Highly leveraged	
Business Risk Profile	Excellent	(AAA/AA)	AAA	AA	A	BBB	BB
	Strong	(A)	AA	A	A-	BBB-	BB-
	Satisfactory	(BBB)	A	BBB+	BBB	BB+	B+
	Weak	(BB)	BBB	BBB-	BB+	BB-	B
	Vulnerable	(B)	BB	B+	B+	B	B-

These rating outcomes are shown for guidance purposes only. Other qualitative and quantitative rating factors may override these measures.

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Chart 1 summarizes the ratings process.

Chart 1



Part 1--Business Risk Analysis

Business risk is analyzed in four categories: country risk, industry risk, competitive position, and profitability. We determine a score for the overall business risk based on the scale shown in table 2.

Table 2

Business Risk Measures	
Description	Rating equivalent
Excellent	AAA/AA
Strong	A
Satisfactory	BBB
Weak	BB
Vulnerable	B/CCC

Analysis of business risk factors is supported by factual data, including statistics, but ultimately involves a fair amount of subjective judgment. Understanding business risk provides a context in which to judge financial risk, which covers analysis of cash flow generation, capitalization, and liquidity. In all cases, the analysis uses historical experience to make estimates of future performance and risk.

In the U.S., regulated utilities and holding companies that are utility-focused virtually always fall in the upper range (Excellent or Strong) of business risk profiles. The defining characteristics of most utilities--a legally defined service territory generally free of significant competition, the provision of an essential or near-essential service, and the presence of regulators that have an abiding interest in supporting a healthy utility financial profile--underpin the business risk profiles of the electric, gas, and water utilities.

1. Country risk and macroeconomic factors (economic, political, and social environments)

Country risk plays a critical role in determining all ratings on companies in a given national domicile.

Sovereign-related stress can have an overwhelming effect on company creditworthiness, both directly and indirectly.

Sovereign credit ratings suggest the general risk local entities face, but the ratings may not fully capture the risk applicable to the private sector. As a result, when rating a corporation, we look beyond the sovereign rating to evaluate the specific economic or country risks that may affect the entity's creditworthiness. Such risks pertain to the effect of government policies and other country risk factors on the obligor's business and financial environments, and an entity's ability to insulate itself from these risks.

2. Industry business and credit risk characteristics

In establishing a view of the degree of credit risk in a given industry for rating purposes, it is useful to consider how its risk profile compares to that of other industries. Although the industry risk characteristic categories are broadly similar across industries, the effect of these factors on credit risk can vary markedly among industries. Chart 2 illustrates how the effects of these credit-risk factors vary among some major industries. The key industry factors are scored as follows: High risk (H), medium/high risk (M/H), medium risk (M), low/medium risk (L/M), and low risk (L).

Chart 2

	Utilities regulated	Competitive power	Oil & gas downstream	Autos	Airlines
Industry dynamics and competitive environment					
Industry cyclicality	M	H	H	H	H
Ease of entry	L	M/H	H	M/H	M/H
Product cycle/obsolescence	L	L	L	H	L
Level of product quality	L	L	M	H	M
Disintermediation/substitution	L	L	L	L/M	L
Competition/commoditization	L/M	H	M	H	H
Pricing inflexibility	M	H	M	H	H
Business model stability	M	M/H	L	L/M	M
Demographic trends	L	L	M	H	L
Growth and profitability					
Growth outlook	L	M	L	M/H	L/M
Profit margin pressure/outlook	M	M/H	M	M/H	H
Earnings volatility	M	M/H	H	H	H
Operating considerations and costs					
Technological risk/change	L	L	L/M	L/M	L/M
Cost efficiency/pressures	M	H	M	H	H
Operating leverage	M/H	H	H	H	H
R&D costs	L	L	L	H	L
Energy cost sensitivity	H	H	H	H	H
Raw material cost sensitivity	H	H	H	H	L
Labor costs	M	M	M	H	H
Labor inflexibility/unrest	L	L	M	H	H
Pension costs/contingents	M	L	L/M	H	M/H
Environmental impact/costs	H	L	H	H	M/H
Marketing costs	L	L	M	H	L/M
Customer concentration	L	M	L	L	L
Supplier concentration	H	H	H	M	M
Risk management	M	H	M	M	M
Asset/plant quality and age/upkeep	M	H	H	M	M/H
Event risk sensitivity	M/H	H	H	M/H	H
Financial market volatility/sensitivity	M	M/H	L	M	M
Fashion/ad/design sensitivity	L	L	L	H	L/M
Capital and financing characteristics					
Capital intensity	H	H	H	H	H
Borrowing requirement	H	H	L/M	H	H
Interest rate sensitivity	L/M	L/M	L/M	H	L/M
Government, regulatory, and legal environments					
Regulation/deregulation	H	H	M	M/H	H
Government microeconomic and social policies	H	H	H	H	M/H
Litigiousness/legal risk	L	H	M	M	M

