Exhibit No.:
Issue: Additional Amortizations
Witness: Michael W. Cline
Type of Exhibit: Rebuttal Testimony
Sponsoring Party: Kansas City Power & Light Company
Case No.: ER-2007-0291
Date Testimony Prepared: August 30, 2007

MISSOURI PUBLIC SERVICE COMMISSION

CASE NO.: ER-2007-0291

REBUTTAL TESTIMONY

OF

MICHAEL W. CLINE

ON BEHALF OF

KANSAS CITY POWER & LIGHT COMPANY

Kansas City, Missouri
August 2007

"[redacted]**" Designates "Highly Confidential" Information**
Has Been Removed
Pursuant to 4 CSR 240-2.135.

REBUTTAL TESTIMONY

OF

MICHAEL W. CLINE

Case No. ER-2007-0291

Q: Are you the same Michael W. Cline who submitted Direct Testimony in this proceeding?

A: Yes, I am.

Q: What is the purpose of your Rebuttal Testimony?

A: In my Rebuttal Testimony, I address comments in the Direct Testimony of Russell W. Trippensee on behalf of the Office of Public Counsel ("OPC") with respect to the relationship between return on equity ("ROE") and Additional Amortizations authorized for Kansas City Power & Light Company ("KCPL" or the "Company") in Case No. EO-2005-0329 and authorized by the Missouri Public Service Commission ("Commission") in Case No. ER-2006-0314. I also respond to the challenge in OPC witness Michael Gorman's Direct Testimony with respect to KCPL's methodology in calculating the amount of Additional Amortizations for which it filed in the current proceeding. Finally, I discuss the nature and impact of a modification to the calculation of the Additional Amortizations amount subsequent to KCPL's initial filing in Case No. ER-2007-0291 required as a result of the rating agency treatment of a financing planned by Great Plains Energy Incorporated ("GPE"), the parent company of KCPL.

Q: What is the essence of Mr. Trippensee's position concerning the relationship between Additional Amortizations and ROE, as stated on pages 8-9 of his Direct Testimony?

A: Mr. Trippensee's position is summarized in the following excerpt from his testimony:

"Public Counsel believes this Commission should adopt the reasonable rate of return recommended by its witness and utilize that return to determine an overall revenue requirement on a retail Missouri basis. Then and only then should the Commission determine the appropriate level of the Regulatory Plan Amortization based on the overall revenue requirement. It is a two step process and the steps should be independent of each other.......No where [sic] in the various agreements in Case No. EO-2005-0329 or Case No. ER-2006-0314 will the Commission find that these agreements provided for substituting a higher return on equity than reasonable in the determination of revenue requirement in order to lower the RPA [Regulatory Plan Amortization]. Likewise the Commission will not find any support for having a higher than reasonable RPA in order to include a return on equity that is below a reasonable rate in the revenue requirement determination."

Q: Do you agree with Mr. Trippensee's position?

A: I do in part. I concur with Mr. Trippensee's characterization of the proper means for determining the amount of Additional Amortizations. Indeed, Mr. Trippensee's view echoes my view as reflected in the following excerpt from my Rebuttal Testimony in Case No. ER-2006-0314:

"The [Additional Amortizations] mechanism was developed for a very specific purpose: To provide KCPL with an amount of incremental cash flow needed to attain

certain key credit ratio thresholds, to the extent that cash flow provided through rate relief was otherwise insufficient for this purpose. The mechanism was not contemplated to be a substitute for an appropriate and fair level of rate relief derived through the traditional ratemaking process (emphasis added)."

Although Mr. Trippensee and I agree that the necessary starting point to determining the appropriate level of Additional Amortizations is a "reasonable," "appropriate," and "fair" level of ROE, we disagree on what constitutes that level for KCPL in this proceeding. Mr. Trippensee relies on the ROE of 10.3% recommended by OPC witness Michael Gorman, which is nearly 100 basis points below the 11.25% level recommended by KCPL witness Dr. Samuel C. Hadaway. Dr. Hadaway's Rebuttal Testimony addresses Mr. Gorman's ROE recommendation in detail.

Q: Beyond his ROE recommendation, are there other elements of Mr. Gorman's testimony with which you disagree?

A: Yes, there are. At page 30, line 12 through page 31, line 2 of Mr. Gorman's testimony, he takes issue with KCPL's inclusion of $83 million of "Additional Net Assets on KCPL's Balance Sheet" in Total Capital for Missouri jurisdictional operations for the purpose of calculating credit metrics to determine Additional Amortizations. This is shown in Schedule MWC-5 of my Direct Testimony. He states, *"Calculation of the ratios under the regulatory plan are [sic] specifically supposed to be tied to Missouri jurisdictional operations. Hence, to the extent these assets are in any way related to non-jurisdictional KCPL assets, they should not be included in the ratio analysis."*

Q: How do you respond?

A: I agree with Mr. Gorman's assertion as to the basis for the calculation of credit ratios, *i.e.*, that they should be based on Missouri jurisdictional allocations. The $83 million amount was calculated by (i) allocating KCPL's projected September 30, 2007, total net assets, excluding cash, to Missouri based on the ratio of Missouri jurisdictional rate base to Total Company rate base; and (ii) subtracting the Missouri jurisdictional rate base to derive the amount of additional net assets reflected in Schedule MWC-5. As such, KCPL's methodology was appropriate.

Q: Mr. Gorman also raises an issue on page 31, lines 3-10 of his Direct Testimony regarding the need for KCPL to include in its credit ratio calculations an "imputed amortization expense" related to operating leases. How do you respond?

A: The Company agrees with Mr. Gorman on this point and has adjusted its calculations accordingly. The change causes the numerator of the Funds From Operations ("FFO") to Total Debt ratio to increase by **[redacted]** due to additional Missouri jurisdictional depreciation expense related to the off-balance sheet obligations.

Q: Are there any other changes to the methodology used by KCPL in calculating the amount of Additional Amortizations requested in the current proceeding?

A: Yes, there is one other such change related to the rating agency treatment of a financing planned by GPE / KCPL. **[redacted]

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[redacted]**

Q: What impact does the hybrid debt have on the methodology for calculating Additional Amortizations?

A: The Additional Amortizations calculation initially filed by KCPL in this proceeding treated **[redacted]** in the same fashion as it is treated for capital structure purposes, *i.e.*, as 100% debt. However, because **[redacted]** the same attribution should be done for purposes of calculating Additional Amortizations. In addition, as discussed earlier, the projected amount of hybrid debt to be issued has been increased to **[redacted]**, which needs to be taken into account with respect to this attribution.

Q: What effect does this change in methodology, combined with the change described earlier related to amortization expense attributed to operating leases, have on the amount of Additional Amortizations KCPL is requesting in this case?

A: First, as mentioned earlier, the numerator of the FFO to Total Debt ratio will increase by **[redacted]** of additional Missouri jurisdictional depreciation expense related to the off-balance sheet obligations. Second, the ratio of GPE debt to total GPE capitalization will decline after reclassifying the **[redacted]** When these two impacts are considered, in conjunction with KCPL's recommended rate of return, KCPL will meet the threshold 25% coverage ratio for FFO to Total Debt. As a result, the Additional Amortizations amount requested in ER-2007-0291 will decrease to zero.

