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August 31, 2012

Heather Hunt
Executive Director
New England States Committee on Electricity

The United Illuminating Company's Written Comments on the Coordinated Competitive Renewable Power Procurement Draft Work Plan

Dear Ms. Hunt:

In accordance with the New England States Committee on Electricity's ("NESCOE") August 10, 2012 request for written comments, The United Illuminating Company ("UI") hereby provides written comments on NESCOE's Coordinated Competitive Renewable Power Procurement Draft Work Plan (the "Work Plan"). UI's comments address three key issues related to the potential financial impact of long-term contracts on electric distribution companies ("EDCs"). It is UI's view that the potential for adverse financial impacts is a threshold issue, and should be treated as such and addressed at the front end of the process. UI recommends that NESCOE establish an additional sub-team made up of representatives of NESCOE and EDCs to fully research financial issues and develop recommendations for state policy makers regarding how to avoid or mitigate such adverse financial impacts. State policy makers (legislators and regulators) need solid guidance on these issues. While the issues are important, they are also esoteric and prone to over-simplification by policymakers who may not be familiar with the way that creditors, investors and rating agencies assess risk. A dedicated sub-team effort can provide solid analysis and consistent guidance in the form of recommendations to state policy makers. While ultimately individual states will need to make determinations on how to protect EDC ratepayers and shareholders from adverse financial impacts, the issue is substantive enough to merit detailed analysis and identification of recommended solutions at the onset of the process so that the states can be thoroughly informed of the potential implications of their decisions, and can proactively take steps necessary to ensure the continued financial health of the EDCs.

1. The potential for long-term contracts to adversely impact the financial health of electric distribution companies is a threshold issue that requires proactive analysis and recommendations for state policy makers.

It is UI's view that the impact of long-term contracts on EDCs' financial health should be considered a key threshold issue in determining whether and how to proceed down the

path outlined in the Work Plan. The Work Plan establishes the EDCs as counterparties to renewable developers under long-term contracts, and it is the credit quality of the EDCs that would provide the basis for financing the renewable projects. Yet, ironically there is the potential for the long-term contracts to put that credit quality at risk. UI calls attention to the Brattle Whitepaper "Understanding Debt Imputation Issues" (the "Brattle Paper") which is cited in the Work Plan[1]. The Brattle Paper provides an overview of the risks and potential impacts of imputed debt from long-term contracts, and offers a number of solutions for preserving the credit quality of EDCs that are required to execute such contracts. As the Brattle Paper demonstrates, the issues surrounding imputed debt are very real, and can have dire consequences, particularly for EDCs such as UI that have credit ratings close to the rating agencies' investment grade thresholds. The Work Plan briefly touches on these concerns. Specifically, the Work Plan at 9 states that:

> *Some EDCs, for example, claim that having long-term contracts on their balance sheet may lead to additional financial implications. To the extent EDCs raise such concerns, each state would need to respond accordingly. Some potential solutions include: 1) mitigating the impact of imputed debt on the credit rating of a purchasing EDC through regulatory policies which provide assurance of contract cost recovery (Standard & Poor's methodology, for example, applies a risk factor to the debt calculation which is intended to reflect the probability that contract costs will be fully recovered in rates - the greater the probability of contract cost recovery, the smaller the risk factor, and the smaller the amount of imputed debt from a particular set of contracts.); and/or 2) structuring contracts as financial rather than physical arrangements to help minimize EDC concerns.*

Additionally, the Work Plan at 11 states that:

> *Further, the Legal Subteam should identify and form responses to potential objections that EDCs or others have or might raise to participating in coordinated procurement in light of specific state statutory provisions. Some might include any potential:*
>
> > *- EDC reluctance to act as a counter-party and assume long-term obligations under power purchase contracts due to their perceived impact on utility balance sheets;*
> > *- EDC assertions that coordinated procurement might raise antitrust issues; and,*
> > *- EDC questions about the form of recovery of the costs EDCs would incur if regulatory authorities approve long-term contracts with renewable projects*
>
> *None of the issues above is a likely obstacle to the goals of coordinated competitive procurement. Balance sheet concerns and cost recovery are economic issues that the states will need to resolve if the EDCs raise them in discussions about long-term*

[1] Work Plan at 9; http://www.hks.harvard.edu/hepg/Papers/Brattle%20Imputed%20Debt%2025%20May%202008%20final%20.pdf

contracts. Resolving these kinds of issues prior to commencing the RFP process increases its likelihood of success.