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Industry strengths:

- Material barriers to entry because of government-granted franchises, despite deregulatory trends;
- Strategically important to national and regional economies; key pillar of the consumer and commercial economy;
- Improving management focus industry-wide on operating efficiency in recent years; and
- Cross-border growth opportunities in Europe and industrializing emerging markets.

Industry challenges/risks:

- Maturity, with a weak growth outlook in developed countries;
- Highly politicized and burdensome regulatory (i.e., rate setting and investment recovery) process; and
- Risks of "legacy cost drag" as wholesale and retail markets move toward greater deregulation.

Major global risk issues facing the utilities industry:

- Increased volatility in the regulatory environment and competitive landscape leading to greater uncertainty regarding adequacy of pricing and return on capital;
- Longer-term impact of, and ability to absorb, significant secular upturn in fuel costs, which is the industry's major operating expense;
- Ability to recover massive investment costs that will likely be necessary to replace aging industry infrastructure in a harsher cost and regulatory environment; and
- The debate over global warming will continue far beyond 2008. What the ultimate outcome will be is unclear, but growing legislation addressing carbon emissions and other greenhouse gases is probable in the near future. Utilities' ability to recover environmentally mandated costs in authorized rates and consumers' willingness to pay them could impact the industry's future credit strength.

Industry business model and risk profile in transition

Regulated utilities are in many developed countries transitioning away from quasi-monopolies toward more open competitive environments.

The level of business and credit risk associated with the investor-owned regulated utilities has historically proven in most countries to be lower (risk) than for many other industries. This has been because of the existence of government policy and related regulation that created significant barriers to entry limiting competition, and regulatory rate setting designed to provide an opportunity to achieve a specific level of profitability. The credit quality of most vertically integrated utilities in developed countries has historically been, and remains, solidly investment grade. This, to reiterate, is primarily a function of the existence of protective regulation.

The risks of, and rationale for, deregulation

The traditional protected and privileged utilities industry business model with its marked monopolistic characteristics is in many countries undergoing transition to a more competitive and open framework. This transition process, known as deregulation or liberalization, is weakening the business and credit risk profile of the industry. While the impact of these changes may prove positive in the longer term for more efficient industry players, it is important to bear in mind that economic history is littered with the vestiges of industries and enterprises that once flourished under the protection of government-created barriers and other protections. The shift is being driven by introduction in many countries of policies to encourage the entrance of new competitors and to reduce the traditional regulatory protections and privileges enjoyed by incumbents. Historically, the regulated investor-owned utilities were usually granted exclusive franchises. Because of the significant risks associated with the capital-intensive nature of the utility investment, including massive sunk/fixed costs and long-term break-even horizons, governments in many countries created legal and regulatory frameworks that granted exclusivity to one operator in a given geographic area. To offset the monopolistic pricing power this exclusivity created, a system of heavy regulation was typically developed, which included the setting of pricing. The model often set pricing on a "cost-plus-basis", i.e., the margin over cost allowing for a perceived fair return to shareholders of investor-owned utilities. One major weakness of this system is that it created little incentive for utilities to efficiently manage costs. In recent years as many governments have adopted more liberal open market economic philosophies and related

policies focused on the creation of greater competition—in an effort to foster improved economic growth and pricing efficiency throughout the economy—the traditional utility models in many countries have come under increasing political scrutiny and pressure.

A major public policy and political risk, as well as a credit risk, associated with deregulation of protected industries, is that existing incumbents often experience significant challenges in readjusting their management strategies, cultures, and expense basis to be able to compete effectively in the new environment.

The turmoil and bankruptcies in the U.S. in the nonregulated power marketing and trading arena between 2000 and 2002 arose subsequent to a major government initiative to deregulate the wholesale market. These failures, as well as other high-profile problems arising from deregulation elsewhere in the world, have given governments pause as to the desirability of a headlong rush into deregulation. In the U.S., for example, there is currently little impetus to carry deregulation any further.

Regulation and deregulation in the U.S.