Q: Does that conclude your testimony?

A: Yes, it does.

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BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of the Application of Kansas City Power & Light Company to Modify Its Tariff to Continue the Implementation of Its Regulatory Plan	)))	Case No. ER-2007-0291

AFFIDAVIT OF MICHAEL W. CLINE

STATE OF MISSOURI)
) ss
COUNTY OF JACKSON)

Michael W. Cline, being first duly sworn on his oath, states:

1. My name is Michael W. Cline. I work in Kansas City, Missouri, and I am employed by Kansas City Power & Light Company as Treasurer and Chief Risk Officer.

2. Attached hereto and made a part hereof for all purposes is my Rebuttal Testimony on behalf of Kansas City Power & Light Company consisting of Six (6) pages, having been prepared in written form for introduction into evidence in the above-captioned docket.

3. I have knowledge of the matters set forth therein. I hereby swear and affirm that my answers contained in the attached testimony to the questions therein propounded, including any attachments thereto, are true and accurate to the best of my knowledge, information and belief.

Michael W. Cline

Michael W. Cline

Subscribed and sworn before me this 30th day of August 2007.

Nicole A. Wehry

Notary Public

My commission expires: Feb. 4 2011

" NOTARY SEAL "
Nicole A. Wehry, Notary Public
Jackson County, State of Missouri
My Commission Expires 2/4/2011
Commission Number 07391200

Rating Methodology

February 2005

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Refinements to Moody's Tool Kit:

Evolutionary, not Revolutionary!

A Product Of The New Instruments Standing Committee

Moody's Investors Service
Global Credit Research

Schedule MWC-6

Summary Of Refinements To Moody's Tool Kit

Moody's Tool Kit, which is a framework for calibrating the relative debt and equity characteristics of hybrid securities, was introduced to the market in 1999. Since that time, the New Instruments Committee (NIC) has assessed hundreds of instruments, positioning them along the debt – equity continuum in baskets from A to E[1]. Against this backdrop, the NIC decided to step back and review its approach to assessing hybrids with the benefit of five years' experience and feedback from market participants.

The conclusion of the NIC review process was that Moody's Tool Kit, which compares the characteristics of hybrids to the features of common equity, remains a relevant and useful framework. At the same time, there are a number of areas where refinements to our thought process are warranted. For example, in addition to considering how a hybrid behaves relative to common equity, it is also important to recognize the support that a hybrid may provide for senior creditors as well as its ability to impact the issuer's probability of default[2]. The NIC also revisited how a number of hybrid characteristics compare to the features of common equity to ensure that the same criteria are being applied consistently.

In summary, the evolution in our thought process has led to changes in the way that certain hybrid characteristics are ranked along the three dimensions of equity:

No Maturity

The NIC's thinking has changed on undated hybrids with cash calls[3], which confer a right rather than an obligation to repay the hybrid. In general, capital structures have become more fluid as issuers determine the most cost-effective cushion to cover their risks. Driven by economic considerations, an issuer may repurchase common shares at any time or refinance existing hybrids by exercising a call option. This general lack of permanence is not driven by the features of common equity or the hybrid's characteristics themselves, but is driven by the issuer's view of the optimal capital structure. Consequently, a cash call is viewed less negatively than previously.

No Ongoing Payments

In shifting focus to consider how a hybrid may impact an issuer's probability of default, the NIC recognizes that non-payment of deferrable distributions generally does not result in an event of default. This is the same outcome as for the non-payment of common dividends. A hybrid may have one of a number of deferral mechanisms, which may result in the cessation of distributions at a time of financial distress. While continuing to calibrate the relative equity-like benefit of each, deferral mechanisms overall will now receive greater equity benefit than in the past due to the recognition of their generally favorable impact on an issuer's probability of default.

Loss Absorption

In many cases, hybrids provide a loss absorbing cushion for senior creditors with recovery far closer to common equity than to either senior or subordinated debt in a default. The NIC now more fully recognizes this benefit by giving preferred securities, and certain types of subordinated debt, a ranking that is closer to that of common equity.

In subsequent sections, this rating methodology describes in detail the refinements that are being made to Moody's Tool Kit, the rationale for the changes, and how they impact commonly issued hybrids.

Refresher on Moody's Approach to Hybrid Analysis

Before discussing the refinements to Moody's Tool Kit, it is important to start with a refresher on the thought process used to assess hybrids. In 1999, Moody's introduced a comparative framework, which ranks, on a relative basis, various hybrids and places them in a basket from Basket A (more debt-like) to Basket E (more equity-like) on the debt – equity continuum. Through this analysis, the hybrid is broken down into its basic characteristics including maturity, call options, conversion options, deferral mechanisms, and priority of claim in liquidation. These basic attributes are then compared to the following features of equity:

- No maturity.
- No ongoing payments, the absence of which would result in an event of default.
- Loss absorption for all creditors.

1. Please refer to the section below entitled Refresher on Moody's Approach to Hybrid Analysis. In addition, see also *Moody's Tool Kit: A Framework for Assessing Hybrid Securities*, dated December 1999.
2. This approach is consistent with Moody's expected loss ratings, which incorporate the probability of default and severity of loss.
3. Specifically, the issuer can exercise a call for cash without having to replace the hybrid with a security that has the same or more equity-like characteristics.

The hybrid's characteristics are then scored in terms of their strength relative to common equity. The four gradations of modifiers used are ***none***, ***weak***, ***moderate***, and ***strong*** relative to common equity with ***none*** corresponding to most debt-like and ***strong*** corresponding to most equity-like. Once these scores have been assigned, the hybrid is compared to hybrids already on the debt – equity continuum and placed in a basket. There is a specific percentage of debt and equity associated with each basket, which is used to adjust full sets of financial statements[4]. The hybrid is then considered within the context of each issuer's overall credit fundamentals and its impact on the rating is left to the relevant rating committee.

Changes in Scoring for Certain Hybrid Characteristics

The following chart summarizes the changes that have been made to the scoring for certain hybrid characteristics. It is applicable to investment grade issuers including corporates, insurers, and banks. The changes are classified according to the dimension of equity that is impacted, with explanations provided below.

Feature	Old	New
No Maturity		
Cash call for an undated hybrid (corporates)	None	Weak
Cash call for an undated hybrid (banks and insurers)	None	Moderate
Cash call for an undated hybrid with replacement language (all issuer types)	Moderate	Moderate
No Ongoing Payments		
Mandatory deferral[a], non-cumulative (all issuer types)	Moderate	Strong
Mandatory deferral[a], stock settled (all issuer types)	Moderate	Strong
Optional deferral, non-cumulative (all issuer types)	Weak	Moderate
Loss Absorption		
Preferred securities	Moderate	Strong
Subordinated debt (no rights; only common equity is more junior)	Moderate	Strong
Subordinated debt (no rights)	None	Moderate
[a] *Mandatory deferral of distributions tied to the breach of pre-specified triggers.*		

Changes to Scoring: Hybrid Characteristics that Impact No Maturity

The scoring changes impacting the *No Maturity* dimension of equity relate solely to an issuer's ability to call an undated hybrid. When the Tool Kit was first introduced, a cash call[5] was viewed negatively because the hybrid could be called in the future with no guarantee that the replacement security would be neutral in its effect on other senior creditors. While a call is only likely to occur when the issuer's financial condition is sound and there is economic justification for doing so, it could potentially hurt creditors if the replacement security is debt. A call was viewed as detracting from the instrument's permanency, which made the instrument less equity-like.

