

DIRECT TESTIMONY
OF
STACEY A. RENNER

1 Q. Please state your name and business address.

2 A. My name is Stacey A. Renner and my business address is Central Hudson
3 Gas & Electric Corporation (“CHGE” or the “Company”), 284 South Avenue,
4 Poughkeepsie, NY 12601.

5

6 Q. Please describe your educational background.

7 A. I hold a B.A. degree in Economics from Union College (Schenectady, NY)
8 and an M.B.A from Marist College (Poughkeepsie, NY).

9

10 Q. What is your position with CHGE and your professional background?

11 A. My position with CHGE is Treasurer. I have been employed by CHGE for a
12 total of ten years. I joined CHGE in 1990 and worked as a rate analyst until
13 1996. In that role, I focused on electric sales forecasting and electric rates.
14 From 1996 through 2003, I was employed by IBM, where I worked as a
15 financial analyst and finance manager. In those roles, I provided financial
16 support for various units of IBM Global Services, including business cases
17 and discounted cash flow analysis, as well as many aspects of corporate and
18 strategic planning. In 2003 I re-joined CHGE as Director-Investment
19 Planning and Analysis. In 2005 I was appointed Assistant Treasurer, and
20 then to Treasurer in 2006. My current responsibilities include developing and
21 implementing CHGE’s financing plans, managing cash and maintaining

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1 adequate liquidity, understanding and managing CHGE's creditworthiness,
2 and managing CHGE's banking and rating agency relationships.

3

4 Q. Have you previously testified before the New York State Public Service
5 Commission?

6 A. No. However, I prepared and submitted CHGE's last financing petition, Case
7 06-M-0785, which was filed on July 3, 2006.

8

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

10 A. I address the following topics in my testimony: cash requirements, financing
11 program, capitalization and the cost of capital, projected financial indices,
12 and financial integrity. Accompanying exhibits, supporting my testimony,
13 were prepared under my direction and supervision.

14

15 CASH REQUIREMENTS

16 Q. Please describe the exhibits showing CHGE's cash requirements.

17 A. Exhibit__(SAR-1) includes four schedules addressing cash requirements.
18 Schedule A shows a forecast of cash requirements for the twelve months
19 ending June 30, 2010. Schedule B shows a forecast of cash requirements
20 for calendar years 2008 through 2012. Schedule C shows a forecast of cash
21 construction expenditures for calendar years 2008-2012 and for the twelve
22 months ending June 30, 2010. Schedule D shows annual historical cash

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1 requirements for the calendar years 2003 through 2007. The exhibits
2 demonstrate the significance of the Company's current revenue shortfall on
3 cash requirements during the years covered by the current rate agreement,
4 as well as the impact of construction expenditures on the Company's
5 financing needs. Internal funds are bolstered by a significant increase in
6 retained earnings that begins in 2006, while the remaining financing
7 requirements are provided by debt.

8

9 Q. Please discuss the Company's cash requirements in more detail.

10 A. Exhibit___(SAR-1) shows projected and historical cash requirements for
11 CHGE's operations. Cash construction expenditures are projected at \$463.0
12 million over the period 2008 to 2012. This is consistent with the projection of
13 construction program spending presented in Mr. Haering's testimony.
14 Internal funds are projected to be \$396.4 million over the same period,
15 providing funding for only 85.6 percent of cash construction expenditures.
16 The remaining \$66.6million of cash construction expenditures will require
17 financing. Please note that the projection of internal funds reflects the
18 retention of a significant portion of CHGE's earnings.

19

20 In 2009, CHGE will be required to refund \$20 million of long-term debt as
21 unsecured notes mature. An additional \$24 million matures in 2010 and \$36
22 million in 2012. There is also some likelihood that a substantial portion of

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1 CHGE's \$166 million tax-exempt long-term debt will require refinancing
2 during the forecast period. I will address that likelihood and the underlying
3 issues affecting the viability of that debt as currently structured in more detail
4 later in my testimony. For purposes of presenting a forecast in the exhibits, it
5 was assumed that no refunding is required. Any change in circumstances
6 materially affecting refinancing of the tax-exempt debt should be recognized
7 through appropriate updates.