While UI agrees with the last sentence cited above, it is concerned that the Work Plan appears to downplay EDC concerns over the impact of long-term contracts on their financial health as not being "a likely obstacle to the goals of coordinated procurement.[2]" To deem these concerns as simply "objections" that the Legal Subteam needs to form responses to falls short of what's needed to guide policy makers. The concerns are real, and should not be trivialized simply because they are not easily quantifiable.

The issues are substantive, and affect shareholders and customers alike. EDC customers are heavily impacted when an EDC suffers financial impairment. If an EDC executes a long-term contract, and the obligations under that contract are imputed as debt by lenders and rating agencies, the EDC's cost of debt will almost certainly increase, as will the return on equity required by investors. In some cases access to both debt and equity capital can be constrained and costly, which can limit the EDC's ability to make the investment necessary to fulfill its core mission of providing reliable electric distribution and transmission services to customers. The imputed debt could cause the EDC's debt to total capitalization ratio to increase to a level that violates debt covenants contained in bank and capital market financing agreements. Such defaults could result in requirements to immediately repay principal and/or costly waiver processes – depending on the magnitude of the impact and increase above the covenant threshold. For EDCs that are already leveraged, such an event could occur with little in the way of new contractual commitments. Even if no debt is imputed, the rating agency may ascribe a degree of risk related to the long-term contracts and recovery of contract costs when assessing an EDC's credit rating, which could contribute to a decision to either downgrade the EDC's credit, or to not upgrade the EDC's credit when it would have otherwise met all other thresholds for an upgrade (which, from a customer cost perspective is effectively the same as a downgrade). Rate increases would become necessary to allow the EDC to continue to finance its day to day business at a higher cost of capital. Results such as these are negative for both EDCs and their customers, and it is imperative that the issues be vetted and solutions developed before proceeding with procurement efforts.

A current regulatory proceeding related to debt imputation is underway in California. In Docket A1204016 before the CPUC, San Diego Gas & Electric Company ("SDG&E") has submitted testimony showing that, under S&P's methodology for imputing debt, SDG&E expects to have nearly $1.6 billion of imputed debt on its balance sheet in 2013, with over $1.4 billion coming from renewable energy contracts. The table below shows the impact of this $1.6 billion on some of SDG&E's financial ratios[3]:

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[2] Work Plan at 11

[3] April 20, 2012 testimony of Sandra K. Hrna in CPUC Docket A1204016 at 13; http://docs.cpuc.ca.gov/SearchRes.aspx?DocFormat=ALL&DocID=58979

	Without PPA Debt Equivalence	Including **Existing and Approved** PPA Debt Equivalence ($805M)	Including **Existing, Approved, and Filed** PPA Debt Equivalence ($1.6B)
Funds From Operations (FFO) + Imputed PPA Depreciation	971	1,018	1,032
Adjusted FFO + Cash Interest Paid	1,220	1,313	1,370
Adjusted Total Debt	4,988	5,793	6,565
Total Capitalization	9,607	10,412	11,184
Net Interest Expense	254	300	343
FFO / Adjusted Debt	**19.5%**	**17.6%**	**15.7%**
Adjusted Total Debt / Total Capitalization	**51.9%**	**55.6%**	**58.7%**
Funds From Operations Interest Coverage	**4.80**	**4.38**	**3.99**

