WASHINGTON UTILITIES & TRANSPORTATION COMMISSION
UE-030423
Northwest Independent Power Producers Coalition
Comments on "Debt Equivalency"

November 9, 2005

The Northwest Independent Power Producers Coalition (NIPPC) submits these comments on the issue of debt equivalency in connection with the Commission's consideration of its policies – and rules – related to electric companies' purchases of electricity from qualifying facilities and independent power producers (UE-030423).

Introduction

Wall Street, including the credit ratings agencies, continues to see real value in the role played by independent power producers (IPPs) in diversifying utility generation portfolios. The power purchase agreements (PPAs) that utilities enter into with IPPs diversify the utility's risk and lead to lower cost power for utility customers. Yet, as electric utilities increasingly seek to own more traditional, rate-based power plants, the topic of debt equivalency has surfaced in the debate over whether utilities should "build or buy."

NIPPC appreciates the impact that rating agencies' treatment of PPAs has on the status of utility finances, and thereby, on the utilities' attitudes about whether or not to acquire resources via PPAs. The rating agencies' influence in this area is real, and their role understandable.

The challenge that the Commission faces is a familiar one. The Commission should seek to see the debt equivalency issue for what it is and what it is not. It should balance, and even mitigate its impact, to avoid compromising Washington consumers' access to least cost electric power. The challenge the Commission faces is two-fold.

First, how does the Commission manage the debt equivalency issue? The issue arises when rating agencies impute debt to PPAs, thereby assigning a higher debt-to-equity ratio for their evaluative purposes.

Second, how does the Commission assure that all future power generation, both from PPAs and from the utility's rate base, is treated comparably from a debt-equity standpoint and for evaluative purposes in determining the best option for utility customers?

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NIPPC agrees that debt equivalency, the so-called "balance sheet penalty," can have an impact, but that impact can easily be overstated and should not be included as a factor in open, transparent, and fair competitive solicitations.

What is Debt Equivalency?[1]

While debt equivalency is calculated differently by each of Wall Street's rating agencies (Standard & Poor's, Moody's, and Fitch) the objective is the same: reduce the risk to the value of bondholders' share in utility assets. The insertion of debt equivalency into utility finances is Wall Street-centric.

Debt equivalency is not a new idea. Rating agencies first established formulas for calculating the impacts of PPAs on utility balance sheets in the early 1990s. S&P did not revisit the formulas it developed 15 years ago until 2002.

S&P adopted its initial methodology to compensate for favoritism that utilities were showing for PPAs over generation they would otherwise have built and rate-based.[2] S&P, concerned about unbalanced utility supply portfolios, introduced its debt equivalency formulas to encourage conventional utility investment. S&P sees a PPA that is longer than three years as a fixed commitment, analogous to entering into a lease agreement. A PPA is akin to a "powerplant lease" and is treated on the utility's balance sheet as an increased risk, given the fixed payments (i.e., capacity payments) the utility is obligated to pay to the IPP. S&P develops and applies a risk factor to the future value of expected payments.

S&P, Moody's, and Fitch focus on the utility's ability to fulfill its obligation (the agencies assume that the IPP power plant will perform as per contract). The formula reflects a number of factors including the timing and extent of regulatory-sanctioned cost recovery for purchased-power costs. S&P considers the resulting product of the risk factor (expressed as a percentage) and the net present value of the PPA's capacity payments as the equivalent of a debt component for purposes of calculating more appropriate rating ratios. These adjusted ratios can then be compared to the ratios of utilities that do not purchase power (or that purchase less power).

[1] In preparing these comments NIPPC has relied on a white paper by the Electric Power Supply Association entitled "Electric Utility Resource Planning: The Role of Competitive Procurement and Debt Equivalency, 2005."

[2] Utilities have good reason to be concerned with managing the impact of construction of self-built resources on their credit ratings. This impact will likely be greater (especially for smaller utilities) than a debt equivalency calculation for a PPA. This is because the utility must carry on its books an "allowance for funds used during construction (AFUDC)" during the several years of construction. This usually means that the utility is issuing debt to cover construction costs, paying the interest out of pocket, but only booking the interest payments for future earnings in anticipation that it will be permitted to recover those costs once its powerplant goes commercial.