While considerable attention has been focused on companies in states that deregulated in the late 1990s and the early part of this decade, and the related consequences of disaggregation and nonregulated generation, 27 states (plus four that formally reversed, suspended, or delayed restructuring) have retained the traditional regulated model. For utilities operating in those states, the quality of regulation and management loom considerably larger than markets, operations, and competitiveness in shaping overall financial performance. Policies and practices among state and federal regulatory bodies will be key credit determinants. Likewise, the quality of management, defined by its posture towards creditworthiness, strategic decisions, execution and consistency, and its ability to sustain a good working relationship with regulators, will be key. Importantly, however, it is virtually impossible to completely segregate each of these characteristics from the others; to some extent they are all interrelated.

Fragmentation of original model emerges in the U.S.

- Traditional regulated, vertically integrated utilities (generation, transmission, and distribution);
- Transmission and distribution;
- Diversified;
- Transmission; and
- Merchant generation.

We view a company that owns regulated generation, transmission, and distribution operations as positioned between companies with relatively low-risk transmission and distribution operations and companies with higher-risk diversified activities on the business profile spectrum. What typically distinguishes one vertically integrated utility's business profile score from another is the quality of regulation and management, which are the two leading drivers of credit quality.

Deregulation in the U.S. creates a new volatile industry subsector

The birth of large-scale, nonregulated power generators created the opportunity--and the need--for companies to market and broker power. Power marketers, independent power producers, and unregulated subsidiaries of utility companies offer power-supply alternatives to other utilities in the wholesale market as well as to large industrial customers. Power marketing operations have been formed by energy companies (many with experience in marketing natural gas), utility subsidiaries, and independents. As with the gas industry, electric power marketers expected to develop an efficient market by straddling the gulf between electricity generators and their customers, who have become "free agents" in the newly competitive environment.

Deregulation creates tiering of industry, business and credit risk profiles in Europe

The regional differences in market liberalization across Western Europe result in material variations in industry and business risk profiles for the utilities industry at the national level. The U.K. and Nordic markets, in particular, are substantially deregulated and open, and consequently present higher risks than other markets that are less open, including France and the Iberian market. Ratings therefore generally are lower in these more deregulated markets. The less-liberalized markets may face more regulatory risk going forward, particularly if efforts by the EU to advance the internal market by increasing the extent of market liberalization across the EU continue.

Legal action against companies that infringe on competition laws should be expected--particularly against those that move to prevent new entry and limit customer choice (for example, through the tying of markets and capacity hoarding) or collude with other incumbents to do so. The European Commission (EC) can fine companies that have violated antitrust laws up to 10% of their global annual turnover and, under certain conditions, impose structural remedies. Particular emphasis would be placed on increasing the effective unbundling of network and supply activities and on diminishing market concentration and barriers to entry.

The EC has publicly stated its intention to pursue, as a priority, abuses of the dominant position of vertically integrated companies (called vertical foreclosure). Behavioral remedies, such as energy release programs, are expected to be imposed by the EC for which such abuses, or collusion, are proved. The commission could also enforce structural measures when behavioral remedies are deemed insufficient.

3. Company competitive position and keys to competitive success

In analyzing a company's competitive position, we consider the following:

- Regulation;
- Markets;
- Diversification;
- Operations;
- Management, including growth strategy;
- Governance; and
- Profitability.

We are most concerned about how these elements contribute individually and in aggregate to the predictability and sustainability of financial performance, particularly cash flow generation relative to fixed obligations.

Regulation. Critical success factors include:

- Consistency and predictability of decisions;
- Support for recovery of fuel and investment costs;
- History of timely and consistent rate treatment, permitting satisfactory profit margins and timely return on investment; and
- Support for a reasonable cash return on investment.

Regulation is the most critical aspect that underlies regulated integrated utilities' creditworthiness. Regulatory decisions can profoundly affect financial performance. Our assessment of the regulatory environments in which a utility operates is guided by certain principles, most prominently consistency and predictability, as well as efficiency and timeliness. For a regulatory process to be considered supportive of credit quality, it must limit uncertainty in the recovery of a utility's investment. They must also eliminate, or at least greatly reduce, the issue of rate-case lag,

especially when a utility engages in a sizable capital expenditure program.

Our evaluation encompasses the administrative, judicial, and legislative processes involved in state and national government regulation, and includes the political environment in which commissions render decisions. Regulation is assessed in terms of its ability to satisfy the particular needs of individual utilities. Rate-setting actions are reviewed case by case with regard to the potential effect on credit quality.

Evaluation of regulation focuses on the ability of regulation to provide utilities with the opportunity to generate cash flow and earnings quality and stability adequate to:

- Meet investment needs;
- Service debt and maintain a satisfactory rating profile; and
- Generate a competitive rate of return to investors.