8
9 Other notable cash requirements include pension and other post-
10 employment benefit plan contributions. Mr. Borchert has informed me that
11 manufactured gas plant remediation costs are expected to total \$32.5 million
12 over the period 2008 to 2012. CHGE's forecast of cash requirements after
13 June 30, 2009, assumes current cash recovery of these expenditures
14 through delivery rates and the cash financing requirements could be affected
15 by any other disposition. The forecast of cash requirements associated with
16 remediation expenditures after June 30, 2009, should be updated to
17 recognize the final ratemaking treatment for these expenditures.

18
19 Total cash requirements requiring financing for the five-year forecast period
20 are projected at \$207.9 million.

21
22 FINANCING PROGRAM

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1 Q. Please describe the exhibits addressing CHGE's financing program.

2 A. Exhibit___(SAR-2) contains two schedules addressing Central Hudson's
3 financing program. Schedule A shows the proposed financing program for
4 the twelve months ending June 30, 2010. Schedule B shows the financing
5 program for calendar years 2008-2012.

6

7 Q. Please discuss the Company's financing program in more detail.

8 A. Exhibit___(SAR-2) shows the Company's projected financing program over
9 a five-year forecast period. Through a combination of short-term financing
10 arrangements, a medium-term notes program, and the infusion of equity from
11 its parent company, CHGE expects to finance its cash requirements in an
12 economical and efficient basis. Generally, CHGE uses short-term debt to
13 fund seasonal cash requirements and to provide interim financing of
14 construction expenditures incurred between issuances of medium-term
15 notes. For these short-term needs, CHGE maintains a bid rate program,
16 comprised of uncommitted credit lines from various commercial banks, and a
17 \$125 million multi-year revolving credit facility, which provides committed
18 credit from four commercial banks. It is expected that CHGE will continue to
19 first utilize its uncommitted bid rate program to raise short-term funds, as that
20 market has historically provided the Company with the lowest cost credit and
21 helped to preserve the liquidity available through the committed facility. If for
22 any reason the market fails to provide credit under the bid rate program or

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1 that credit becomes less economical than the revolving credit facility, the
2 Company would access funds under the terms of the revolving credit facility.

3 I note also that banks' willingness to extend these uncommitted credit lines
4 for our bid rate program has declined over the past two years. In the
5 forecast period, it is expected that CHGE will become more dependent on
6 the revolving credit facility to meet short-term funding needs, maintaining a
7 lower average short-term debt balance to preserve liquidity in an
8 environment of high and volatile energy prices.

9
10 All long-term debt needed to meet net cash requirements is projected to be
11 twenty-year unsecured debt issued under the terms of the medium-term note
12 program. The use of twenty-year maturities in the projections represents an
13 average of ten-year and thirty-year maturities. CHGE typically issues notes
14 with maturities ranging from ten years to thirty years, depending on prevailing
15 conditions in the market for taxable long-term corporate debt and CHGE's
16 maturity schedule, in which considerations are made for spacing future
17 maturities in a manner that will avoid unnecessary refinancing risk.

18
19 CAPITALIZATION AND COST OF CAPITAL

20 Q. Please describe the exhibits showing CHGE's capitalization and cost of
21 capital.

22 A. Exhibit___(SAR-3) shows the estimated cost of long-term debt for Central

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1 Hudson compared to select other New York State electric utilities at
2 December 31, 2007. The figures were calculated using data from the long-
3 term debt schedules filed on FERC Form No. 1 for each operating company.
4 This exhibit also shows each utility's common equity ratio and Standard and
5 Poor's (S&P) credit rating for comparable long-term debt. Note that the
6 common equity ratio is calculated in a consistent manner for each company,
7 using a formula that is fairly standard in financial analysis. For purposes of
8 setting delivery rates, the calculation may differ from one company's rate
9 proceeding to the next. In the case of CHGE, the ratemaking equity ratio
10 excludes short-term debt, but includes customer deposits in the total
11 capitalization.

12
13 Exhibit____(SAR-4) contains four schedules that address capitalization and
14 the average cost of capital. Schedule A shows the calculation of the
15 Company's average forecast cost of capital for the twelve-month period
16 ending June 30, 2010. Schedule B shows the Company's projected average
17 long-term debt for the twelve-month period ending June 30, 2010. Schedule
18 C shows the Company's projected average preferred stock for the twelve-
19 month period ending June 30, 2010. Schedule D shows the calculation of
20 the Company's average common equity for the twelve-month period ending
21 June 30, 2010.

22

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1 Q. Please discuss the reasons why Central Hudson's embedded cost of debt
2 has historically been significantly below that of other New York combination
3 companies, as shown on Exhibit _____ (SAR-3).