The concept of capital permanency has increasingly become a fluid notion as issuers have become more active in adjusting their capital structures in response to changing operating environments. Driven by economic considerations, an issuer may repurchase common shares at any time or refinance existing debt or hybrids. This general lack of permanence is not driven by the features of common equity or the hybrid's characteristics themselves, but results from decisions made by the issuer regarding its view of the optimal capital structure.

In addition, the existence of a cash call does not necessarily result in a de-facto maturity. When a hybrid with a cash call is issued, the call does not result in an ***obligation*** to repay the hybrid, but only provides the issuer with the ***right*** to repay the hybrid. As a result, a call, when exercised, acts in a manner similar to a common share repurchase[6].

For these reasons, we have shifted scoring of a cash call on undated hybrids to ***weak*** from ***none*** for corporates. While the argument could be made to shift the scoring further to ***moderate***, the new designation reflects the uncertainty in terms of the replacement security. The scoring for a cash call where the hybrid can only be called if it is

4. On the balance sheet, the hybrid is classified in accordance with the weights assigned to its equity and debt features. The income statement is also adjusted to reflect interest expense or dividends, depending on the balance sheet classification. Similar thinking is applied to the cash flow statement, again reflecting cash outflows as interest or dividends depending on the balance sheet classification. Ratios are then computed based on the adjusted financial statements in the same manner for both investment grade and non-investment grade issuers. This is a change to the approach described in *Hybrid Securities Analysis: New Criteria for Adjustment of Financial Ratios to Reflect the Issuance of Hybrid Securities*, dated November 2003, which established that fixed charge coverage ratios would generally not be adjusted for investment grade issuers while coverage ratios for non-investment grade issuers would be calculated both with and without hybrid coupons that are deferrable, payable-in-kind, or payable in common stock.
5. See footnote 3
6. Note that the ability to repurchase common stock or call a hybrid may be viewed similarly in terms of equity replication. However, both actions may have negative rating implications.

replaced by a similar or more equity-like security remains ***moderate***. While such replacement language signals an issuer's intent regarding the form of replacement security for the hybrid if called, it only signals intent. As a result, it is not viewed as legally enforceable, although an issuer may have some moral obligation to act in accordance with its public statement of intent.

A further distinction has been made for banks and insurers on this dimension of equity. The ability of regulators to prohibit a cash call for a hybrid[7], if regulatory capital has deteriorated, is viewed to be at least as effective as a corporate with the intent to replace a hybrid with the same or more equity-like security. Consequently, for undated regulatory capital hybrids issued by banks and insurers, a cash call will receive ***moderate*** on *No Maturity*, which is the same scoring for a corporate that issues a hybrid with a cash call subject to replacement language. The ***moderate*** score is more equity-like than the ***weak*** that corporates receive with a cash call and no replacement language.

Changes to Scoring: Hybrid Characteristics that Impact No Ongoing Payments

The change in scoring for hybrid characteristics that impact the ***No Ongoing Payments*** dimension of equity relates to deferral mechanisms and whether a dividend is skipped entirely or settled with common shares. Many hybrids positively impact an issuer's probability of default because non-payment of deferrable distributions does not result in an event of default. Since non-payment of common dividends also does not result in an event of default, many hybrid scorings where deferral features are present have been shifted to stronger equity-like designations.

Moody's continues to believe that investment grade corporates, insurers, and banks are not likely to defer on hybrid distributions in order to retain capital market access. Consequently, mandatory deferral of distributions tied to the breach of triggers is viewed as a way to level the playing field between common dividends (which an investment grade issuer may opt to defer) and hybrid distributions (which an investment grade issuer is unlikely to defer). By introducing triggers, the decision to defer hybrid distributions is taken out of the hands of the issuer and based on objective criteria. The investor knows upfront that deferral is a possible outcome. While leveling the playing field, mandatory deferral may also result in a hybrid that provides more equity-like benefit than common equity itself.

Due to these considerations, we still view mandatory deferral based on the breach of pre-specified triggers to be beneficial, but it is now scored as ***strong*** rather than ***moderate***. Moreover, we will score hybrids with optional deferral as ***moderate*** rather than ***weak***. The ***moderate*** scoring for optional deferral captures the same optionality that exists for the payment of common dividends, but considers that an issuer will always be less likely to defer hybrid distributions than common dividends.

The revised designations assume that the deferral of hybrid distributions, whether optional or mandatory, are non-cumulative and will effectively be skipped if unpaid. An alternative to skipping dividends, which also scores ***strong*** on this dimension of equity, is stock settlement of the distribution if pre-specified triggers are breached. While share settlement results in the "payment" of distributions, it is a non-cash payment that provides the issuer with flexibility at a time of financial distress and is covered by the issuance of the most junior form of capital.

Changes to Scoring: Hybrid Characteristics that Impact *Loss Absorption*

The primary change impacting the ***Loss Absorption*** relates to the scoring for preferred securities and subordinated debt that effectively behaves like preferred securities. To date, preferred securities have received ***moderate*** on ***Loss Absorption*** because while preferred securities have always provided a loss absorbing cushion, it is clearly secondary to the cushion provided by common equity. However, Moody's defaulted bond recovery studies have shown that in default, the average recovery rate on preferred securities is closer to the recovery rate on common equity than it is to the recovery rate for either senior or subordinated debt holders[8]. Consequently, preferred securities are now scored as ***strong*** versus ***moderate*** on this dimension of equity.

There are certain jurisdictions, primarily in Europe, where preferred securities do not exist or issuers themselves may not have board resolution to issue preferred securities. Consistent with our past views[9], we have become comfortable with subordinated debt as equivalent to preferred securities if:

- It cannot default or cross default and has no rights in bankruptcy.
- Only common equity is more junior during the life of the subordinated debt. If more junior capital is issued between the subordinated debt and common equity, the original terms of the subordinated debt require that it will be exchanged into or refinanced by the more junior capital.

7. That is, a hybrid qualifying for regulatory capital treatment.
8. Please refer to *Default & Recovery Rates of Corporate Bond Issuers: A Statistical Review of Moody's Performance*, 1920 – 2003, dated January 2004.
9. Please refer to *An Application of Moody's Tool Kit: Characteristics of a Basket C Perpetual Preferred for Financial Institutions and Corporates*, dated May 2004.

For this type of subordinated debt, consistent with the scoring for preferred securities, the designation has also shifted to ***strong*** from ***moderate*** on this dimension of equity. For subordinated debt, which has no rights, but which may have more junior capital issued under it[10], the scoring shifts to ***moderate*** from ***none***.