To achieve this, regulation must allow for:

- Timely recognition of volatile cost components such as fuel and satisfactory returns on invested capital and equity;
- Ability to enter into long-term arrangements at negotiated rates without having to seek regulatory approval for each contract; and
- Ability to recover costs in new investment over a reasonable time frame.

Because the bulk of a utility's operating expenses relate to fuel and purchased power, of primary importance to rating stability is the level of support that state regulators provide to utilities for fuel cost recovery, particularly as gas and coal costs have risen. Utilities that are operating under rate moratoriums, or without access to fuel and purchased-power adjustment clauses, or face significant regulatory lag, also are subject to reduced operating margins, increased cash flow volatility, and greater demand for working capital. Companies that are granted fuel true-ups may be required to spread recovery over many years to ease the pain for the consumer. In addition to fuel cost recovery filings, regulators will have to address significant rate increase requests related to new generating capacity additions, environmental modifications, and reliability upgrades. Current cash recovery and/or return by means of construction work in progress support what would otherwise sometimes be a significant cash flow drain and reduces the utility's need to issue debt during construction.

Markets/market position. Critical success factors include:

- A healthy and growing economy;
- Growth in population and residential and commercial customer base;
- An attractive business environment;
- An above-average residential base; and
- Limited bypass risk.

The importance of diversification and size. Critical success factors include:

- Regional and cross-border market diversification (mitigates economic, demographic, and political risk concentration);
- Industrial customer diversification;
- Fuel supplier diversification;

- Retail, compared with wholesale;
- Regulatory regime diversification; and
- Generating facility diversification.

Operations (operating strategy, capability, and performance efficiency). Critical success factors include:

- Low cost structure;
- Well-maintained assets;
- Solid plant performance;
- Adequate generating reserves, and compliance with environmental standards; and
- Limited environmental exposures.

Management evaluation. Utilities are complex specialized businesses requiring experienced and successful management teams to have a strong mix of the aforementioned disciplines. Critical elements of management success include:

- Commitment to credit quality;
- Operating efficiency and cost control;
- Maintaining a competitive asset base, i.e., power plant construction project management, and plant upkeep and renovation;
- Regulatory track record, process, and relationship management;
- M&A experience in successfully identifying, executing, and integrating acquisitions;
- Credibility and strong corporate governance;
- Conservative financial policies, especially regarding non-regulated activities; and
- Ability and track record in repositioning and transforming business to not just survive, but prosper in a more open market environment.

Management is assessed for its ability to run and expand the business efficiently, while mitigating inherent business and financial risks. The evaluation also focuses on the credibility of management's strategy and projections, its operating and financial track record, and its appetite for assuming business and financial risk.

The management assessment is based on tenure, turnover, industry experience, financial track record, corporate governance, a grasp of industry issues, and knowledge of regulation, the impact of deregulation, of customers, and their needs. Management's ability and willingness to develop workable strategies to address system needs, and to execute reasonable and effective long-term plans are assessed. Management quality is also indicated by thoughtful balancing of multiple priorities; a record of credibility; and effective communication with the public, regulatory bodies, and the financial community.

We also focus on management's ability to achieve cost-effective operations and commitment to maintaining credit quality. This can be assessed by evaluating accounting and financial practices, capitalization and common dividend objectives, and the company's philosophy regarding growth and risk-taking.

4. Profitability/peer comparison

Regulated. Traditionally, the lower levels of risk in utilities because of the highly regulated environment has resulted in lower profitability and return on capital than in many other industrial sectors. In the regulated marketplace the level and margin of profitability has often primarily been a function of regulatory leeway, with the contribution of operating efficiency and revenue growth taking more of a back seat.

Deregulated/liberalized environments. In deregulated markets, cost efficiency and flexibility, and internal growth, are the major profitability drivers. The development of a robust risk management culture and infrastructure are also keys to creating stability of earnings, because the company no longer has recourse to the regulator to cover costs or losses—a recourse that usually protects from downside earnings surprises in the regulated sector.

Whether generated by the regulated or deregulated side of the business, profitability is critical for utilities because of the need to fund investment-generating capacity, maintain access to external debt and equity capital, and make acquisitions. Profit potential and stability is a critical determinant of credit protection. A company that generates higher operating margins and returns on capital also has a greater ability to fund growth internally, attract capital externally, and withstand business adversity. Earnings power ultimately attests to the value of the company's assets, as well. In fact, a company's profit performance offers a litmus test of its fundamental health and competitive position. Accordingly, the conclusions about profitability should confirm the assessment of business risk, including the degree of advantage provided by the regulatory environment.