4 A. Exhibit____(SAR-3) shows that CHGE's embedded cost of long-term debt, as
5 of December 31, 2007, was lower than comparable companies in New York
6 State, in most cases by a significant margin. CHGE's cost of debt reflects its
7 strong debt rating over the past 10 years as well as the impact of low-cost
8 tax-exempt debt, of which \$116 million has been in auction rate interest
9 mode since 1999.

10

11 Please note also that Central Hudson's "A" rating for its senior unsecured
12 debt, the highest rating among the New York electric utilities, corresponds to
13 a financial equity ratio of 42.6 percent. Two other utilities with "A-" ratings
14 had significantly higher equity ratios, at 46.8 and 49.6 percent. The other
15 utilities had equity ratios of 46.8 and 46.4 percent and ratings of "BBB+".
16 Equity ratios are an important determinant in credit quality and I will further
17 discuss the implications later in my testimony.

18

19 Exhibit____(SAR-4), Schedule A shows the projected average cost of capital
20 for the rate year ending June 30, 2010. Schedule B of Exhibit____(SAR-4)
21 shows the average cost rate of long-term debt, corresponding annual interest
22 expense and projected new issuances and retirements for the twelve months

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1 ending June 30, 2010.

2

3 The forecast reflects a gradual increase in the cost of long-term debt, driven
4 by higher market interest rates over the forecast period. Please note the
5 importance of CHGE's access to competitively priced long-term debt, which
6 benefits our customers through a lower weighted average cost of capital.

7 CHGE's strong investment grade credit rating provides support for accessing
8 the debt. It is also worth noting the impact that unexpectedly higher interest
9 rates would have on CHGE's cost of borrowing and total cost of capital.

10 Since a significant portion of CHGE's long-term debt is variable (auction) rate
11 NYSERDA bonds that are vulnerable to rising interest rates, the Company
12 expects to continue the practice of securing reasonably priced interest rate
13 instruments to protect against a steep rise in interest rates that would result
14 in a significant increase in interest expense payments. These efforts aside,
15 continuation of the longstanding interest rate deferral provision is essential to
16 avoid disproportionate variations in interest expense and an increase in
17 relative risk. New issuances of long-term unsecured debt will reflect
18 prevailing market interest rates at the time of issuance.

19

20 The 3.75 percent cost rate assigned to customer deposits reflects the current
21 rate mandated by the Commission. The Commission updates the rate
22 annually to reflect prevailing market conditions. The current rate is applied in

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1 all projections of the cost of capital.

2

3 CHGE has a small amount of preferred stock that remains outstanding, as
4 shown on Schedule C of Exhibit____(SAR-4). This preferred stock has a
5 relatively low average cost rate of 5.05 percent.

6

7 Average common equity for the forecast period, as shown on Schedule D of
8 Exhibit____(SAR-4), reflects a return of 10.25 percent, as recommended by
9 Company witness Mosher and supported by the testimony of Company
10 witness Morin. Note that CHGE retains a significant portion of its earnings
11 for reinvestment in its infrastructure in all forecast years and maintains 48
12 percent (see further discussion regarding the equity ratio later in my
13 testimony) of its capital structure as equity.

14

15 The weighted average cost of capital is estimated to be 7.81 percent for the
16 twelve months ending June 30, 2010 and is used by the Revenue
17 Requirement Panel in determining the revenue requirement in this case. As
18 an important determinant in setting delivery rates, any factors causing the
19 projected cost of capital to change should be reflected in an update prior to
20 the conclusion of the rate proceedings.

21

22 Q. How have the widely reported auction failures in the tax-exempt debt market

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1 affected CHGE?

2 A. Central Hudson has five tranches of long-term tax-exempt bonds issued
3 through NYSERDA and insured by AMBAC Assurance Corporation
4 (“AMBAC”). These bonds total \$166 million and represented approximately
5 41 percent of CHGE’s long-term debt at June 30, 2008. 1999 Series A
6 (\$33.4 million) has a fixed coupon to maturity, 1998 Series A (\$16.7 million)
7 was last marketed with a 5-year interest rate that expires in December 2008,
8 and 1999 Series B, C, and D (\$115.9 million) have short-term interest rates
9 that are reset every 35 days through an auction process.