Refinements in Practice: Some Examples

The charts below illustrate the impact of the Tool Kit's refinements on commonly issued hybrids for investment grade issuers. There is no change to basket designations for trust preferred securities. The biggest impact of the refinements is on perpetual preferred securities and, depending on their characteristics, they will generally be placed in more equity-like baskets.

Perpetual Preferreds with Replacement Language and Mandatory Dividend Deferral

- Perpetual preferred securities.
- Callable only if it is replaced with a security that has the same or more equity-like characteristics.
- Mandatory deferral of dividends tied to the breach of meaningful triggers; non-cumulative if deferred (i.e., dividend is skipped). If triggers are breached, dividends may also be settled with common shares.

Equity Replication Summary	Old	New
No Maturity	Moderate	Moderate
No Ongoing Payments	Moderate	Strong
Loss Absorption	Moderate	Strong
Basket	**C**	**D**

Perpetual Preferreds without Replacement Language, but with Mandatory Dividend Deferral

- Perpetual preferred securities
- Callable, but without replacement language.
- Mandatory deferral of dividends tied to the breach of meaningful triggers; non-cumulative if deferred (i.e., dividend is skipped). If triggers are breached, dividends may also be settled with common shares.

Equity Replication Summary	Old	New
No Maturity	None	Weak[a]
No Ongoing Payments	Moderate	Strong
Loss Absorption	Moderate	Strong
Basket	**A**	**C**
[a] *Banks and insurers receive a **Moderate** on **No Maturity** and the security is placed in **Basket D**.*		

Perpetual Preferreds with Replacement Language and Optional Dividend Deferral, non-cumulative

- Perpetual preferred securities.
- Callable only if it is replaced with a security that has the same or more equity-like characteristics.
- Optional deferral of dividends; if deferred, dividends are non-cumulative (i.e., dividend is skipped).

Equity Replication Summary	Old	New
No Maturity	Moderate	Moderate
No Ongoing Payments	Weak	Moderate
Loss Absorption	Moderate	Strong
Basket	**B**	**C**

10. For example, subordinated debt issued by Australian companies.

Perpetual Preferreds without Replacement Language, with Optional Dividend Deferral, non-cumulative

- Perpetual preferred securities.
- Callable, but without replacement language.
- Optional deferral of dividends, non-cumulative if unpaid (i.e., dividend is skipped).

Equity Replication Summary	Old	New
No Maturity	None	Weak[a]
No Ongoing Payments	Weak	Moderate
Loss Absorption	Moderate	Strong
Basket	**A**	**B**

[a] *Banks and insurers receive a **Moderate** on **No Maturity** and the security is placed in **Basket C**.*

Perpetual Preferreds with Replacement Language and Optional Dividend Deferral, cumulative

- Perpetual preferred securities.
- Callable only if it is replaced with a security that has the same or more equity-like characteristics.
- Optional deferral of dividends; if deferred, dividends are cumulative.

Equity Replication Summary	Old	New
No Maturity	Moderate	Moderate
No Ongoing Payments	None	Weak
Loss Absorption	Moderate	Strong
Basket	**B**	**B**

Subordinated Debt with No Rights and Inability to Issue More Junior Capital

- Perpetual subordinated debt which: 1) cannot default or cross default and has no rights and 2) nothing else is more junior to the subordinated debt except common equity . If more junior capital is issued, it will be exchanged for or refinance the subordinated debt.
- Callable, but without replacement language.
- Optional deferral of dividends; if deferred, dividends are non-cumulative (i.e., dividend is skipped).

Equity Replication Summary	Old	New
No Maturity	None	Weak[a]
No Ongoing Payments	Weak	Moderate
Loss Absorption	Moderate	Strong
Basket	**A**	**B**

[a] *Banks and insurers receive a **Moderate** on **No Maturity** and the security is placed in **Basket C**.*

Subordinated Debt with No Rights, but the Ability to Issue More Junior Capital

- Perpetual subordinated debt, which cannot default or cross default and has no rights.
- Callable, but without replacement language.
- Optional deferral of dividends; if deferred, dividends are non-cumulative (i.e., dividend is skipped).

Equity Replication Summary	Old	New
No Maturity	None	Weak[a]
No Ongoing Payments	Weak	Moderate
Loss Absorption	Moderate	Moderate
Basket	**A**	**B**[b]

[a] *Banks and insurers receive a **Moderate** on **No Maturity** and the security is placed in **Basket C**.*
[b] *Note that in this example and the previous one (subordinated debt with no rights and the inability to issue more junior capital), the designation for loss absorption is different. However, the basket outcome is the same because less weight is given to the **Loss Absorption** dimension of equity for investment grade issuers.*

Trust Preferred Securities

- Trust issues preferred securities and proceeds are on-lent to the parent company through a deeply subordinated loan. The terms of the subordinated loan mirror the terms of the preferred securities.
- The maturity is typically 30 years.
- Callable, but without replacement language.
- Optional deferral of dividends for 5 years; if deferred, dividends are cumulative

Equity Replication Summary	Old	New
No Maturity	None	None
No Ongoing Payments	None	None
Loss Absorption	Weak	Weak
Basket	**A**	**A**

Mandatorily Convertible Preferred

- Preferred securities, which mandatorily convert into equity within 3 years.
- Non-callable for life.
- Optional deferral of dividends; if deferred, dividends are cumulative.

Equity Replication Summary	Old	New
No Maturity	Strong	Strong
No Ongoing Payments	Moderate	Moderate
Loss Absorption	Strong	Strong
Basket	**E**	**E**

Summary and Conclusion

This research methodology describes the refinements that we have made to Moody's Tool Kit. While not affecting the basket designations for certain hybrids such as trust preferred securities, they generally result in more equity-like treatment for perpetual preferred securities. The changes are evolutionary, not revolutionary. They better reflect the support that hybrids provide for more senior creditors and give more weight to characteristics that are similar to the features of common equity. The changes also consider the fluidity of an issuer's capital structure, which increasingly needs to provide more flexible support than in the past to cover a range of risks that issuers continue to face.

List of Publications by the New Instruments Committee

Rating Methologies:

Hybrid Securities Analysis: New Criteria for Adjustment of Financial Ratios to Reflect the Issuance of Hybrid Securities Products, November 2003, #79991

Moody's Tool Kit: A Framework for Assessing Hybrid Securities, December 1999, #49802

Special Comments:

An Application of Moody's Tool Kit: Characteristics of a Basket E Mandatorily Convertible Security, November 2004, #89899

An Application of Moody's Tool Kit: Characteristics of a Basket C Perpetual Preferred for Financial Institutions and Corporates, May 2004, #86981

Aussie Hybrids: The Search for Equity-Like Instruments, March 2001, #64504

An Application of Moody's Tool Kit: The Analysis of Foundation Funds or Kikin for Japanese Mutual Life Insurers, September 2004, #88441

A Time to Unwind: Moody's Views about the Use of Exchangeable Bonds by Insurers, March 2000, #54632

The Role of The New Instruments Committee

Through the use of Moody's Tool Kit, the New Instruments Committee (NIC) primarily assesses the relative debt and equity characteristics of hybrid securities. In addition, the NIC assesses monetization structures that seek to unlock the value of specific balance sheet assets or investment holdings as well as liquidity products provided by the capital markets. Given the proliferation of hybrids, monetization structures, and liquidity products worldwide, the NIC is focused on achieving global consistency.

