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Introduction

Good morning Chairman Lieberman, Senator Thompson and members of the Committee. My name is John Diaz, and I am a Managing Director of Moody's Investors Service. I am pleased to have the opportunity to appear before you today to discuss Moody's, the role that rating agencies play in the financial markets, and Moody's actions in rating the Enron Corporation and its debt instruments.

Moody's Investors Service is owned by Moody's Corporation, a New York Stock Exchange traded company. Moody's is the oldest credit rating agency in the world. Our roots can be traced to 1900, when John Moody & Company first published Moody's Manual of Industrial and Miscellaneous Securities. From its beginning, Moody's Investors Service focused on rating debt instruments—and, as early as 1924, Moody's was rating nearly every bond in the United States bond market.

Moody's and the other rating agencies occupy a niche in the investment information market. Ratings are a simple symbol system to express relative creditworthiness. The heart of our service lies in ratings on long-term fixed-income debt instruments. We also provide, for instance, short-term ratings, deposit ratings for banks, and a variety of rating services in foreign countries. Moody's has nine primary long-term debt rating categories. Investment-grade ratings range from a high of Aaa, down to a low of Baa. Ratings below Baa are considered speculative-grade, or junk. Moody's applies this long-term scale to ratings on other types of financial obligations and to companies. Moody's also assigns short-term ratings—primarily to issuers of commercial paper—on an independent rating scale that ranks obligations Prime-1, Prime-2, Prime-3 or Not Prime. In all, Moody's ratings are designed to provide a relative measure of risk, with the likelihood of default increasing with lower ratings. The lowest expected probability of default is at the Aaa level, with a higher expected default rate at the Aa level, a yet higher expected default rate at the single-A level, and so on down through the rating scale.

As part of Moody's commitment to predictive ratings, we review the relationship between defaults and our ratings. We publish a study annually, which we call our "default study," which consistently shows that higher rated bonds default less frequently than lower-rated bonds, although the rates of default vary over time. Our default studies show the predictive nature of our ratings. Put simply, as a forward-looking opinion, ratings effectively distinguish bonds with higher credit risk from bonds with lower credit risk.

Our strong record is due in large part to the availability of reliable information. The combination of the financial disclosure regime in the United States, audited accounts, information provided directly to Moody's, and issuers' good-faith dealings have normally been sufficient. Enron was an anomaly, partly in the nature of its activities, and certainly in the disclosure of its activities. As we have come to learn, Enron's public disclosures and its responses to our specific requests for information were misleading and incomplete. Although we do not have investigative authority, our analysts are encouraged to exercise skepticism with respect to an issuer's claims and promises. That skepticism led us to assign Enron a long-term rating that—at all times—was no better than low investment-grade and contained speculative elements.[1]

Throughout Moody's rating history with Enron, we followed processes and practices that conformed to our established methods of credit analysis—methods that have been proven to predict relative creditworthiness. In the case of Enron, however, that methodology was undermined by the missing information upon which our ratings should have been based and the misleading information on which the ratings were, in fact, based.

That said, my colleagues at Moody's and I wish we had discovered the information that would have allowed us to serve the market more effectively in this instance. We acknowledge that the public bond market looks to us for our opinion forecasts of long-term creditworthiness, and we recognize that the market does not expect a very large issuer of bonds, which we have rated investment-grade, to default very shortly after holding such a rating.

The integrity and reliability of our ratings and rating processes are the essence of our business. We are constantly striving to enhance rating processes and quality and we have examined the circumstances around the Enron bankruptcy to see what lessons can be learned. For example, we are looking more comprehensively at the role of so-called rating "triggers," which can cause payment obligations to accelerate or require posting of collateral based upon a rating downgrade. We have enhanced our analysis of short-term corporate financial capacity, that is, liquidity, reviewing more thoroughly the sufficiency and certainty of an issuer's near-term sources of cash and credit under conditions of stress. We have also contacted the large asset management firms in a coordinated review

[1] Please refer to the rating definition on Page 7.

of their use of ratings in the marketplace. Finally, we commend this Committee, along with Congress in general, for your efforts to ensure the continued health of our financial markets.

