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April 22, 2019

Luly E. Massaro, Commission Clerk
Rhode Island Public Utilities Commission
89 Jefferson Boulevard
Warwick, RI 02888

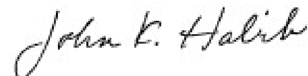
RE: Review of Proposed Power Purchase Agreements
Pursuant to R.I. Gen. Laws § 39-31
Docket No. 4929

Dear Ms. Massaro:

Enclosed for filing with the Rhode Island Public Utilities Commission (PUC) is the rebuttal testimony of Robert B. Hevert on behalf of National Grid[1].

Please contact me at 617-951-1400 if you have any questions regarding this filing.

Very truly yours,



John K. Habib, Esq.
R.I. Bar # 7431

cc: Docket No. 4929 Service List

[1] The Narragansett Electric Company d/b/a National Grid (National Grid or the Company).

Docket No. 4929 -- National Grid's Review of PPA w/ WWD Rev I, LLC

Service List updated 4/15/2019

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REBUTTAL TESTIMONY

OF

ROBERT B. HEVERT

REBUTTAL TESTIMONY OF ROBERT B. HEVERT

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1 ## I. INTRODUCTION AND OVERVIEW

2 **Q. Please state your name, position, and business address.**

3 A. My name is Robert B. Hevert. I am a Partner at ScottMadden, Inc. ("ScottMadden"). My
4 business address is 1900 West Park Drive, Suite 250, Westborough, Massachusetts, 01581.

5 **Q. On whose behalf are you submitting your Rebuttal Testimony?**

6 A. I am submitting this Rebuttal Testimony to the Rhode Island Public Utilities Commission
7 (the "Commission") on behalf of Narragansett Electric Company, d/b/a National Grid
8 ("Narragansett" or "the Company").

9 **Q. Have you previously filed Direct Testimony in this proceeding?**

10 A. Yes, I have.

11 **Q. What is the purpose of your Rebuttal Testimony?**

12 A. The purpose of my Rebuttal Testimony is to respond to the Direct Testimony of Matthew
13 I. Kahal on behalf of The Division of Public Utilities and Carriers ("Division"), regarding
14 the Company's request for financial remuneration and incentives of 2.75 percent of the
15 actual annual payments (the "Remuneration Rate") under a new long-term renewable
16 energy power purchase agreement (the "Contract") with Deepwater Wind for the 400-
17 megawatt ("MW") Revolution Wind Project (the "Project", or "DWW"). My Rebuttal
18 Testimony also responds to the Division's Memorandum Supplement, provided by Mr.
19 Schrag.

1 **Q. Do you have any overall observations regarding Mr. Kahal's testimony, or the**
2 **Division's Memorandum Supplement?**

3 A. Yes, I do. Remuneration is a critical component of the regulatory structure enabling the
4 cost-effective financing of the Project, and of future renewable energy facilities. A
5 reasonable Remuneration Rate would help mitigate the adverse effects on the Company's
6 credit quality from assuming a $3.21 billion financial obligation. As noted in my Direct
7 Testimony, the ACES Act calls for coordinated, cost-effective, strategic investments in
8 energy resources and infrastructure to achieve economic and environmental objectives for
9 Rhode Island and New England. By approving the Company's proposed Remuneration
10 Rate, the Division would clearly state its recognition of the Company's critical role in
11 securing and maintaining the long-term obligations needed to promote renewable
12 development, and that there is a clear and unambiguous intent to compensate the Company
13 for taking on large, long-term financial obligations for the sole purpose of furthering the
14 State's economic and environmental objectives.

15 The importance of avoiding an adverse effect on the Company's credit quality in
16 connection with those obligations cannot be overstated. Credit quality measures financial
17 strength, and financial strength is necessary to maintain constant, efficient, low-cost access
18 to the capital required to support utility operations. If financial strength is eroded, the cost
19 of utility operations will increase materially for customers. Absent an explicit recognition
20 of that outcome, and clear steps to avoid it, the erosion of the Company's credit quality
21 would jeopardize its ability to continue its voluntary collaboration in achieving the

1 objectives set forth in the ACES Act.