Part 2—Financial Risk Analysis

Having evaluated a company's competitive position, operating environment, and earnings quality, our analysis proceeds to several financial categories. Financial risk is portrayed largely through quantitative means, particularly by using financial ratios.

We analyze five risk categories: accounting characteristics; financial governance/policies and risk tolerance; cash flow adequacy; capital structure and leverage; and liquidity/short-term factors. We then determine a score for overall financial risk using the following scale:

Table 3

Financial Risk Measures

Description	Rating equivalent
Minimal	AAA/AA
Modest	A
Intermediate	BBB
Aggressive	BB
Highly leveraged	B

The major goal of financial risk analysis is to determine the quality of cash resources from operations and other major sources available to service the debt and other financial liabilities, including any new debt. An integral part of this analysis is to form an understanding of the debt structure, including the mix of senior versus subordinated, fixed versus floating debt, as well as its maturity structure. It is also important to analyze and form an opinion of management's financial policy, accounting elections, and risk appetite. Using cash flow analysis as a building block, it is further necessary to establish the company's liquidity profile and flexibility. While closely interrelated, the analysis of a company's liquidity differs from that of its cash flow as it also incorporates the evaluation of other sources and uses of funds, such as committed undrawn bank facilities, as well as contingent liabilities (e.g., guarantees, triggers, regulatory issues, and legal settlements).

1. Accounting characteristics

Financial statements and related footnotes are the primary source of information about a company's financial condition and performance. The analysis begins with a review of accounting characteristics to determine whether

ratios and statistics derived from the statements adequately measure a company's performance and position relative to those of both its direct peer group and the universe of industrial companies. This assessment is important in providing a common frame of reference and in helping the analyst determine the quality of disclosure and the reliability of the reported numbers. We focus on the following areas:

- Analytical adjustments and areas of potential concern;
- Significant transactions and notable events that have accounting implications.
- Significant accounting and financial reporting policies and the underlying assumptions.
- History of nonoperating results and extraordinary charges or adjustments and underlying accounting treatment, disclosure, and explanation.

2. Financial governance/policies and risk tolerance

The robustness of management's financial and accounting strategies and related implementation processes is a key element in credit risk evaluation. We attach great importance to management's philosophies and policies involving financial risk.

Financial policies are also important because companies with more conservative balance sheets and the credit capacity to pursue the necessary investments or acquisitions gain an advantage. Overly aggressive capital structures can leave very little capacity to absorb unexpected negative developments and will certainly leave little capacity to make future strategic investments. Companies with the credit capacity to support strategic investments will be better positioned to both evolve with industry change and to withstand inevitable downturns.

Understanding management's strategy for raising its share price, including its financial performance objectives, e.g., return on equity, can provide invaluable insight about the financial and business risk appetite.

3. Cash flow adequacy

Cash-flow analysis is one of the most critical elements of all credit rating decisions. Although there usually is a strong relationship between cash flow and profitability, many transactions and accounting entries affect one and not the other. Analysis of cash-flow patterns can reveal a level of debt-servicing capability that is either stronger or weaker than might be apparent from earnings. Focusing on the source and quality/volatility of cash flow is also important (e.g., regulated/deregulated; generation/transmission/trading).

A review of cash flow historically, as well as needs on a forward-looking basis, should take into account levels of capital expenditures for new generation plants. In periods where elevated new construction occurs in anticipation of a rise in power demand, cash outflows will be high.

It is particularly important to evaluate capital-intensive businesses, such as utility companies, on the basis of how much cash they generate and absorb. Debt service is an especially important use of cash flow.

Cash-flow ratios. Ratios show the relationship of cash flow to debt and debt service, and also to the company's needs. Because there are calls on cash flow other than repaying debt, it is important to know the extent to which those requirements will allow cash to be used for debt service or, alternatively, lead to greater need for borrowing. The most important cash flow ratios we look at for the investor-owned utilities are:

- Funds from operations (FFO)/Total debt;
- FFO/Income;
- Funds from operations/Total debt (adjusted for off-balance-sheet liabilities);

- EBITDA/Interest; and
- Net cash flow/Capital spending requirements.