<u>About Moody's and credit ratings</u>

Moody's is the oldest credit rating agency, founded more than a century ago by John Moody to rate the creditworthiness of railroad bonds. Today Moody's is a leading global credit rating, research, and risk analysis firm with more than 800 analysts worldwide. Our credit research covers a broad range of debt totaling over $30 trillion, and our analysts publish research covering thousands of institutions. Moody's products include in-depth research on major issuers, industry studies, special reports, and credit-opinions that reach subscribers globally. A Moody's credit rating is a forward-looking opinion that reflects our analysis of the relative quality of fixed income securities, issuers of such securities, and other credit obligations. Ratings are informational tools used by (1) institutional investors to analyze the credit risks associated with fixed-income securities and other debt obligations; (2) issuers seeking access to the capital markets; (3) regulators, for such purposes as measuring the capital adequacy of banks, broker/dealers, and insurance companies; and (4) governments, economists, the media, academics, and other market observers.

Ratings create efficiencies in financial markets by providing reliable, credible, and independent assessments of credit risk. The ultimate value of a rating agency's contribution to market efficiency depends on its ability to offer predictive risk opinions for the universe of rated credits.

The predictive quality of credit ratings is empirically verifiable and is evaluated by Moody's and independent third parties. Our track record is published annually in our default studies. These studies, which examine ratings performance dating back to 1920, consist of a detailed statistical analysis of the relationship between Moody's ratings and issuer defaults. They confirm the predictive nature of our ratings over time.

How Moody's works

Moody's takes a number of steps to ensure the rigor of our ratings process. We assign ratings by committee. Rating committees vary in size and generally include senior and junior analysts and one or more Managing Directors. A Credit Policy Committee (CPC) and credit standing committees under the control of the CPC review ratings practices and policies internally.

We derive over eighty-five percent of our annual revenue from issuers whom we rate. We have done so since the early 1970s, when the scope and complexity of the financial markets evolved to a state where subscription-based sales of "manuals" no longer supported the human resources necessary to conduct global credit analysis competently. Despite the fact that we obtain our revenues from issuers, we maintain our independence and objectivity with issuers, as we recognize that the long-term value of our franchise depends on our reputation. The influence of individual issuers is limited because Moody's does business with over five thousand issuer groups. No single issuer represents more than about one-and-a-half percent of Moody's total annual revenue, and the vast majority represent much less. Last year, for example, fees paid by Enron represented less than one-quarter of one-percent of Moody's 2001 revenues.

Moody's also takes active steps to maintain the integrity of our ratings process. Moody's analysts are not measured or compensated for the revenues associated with the portfolios they rate. Nor are they permitted to hold or trade the securities of the issuers they rate. Finally, Moody's does not create investment products, or buy, sell, or recommend securities to our clients, or invest in securities for its own account.

Ratings are based largely on publicly available information

In making our rating decisions, Moody's analysts largely rely on publicly available information, including SEC filings and audited financial statements. We believe that United States disclosure requirements are strong enough that, in the great majority of cases, we have sufficient public information to express an opinion. The remainder of the information we rely upon comes from macroeconomic analysis, industry-specific knowledge, and issuers' voluntary disclosure of additional information. Although issuers may choose to volunteer nonpublic information to inform our deliberations, we do not necessarily receive all of an issuer's relevant nonpublic information. Importantly, in our experience, most issuers—and for that matter the capital markets—operate in good faith; Enron, with its intentional lack of candor, did not.

Moody's ratings of Enron's debt obligations consistently reflected our caution with respect to the company's credit prospects

Moody's has consistently taken a cautious view in rating Enron's debt obligations. Beginning in 1989, Moody's assigned Enron's long-term debt a rating in the category of Baa, the lowest investment-grade category. Since 1939, Moody's has publicly defined Baa as follows:

> Bonds and preferred stock which are rated Baa are considered as medium-grade obligations (i.e., they are neither highly protected nor poorly secured). Interest payments and principal security appear adequate for the present but certain protective elements may be lacking or may be characteristically unreliable over any great length of time. Such bonds lack outstanding investment characteristics and in fact have speculative characteristics as well.

Beginning in the fall of 1999, Enron began a concerted effort to obtain an upgrade of its long-term debt rating. We asked Enron for information that might justify such a move, including financial data on leverage and the sustainability of the company's cash flow. Enron responded by providing Moody's with what Enron executives termed the "kitchen sink" disclosure, which purportedly presented all significant financial information about the company, including unconsolidated assets and debt. We now know that material information was missing. For example, Enron did not disclose to Moody's the Rawhide, Raptor and Braveheart partnerships. Furthermore, based on recent public disclosures, much of the information that was provided was inaccurate.

