

Rocky Mountain Power  
Exhibit RMP\_\_(BNW-3)  
Docket No. 08-035-38  
Witness: Bruce N. Williams

BEFORE THE PUBLIC SERVICE COMMISSION  
OF THE STATE OF UTAH

ROCKY MOUNTAIN POWER

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Exhibit Accompanying Direct Testimony of Bruce N. Williams

Standard & Poors – Imputed Debt for PPAs

July 2008

## RESEARCH

## Credit FAQ:

## Imputed Debt Calculation For U.S. Utilities' Power Purchase Agreements

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In November 2006, Standard & Poor's Ratings Services invited members of the U.S. electric industry and interested parties to provide us with comments on our proposal to incorporate evergreen treatment in the debt equivalents we calculate to reflect the fixed obligations created by power purchase agreements (PPAs). Evergreen treatment would, for analytical purposes, assume an extension of the life of some short- and intermediate-term PPAs, so as to achieve comparability in the financial metrics of companies with supply arrangements of varying durations.

We received comments from every sector of the power industry--utilities, independent power producers, trade organizations, consultants, investors, and regulators. Based on the comments received, we have reached a number of conclusions regarding the application of evergreen treatment to PPAs in our analysis. We have also made a number of clarifications and refinements to our rating methodology. This discussion supplements our Nov. 1, 2006 article "Request for Comments: Imputing Debt to Purchased Power Obligations," which is available on RatingsDirect.

### Frequently Asked Questions

#### How is evergreen treatment applied in Standard & Poor's credit analysis?

Standard & Poor's adjusts reported financial metrics to capitalize portions of the costs of PPAs. The intent of these adjustments is to capture fixed PPA obligations that have debt-like attributes because they fund the recovery of third-party power suppliers' capital investments in generation assets. These fixed obligations merit inclusion in a utility's financial metrics as though they are part of a utility's permanent capital structure. Evergreen treatment would extend the tenor of short- and intermediate-term contracts to reflect the long-term obligation of electric utilities to meet their customers' demand for electricity.

We have concluded that there is a limited pool of utilities whose portfolios of existing and projected PPAs do not meaningfully correspond to long-term load serving obligations. Although evergreen treatment will be applied selectively in those cases where the portfolio of existing and projected PPAs is inconsistent with long-term load-serving obligations, a blanket application of evergreen treatment is not warranted.

The net present value (NPV) of the fixed obligations associated with a portfolio of short-term or intermediate-term contracts can lead to distortions in a utility's financial profile relative to the NPV of the fixed obligations of a utility with a portfolio of PPAs that is made up of longer-term commitments. Where there is the potential for such distortions, rating committees will consider evergreen treatment of existing PPA obligations as a scenario for inclusion in the rating analysis.

#### What are the mechanics of PPA debt imputation and evergreen treatment?

A starting point for calculating the debt to be imputed for PPA-related fixed obligations can be found among the "commitments and contingencies" in the notes to a utility's financial statements. An NPV is calculated for the stream of capacity payments associated with the outstanding contracts included in the

financial statements. The notes to the financial statements report capacity payments for the succeeding five years and a "thereafter" period.

While we have access to proprietary forecasts that show the detail underlying the costs that are amalgamated beyond the five-year horizon, others, for purposes of calculating an NPV, can divide the amount reported as "thereafter" by the average of the capacity payments in the preceding five years to derive an approximate tenor of the amounts combined as the sum of the obligations beyond the fifth year.

In calculating debt equivalents, we also include new contracts that will commence during the forecast period and aren't reflected in the notes to the financial statements. For this group of contracts, debt imputation will not commence until the year that energy deliveries are to begin under the anticipated contract.

### **How is NPV calculated?**

The NPV is calculated using a discount rate equivalent to the company's average cost of debt, net of securitization debt. Once we arrive at the NPV, we apply a risk factor to reflect the benefits of regulatory or legislative cost recovery mechanisms (see "Request for Comments: Imputing Debt to Purchased Power Obligations," (cited above) for a discussion of risk factors).

### **How does evergreen treatment alter the PPA debt adjustment?**

If evergreen treatment is warranted, we would extend the expiration of existing contracts and those that are slated to commence during the five-year horizon. Based on our analysis of several companies, we have determined that any evergreen extension of the tenor of existing contracts and anticipated contracts should extend those contracts to 12 years beyond the relevant forecast year.