4. Capital structure and leverage

For utilities, the long-term nature of capital commitments and extended breakeven periods on investment, make the type of financing required by these companies to finance these needs to be similar in many ways to the financing needs of other long-term asset-intensive businesses. Our analysts review projections of future CAPEX, debt, and FFO levels to make a determination of the likely level of leverage and debt over the medium term, and the companies' ability to sustain them. The valuation of the debt amortization scheduled is tied into projections of profitability breakeven, and the underlying assets becoming cash-flow-positive, are key components of the combined cash flow and leverage analysis.

Capitalization ratios. When analyzing a utility's balance sheet, a key element is analysis of capitalization ratios. The main factors influencing the level of debt are the level of capital expenditures, particularly construction expenditures, and the cost of debt. Companies with strong balance sheets will have more flexibility to further reduce their debt, and/or increase their dividends. The following are useful indicators of leverage:

- Total debt*/total debt + equity; and
- Total debt* + off-balance-sheet liabilities/total debt + off-balance-sheet liabilities + equity.

*Power purchase agreement-adjusted total debt. Fully adjusted, historically demonstrated, and expected to consistently continue.

Debt leverage, and interest and amortization coverage ratios are the key drivers of the financial risk score.

5. Liquidity/working capital/short-term factors:

Our liquidity analysis starts with operating cash flow and cash on hand, and then looks forward at other actual and contingent sources and uses of funds in the short term that could either provide or drain cash under given circumstances.

A key source of liquidity is bank lines. Key factors reviewed are total amount of facilities; whether they are contractually committed; facility expiration date(s); current and expected usage and estimated availability; bank group quality; evidence of support/lack of support of bank group; and covenant and trigger analysis. Financial covenant analysis is critical for speculative-grade credits. We request copies of all bank loan agreements and bond terms and conditions for rated entities, and review supplemental information provided by issuers for listing of financial covenants and stipulated compliance levels. We review covenant compliance as indicated in compliance certificates, as well as expected future compliance and covenant headroom levels. Entities that have already tripped or are expected to trip financial covenants need to be subject to special scrutiny and are reviewed for their ability to obtain waivers or modifications need to be subject to special scrutiny and are reviewed for their ability to obtain waivers or modifications to covenants. Tripping covenants can have a double negative effect on a company's liquidity. It may preclude it from borrowing further under its credit line, and may also lead to a contractual acceleration of repayment and increased interest rates.

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MOODY'S
INVESTORS SERVICE

Credit Opinion: Gulf Power Company

Global Credit Research - 12 Aug 2011

Florida, United States

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	A3
Senior Unsecured	A3
Subordinate Shelf	(P)Baa1
Pref. Stock	Baa2
Parent: Southern Company (The)	
Outlook	Stable
Sr Unsec Bank Credit Facility	Baa1
Senior Unsecured	Baa1
Jr Subordinate Shelf	(P)Baa2
Commercial Paper	P-2

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Key Indicators

[1]Gulf Power Company

	LTM 6/30/2011	2010	2009	2008
(CFO Pre-W/C + Interest) / Interest Expense	6.2x	6.3x	6.2x	4.8x
(CFO Pre-W/C) / Debt	24%	23%	21%	18%
(CFO Pre-W/C - Dividends) / Debt	16%	16%	14%	10%
Debt / Book Capitalization	48%	49%	49%	48%

[1] All ratios calculated in accordance with the Global Regulated Electric Utilities Rating Methodology using Moody's standard adjustments.

Note: For definitions of Moody's most common ratio terms please see the accompanying [User's Guide](#).

Opinion

Rating Drivers

- Stabilized Florida political and regulatory environment
- Regulatory risk with first base rate case filed since 2001
- Substantially higher capital expenditures for environmental compliance
- Cash flow coverage metrics have been weak for its A3 credit rating

Corporate Profile

Gulf Power Company, headquartered in Pensacola, Florida, is a vertically integrated utility subsidiary of The Southern Company that provides electricity to retail customers in northwest Florida and to wholesale customers in the Southeast. Gulf Power serves 430,000 customers in a 7,500 square mile region. It owns 2,663 megawatts of nameplate capacity, 78% of which are coal-fired, and operates within the Southern Company power pool.

SUMMARY RATING RATIONALE

Gulf Power's A3 senior unsecured debt rating reflects the stabilized political and regulatory environment in Florida, regulatory risk with its first base rate case filing since 2001, higher capital expenditures for environmental compliance and transmission and distribution system

investment, and cash flow coverage metrics that are weak for its rating but are expected to improve. The rating also considers Gulf Power's position as part of the Southern Company corporate family, the utility's relatively small size and concentrated service territory exposed to storm related event risk, and its exposure to more stringent environmental regulations.