After review and analysis of the information provided, Moody's upgraded Enron's corporate long-term debt from Baa2 to Baa1 on March 23, 2000, a rating that placed Enron at the upper range of the lowest investment-grade category.

Enron's deteriorating financial situation prompted Moody's to lower the company's senior unsecured long-term debt ratings in October 2001

Beginning in mid-October 2001, Enron publicly disclosed troubling information that ultimately led to its filing for bankruptcy in early December 2001. During that time period, Moody's representatives requested information regarding the company's deteriorating financial picture. We moved diligently to digest the rapidly changing realities of Enron's deteriorating financial status. When Moody's rates an issuer, we assess any support that may be provided to that issuer. Therefore, we attempted to gauge the likelihood that a proposed merger with Dynegy Inc. would be consummated. This merger would have justified keeping Enron's debt rating at an investment-grade level. At all times, Moody's endeavored to act prudently and to ensure that it performed the necessary analysis to provide for an appropriate rating determination.

Following the resignation of Jeffrey Skilling in August 2001, Moody's asked senior management at Enron if they anticipated any write-downs or other charges. We were assured that none were forthcoming. Then, on October 16, despite those assurances, Enron announced its third quarter results, which included after-tax charges of approximately $1 billion resulting in a net loss of $618 million. That same day, Moody's placed Enron's long-term debt rating on review for downgrade. After our public announcement, in a number of meetings and phone conversations, Moody's repeatedly requested information from Enron regarding its October 16 disclosures. During the roughly one-month period beginning on October 16 and ending on November 19 when Enron filed its 10-Q for the third quarter, the company revealed to investors that it had misrepresented its financial performance by reporting inflated profits and omitting substantial amounts of debt.

Because of our concerns with the company's financial condition, on October 29 Moody's lowered the ratings on Enron's senior unsecured long-term debt from Baa1 to Baa2, and placed the company's long-term and short-term ratings on review for further possible downgrade. Moody's noted that we would be carefully monitoring the situation and would focus on three key factors: (1) Enron's efforts to line up further liquidity support and its ability to retain credit availability from its major counterparties; (2) Enron management's asset sale plan; and (3) the company's off-balance sheet transactions.

Moody's maintained Enron's investment-grade rating based on the likelihood of Enron's acquisition by Dynegy and a promised infusion of significant amounts of equity

By early November 2001, Moody's was increasingly concerned that Enron no longer merited an investment-grade rating. At that point, we received word of material information that would have warranted maintaining the company's investment-grade status: Dynegy and Enron disclosed to us their proposed merger. The merger would have resulted in an equity infusion of $1.5 billion from ChevronTexaco through Dynegy, in which ChevronTexaco holds a twenty-six percent stake. The deal also included an additional $1 billion in secured financing from JP Morgan Chase and Citigroup. From this point forward, Moody's focused on determining whether this merger would be consummated, and if so, how we would rate the debt of the new company. This inquiry led to numerous discussions with Enron and Dynegy regarding the details of the merger. Based on our understanding of Enron's financial condition at that time, we came to the conclusion that a merged Dynegy and Enron would likely warrant a marginally investment-grade rating.

Once we analyzed the terms of the merger, however, it became apparent that numerous weaknesses in the merger agreement and in the related financing agreement diminished the probability of the transaction being completed. Specifically, the terms of the merger contained a "material adverse change" (MAC) provision, which would have allowed Dynegy to pull out of the deal under certain circumstances. Moreover, the merger agreement as well as the secured financing agreement contained certain rating triggers that would allow Dynegy and the banks to walk away from the deal if Enron's ratings were to be lowered to non-investment-grade. These and other provisions caused us to question the probability that the transaction would be completed.

Based on this analysis, Moody's decided to downgrade Enron's long-term debt from Baa2 to Ba2, below investment-grade status, and to keep the company's long-term debt rating under review for further possible downgrade. On November 8, 2001, Moody's called Enron to tell them of this decision. During the call, Enron informed us of an imminent, material change to the Dynegy transaction, in the form of an additional equity infusion of up to $1 billion. On that basis, we made the judgment to withhold the press release until we had more information. In subsequent discussions with Enron's lead banks, and separately with Dynegy and ChevronTexaco officials, we learned that the parties had committed to positive changes to the deal to help facilitate its success. The changes included the addition of $500 million in equity from the lead banks, removal of certain MAC provisions and removal of the rating triggers from the merger agreement and from the secured financing agreement.