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Report Number: 91696

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RESEARCH

Criteria: Equity Credit For Corporate Hybrid Securities

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Equity hybrids--as the name suggests--combine features of debt and of equity. The many combinations and permutations of such features are growing, as new instruments are devised almost daily. Standard & Poor's Ratings Services' analytical treatment reflects this varying equity content—basically attributing 'partial credit' to various hybrid instruments.

Hybrid Hierarchy Has Been Streamlined

We introduced the equity hybrid hierarchy in 1999, pioneering a quantitative approach to the equity credit associated with hybrids securities issued by corporates. Last year, we streamlined that hierarchy in order to communicate our position more effectively. The different levels of equity content consist of three categories:

- 'Minimal equity content,' which includes instruments with little or questionable permanence; terms or nomenclature that restrict or discourage discretion over payments; after-tax costs or conversion terms that may become unattractive to the issuer.
- 'Intermediate equity content,' which encompasses most the of preferred stock genre, from 30-year trust preferred with five-year cumulative deferral rights to perpetual, tax-deductible preferred (as in the U.K.), with unlimited and/or non-cumulative deferral rights.
- 'High equity content,' which include features that support the current rating. These typically involve a mandatory component, either regarding deferral of ongoing payments at appropriately high trigger levels, or near-term conversion into a fixed number of common equity shares (on a basis that would not be deemed unpalatable to the issuer at the time of conversion).

The treatment of hybrids for ratio calculation purposes is discussed below ('Rating Methodology'). We recently decided to change how we calculate ratios for the intermediate equity content category. Going forward, we will emphasize the ratios that split hybrid-related amounts 50%-50% between debt and equity.

We use a common framework across our Corporate and Financial Services practices and across regions. However, there are significant differences, reflecting the different nature of the companies and the rating methodologies. The analysis of regulated financial institutions emphasizes capital adequacy—and, in particular, regulatory capital. In turn, the hybrid methodology for financial institutions does not follow the partial approach described above; rather, it grants full equity credit with certain threshold limits, which are set depending on the degree of equity content.

Moreover, potential regulatory intervention is a critical aspect of the financial institution dynamic. Given the high funding needs of banks and the importance of maintaining confidence in the specific bank and the entire financial sector, regulators may order deferral when the credit quality of a bank is still stronger than the point where most corporates would consider such an action.

Standard & Poor's ratings on the hybrid securities themselves highlight the risk of nonpayment—even while the company has not legally defaulted. Since we deem payment deferral or partial payment deferral a (nonlegal) default, upon such deferral, the issue rating would be 'D'. Working backwards, the impending issue default risk rises as the triggers for nonpayment approach, and the initial rating on such securities can be several notches below the corporate rating. (See "Corporate Default Risk With A Twist," published July 5, 2005, on RatingsDirect, Standard & Poor's web-based publishing system.)

Equity Has Several Attributes

What constitutes equity in the first place? Traditional common stock--the paradigm equity--sets the standard. But equity is not a monolithic concept; rather, it has several positive characteristics:

- Equity requires no ongoing payments that could lead to default;
- It has no maturity or repayment requirement;
- It provides a cushion for creditors in the case of a bankruptcy; and
- It is expected to remain as a permanent feature of the enterprise's capital structure.

Equity hybrids normally possess some--or all--of these characteristics to some degree. Yet, because equity has these several defining attributes, it should be apparent that a specific security can have a mixed impact. Hybrid securities, by their very nature, can be equity-like in some respects and debt-like in others. Moreover, the specific features may provide the positive characteristic only to a limited extent.

In any event, the security's economic impact is most relevant: its nomenclature is a secondary consideration. A transaction labeled debt for accounting, tax, or regulatory purposes may still be viewed as equity for rating purposes, and vice versa.

Soft capital--a commitment from a nonaffiliated provider of capital to inject equity capital at a later date--can be valuable. Still the company does not have the funds now, when it might be invested to support the health of its business. And, by making the funds available at the company's discretion, there is the risk that a delay in exercising that option may lead to a situation of too little, too late.

Ongoing payments. Equity pays dividends, but has no fixed requirements that could lead to default and bankruptcy if these dividends are not paid. Moreover, there are no fixed charges that might, over time, drain the company of funds that may be needed to bolster operations. While a company is under pressure to pay both preferred and common dividends, it ultimately retains the discretion to eliminate or defer payment when it faces a shortage of funds. The degree of discretion, however, can vary.

We assume a company will have greater reluctance to pass on a preferred dividend than to reduce or eliminate its common dividend. Accordingly, there is a difference in 'equity credit' afforded to common equity relative to preferred equity. Similarly, common equity issued in conjunction with so-called income depository securities (IDSs), master limited partnerships, and real estate investment trusts (REITs) is viewed as possessing less discretion over dividends: investors are promised a payout of virtually all cash flow, and they are marketed with an expected yield.

The longer a company can defer dividends, the better. An open-ended ability to defer until financial health is restored is best. As a practical matter, the ability to defer dividend payments for five or six years is most critical in helping to prevent default. If the company cannot restore financial health in five years, it probably never will. The ability to defer payments for shorter periods also is valuable, but equity content diminishes quickly as constraints on the company's discretion increase.

We also discount the right of deferral if it entails some potential disincentive. For example, some new instruments require the company to issue stock--common or preferred--once they have deferred for one or two years. Because companies presumably would want to avoid such a requirement, they would be even more reluctant than usual to defer in the first place.

Debt instruments can be devised to provide equity-like flexibility with regard to debt service. Deferrable payment debt issued directly to investors--i.e., without a trust structure--legally affords the company flexibility regarding the timing of payments that is analogous to that of preferreds. Yet, the identification of a security as debt constrains the company's practical discretion to defer payments, thereby diminishing the equity credit attributed to such hybrids compared with deferrable payment preferred stock.

By removing the discretionary element, mandatory trigger mechanisms can increase comfort that deferral actually will occur when the circumstances of the issuer make this desirable from the creditors' perspective. (Historically, income bonds--i.e., where the payment of interest is contingent on achieving a certain level of earnings--were designed with this in mind. However, to the extent that cash flow diverges from earnings measures, income bonds tend to be imperfect instruments.) The equity content of such instruments is a function of the trigger levels used to determine when payments are diminished. For example, if the level of cash flow that triggers payment curtailment is relatively low, that instrument is not supportive of high ratings. A more straightforward concept entails linking interest payments to the company's common dividend, creating an equity-mimicking bond. (A number of international financial institutions issued such bonds in the late 1980s.) Of course, if a company had an inordinate amount of dividend-linked issues outstanding, this ultimately could increase its reluctance to curtail its common dividend.

Maturity or repayment requirement. Obviously, the ability to retain the funds in perpetuity offers the company the greatest flexibility. Extremely long maturities are next best. Accordingly, 100-year bonds possess an equity feature in this respect (and only in this respect) until they get much nearer their maturity. (To illustrate the point, consider how much, or how little, the company would have to set aside today to defease or handle the eventual maturity.) However, interest payments are not deferrable and cross-default provisions would lead to these bonds being accelerated.