DETAILED RATING CONSIDERATIONS

- Stabilization of the utility's political and regulatory environment with four new Florida commissioners in place

The political and regulatory environment for investor-owned utilities in Florida has largely stabilized since base rate proceedings for two other utilities in the state became highly politicized in late 2009 and early 2010. Since these rate proceedings, there has been an almost complete change in the composition of the Florida Public Service Commission, with the turnover of four of the five commissioner seats. There was also a new governor elected in the state. Although Gulf Power was not directly affected by these developments (as it had no base rate proceedings pending at the time), we revised our opinion of the regulatory framework for all investor owned electric utilities in Florida, viewing the state as substantially less supportive of credit quality than it had been previously. As a result, Moody's lowered Gulf Power's score on Factor 1 in our rating methodology grid, Regulatory Framework, to the "Baa" or average category from the "A" or above average category. For more details on this and other factors in our methodology, see Moody's Rating Methodology for Regulated Electric and Gas Utilities, published in August 2009.

Despite these adverse developments, Moody's notes that Gulf Power currently operates under base rates that were established in 2002 and are based on a 12% return on equity (although a new base rate case has recently been filed, as discussed below). The utility also benefits from a FPSC approved fuel cost recovery mechanism that includes a true-up of actual costs, a projection of future costs, and interest on the over/under recovery balance. The mechanism also allows for interim rate adjustments if the end of period over- or under-recovery balance exceeds 10% of the projected annual fuel revenues for that period. Because of these strong and timely cost recovery provisions in place in Florida, Moody's continues to view the company's ability to recover its costs and earn returns (Factor 2 in our Rating Methodology) as above average, i.e. "A" category.

With utilities in Florida vulnerable to hurricane activity, regulatory treatment to address storm costs has also been an important factor supporting the credit quality of the company during storm affected years. In the event the company incurs significant storm costs, it may file a streamlined approval for an interim surcharge of up to 80% of the cost of the storm-recovery when recovery costs exceed \$10 million. Gulf Power would then be able to petition for full and permanent recovery of all costs. Securitization legislation for the recovery of storm-related costs is also in place in Florida, although Gulf Power has not pursued securitization of past storm costs.

- Regulatory risk with \$93.5 million base rate increase pending, the first major Florida electric utility base rate case since four new Florida commissioners were put in place

On July 8, 2011, Gulf Power filed for a \$93.5 million base rate increase based on an 11.7% return on equity, with a decision expected from the FPSC in approximately eight months. In addition, the company filed for interim rate relief of \$38.5 million, requesting that the FPSC act on this request within 60 days. This base rate increase request is the first for the company in nearly 10 years and results from several factors including the addition of new power lines, infrastructure upgrades and hardening, the impact of several major hurricanes over the last few years, and higher material costs. In a letter to the new FPSC chairman, the company indicated that base rate revenues have not kept pace with increases in investment and operating and maintenance expenses. Gulf Power's base rate case will also be the first one to be addressed by a newly constituted FPSC and may give an indication of the future direction of utility regulation in Florida.

- Substantial capital expenditures for environmental compliance, transmission and distribution

Gulf Power generates approximately 80% of its power from coal, making it particularly vulnerable to potential additional costs from EPA mandated environmental compliance regulations. The company is expected to spend approximately \$1.2 billion from 2011 - 2013 on capital expenditures, including approximately \$600 million for environmental compliance. It estimates that potential new environmental regulations could incrementally add approximately \$180 million to these figures. Most of the other capital spending is for transmission and distribution, since the company has no need for new generation over the near term. The FPSC has approved recovery of prudently incurred environmental compliance costs through an environmental cost recovery clause that is adjusted annually subject to certain limits. The company expects to finance these capital expenditures from a combination of operating cash flow, long and short-term debt issuances, and equity contributions from the parent company.

- Cash flow coverage metrics that have been weak for its A3 rating but are expected to improve

Gulf Power's cash flow coverage metrics have been weak for an A rating in recent years, using parameters outlined in Moody's Regulated Electric and Gas Utilities Ratings Methodology. Cash flow from operations pre-working capital (CFO pre-W/C) to debt of 17.9% in 2008, 21% in 2009, and 23.2% in 2010, on a Moody's adjusted basis, compared to a minimum guideline of 22% for an A rating under the rating methodology. The company has experienced higher operating costs and incurred additional debt to finance rising capital expenditure requirements. The improvement in coverage in 2010 was partly due to the impact of bonus depreciation, a temporary acceleration of future cash flows that will likely help improve coverage ratios in 2011 and 2012 as well. Any permanent, sustained improvement in cash flow coverage metrics will be largely dependent on the outcome of its pending rate case.