Notwithstanding these changes, on the next day, November 9, Moody's lowered Enron's long-term debt rating to Baa3, keeping it under review for possible further downgrade. Importantly, we also lowered the company's short-term debt rating from Prime-2 to Not Prime, a speculative-grade rating and the lowest on our short-term rating scale. Taken together, these actions reflected Moody's belief that Enron's senior debt securities were not investment-grade in the short term although the company might continue to be investment-grade over the longer term. That conclusion reflected our assessment that this transaction was highly likely to occur based on the information we had received. Over the next few weeks, Moody's actively requested additional information from Enron, Dynegy and the investment banks, in an effort to monitor the progress of the merger transaction and confirm our conclusion that it would ultimately materialize.

Despite the banks' motivation to complete the Dynegy transaction, Enron's credit prospects continued to decline because the company was consuming cash at a significant rate. Moreover, new adverse disclosures in the company's 10-Q filed on November 19 and a required restatement of prior period earnings gave us significant concern. By Thanksgiving, these factors, combined with other negative financial indicators, caused Moody's analysts to determine that the probability of Dynegy completing the acquisition had diminished considerably, warranting a downgrade of Enron's long-term debt to below investment-grade.

On November 25, Enron further communicated that the banks and Dynegy would add an additional $500 million of new equity to the deal, bringing a total of $1 billion to the enterprise, and that the banks were looking to provide an additional $1 billion in lines of credit. The merger price would also be renegotiated to reflect Enron's lower current share price. Yet when Moody's received the term sheet for the deal on the following day, it included troubling and surprising terms, such as a provision for far less than the $1 billion in additional equity that had been promised and a rating trigger. We were further informed that the banks were not willing to provide the $1 billion in lines of credit. We discussed our concerns with Dynegy and Enron, and then, on November 27, Moody's decided to downgrade Enron to below investment-grade status, to B2. The Moody's rating committee voted unanimously in favor of the downgrade and Moody's disseminated a press release announcing that decision on November 28. Moody's action reflected concerns regarding Enron's financial condition in light of significant cash consumption in its wholesale trading business. In addition, we cited refinancing risk given Enron's substantial near-term debt maturities, concerns relating to the profitability and stability of the company's trading operations and the effective subordination of Enron's senior unsecured notes to an increasing amount of secured indebtedness.

Moody's acted prudently in this deteriorating and rapidly changing situation. Up until our issuance of the downgrade to below investment-grade status, we were aware that the Dynegy deal was being renegotiated and, based on information provided to us, believed that additional equity and debt financing were being pursued. All the parties to the transaction appeared to be highly committed to its success. Prior to our decision to downgrade, we believed that the merger between Dynegy and Enron would be completed.

Where do we go from here?

While our desire to assign and communicate predictive ratings remains unchanged, the bond rating system, like the financial markets themselves, is subject to ongoing evolution. We continue to enhance the content in our ratings and research, and regularly communicate these enhancements to market participants via reports on methodology, trends, and industry outlooks.

In December 2001, we released a report on ratings triggers, which describes how these mechanisms work, why they are employed, and how they can have unexpected—and sometimes highly disruptive—consequences for lenders and borrowers alike.

Moody's has met with over twenty asset management firms this year to seek comments on the role of ratings. These meetings corresponded with publication of the first of two Moody's Special Comments on proposed enhancements to the rating process. The comments received from market participants include the following:

1) Investors want ratings to continue to be a stable signal of medium- to long-term fundamental credit risk.

2) Investors support shorter review periods for reassessing ratings in light of changed company or market circumstances. They use and appreciate Moody's current rating review and rating outlook announcement processes, derive substantial information from them, and desire that the issuer be given an opportunity to act on correctable conditions that could otherwise lead to credit deterioration.

3) They want us to focus more on issues of accounting quality, corporate governance, and disclosure.

Going forward, we are enhancing the ratings process by putting increased focus in several areas. We have substantially intensified our assessment of liquidity risk for issuers with both investment-grade and speculative-grade ratings. We are also focusing on corporate governance and how aggressive or conservative are accounting practices.

Beyond enhancements in the rating process itself, the Enron situation underscores the critical importance of full disclosure for the effective functioning of the marketplace. As a major consumer of financial data and SEC filings, Moody's strongly supports efforts to enhance financial disclosure. We would welcome the opportunity to assist the Committee in this process, and appreciate the chance to appear before you today.