2 Although the Division recognizes the Company's crucial role in enabling the Project's
3 cost-effective financing, Mr. Kahal incorrectly assumes the $3.21 billion obligation under
4 the Contract presents no meaningful risks for Narragansett, its customers, or its investors.
5 He assumes the Company's ability to continue its collaboration with the State and the
6 Commission to enable future projects would be unconstrained by those, and presumably
7 future fixed financial obligations. Not only is Mr. Kahal's assumption incorrect, if adopted
8 it would have the counterproductive effect of frustrating the public interest objectives the
9 ACES Act hopes to achieve.

10 **Q. Are there points on which you agree with the Division?**

11 A. Yes, there are. I agree, for example, that the public benefits and policy objectives
12 contemplated by the ACES Act and brought by the Project would not be realizable but for
13 the Company's strong credit profile and balance sheet. I also agree the Company is under
14 no obligation to extend its balance sheet and credit profile to the Project, or to accept the
15 significant financial obligation under the Contract. As Mr. Schrag correctly notes, the
16 Company's collaboration under ACES is voluntary. Mr. Schrag's consideration of the
17 benefits created by the Company's voluntary acceptance of the large, fixed obligations
18 under the Contract also is consistent with my view that net benefits are important to
19 determining the appropriate Remuneration Rate.

20 The principal point of departure between our positions is the extent to which the Contract

1 and its associated obligations create risks for the Company, its investors, and ratepayers;
2 and whether remuneration can, or should be directly tied to some measure of benefits
3 created by the Project. Mr. Kahal dismisses as "doubtful" and "likely to be easily
4 manageable,"[1] the financial risks brought about by an obligation he terms "enormous"[2].
5 Mr. Kahal further considers the prospect of incremental risk to equity investors arising
6 from the Contract's $3.21 billion obligation to be "implausible".[3] In Mr. Kahal's view,
7 the risks that matter are the market-price risks, for which he considers the Contract a hedge
8 supported by ratepayers, and the development and operating risks, which remain with the
9 Project. As explained in more detail below, Mr. Kahal's narrow view overlooks the varied
10 and considerable risks the $3.21 billion obligation creates for investors and customers.

11 Although Mr. Kahal disagrees with the Company's positions and Remuneration proposal,
12 he provides neither a specific recommendation, nor a constructive approach to developing
13 one. The Division, (through Mr. Schrag), provides certain principles the Commission may
14 consider in determining the proper Remuneration Rate. As Table 1 (below) explains, there
15 are several points on which I agree with those principles, and with Mr. Schrag's
16 interpretation of them. Those points considerably narrow the scope of otherwise-disputed
17 issues.

[1] Direct Testimony of Matthew I. Kahal, at 16.

[2] Direct Testimony of Mathew I. Kahal, at 15.

[3] Direct Testimony of Matthew I. Kahal, at 21.

1

Table 1: Summary of the Division's Principles[4]

Principle	Division Position	Response
What are the specific objectives of the proposed remuneration?	To reward the Company for administrative collaboration in execution of a large Contract with benefits to ratepayers and in furtherance of state energy and environmental goals	• Agree • There are other critical objectives, such as mitigating risks associated with large, fixed financial obligations, which will accrue to the benefit of customers.
Does the proposed remuneration promote the realization of new consumer and societal benefits?	Yes, in that the Contract for a new resource, offshore wind, is not likely to develop without the role of Company as a counterparty to the Contract.	• Agree. given the current lack of wholesale market mechanisms in ISONE that would enable public policy projects such as this
Does the proposed remuneration promote behavior that the utility otherwise would not take?	Yes. The Company has no "natural incentive" to undertake this activity and its collaboration under ACES is voluntary.	• Agree.
Is there a clear nexus between the design of the proposed remuneration and the expected benefits?	As proposed by the Company there is not. Therefore, the Division recommends reforming the remuneration to better correlate with the benefits.	• The financing benefits created by the Company's credit profile far outweigh the Remuneration Rate. • Although expected benefits are a relevant consideration, the risks created by accepting the fixed obligation required under the Contract likewise are important considerations.
Is there a clear and stated reason why the proposed remuneration is needed to achieve the specific objectives?	Yes, the Contract would not be viable without a financially strong counterparty.	• Agree, that it is the strength of the Company's credit profile, including its capital structure, that enables the Project's cost-effective financing.
Is the proposed remuneration designed to promote superior utility performance and significantly advance the expected benefits as efficiently as possible?	This is unclear as currently proposed by the Company. No performance metrics have been identified.	• The relevant measure of performance is whether the Company's credit profile enabled the public benefits contemplated by the State, and recognized by the Division. • The ability to maximize the

[4] *See*, Memorandum Supplement, April 12, 2019, at 3 – 4.