10

11 Over the last several months, auctions in the market for tax-exempt auction-
12 rate securities have experienced widespread failures. Generally, an auction
13 fails when there are not enough bidders for a series of bonds on the day the
14 interest rate is reset, and the bondholders who wanted to sell are left holding
15 the bonds for the next interest rate period. Since February 2008, the
16 auctions for CHGE’s 1999 Series B, C, and D bonds have failed. As a
17 consequence, the interest rate paid to the bondholders has been set to the
18 then prevailing maximum rate defined in the trust indenture. This results in
19 interest rates that are generally higher than those that are expected from a
20 successful auction. Due to market conditions beyond the Company’s control,
21 failures are expected to continue for the foreseeable future and CHGE
22 expects the maximum rate, determined on the date of each auction, to be

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1 175 percent of the yield on an index of tax-exempt short-term debt, or its
2 approximate equivalent. Since the first auction failure in February, the
3 applicable maximum rate for CHGE's bonds has ranged from 2.62 percent to
4 4.81 percent. To mitigate the impact of unexpected increases in short-term
5 interest rates, CHGE typically purchases interest rate caps on an index for
6 short-term tax-exempt debt. A one-year, 3.0 percent cap on this index is
7 currently in place and is effective through April 1, 2009. Under most market
8 conditions, CHGE expects that cap to effectively limit the maximum rate for
9 its auction-rate bonds to approximately 5.25 percent.

10
11 Q. What other factors are affecting CHGE's tax-exempt debt?

12 A. The subprime mortgage crisis resulted in considerable financial challenges
13 for the monoline bond insurers. These insurers typically had "AAA" credit
14 ratings, enabling them to provide insurance for municipal tax-exempt debt
15 issuances and thereby extending the "AAA" rating to that debt. Rating
16 agencies have downgraded many of the bond insurers to below "AAA" and
17 outlooks continue to be generally negative. For insured bonds from which
18 the downgrades are extended to, bond investors in today's markets are
19 focusing more on the underlying rating of the issuer than on the current rating
20 of the troubled insurers. In fact, insured debt may be avoided altogether by
21 some institutional investors to distance them from future risk and scrutiny
22 should conditions for the insurers worsen. A consequence of the declining

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1 financial health and investor perception of bond insurers has been increased
2 costs to issue tax-exempt debt. As confidence fell in 2007, the historical
3 discount of tax-exempt yields versus treasury yields across all maturities
4 shrank considerably. In early 2008, tax-exempt yields were actually at a
5 premium to treasuries, and while they have improved since April, they remain
6 near treasury yields.

7

8 The uncertain future of bond insurance and dislocations in the market for tax-
9 exempt debt have an impact on four series of debt at CHGE. As I mentioned
10 earlier, our three series of auction rate bonds are subject to higher interest
11 rates than they would be under more normal circumstances. It is becoming
12 increasingly certain that the auction markets are not going to return. As I will
13 discuss further later in my testimony, it is likely that this debt will need to be
14 remarketed or refinanced. CHGE's 1998 NYSERDA Series A (\$16.7 million)
15 is scheduled to be remarketed later this year when its five-year interest
16 period concludes. There is some uncertainty about the market for those
17 bonds, primarily related to the insurance provided by AMBAC. The relatively
18 small size of the series limits the potential problem, as a failed remarketing
19 would require refunding that is within the ability of CHGE to handle with
20 short-term debt until a medium-term note issuance can be arranged. The
21 results of the remarketing effort will be known in December 2008 and I plan
22 to update CHGE's cost of capital to reflect the outcome (or in the case

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1 refunding is required, the projected refinancing of those funds with medium-
2 term notes) once the facts become known.

3

4 Q. What specific assumptions for the auction-rate bonds are reflected in your
5 projection for CHGE's weighted average cost of capital?

6 A. CHGE's financial projections assume that interest rates for the auction-rate
7 bonds are set at the applicable maximum rate through the end of the forecast
8 period. This rate, at 175 percent of an index of tax-exempt short-term debt,
9 is somewhat representative of the long-term coupon the notes would be
10 subject to upon remarketing or refinancing. However, long-term rates would
11 be fixed at the time of remarketing or refinancing; the maximum rate, reset
12 every 35 days upon the failure of the auctions, is variable, and the bonds will
13 carry interest rate risk.