To decide whether to apply evergreen treatment, we would start with an examination of actual capacity payments scheduled during the five-year horizon and the period represented as the thereafter period in the financial statements. If we conclude that the duration of PPAs is short relative to our targeted tenor, we would then add capacity payments until the targeted tenor is achieved. The price for the capacity that we add will be derived from new peaker entry economics.

We use empirical data to establish the cost of developing new peaking capacity and will reflect regional differences in our analysis. The cost of new capacity is translated into a dollars-per-kilowatt-year figure using a proxy weighted average cost of capital and a proxy capital recovery period.

### **Does customer choice curb the need for evergreen treatment?**

Several comments submitted to us observed that over the long term there is the potential that customers may switch to third-party providers, thereby undermining the rationale for an evergreen adjustment. We acknowledge that the introduction of customer migration would alter the long-term obligation to serve. At the same time, it must be noted that our rating methodology already addresses this concern. Customer choice typically goes hand in hand with the transformation of a utility into a pure transmission and distribution system. We have previously stated that we won't impute debt for those utilities whose role--as a result of either regulatory orders or legislation--is limited to that of a conduit between suppliers and retail customers. Therefore, utilities whose customers have retail choice aren't generally exposed to debt imputation and, in turn, we won't apply evergreen treatment to their supply obligations.

### **Have there been revisions to the analytical treatment of short-term PPAs?**

For many years, Standard & Poor's didn't calculate debt equivalents for the fixed costs of power supply arrangements whose tenor was three years or less. We recently announced our abandonment of this exception to our debt imputation criteria. However, we understand that there are some utilities that use short-term PPAs of approximately one year or less as gap fillers pending either the construction of new capacity or the execution of long-term PPA contracts. To the extent that such short-term supply arrangements represent a nominal percentage of demand and serve the purposes described above, we will neither impute debt for such contracts nor provide evergreen treatment to such contracts.

### **Are accommodations made for PPAs that are treated as leases in the financial statements?**

Several utilities have reported that their accountants dictate that certain PPAs need to be treated as leases for accounting purposes due to the tenor of the PPA or the residual value of the asset upon the PPA's expiration. We have consistently taken the position that companies should identify those capacity charges

that are subject to lease treatment in the financial statements so that we can accord PPA treatment to those obligations, in lieu of lease treatment. That is, PPAs that receive lease treatment for accounting purposes won't be subject to a 100% risk factor for analytical purposes as though they were leases. Rather, the NPV of the stream of capacity payments associated with these PPAs will be reduced by the risk factor that is applied to the utility's other PPA commitments.

### **How is the depreciation expense related to PPAs calculated?**

We noted in our November article that we now add an implied depreciation expense to funds from operations (FFO) to align the analytical treatment of PPAs with the concept of purchased power as a substitute for self-build. We observed that we calculate imputed depreciation expense in conformity with the methodology used for calculating a depreciation adjustment as an offset to debt equivalents created by leases.

The imputed depreciation expense is calculated for any given year by taking the scheduled fixed capacity payment commitment for that year and subtracting from it the implied interest expense calculated from the NPV of the stream of capacity payments associated with that year. The calculated depreciation proxy is added to FFO in the numerator as part of the calculation of both the FFO-to-interest and FFO-to-debt ratios.

### **What adjustments are made for tolling contracts?**

We will assign a 100% risk factor when imputing debt to an unregulated energy company that has entered into a tolling agreement for a power plant's output. This is done because of the absence of a regulatory mechanism for the recovery of the fixed costs presented by the tolling arrangement.

### **Are transmission contracts treated differently than PPAs?**

In recent years, some utilities have entered into long-term transmission contracts in lieu of building generation. In some cases, these transmission contracts provide access to specific power plants, while other transmission arrangements provide access to competitive wholesale electricity markets. We have concluded that these types of transmission arrangements represent extensions of the power plants to which they are connected or the markets that they serve. Irrespective of whether these transmission lines are integral to the delivery of power from a specific plant or are conduits to wholesale markets, we view these arrangements as exhibiting very strong parallels to PPAs as a substitute for investment in power plants. Consequently, we will impute debt for the fixed costs associated with long-term transmission contracts.

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