Principle	Division Position	Response
		Project's net benefits depends critically on the Company's ability to maintain its credit profile over Contract term.
Is the proposed remuneration designed so that customers receive most of the benefit?	In the Company's proposal it would receive about 40 percent of the benefits. This is significantly greater than the Commission has historically entertained.	• Customers receive the majority of direct benefits and benefit as well from the indirect benefits brought to the state of RI through the company's enablement of the project. • Customers also will benefit by the Company's ability to maintain its credit profile, which will reduce the Cost of Capital in future rate proceedings.
Is the proposed remuneration designed to grant increasing levels of rewards to the utility for higher levels of performance?	No, it is not.	• Beyond maintaining its credit profile, it is not within the Company's control to maximize the net benefits under the Contract over its entire 20-year term. • The Company's ability to maintain its credit profile, however, depends critically on the regulatory support it receives in this, and other proceedings.
Will the design and implementation of the proposed remuneration be completely transparent and fully document and reveal inputs and methodologies to ensure no duplication of incentives across various ratepayer funded programs?	In both cases, the accounting is expected to be completely transparent.	• Agree.
Is it possible to compare the cost of achieving the proposed remuneration to the potential benefits?	The costs to achieve the remuneration should not be in excess of standard administrative costs in execution of the Contract.	• The premise is somewhat unclear. • The Remuneration Rate provides a cost-effective means of achieving the Projects' benefits. • In addition to administrative costs, costs associated with

Principle	Division Position	Response
		the Company's diminished balance sheet strength and credit quality should also be considered.
Are there opportunities for National Grid to earn multiple incentives for attaining the objectives?	The Division is not aware that opportunities for duplication exist.	• Agree.

1

2 The Division's principles are also consistent with the three criteria provided in my Direct
3 Testimony. Those criteria address whether the Remuneration Rate, together with the
4 Contract obligations, is likely to:

5 (1) Create a cost-effective financing structure for the Project, thereby advancing the public
6 interest objectives contemplated under the ACES Act;
7
8 (2) Help mitigate adverse effects associated with large, long-lived, fixed financial
9 obligations, such as the Contract, on the Company's financial profile and flexibility;
10 and
11
12 (3) Produce net economic and environmental benefits for customers after giving effect to
13 the proposed Remuneration Rate.[5]
14
15 Although the Division's principles and the three criteria noted above appear generally
16 aligned, there remain several significant areas of disagreement between the Company and
17 the Division regarding the Division's application. Those differences include the Division's
18 positions that: the Contract is a market "hedge" that creates no additional risks for the
19 Company and its investors; compensation for taking on the large fixed financial obligations

[5] Pre-filed Direct Testimony of Robert B. Hevert, at 9.

1 is generally inconsistent with regulatory policies; the Company is but a "passive"
2 participant in the Contract; any increases in costs, including the cost of capital, are of little
3 concern because they would be recoverable in future base rate proceedings, and; the
4 proposed Remuneration Rate is too high relative to the benefits created and to the
5 Company's current equity base.[6]

6 As I explain, even if not readily quantifiable, the risks associated with assuming large fixed
7 obligations are significant and relevant to the financial community. I further explain that
8 maintaining the credit quality required to cost-effectively finance the Project, and to enter
9 into future renewable energy contracts, is not a "passive" exercise. Rather, establishing
10 and maintaining credit quality is an active, iterative and highly complex function that
11 depends on the capital provided by investors (the Company's balance sheet), the
12 Company's prudent management of that capital, and the Commission's continued support
13 of the Company's credit quality.