As can be seen above, imputed debt can have a profound impact on EDC financial ratios, which can in turn have a profound impact on the EDCs' credit/debt ratings, cost of capital and overall financial health. In its testimony, SDG&E proposes an adjustment of its allowed capital structure by increasing allowed equity as an offset to imputed debt to keep ratios at levels that are supportive of its current "A" credit rating. The Brattle Paper discusses this approach and others. While the issuance of equity may be part of a solution, the viability of this approach will vary between EDC parent companies. The ability to issue equity and cost of issuing equity by parent companies of EDCs will depend on many corporate and financial factors, and companies whose EDCs have lower allowed ROEs may find it more difficult, or costly, to raise equity for this purpose. Also, it is important to note that the approach proposed by SDG&E still has a cost to ratepayers because SDG&E would be required to issue new equity (and earn a return on such equity) to restore its ratios to levels that they would have been absent the imputed debt. Therefore, if debt is imputed, customers are likely to see increased costs, either through weakening of the EDCs' credit (and commensurate increases in the cost of capital required to maintain operation), or through mitigation measures required to restore the EDCs' credit quality. If debt is imputed, it is ultimately a ratepayer cost issue and this needs to be fully understood by policy-makers prior to embarking on the procurement process. While UI has not researched whether the SDG&E approach, or the approaches discussed in the Brattle Paper would be optimal for UI, the statement below from the Brattle Paper aptly sums up the appropriate goal of a balanced mitigation approach:

> *The goal of any mitigation effort should be to treat shareholders and rate payers fairly, but mitigation will also benefit ratepayers and shareholders by neutralizing the negative effects from PPAs, including the weakening of the company's credit metrics and the increased cost of capital.*[4]

As is discussed above, UI proposes that NESCOE establish a team made up of representatives of the states and EDCs to thoroughly analyze the issues and develop recommendations for the states to consider. A key part of this team's efforts should be to reach out to each of the three major rating agencies (S&P, Moodys and Fitch) to discuss the Work Plan's goals and benefits to customers and EDCs, the perceived risks and risks

[4] Brattle Paper at 8

that are not present compared to other types of long-term contracts and generation projects, and to obtain information from the agencies regarding their methodologies for reviewing and analyzing the rating impacts to EDCs associated with the Work Plan.

2. EDC cost recovery must be an ironclad assurance codified in state statutes.

Anything less than ironclad assurance of cost recovery creates uncertainty. Parties such as ratings agencies and lenders will view such uncertainty as increased risk, and may respond to such risk in a manner that adversely impacts the EDC. In its May 7, 2007 "Methodology For Imputing Debt For U.S. Utilities' Power Purchase Agreements" (the "S&P Report") S&P explains that it generally assesses a 25% - 50% risk adjustment to PPAs that are subject to cost recovery under regulatory mechanisms. In such instances, S&P would impute 25% - 50% of the contract obligations as debt. However, S&P indicates a strong preference for legislatively mandated cost recovery mechanisms:

> *we view legislatively created cost recovery mechanisms as longer lasting and more resilient to change than regulatory cost recovery vehicles. Consequently, such mechanisms lead to risk factors between 0% and 15%, depending on the legislative provisions for cost recovery and the supply function borne by the utility. Legislative guarantees of complete and timely recovery of costs are particularly important to achieving the lowest risk factors*[5].

In Hawaii, Senate Bill 2752 was signed into law on April 24, 2012. S.B. 2752 provided for legislatively mandated cost recovery of long-term contract costs specifically to reduce the imputed debt of Hawaiian Electric Company, Inc. ("HECO"). The Chair of the Hawaii Public Utilities Commission, Hermina Morita, testified in support of the bill. An attachment to the Chair's testimony shows that S&P had imputed $322 million of debt from long-term contracts in HECO's 2010 financial statements based on a 25% risk adjustment to contract obligations. It was expected that the legislation would reduce the risk adjustment to a level at or near zero, and essentially eliminate the imputed debt[6]. While UI has not had the opportunity to research the circumstances in Hawaii, and their applicability in New England, events in Hawaii show that policy makers in some other states are keenly aware of the imputed debt issue, and are willing to take steps to minimize imputed debt or mitigate its impact on EDCs. Since an ounce of prevention is worth a pound of cure, approaches that prevent debt from being imputed in the first place are most critical to avoiding adverse financial impacts.