14

15 Q. What actions is CHGE taking with regard to its auction-rate notes in light of
16 the auction failures?

17 A. CHGE has been following the developments in the market for tax-exempt
18 debt, as well as the actions taken by participants in that market to remarket
19 or refinance auction-rate securities. Owing to an applicable maximum rate
20 that is very reasonable at present, expectations that the rate will remain
21 reasonable in the near future, and the protection provided by an interest rate
22 cap through April 2009, CHGE has determined it is in the best interest of

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1 customers to let the financial markets adjust to the flood of refinancing and
2 capital raising prior to implementing an alternative to most, if not all, of its
3 auction rate debt. The alternatives being evaluated include converting the
4 debt to another interest rate mode (variable, term, or fixed to maturity) or
5 refinancing the debt. The size of the three series makes conversion of the
6 full amount to a variable rate unlikely, since it would require a doubling of the
7 committed credit at CHGE to support the corresponding liquidity needs,
8 without fully resolving the uncertainty that exists in the tax-exempt market.
9 Fixing all or most of the debt to maturity, either within the terms of the
10 existing indenture or through a refinancing, depending on developments with
11 bond insurers, the economics of the available alternatives, and other factors
12 is another potential outcome.

13
14 Given these uncertainties in relation to market conditions for a substantial
15 portion of the Company's capitalization, deferral authorization should be
16 granted for future recovery (or refunding) with carrying charges of cost
17 variations compared to the debt structure and costs assumed for ratemaking
18 purposes.

19

20 PROJECTED FINANCIAL INDICES

21 Q. Please describe the exhibits showing CHGE's projected financial indices.

22 A. Exhibit__(SAR-5) shows the Company's actual and projected capitalization

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1 and capitalization ratios for 2003 through 2012.

2

3 Q. Please discuss the exhibits in more detail.

4 A. Exhibit___(SAR-5) shows historical and projected capitalization and
5 capitalization ratios based on the Company's financing program. For the
6 five-year period ending December 31, 2007, CHGE's total capitalization grew
7 by 32 percent, from \$584 million to \$772 million. This growth was driven
8 primarily by financing required for expenditures on the Company's
9 construction program and growing working capital requirements. That trend
10 is projected to continue, with total capitalization reaching \$1 billion in 2012.
11 CHGE will require significant additional financing over the forecast period.

12

13 FINANCIAL INTEGRITY

14 Q. What additional exhibits have you included to address CHGE's financial
15 integrity?

16 A. Exhibit___(SAR-6) shows a copy of the most recent rating agency reports on
17 CHGE from Standard & Poor's, Moody's Investor Service, and Fitch Ratings.

18

19 Q. Please discuss CHGE's commitment to financial integrity.

20 A. CHGE has a longstanding commitment to maintaining a sound, creditworthy
21 financial structure. This commitment is not ideological, but based on
22 practical considerations and balances two responsibilities the Company has

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1 relative to its customers:

2 1) The Company has an obligation to serve the customers in its franchise
3 area. This obligation continues uninterrupted through time and
4 encompasses periods of economic growth and stagnation as well as credit
5 markets that range from supportive to difficult. As a permanent institution
6 with a critical role in the economy, the Company must be able to raise capital
7 to meet its service obligations at all times and under all conditions. For this
8 reason, a strong balance sheet and strong bond rating are important over the
9 long term.

10 2) The Company must provide reasonably priced service, and as a
11 capital-intensive company, must pay close attention to the cost of capital
12 since it is a key component of the Company's cost structure. Studies done in
13 the Generic Finance Case, Case 91-M-0509, indicated that an investment
14 grade bond rating in the range of BBB to A minimizes the long-term cost of
15 capital. At bond ratings above "A", an equity heavy structure fails to take
16 appropriate advantage of the tax deductibility of interest on debt and the
17 weighted average cost of capital begins to rise. At bond ratings below "BBB",
18 the risk of financial distress drives the cost of both debt and equity rapidly
19 upward. The Company continues to balance these two considerations by
20 targeting a solid "A" rating, which minimizes long-term capital costs, provides
21 some added assurance of being able to raise needed capital in all situations,
22 and acts as a cushion against unforeseen events.

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1

2 Q. Has CHGE met its financial integrity target?

3 A. Yes. For more than ten years, CHGE has had a senior unsecured debt
4 rating of "A" or equivalent. Exhibit____(SAR-6) shows the most recent reports
5 by Standard & Poor's, Moody's Investors Service, and Fitch Ratings. This
6 achievement and stability over the long term is a key factor in the Company's
7 low cost of long-term debt.