14 The Company's capacity to absorb large, ongoing obligations while financing the
15 investments and operations needed to provide utility service is not infinite, as Mr. Kahal's
16 position appears to assume. There is no doubt that if its financial profile is compromised
17 by its obligations under the Contract, the Company's ability to enter into future long-term
18 contracts also will be compromised. As discussed throughout my Direct and Rebuttal

[6] *See*, Memorandum Supplement, April 12, 2019, at 2; Direct Testimony of Matthew I. Kahal, at 12.

1 Testimonies, the Company's proposed Remuneration Rate helps mitigate that risk.[7]

2 As to the Division's view that the proposed Remuneration Rate is inconsistent with
3 regulatory practice, I note that the Massachusetts Department of Public Utilities recently
4 authorized a remuneration rate of 2.75 percent for the Vineyard Wind project.[8] In my view,
5 the financial community will see that decision as credit-supportive and constructive, and
6 investors will view it as an important benchmark as they consider their investment
7 opportunities.

8 Moreover, the question of how electric distribution companies should be compensated for
9 assuming the large, fixed obligations associated renewable energy contracts meant to
10 further public policy objectives is a relatively new regulatory issue. It therefore is not
11 surprising that Mr. Kahal is not familiar with similar circumstances.[9] That said, the recent
12 order by the Massachusetts Department of Public Utilities authorizes a Remuneration Rate
13 of 2.75 percent, the same rate proposed in this proceeding, for accepting the financial

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[7] *See*, also, Direct Testimony of Robert B. Hevert, at 10.

[8] *Petition of NSTAR Electric Company, d/b/a Eversource Energy for approval by the Department of Public Utilities of two long-term contracts for procurement of Offshore Wind Energy Generation, pursuant to Section 83C of An Act Relative to Green Communities, St. 2008, c. 169, as amended by St. 2016, c. 188, § 12*, D.P.U. 18-76; *Petition of Massachusetts Electric Company and Nantucket Electric Company, each d/b/a National Grid for approval by the Department of Public Utilities of two long-term contracts for procurement of Offshore Wind Energy Generation, pursuant to Section 83C of An Act Relative to Green Communities, St. 2008, c. 169, as amended by St. 2016, c. 188, § 12*, D.P.U. 18-77; *Petition of Fitchburg Gas and Electric Light Company, d/b/a Unitil for approval by the Department of Public Utilities of two long-term contracts for procurement of Offshore Wind Energy Generation, pursuant to Section 83C of An Act Relative to Green Communities, St. 2008, c. 169, as amended by St. 2016, c. 188, § 12*, D.P.U. 18-78, April 12, 2019, at 72.

[9] Direct Testimony of Matthew I. Kahal, at 27 – 28.

1 obligation associated with a renewable energy project.

2 Moreover, providing Remuneration to utilities that commit resources to advance public
3 policy objectives is not an unusual practice. Notably, § 39-26.1-4, the Long-Term
4 Contracting Standard ("LTCS") for Renewable Energy, specifically entitles the Company to
5 Remuneration as compensation for accepting the financial obligations created by long-term
6 contracts supporting newly developed renewable energy resources, equal to 2.75 percent of the
7 actual annual contract payments for projects that are commercially operating. Although
8 Remuneration under the LTCS is required by that statute, under § 39-31-7(a)(7) of the ACES
9 Act, the Commission is authorized to "[a]pprove any other proposed regulatory or ratemaking
10 changes that reasonably advance the goals set forth herein." Accordingly, Remuneration should
11 be provided to Narragansett for extending its strong balance sheet and credit rating, which are
12 derived from its investors' capital and the Company's prudent management of that capital, to
13 support the cost-effective financing and development of new and innovative renewable energy
14 generation projects to achieve Rhode Island's public interest objectives.