Debt Equivalency is art, not science

How the rating agencies calculate risk factors in utility/IPP power purchase agreements is more art than science. Predictably the 2000-01 West Coast Power Crisis encouraged S&P, Moody's, and Fitch to reexamine their methodologies.

GF Energy LLC, on behalf of the Electric Power Supply Association (EPSA), recently interviewed management at each of the agencies. GF Energy heard the following recurring messages:

1. The rating agencies all intend to continue assigning debt-equivalency amounts to PPAs.

2. They justify doing so on the basis that PPAs expose the buyer to risk that the ordinary balance sheet does not capture, apparently reflecting a view that cost recovery for longer-term PPAs is less certain than cost-recovery for a long-lived utility-owned plant.

3. The agencies consider the time lag between the execution of a PPA and the application of the debt-equivalence impact on the utility's balance sheet to be a significant issue, again because of uncertainty surrounding eventual cost recovery.

4. In their opinion, the imputation of debt to PPAs is not intended to question the quality of the seller, but rather to capture the exposure that otherwise doesn't show on the buyer's balance sheet.

5. The agencies assume that the assignment of debt equivalence is not to be seen as a negative penalty on the PPA (unless it is specifically noted as such), but, rather, as an adjustment.

6. Except in extreme cases, debt equivalency is not to be viewed as questioning the concept of PPAs generally or the efficacy of PPAs as a resource planning tool.

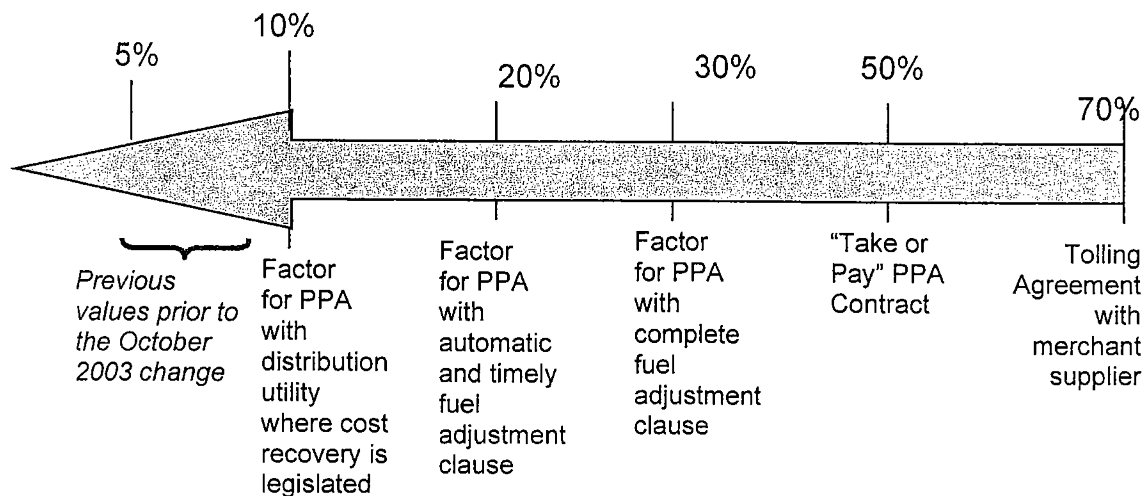
7. They assume that state regulators may choose to adjust debt/equity ratios to equalize the impact of PPA debt equivalencies and, in discussions, had no objections to regulators adopting this approach.

8. Finally, and in many ways most important, all three agencies agreed and assumed that PPAs would continue to be an important way for utilities to acquire generation as part of a balanced power supply portfolio approach. All suggested in these discussions that such balance in the utility's supply portfolio would be reflected in its credit ratings.