8

9 Q. Do you believe a solid "A" target credit rating remains appropriate going
10 forward?

11 A. Yes. While much has changed in our industry in recent years and additional
12 change is likely in the future, the two fundamental considerations discussed
13 previously have not changed: the Company has an obligation to serve its
14 customers and to provide service at a reasonable price. Maintaining a solid
15 "A" credit rating is an important factor in the Company's access to low cost
16 capital. This is particularly important in troubled financial markets like the
17 one we are currently experiencing in 2008. In such markets, aversion to risk
18 increases and the range of credit spreads widens accordingly, placing a
19 larger relative premium on lower-rated credit. Maintaining an "A" rating
20 provides the most benefit during these conditions. When higher-rated debt is
21 issued with maturities extending out several decades, customers benefit from
22 a lower cost of capital over the long-term.

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1

2 Q. Please discuss the risk factors CHGE faces in maintaining its financial
3 integrity.

4 A. As I discussed above and demonstrated in Exhibit___(SAR-1), CHGE's cash
5 flow from internal sources is insufficient to fund its construction expenditures.

6 CHGE projects continued capital investment at levels approximately two and
7 a half times the funding provided by depreciation. It should be recalled that
8 the projections provided in my exhibits assume approximate full and current
9 recovery of substantial cash outlays like MGP site remediation. The
10 Company's financing requirements are driven by the capital-intensive nature
11 of our business and by the long depreciable lives of utility plant in service.
12 Infrastructure investments made today generally have a greater average cost
13 than the system average. The consequence is a ratio of capital investment
14 to cash flow from internal sources that results in perennially weak cash flow.

15

16

17 These factors are determinants in CHGE's credit profile and, ultimately, its
18 cost of financing. CHGE's credit ratings are based on qualitative and
19 quantitative assessments of the Company's business and regulatory
20 environments and its past and projected financial profile and performance.

21

22 Generally, the rating agencies have determined that CHGE's credit
measurements are weak for an "A" rating. In fact, Moody's states, "with most

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1 key metrics more typical of what we see for regulated electric utility
2 companies in the Baa rating category.” The rating agencies’ expectation that
3 CHGE’s credit measurements will improve based on supportive treatment by
4 its regulatory agencies is an important factor in maintaining the ratings and
5 outlook and a financial challenge for the Company.

6

7 Q. What is the basis for the near-term targeting of a 48 percent equity ratio in
8 the projections of cost of capital?

9 A. A review of peer companies in New York State, shown in Exhibit____(SAR-3),
10 indicates that CHGE’s equity ratio is the lowest in the group by a significant
11 amount. CHGE’s equity ratio (financial) is approximately 400 basis points
12 lower than New York State Electric & Gas, Orange & Rockland, and
13 Rochester Gas & Electric, and 700 basis points lower than Consolidated
14 Edison. It seems unreasonable to believe that the rating agencies will
15 continually permit CHGE to have financial criteria falling below the rating
16 agencies criteria for an “A” rating, when these peer companies have been
17 downgraded to lower ratings.

18

19 CHGE’s current delivery rates reflect a return on 45 percent common equity,
20 with a sharing mechanism that allows for up to 47 percent common equity for
21 purposes of the ratemaking ROE calculation. In the view of the rating
22 agencies, and in particular Standard & Poor’s, which publishes the financial

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1 guidelines used in its rating evaluations, a 45 percent ratemaking equity ratio
2 is weak for an A rating. In 2006 and 2007, CHGE maintained the 45 percent
3 ratemaking equity ratio. The corresponding ratio focused on by the rating
4 agencies is total debt to total capitalization. Standard & Poor's has a target
5 range of 50 percent to 55 percent for total debt to total capitalization for
6 companies with CHGE's business profile. Adjusting for unfunded benefit
7 plan obligations and leases, which are commitments that have debt-like
8 characteristics, Standard & Poor's calculated CHGE's total capitalization to
9 be 57.6 percent in 2006 and 57.5 percent in 2007, placing CHGE outside of
10 the target range.

11
12 Another key financial ratio used by the rating agencies is the ratio of funds
13 from operations (FFO) to total debt. Standard & Poor's calculates that ratio
14 at 15.75 percent for 2006 and 15.98 percent for 2007, both of which are at
15 the bottom of the target range of 25 percent to 15 percent.