Preferred equity often comes with a maturity--as a limited-life or sinking-fund preferred--which would constitute a clear shortcoming in terms of this aspect of equity. Limited credit would be given for this type of preferred; even if it could be assumed the issue successfully is refinanced at maturity, the potential for using debt in the refinancing would be a concern (see the following discussion on the permanence of equity). Our normal standard for intermediate equity credit is 25 years remaining life.

Cushion for creditors in the event of default. What happens in bankruptcy also pertains to the avoidance of bankruptcy and default, albeit indirectly. Companies' access to debt capital depends on providers feeling secure about the ultimate recovery of their loans in the event of a default. Debt-holders' claims have priority in bankruptcy, while equity holders are relegated to a residual claim on the assets. The protective cushion created by such equity subordination allows the company access to capital, enabling it to stave off a default in the first place.

Subordination typically is a secondary consideration compared with other beneficial aspects of equity. Thus, if an instrument is senior, but ongoing payments are deferrable and it has a long-dated maturity, we could well view it as having substantial equity content. On the other hand, if an instrument is subordinated, but lacks the other equity-like traits, it would be viewed as predominantly debt-like.

The distinction between subordination and deep subordination generally is not significant in our analysis, although deep subordination incrementally is somewhat more supportive. Also, many U.S. securities--to meet IRS guidelines for tax-deductibility--may be termed subordinated while providing pari passu status to trade creditors. This can be a meaningful shortcoming--although, in the total scheme of things, it rarely would determine the overall equity category.

Permanence. At any time, a company can choose either to repurchase equity or to issue additional shares. However, some securities are more prone to being temporary than others. Our analysis tries to be pragmatic, looking for insights as to what may ultimately occur. For example, auction or remarketed preferred stock is designed for easy redemption. Even though the terms of this type of preferred provide for its being perpetual, failed auctions or lowered ratings typically prompt the issuer to repurchase the shares. (They are sold as commercial paper equivalents, which leads to failed auctions if credit quality ever falls to 'A-3'--or even 'A-2'--levels. While the company has no legal obligation to repurchase the paper--i.e., the last holder could be left with this 'perpetual' security--the issuer invariably bows to market pressures, and chooses to repurchase the preferred. Accordingly, such frequently remarketed preferreds are treated as debt.)

The ability to call always gives reason for pause; however, we have not placed much emphasis on this feature if the instrument is truly low-cost--such as tax-deductible preferred--and, therefore, should not pressure the company to refinance. Calls exercisable after five years are very common to long-dated hybrids. (We would question the rationale for a call date only two to three years after issuance.) However, coupon step-ups are designed to motivate calling the issue. To address the risk of refinancing with a less equity-like security, issues should have at least 10 years of no call and incorporate replacement language that specifies the type of replacement security to be used. To achieve intermediate equity treatment, it ordinarily suffices to establish management intent regarding replacement--even though companies' financial policies can vary over time, future capital market conditions could limit the ability to issue specific types of securities, and legal enforcement is dubious.

Another important consideration is the issuer's tax-paying posture. It is difficult for a nontaxpaying issuer to make the case that the company will continue to finance with non-tax-deductible preferred stock once it becomes a taxpayer, and can lower its cost of capital by replacing the preferred with debt.

Other clues can come from the nature of investors in the issue (e.g., money market, as opposed to long-term fixed-income investors) and the mode of financing that is typical of the company's peer group. For example, utilities traditionally finance with preferred stock, and industry regulators are comfortable with it; therefore, the usual concern that limited-life preferred stock will be refinanced with debt is less of an issue in the case of utilities.

In the case of so-called tax-deductible equity, risk exists that their favorable tax status is overturned, and--especially with new hybrids--that risk may be substantial. This concern can be mitigated by provisions in the transaction to convert into another equity-like security in the event of loss of tax-deductibility.

Rating Methodology

Different attributes of equity hybrids are relevant to different elements of Standard & Poor's analytical methodology. The aspect of ongoing payments is considered in fixed-charge coverage and cash-flow adequacy; equity cushion in leverage and asset protection; need to refinance upon maturity in liquidity; and potential for conversion in financial policy. The before- and after-tax cost of paying for the funds also is a component of both earnings and cash flow analysis.

How to reflect hybrids in credit ratios, though, is not a simple question. One possibility is to divide the amounts involved in proportion to the equity content of the specific security. However, the resulting numbers can be misleading. To illustrate: the company will either pay the stipulated amount or defer it; in no scenario would it defer a fraction of the payment. So calculating a fixed charge coverage ratio with a fractional amount has no intuitive meaning.

Accordingly, hybrids with minimal equity content are treated entirely as debt for ratio purposes; hybrids with high equity content are treated entirely as equity for calculating ratios.

For hybrids with intermediate equity content, we have computed financial ratios both ways--viewed alternatively as debt and as equity, i.e., two sets of coverage ratios are calculated--to display deferrable ongoing payments (whether technically dividends or interest) entirely as ordinary interest and alternatively as an equity dividend. Similarly, two sets of balance-sheet ratios are calculated for the principal amount of the hybrid instruments, displaying those amounts entirely as debt and entirely as equity.

For these hybrids in the middle category, analytical truth lies somewhere between the two. Analysts can interpolate between the two sets of ratios to arrive at the most meaningful depiction of an issuer's financial profile. They can note and give effect to each more-equity-like/less-equity-like feature of various hybrids in the same category--although such nuances play, at most, a very subtle role in the overall rating analysis. (The numerical gradations we used to indicate equity content never implied fractional treatment for the purpose of ratio calculations—as we clearly stated.)

However, this methodology also has drawbacks, including the challenges for issuers in appreciating the potential impact on our view of their financial profile. Therefore--notwithstanding the issues mentioned above--we decided to calculate ratios with the amounts relating to intermediate category hybrids split 50%-50%. This set of ratios will be emphasized as the basic adjusted measures, and these are the ratios we intend to publish. We expect the advantages of this approach--greater transparency and ease of comparability (including with measures used by other rating firms)--will outweigh the negatives. Analysts are encouraged to continue viewing hybrids from all perspectives--i.e., continuing to compute additional ratios with the security as debt and, alternatively, as equity.

Tax-Deductible Preferreds: A Major Innovation In Hybrid Securities

Texaco Capital LLC issued the first of the so-called 'tax-deductible' preferred stocks in 1993. This hybrid equity security was a major innovation in corporate finance, creating a modern-day version of the long-existing preferred stock. A version of this instrument was introduced the following year that used a trust as the issuer--leading to the term 'trust preferred'. The typical terms of this very popular instrument set the minimum standard for intermediate equity content. These include:

- Optional deferral of payments for up to 60 months, as long as no common dividends are being paid. (Conventional preferreds have unlimited potential for nondeclaration of dividends, subject only to board representation by preferred holders after six quarters of nonpayment.)
- Deep subordination.
- Thirty-year life. (Conventional preferreds are perpetual, although many have call provisions. The new-genre preferreds also are nominally perpetual, but terminate when the intercompany loan matures, normally in 30 years. As the remaining life of the specific issue dwindles over time, the equity attribution is reduced. Conventional preferreds, by way of comparison, typically possess equity content that does not diminish over time, given their perpetual tenor.)