UI believes that there is substantial evidence supporting ironclad, legislatively mandated cost recovery as a key step toward minimization of imputed debt. The Work Plan calls for "regulatory policies" to provide for cost recovery, but this may not be sufficient. As part of any coordinated procurement, NESCOE and state regulators should work to introduce and promote legislation in participating states that provides EDCs with

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[5] S&P Report at 4

[6] http://www.capitol.hawaii.gov/session2012/testimony/SB2752_SD1_TESTIMONY_CPC-JUD_03-19-12_.PDF

legislative cost recovery mechanisms. Because the Work Plan contemplates an apportionment of long-term contracting obligations to EDCs in different states, the program would benefit if the states had similar ironclad, legislatively-mandated cost recovery mechanisms.

While legislatively-mandated cost recovery contributes to minimization of imputed debt, it is not likely to eliminate it entirely. Note that the quote above from the S&P Report states that "such mechanisms lead to risk factors between 0% and 15%, depending on the legislative provisions for cost recovery and the supply function borne by the utility." Therefore, even with legislatively-mandated cost recovery, there are other factors that can lead to some level of imputed debt. Ironclad cost recovery is simply one tool in the toolbox that should be used in conjunction with other means of prevention and mitigation.

3. EDCs should be compensated for their role in the development of new renewable generation that is built under the Coordinated Procurement.

While the direct costs that are paid to suppliers and costs related to administration of long-term contracts are relatively easy to measure, there are other costs and risks that may be impactful, but cannot be measured with specificity. For example, the working capital required to support the lag between contract payments and cost recovery may preclude the EDC for making other investments, or even absent a rating downgrade, the EDC's cost of debt and equity capital may be impacted by lender risk perceptions. When EDCs are required to execute long-term contracts to fulfill policy objectives, they assume risk with no corresponding reward.

In 2008, Massachusetts recognized that EDCs face risk when they take on long-term contractual obligations to meet policy objectives. In An Act Relative to Green Communities (the "Green Communities Act") Massachusetts granted its EDCs renumeration equal to 4% of annual contract costs for entering into long-term contracts as compensation for taking such risk:

> *(c) provide for an annual remuneration for the contracting distribution company equal to 4 per cent of the annual payments under the contract to compensate the company for accepting the financial obligation of the long-term contract, such provision to be acted upon by the department of public utilities at the time of contract approval*[7]

In 2012, Massachusetts followed up the Green Communities Act with An Act Relative to Competitively Priced Electricity in the Commonwealth. In Section 36 of this act, Massachusetts again recognized that EDCs take on financial risk by entering into long-term contracts, and again provided renumeration as compensation for this risk:

[7] Green Communities Act; Section 83; Lines 2351-2354 (emphasis added)

(c) provide for an annual remuneration for the contracting distribution company equal to 2.75 per cent of the annual payments under the contract to compensate the company for accepting the financial obligation of the long-term contract, such provision to be acted upon by the department of public utilities at the time of contract approval[8]

Massachusetts clearly recognizes that renumeration to contracting EDCs represents a viable and reasonable way for compensating EDCs for some of the less measurable risks and costs associated with long-term contracts[9]. Also, when policy makers acknowledge the risks and costs incurred by EDCs by providing renumeration, they send a signal to the financial community that the EDCs are considered to be partners in the process and not simply vessels for the implementation of policy.

Thank you for the opportunity to provide comments. If you have any questions, please contact me at (203) 499-3271, or alan.trotta@uinet.com.

Regards

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[8] An Act Relative to Competitively Priced Electricity in the Commonwealth; Section 36; Lines 389-392

[9] UI does not endorse the Massachusetts approach in its entirety, however. Both of the acts referenced allow the Massachusetts EDCs to "structure its contracts, pricing or administration of the products purchased to mitigate impacts on the balance sheet or income statement of the distribution company or its parent company, subject to the approval of the department of public utilities; provided, that such mitigation shall not increase costs to ratepayers." Increasing equity would increase costs to ratepayers, so mitigation of debt ratio impacts through the issuance of equity, as proposed by SDG&E and in the Brattle Paper, may not be allowed under Massachusetts law.