16
17 I believe it is important for CHGE to improve its credit measurements to
18 maintain the financial integrity required for its current ratings level and
19 business risk profile. To bring the ratio of total debt to total capital into the
20 target range, it is necessary to reduce total debt by 300 basis points. A rate
21 structure based on an equity ratio 300 basis points higher than current rates
22 would accomplish this, improving the ratemaking equity ratio from 45 percent

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1 to 48 percent.

2

3 To improve its equity ratio, CHGE is retaining significant amounts of its net
4 income. In each of 2006 and 2007, CHGE retained more than 70 percent of
5 its reported net income to meet its financing requirements and capital
6 structure targets. In each of 2008 and 2009, CHGE expects to retain 100
7 percent of its reported net income. Despite these efforts, CHGE does not
8 expect to reach the 300 basis point target improvement through retained
9 earnings alone. As shown in Exhibit____(SAR-2), \$25 million of equity will
10 need to be infused from the parent to reach a ratemaking equity ratio of 48
11 percent.

12

13 Q. What is the current rating agency perception of the regulatory climate in New
14 York State?

15 A. In my assessment, the rating agencies have historically deemed New York's
16 regulatory structure for electric and natural gas utilities as supportive of credit
17 quality. This has taken a notable turn with the significant reductions in
18 allowed ROE's in recent rate cases, which have a direct impact on the cash
19 flow measurements used in the determination of credit quality. In particular,
20 the order in Consolidated Edison's recent electric rate case received a
21 negative response from three leading rating agencies. Standard & Poor's
22 downgraded Consolidated Edison and Orange & Rockland from "A" to "A-" to

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1 more closely align the rating with the resulting projection of financial ratios.
2 Even at the lower rating, Standard & Poor's cites financial ratios as a major
3 weakness. On March 21, 2008, Moody's assigned Consolidated Edison and
4 Orange & Rockland a negative outlook, noting "...the increasing propensity
5 for the NYPSC to extend the cash recovery for certain previously incurred
6 costs, take a less supportive view with respect to certain types of future
7 costs, and base decisions on a much lower authorized ROE." On March 28,
8 Fitch Ratings resolved its designation of "ratings watch negative" for
9 Consolidated Edison and Orange & Rockland by downgrading both
10 companies and noting that Consolidated Edison's 9.1 percent authorized
11 ROE was "below average for companies of comparable risk and in Fitch's
12 view is not supportive of the projected need to raise equity and debt capital."

13

14 Q. What is your outlook for CHGE's senior unsecured debt rating?

15 A. I believe CHGE is at risk for a downgrade without a sustained improvement
16 in its financial ratios. The most recent rating outlooks from both Standard &
17 Poor's and Moody's have identified expectations of improving financial ratios.
18 CHGE's improvements to its liquidity position and its current attention on
19 capital structure and overall debt are efforts to address these concerns.
20 Benefit plan changes, which will result in lower liabilities and unfunded
21 obligations, also improve CHGE's financial ratios wherever those obligations
22 are imputed as debt in the calculations. I also note that CHGE's historically

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1 weak financial ratios for its rating reflect the benefit of its parent company's
2 high liquidity position and strong consolidated capital structure. For the
3 period 2003 through 2007, CH Energy Group had large cash reserves and
4 no external debt financing. And while the rating agencies cite the parent's
5 non-regulated growth strategy as a rating concern, the parent's track record
6 has shown only modest non-regulated investments that have caused little
7 change in the overall profile of the consolidated company. In fact, CH
8 Energy Group's capital structure has been gradually shifting toward a heavier
9 weight in CHGE. In 2003, CHGE represented approximately 55 percent of
10 CH Energy Group's common equity. By 2007, CHGE had grown to
11 approximately 66 percent of CH Energy Group's common equity as a result
12 of financing significant ongoing infrastructure investments.

13
14 Please also note that the CHGE projections discussed here and presented in
15 the exhibits reflect the improved financial ratios expected by the rating
16 agencies, as well as the continuation of CHGE's current debt ratings. If there
17 are changes to CHGE's financial ratios recognized by the rating agencies
18 (whether during the rate proceedings or subsequently) as a result of
19 recognition of the current revenue and cash shortfalls being experienced by
20 CHGE or rating agency assumptions as to future conditions, I believe it
21 would be appropriate to recognize any increases to the cost of capital to
22 reflect debt ratings and capital costs that are consistent with the

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1 corresponding credit measurements.

2

3 Q. Does this conclude your prepared direct testimony?

4 A. Yes.