To broaden investor appeal, preferreds with variable rates were introduced. This does not, in our view, alter the equity content, although the exposure to floating rates, if material, can pose a risk that is considered in other aspects of the analysis.

A further 'innovation' called for resetting rates after an initial five- or 10-year period. The idea was to create an incentive for the company to call the issue at that point, to avoid a penalty rate. We regard issues with step-up rates (of 50 basis points or more) as having an effective maturity at that point, thereby largely undermining their equity content.

A reset that merely captures any change in the issuer's credit spreads is less troublesome, because the company presumably would have little incentive to refinance the issue. That still could be problematic, if, for example, the issuer dropped to noninvestment grade: its cost for long-term funds might be expected to widen to the point that only shorter-term alternatives would be palatable.

To mitigate the impact of stepped-up rates on the equity credit afforded to that financing, some issues proffer replacement language, promising that any refinancing of the instrument will come from proceeds of an equity issuance or a new instrument of equivalent equity content. The legal enforceability of such terms is highly dubious. Nonetheless, we put some stock in such provisions as expressions of intent--as long as the company involved has a decent record of credibility, and the language is highly specific regarding the definition of instruments that would qualify as replacements.

Some European deals introduced greater restrictions on the ability to defer dividends. The issuer can defer only after curtailing its common dividend for some period of time. This translated into seriously lower equity credit afforded to those issues. In the case of companies that do not pay a quarterly common dividend--not unusual in Europe--the problem is compounded, because there might be an even longer period between when the company experiences financial distress and when it can defer preferred dividend payments. Similarly, the value of deferability is diminished if the deferral can only occur following a period when the company has reported a net loss, but where the company reports results on a semiannual, rather than quarterly, basis.

On the other hand, the quest for enhancing equity content continues. Recent preferred instruments make payment deferral automatic upon reaching certain triggers or occurrence of certain events. Indeed, replacing issuer discretion with a formulaic approach to deferral adds significantly to the equity content--if the threshold for stopping payments is set high. Each issuer's situation requires a unique analysis, making standardization impossible. Triggers can be based on financial data or ratios or rating levels. (Alternatively, payments could be linked to the company's common dividend.)

Additionally, some issues offer longer deferral periods and/or longer tenor. Others are non-cumulative, and do not require the company to make up for payments skipped because of financial distress. (Beyond that, forgiveness of part of the principal in cases of company stress could theoretically be offered.)

The rub is that investors would be leery about accepting the risks associated with nonpayment associated with high thresholds. (Such incremental risk of nonpayment is reflected in our rating policies for notching of issue ratings.) The key is to find the right balance that would be meaningful for the issuer and still acceptable to investors at a reasonable rate. In any case, the stigma in the capital markets that might be associated with involuntary deferral needs to considered, apart from the cash savings that result.

Our High Standards For The High Equity Content Category

Much of the recent innovative efforts in designing mandatory instruments are intended to achieve rating-agency treatment as 'high equity content'; however, we believe most of the proposed and actual recent mandatory securities only merit the intermediate equity category. Securities that would warrant high equity content recognition would entail the following features:

- High thresholds. The mere existence of a mandatory deferral provision is meaningless: Everything depends on the thresholds that define the deferral trigger. To illustrate: If the trigger for nonpayment is 10 years of losing money, that provision is virtually worthless. The company would probably have defaulted prior to the deferral provision going into effect. To be included in the high equity category, an instrument's trigger must go into effect at a level relatively close to the current rating level. The scenario that triggers deferral must be within two or three rating notches from the company's current credit quality. A threshold that approximates crossing over to noninvestment grade does not suffice (unless, of course, the corporate rating happens to be within two or three notches of that level.) A variety of financial benchmarks can serve as a proxy for that threshold level--and need to be crafted to fit the specific corporate context. In any event, we need to be mindful that a single ratio cannot entirely be relied upon to capture all of the business and financial changes the credit may have undergone by the time the trigger activates. This fact itself lends support to the tight standard we apply.
- No loopholes. For example, some deals stipulate that the mandatory deferral must be simultaneous with or following cessation of common dividends (a look-back period). As long as the company chooses to pay even a paltry dividend, the security continues to pay. Obviously, such an instrument is 'mandatory' in name only. (With respect to the intermediate equity category, these limitations may also be problematic, for other reasons. While the middle equity category only calls for the company's discretion over payments, an extended look-back period undermines the flexibility of discretionary deferral.)
- No back-door payment mechanisms. Many proposed high-equity structures provide for requiring payment or allowing payment in common stock while mandatory deferral is in effect. While appealing on the surface, we believe such provisions could defeat the purpose of mandatory deferral. The likelihood is that the company will feel pressured--if not actually obliged--to make the payment, and then turn around and repurchase the stock it issued (unless it were otherwise inclined to issue common stock for whatever reason). Ironically, the higher the threshold of the instrument, the greater the likelihood the company would pay and repurchase.
- No step-up without a legally binding replacement provision. A key equity attribute is longevity. Securities with five- or 10-year step-up/call provisions are designed to terminate at the step-up date--and our policy has been to treat that date as an effective maturity. To restore the equity credit for step-up deals, companies have proffered so-called replacement language in the issue that promises to replace the called instrument with one that is equivalent in terms of equity content. These clauses in the hybrid security itself are not legally enforceable: The investors who are called out of the security definitely will not sue regarding how they are replaced. Essentially, then, the clauses represent a statement of intent on the part of current corporate management. For the high-equity category, that does not suffice. In July 2005, First Tennessee Bank N. A. demonstrated the feasibility of providing a legally binding replacement clause when it made a declaration of covenant in connection with its preferred stock. The covenants run in favor of holders of the bank's covered debt. For us, this created a litmus test for companies to now back their declarations of intent with a legally enforceable provision.

Similarly high standards apply with respect to mandatory convertibility. (See "Hybrids' 'High Equity Content' Category Held To High Standards", published Sept. 7, 2005, on RatingsDirect, Standard & Poor's web-based publishing system.)

Frequently Asked Questions

Does it make a difference whether a security is identified as preferred stock or junior subordinated debentures?

We consider the legal form and nomenclature of a security to be relevant to the amount of equity credit. The rationale is that there would be a distinction in the investor perception of the instrument--and, consequently, to the issuer's discretion over deferring payments. We all along have made a distinction between trust-preferred and the debt version of that security--despite the two having identical economic substance. That distinction was explicit in the hierarchy of hybrids that we published for many years--and translates into an 'intermediate equity category' for the preferred stock version and 'minimal equity category' for the debt version in our current terminology.

However, we look at equity features of a given hybrid security in a holistic fashion. Recent proposed securities incorporate enhancements to the original trust preferred genre--such as doubling the maturity and providing longer deferral periods--and these would serve as offsetting positives to the weakness associated with debt form. Taking such enhancements into account, even a debt-form hybrid would qualify as 'intermediate'.