Liquidity

Gulf Power maintains \$250 million of unused bank credit facilities supporting a \$150 million commercial paper program (issued through Southern Company Capital Funding Corporation, a Southern Company subsidiary organized to issue and sell commercial paper for its utility subsidiaries). In addition, a portion of its bank facilities are dedicated to providing liquidity support for outstanding variable rate pollution control revenue bonds. As of June 30, 2011, the company had \$61 million of commercial paper outstanding and \$69 million of variable rate pollution control bonds backed by the facilities, leaving the company with \$120 million of available credit facility capacity. As of June 30, 2011, of the \$250 million of credit facilities, \$90 million expire in 2011 and \$55 million in 2012. Subsequent to June 30, \$60 million of the \$90 million due in 2011 was renewed until 2014. There is no material adverse change clause in any of Gulf Power's credit agreements and some of the facilities include a 65% debt to capital covenant. As of June 30, 2011, the company was in compliance with this covenant.

Gulf Power maintains some contracts for physical electricity purchases and sales, fuel purchases, fuel transportation and storage, emissions allowances, and energy price risk management that could require collateral in the event of a ratings downgrade. In the event of a downgrade to Baa3, Gulf Power has potential collateral requirements of \$125 million as of June 30, 2011. If Gulf Power's credit rating is downgraded to below investment grade, the utility's potential collateral requirement rises to \$546 million. On June 30, 2011, Gulf Power had \$17.3 million of cash on

hand, up from \$16.4 million at December 31, 2010. The company has no long-term debt due over the next 12 months.

Rating Outlook

The stable rating outlook reflects Moody's view that the Florida regulatory environment for investor owned utilities has stabilized and could improve as the newly constituted FPSC establishes a track record, Gulf Power's cash flow coverage metrics will strengthen following its current rate case outcome, and that economic conditions in the Florida panhandle will gradually improve.

What Could Change the Rating - Up

An upgrade could be considered if there is a demonstrated improvement in the Florida political and regulatory environment for utilities, a credit supportive rate case outcome, if capital expenditures moderate from currently high levels, or if cash flow coverage metrics show sustained improvement, including CFO pre-W/C interest coverage of at least 5.0x and CFO pre-W/C to debt of at least 25%.

What Could Change the Rating - Down

Ratings could be downgraded if there is additional deterioration in the political and regulatory environment in Florida, including an unsupportive rate case outcome, if there are additional, unanticipated capital expenditure requirements leading to higher debt leverage, or if cash flow coverage metrics decline such that CFO pre-working capital interest coverage falls below 4.5x or CFO pre-working capital debt falls below 22% for a sustained period.

Rating Factors

Gulf Power Company

Regulated Electric and Gas Utilities Industry [1][2]	Current 12/31/2010		Moody's 12-18 month Forward View* As of August 2011	
	Measure	Score	Measure	Score
Factor 1: Regulatory Framework (25%)				
a) Regulatory Framework		Baa		Baa
Factor 2: Ability To Recover Costs And Earn Returns (25%)				
a) Ability To Recover Costs And Earn Returns		A		A
Factor 3: Diversification (10%)				
a) Market Position (5%)		Ba		Ba
b) Generation and Fuel Diversity (5%)		B		B
Factor 4: Financial Strength, Liquidity And Key Financial Metrics (40%)				
a) Liquidity (10%)		Baa		Baa
b) CFO pre-WC + Interest/ Interest (3 Year Avg) (7.5%)	5.8x	A	6.0 - 6.5x	Aa
c) CFO pre-WC / Debt (3 Year Avg) (7.5%)	21.0%	Baa	25 - 30%	A
d) CFO pre-WC - Dividends / Debt (3 Year Avg) (7.5%)	13.3%	Baa	15 - 20%	A/Baa
e) Debt/Capitalization (3 Year Avg) (7.5%)	48.3%	Baa	43 - 47%	A/Baa
Rating:				
a) Indicated Rating from Grid		Baa1		Baa1
b) Actual Rating Assigned		A3		A3

* THIS REPRESENTS MOODY'S FORWARD VIEW; NOT THE VIEW OF THE ISSUER; AND UNLESS NOTED IN THE TEXT DOES NOT INCORPORATE SIGNIFICANT ACQUISITIONS OR DIVESTITURES

[1] All ratios are calculated using Moody's Standard Adjustments. [2] As of 12/31/2010(L); Source: Moody's Financial Metrics



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