In addition to these areas of consensus, GF found considerable elasticity in how each agency arrives at the debt equivalency formulas they assign. The size of the debt equivalency risk factor (or its presence at all) will vary depending, for example, on the utility's credit rating; the lower the rating, the higher the factor. The policies of the utility's regulatory commission will also have a profound effect on the rating agencies' treatment of imputed debt.

The following schematic suggests the range of issues that affect debt equivalency treatment.

S&P's PPA Risk Factor Spectrum and Logic



Source: GF Energy schematics, based on S&P information

The schematic is not meant to be definitive, but rather to point to the range of factors that rating agencies consider in assessing debt equivalency treatment for PPAs. Risk factors, including many familiar to the Commission, are central to these calculations. Also evident is the dampening effect regulatory policy can have on the formulations.

This point warrants emphasis. Debt equivalency treatment, and its impact on utility balance sheets, can fade away as a direct result of Commission action. S&P's calculation of PPA debt factor drops significantly where regulators increase certainty. As indicated in the schematic above, S&P, for example, values the difference between an automatic fuel adjustment policy and a "complete," or periodic adjustment, at 10 percent.

The agencies, of course, consider far more than imputed debt when evaluating utility performance. They prudently look at a full spectrum of issues, including: management's leadership; the regulatory environment; weather patterns (always

important to the Northwest); and power plant performance. Any suggestion that a rating agency's imputed debt calculation of a single PPA will be decisive to an IOU's credit rating is, at best, far-fetched.

Debt Equivalency is Suited to Ex-Ante Consideration

The Oregon Commission demonstrated foresight in choosing to remove debt considerations from the recent PGE procurement it is NIPPC's position that the consideration of debt equivalency impacts should be treated in the context of cost recovery deliberations. NIPPC adds further that debt equivalency should be addressed by the Commission only to the extent that there is a good record of evidence that a debt equivalency issue has arisen that actually and negatively affects the utility's cost of capital or bond liquidity.

It is NIPPC's position that Wall Street evaluations of risk should not influence a utility's pursuit of the least cost resource for its consumers. It is clearly in everyone's interest that utilities maintain investment status, and while Commission action can mitigate for the effect of a PPA on a utility's status – should it prove to be an issue – the time to do so is after the best-possible resource decisions have been made, not before.

The Commission can also choose to act pro-actively in addressing debt equivalency head on. Encouraging competitive acquisition of least cost IPP resources and building greater certainty into utilities' ability to recover their investment in selected resources will vastly reduce – if not outright eliminate – the "balance sheet penalty."

Conclusion

Debt equivalency is rising to the top of commission agendas around the country as utilities express renewed interest in rate-based resources. Meanwhile, far too little is known about the real effect Wall Street's treatment of debt imputations has – or should have – on utility procurement. In addition, few commissions have had the chance to directly mitigate the impacts with explicit action. To date, several states including Oregon,[3] Florida,[4] California[5] and most recently, Utah[6] have explicitly considered debt equivalency in resource procurement. In Florida's case, the Commission allowed for an "equity adjustment" to mitigate the impact of 10 percent risk factor on Florida Power & Light's balance sheet for PPAs it signed with several QFs. In California's case, the Commission explicitly removed any consideration of debt imputation considerations in procurement of renewable energy resources.

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[3] Oregon Public Utilities Commission Order No. 03-387, UM 1080, July 3, 2003.
[4] Florida Public Service Commission Order No. 99-0519-AS-EI, March 17, 1999
[5] California Public Utilities Commission Decision 04-07-029, July 8, 2004
[6] Utah Public Service Commission Decision in Docket No. 03-035-14, October 31, 2005

The Commission is in a position through this proceeding to assure balance in resource procurement. It can ensure that Wall Street does not exercise excessive influence over Washington's resource decisions. And the Commission can also address a utility's preference to earn regulated returns of its invested capital rather than adding debt (in the form of a PPA) to its balance sheet.

Ultimately, the selection of the best possible generation option – built, bought or contracted – should be determined on its merits and on the merits of competing proposals. The best way the Commission can achieve this desirable result is by promulgating open, transparent and fair competitive solicitations and by encouraging progressive treatment of the least cost resources that result.