Is a mandatory share issuance feature positive, neutral, or negative?

Some new-variety securities require the issuer to pay the dividend with proceeds of a common-stock issuance, if certain financial triggers have been breached, or if optional deferral continues beyond a year or two. We view this apparent plus as a potentially serious step backward in terms of equity content. The advantage associated with deferral of payments can be undermined when the company still needs to pay--albeit with the proceeds of a share issuance. The company presumably will want to repurchase shares that it is not inclined to issue, especially given the likelihood that its share price would be depressed (because of the stress situation the company would face at the time of a trigger breach). If the forced share issuance follows a period of optional deferral, this requirement could be a disincentive for the company to exercise its right to defer in the first place. For an instrument with optional deferral to achieve intermediate equity content, we consider five years of unfettered deferral to be a minimum requirement.

Generally speaking, companies cannot be 'forced' to issue stock: They can always repurchase it (that is, if they cannot manage to find a legal loophole to avoid enforcement of the provision in the first place). And, if a particular company were in fact inclined to issue stock, it could always have done so without being coerced. The same is true with respect to being forced to issue 'equity-like' preferred stock. When a company faces distress, the pricing for very long-dated preferred stock could be prohibitive, indeed.

Our concern with mandatory share issuance precludes securities with such features from meriting even intermediate equity treatment. However, there a two possible ways to neutralize this problematic feature:

- The security could preserve the right of optional deferral in the face of breaching the mandatory triggers. That would allow them to get to the intermediate category--just like other optional deferral instruments. (In reality, though, most proposed term sheets we see provide for the mandatory remedies trumping the optional deferral provisions.) If the optional deferral provision included a requirement to issue common or other hybrids within five years, this could deter the deferral, as explained above, and we would relegate such a hybrid to the 'minimal' equity content category. To avoid this outcome, the security could mitigate the risk by allowing flexibility as far as timing of the issuance; allowing choice of common or various hybrids; and/or limiting potential dilution (for example, by restricting the maximum share issuance requirement to 2% of number of shares outstanding).
- Some companies seem prepared to foreswear their ability to repurchase shares--and to covenant to that effect in a legally enforceable fashion. As long as the no-repurchase period extends for as long as the company is in breach of the triggers--and perhaps some period thereafter--the security could still qualify for the intermediate category. (Restricting repurchases helps with regard to stock issued subject to mandatory triggers; with respect to stock issued subsequent to optional deferral, any restriction in repurchases would just exacerbate the problem---by further discouraging the choice to defer.)

Shouldn't such forced share issuance help--at least as far as the issue rating is concerned?

It certainly could help avoid the incremental subtraction of notches that otherwise would apply to the issue ratings of securities with mandatory deferral--since the payment would, after all, be made with proceeds from the share issuance. However, timeliness of payment is also critical. Timeliness can be accomplished either by immediate issuance of shares that equal in value the stipulated dividend directly to the holders or by allowing sufficient time between the determination of a breach and the dividend payment date to market new shares.

Is there a limit to the amount of hybrids a company can issue and still get 'equity credit'?

Without drawing any red lines, we would, indeed, be sensitive at a certain point. That is not because the character of the security changes when a lot of it is issued. Rather, beyond a certain point, a company's nonstandard, complex, or over-engineered balance sheet begins to puts its financial policies in a negative light. In turn, this could lead to market pressures to restructure or normalize company finances. This concern would be compounded to the extent that a company also uses various off-balance-sheet financing vehicles, derivatives, and long-term contracts, and/or other techniques that contribute to an overall opaque financing structure. The perception of financial aggressiveness--by us or the investment community--would certainly overshadow any theoretical benefit from the equity content that might be afforded to hybrid securities.

It helps to focus on measures that would indicate little or no concern. In simple terms, there should be no problem with issuing conventional hybrids in an aggregate amount up to 15% of capitalization. (Capitalization is defined as debt + hybrids + book equity, adjusted for substantial goodwill.)

Some European deals incorporate look-backs: In these instruments, the right to defer applies only after a period with no share repurchases or payment of common dividends. When do these features cause concern?

The main point of payment-deferral securities is to accommodate a company that has a crisis and would like to save cash. Look-backs constrain this flexibility, as a practical matter, if the company had recently paid a dividend or repurchased any stock. (By way of contrast, we are not concerned about 'dividend stoppers' that merely restrict common dividends from being paid in the future--until the preferred arrearages are paid up. This makes sense, as a company that is deferring its preferred dividend payments should not be paying common stock holders.)

The details of the look-back provision dictate the extent of the potential problem. For example: Does even the repurchase of a trivial amount of stock in conjunction with an employee option plan violate the look-back? Is the look-back period a quarter? Six months? One year? How do the frequency and juxtaposition of common and preferred dividend payment dates affect the possible delay?

The existence of a look-back that could potentially impose a maximum delay of one year would disqualify a security for our intermediate equity category. (In the case of hybrid issuers that are already rated speculative grade, even a potential delay of six months would rule out equity treatment.) Importantly, even where a look-back period is shorter and does not in itself disqualify the security, the potential for delay is still problematic--and, in combination with other features of the security, can affect its equity credit categorization.

With respect to mandatory-deferral instruments, look-backs undermine the nondiscretionary aspect of the deferral. The company can choose to short-circuit the deferral by paying a paltry common dividend, for example. Such issues would, therefore, never qualify for our high equity content category.

How has Standard & Poor's thinking evolved about call provisions?

We continue to limit our concern to those securities that build in incentives to exercise the call--i.e., by stepping up the yield at the call date. Where such a step-up applies, we assume the issue will be called. The higher the differential, the greater the likelihood of a call--but even a 50 basis point penalty, compared with the market rate, could be sufficient incentive to refinance such a long-dated instrument. And, ordinarily, we could not presume the instrument will be replaced with a security of equivalent equity content.

To merit being in our high equity category--if the current security otherwise qualified--only legally enforceable replacement language suffices to give us confidence regarding the outcome. Provisions in the instrument itself are not enforceable as a practical matter: Investors called out of the issue have no interest in what replaces that issue. Covenants on behalf of other creditors are, therefore, key. When such legally enforceable provisions exist, it is acceptable if the non-call period were as short as five years.

To qualify for the intermediate category, we use a lower standard. If the instrument includes highly specific wording regarding the replacement with an equity equivalent, we take such statement of management intent seriously. Obviously, situations can change--and management itself will change; nonetheless, companies tend to honor this type of public commitment. However, in those cases where we rely on statement of intent to qualify for intermediate equity treatment, we expect the non-call period be at least 10 years.

Also, we expect to revisit the question of whether to accept mere intent once there is some track record with the legally enforceable approach, which only recently has been introduced. If there are no drawbacks that become apparent with the legally enforceable approach, it will be hard for a sincere management to explain why they are not prepared to offer this provision. This determination will take more than just a few quarters.

In any event, legally enforceable provisions remain stronger than statement of intent. Since we approach the combination of hybrid features in a holistic fashion, the length of the non-call period and the strength of replacement provisions can still play a role in determining the overall characterization of a specific instrument.