My name is Richard Cortright. I am a Managing Director in the Utilities & Infrastructure Practice of Standard & Poor’s Ratings Services. I would like to thank Commissioner Gardner for the opportunity to participate in the Pennsylvania Public Utility Commission’s Technical Conference today concerning the impact of energy conservation efforts on revenue recovery by electric and gas utilities.

As prologue to my brief comments, it is important that I communicate to you the role that Standard & Poor's plays in the capital markets. A credit rating reflects Standard & Poor's independent opinion about the creditworthiness of the entity or the security being rated. An Issuer Credit Rating is a current opinion of an issuer’s overall willingness to pay its financial obligations in full and on time. Our ratings are not in any way recommendations to issuers or investors to buy, sell, or hold a security. We do not advise issuers, investors, or any other market participant, nor do we seek to influence the behavior or opinion of any party, including regulators. Accordingly, you will not hear me use the words “should,” or “ought to” in my comments. Instead, Standard & Poor's focus is on arriving at the best opinion we can on the question of creditworthiness. That utilities or regulators may use that opinion in connection with ratemaking proceedings is something that Standard & Poor's neither encourages nor takes into consideration when arriving at its opinion. It is for market participants, be they issuers, investors, or state utility regulators, to determine whether and to what extent to use credit ratings. Ratings speak to one aspect of an investment decision -- credit quality. In deciding what to do about a particular investment, investors should also consider such factors as the current makeup of their portfolios, their investment strategy and time horizon, their tolerance for risk, and an estimation of the security's relative value in comparison to other securities they might choose.

Having said that, let me be clear that the results of regulatory ratemaking procedures can have a significant impact on the creditworthiness of rated utilities. As we have stated in various commentaries, regulation is the most critical aspect that underlies the unusual credit strength of regulated utilities. Regulatory decisions profoundly affect financial performance.

So with that as background, let me provide some thoughts on the credit quality of the utility industry generally. You will note that the significant majority of my comments will be to provide context for my brief discussion on decoupling. This is appropriate, for it is rare for any single feature or characteristic of a company to influence the overall creditworthiness, though significant events certainly can do so.

My group at Standard & Poor's is responsible for the ratings on all the investor-owned utilities that Standard & Poor's rates; municipal utilities such as Philadelphia Gas Works are rated out of a separate group. The utility industry as a whole is unusually highly rated precisely because of the regulatory relationship and the various financial mechanisms that commissions provide for utilities to recover their costs. The financial profiles of utilities tend in fact to be much weaker than average corporate financial profiles for any given rating category. But because of the relative consistency and predictability of the cash flow stream that utilities generate, utilities can in fact function well with leveraged balance sheets, and maintain reasonable access to the capital markets. The business risk that utilities face is simply much less than the risk that in general nonregulated companies face. We view the business risk profile of utilities generally as excellent or very strong. But a couple cautionary observations…

The point here is that the industry is on the leading edge of a major capital expenditure buildout, the likes of which we have not seen since the 1970s and early 1980s. We can expect costs to rise, perhaps in certain cases dramatically, and how companies and regulators address these pressures and the almost inevitable public resistance to them, will likely be at the core of how well the credit quality of the industry holds up. The prior experience of the industry, together with various other major trends, caused its creditworthiness to decline to the much weaker status of today.

For some perspective, Pennsylvania's utilities are pretty much right down the middle of the pike in terms of credit quality, as this chart shows. The Commonwealth has a handful of ‘A’ category utilities, but the great majority is in the ‘BBB’ category, with even a couple that are at the very edge of investment grade.

So what does this mean? Basically, the balance sheets of utilities, be they electric, gas, or water, will come under pressure as companies become increasingly cash flow negative. In other words, utilities will be entering the capital markets for substantial amounts of both debt and equity to support their infrastructure investments as operating cash flows will not come close to satisfying these infrastructure needs. So we as a rating agency will be closely focused on the various recovery mechanisms that regulators establish to enable utilities to recover their costs --- in particular those costs over which they have little to no control --- on a timely basis. We understand that deferring costs is often a preferred avenue for commissions to follow with many costs, and if we view the certainty of ultimate recovery likely, we are unlikely to penalize a company. However, there may come a point at which deferrals become so large that their ultimate disposition becomes uncertain as future commissions come to view them as a distasteful vestige of past commission indecisiveness.

To the extent that a commission has established recovery mechanisms such as the various trackers noted on this slide, as well as decoupling mechanisms, we would view a commission as being supportive of and attentive to the creditworthiness of a utility. More specifically, when a company is generating lower revenues as a result of successful efficiency programs at precisely the time that capital expenditures are growing and the need for certain recovery through the revenue stream particularly vital, a decoupling scheme, or other similar structure like straight fixed variable, would be viewed quite favorably. As noted at the beginning of my comments, the weight of the regulatory framework and posture --- more than perhaps any other consideration --- is the principal driver of the credit quality of a utility. The ability to forecast with reasonable accuracy the cash flow generating ability of a utility is what distinguishes the industry as an investment grade industry, even during the toughest of times. As noted by others at this conference, the aim of decoupling is to split the connection between earnings and delivered volumes, and to eliminate a major disincentive for utilities to develop conservation programs and better align the interest of consumers with utility shareholders. We believe that in general this would reduce the pressure that will already be building for more and more rate cases, and the costs attendant to them, as well as reduce the need for incremental capacity for generation, transmission, and distribution.

Regulators will always face the unenviable challenge of balancing timely and prudent cost recovery with ratepayer resistance to rising bills. But continued regulatory support is paramount to credit quality of utilities, especially during periods of prolonged high costs and investment pressures. As noted earlier, regulatory decisions can profoundly affect financial performance. 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 is engaged in a sizable capital expenditure program. Decoupling provides just such a means --- in part --- to achieve this.