15 Although Mr. Kahal seems to regard the incentives provided in Virginia to utilities that
16 build certain types of in-state generating assets as not applicable to this proceeding, the
17 purpose of those incentives is to advance policy objectives established by the state

1 legislature.[10] As discussed in my Direct Testimony, the ACES Act sets out certain policy
2 objectives, and as Mr. Schrag observes, the Company voluntarily collaborates under ACES
3 to achieve them.[11]

4 Mr. Kahal also fails to consider that equity investors, who have provided about 51.00
5 percent of the Company's currently authorized capital structure[12], will be compensated (in
6 the form of dividends) only after contractual obligations – including payments under the
7 Contract - are satisfied. That is, equity investors are the "residual claimants" on cash flows,
8 bearing the "residual risk" of ownership. Because equity has an indefinite life, equity
9 investors bear those risks throughout the terms of the contracts entered into under the Act.
10 It simply is unreasonable to assume those investors will be unconcerned by the
11 approximately $3.21 billion of additional financial obligations under the Contract.

12 In that important respect, Mr. Kahal would have the State rely on investors' capital to create
13 significant customer benefits, and advance the public interest contemplated by the Act,
14 while increasing the Company's business and financial risks. In my experience, the
15 financial community would consider that approach and outcome as confiscatory, rather

[10] As explained in the Company's response to DIV 1-11, the legislation in Virginia makes clear the objectives are policy-oriented, and include social benefits beyond adding in-state generating capacity: "To ensure the generation and delivery of a reliable and adequate supply of electricity, to meet the utility's projected native load obligations and to promote economic development, a utility may at any time, after the expiration or termination of capped rates, petition the Commission for approval of a rate adjustment clause for recovery on a timely and current basis…" *See*, Code of Virginia Title 56. Public Service Companies Chapter 23. Virginia Electric Utility Regulation Act, §56-585.1.A.6.

[11] Memorandum Supplement dated April 12, 2019, at 3.

[12] *See*, Direct Testimony of Matthew I. Kahal, at 12.

1 than "just and reasonable".

2 Regarding the Division's position that the Remuneration Rate should be tied to some
3 measure of benefits, the Company cannot manage or maximize the benefits created by the
4 Project over its 20-year life. Rather, as the Division recognizes, by extending its credit
5 profile and balance sheet to enable the Project's cost-effective financing, the Company
6 plays a "unique, necessary and important role". The financing benefits derived from that
7 role, which were estimated in my Direct Testimony, suggest the Remuneration Rate could
8 be as high as 13.59 percent, about five times greater than the Company's 2.75 percent
9 proposal.[13] That is, the 2.75 percent proposed Remuneration Rate represents about 20.00
10 percent of the benefits created by the Company's active and prudent management of its
11 balance sheet and credit profile.

12 Lastly, I appreciate that the Division recognizes the need for future collaboration with the
13 Company to address "the threat of climate change and the need to decarbonize the
14 electricity sector over the coming decades".[14] Presumably, that collaboration would
15 require the Company to be party to additional long-term renewable energy contracts. The
16 Company's ability to accept those obligations, however, depends critically on its ability to
17 maintain the financial profile required to assume future obligations while funding its day-
18 to-day utility and the assets needed to provide those operations. As discussed throughout

[13] Pre-filed Direct Testimony of Robert B. Hevert, at 35.

[14] Memorandum Supplement, April 12, 2019, at 2.

1 my Rebuttal Testimony, the Company's proposed 2.75 percent Remuneration Rate
2 partially addresses the risks created by those financial obligations. In doing so, the
3 proposed Remuneration Rate enables the Company to continue in its unique role ensuring
4 the cost-effective financing of renewable energy projects, and its future collaboration with
5 the State and the Commission.

6 **II. RESPONSE TO MR. KAHAL**

7 **Q. Please briefly summarize Mr. Kahal's conclusions regarding the Remuneration Rate.**

8 A. Mr. Schrag summarizes the principal conclusions contained in Mr. Kahal's testimony as
9 follows:

10 • The Company's request for compensation is not clearly connected to any additional
11 cost that National Grid would incur;
12

13 • Any hypothetical costs related to an increased cost of capital or other costs related
14 to the Contract would be recovered from ratepayers in normal ratemaking
15 proceedings and any additional compensation through Renumeration would
16 constitute double recovery;
17

18 • The Company's primary role is to serve as a passive administrator of funds
19 and counterparty to the Contract;
20

21 • The Contract is a market price hedge provided by ratepayers to the project and
22 does not increase any risk for the Company or its shareholders;
23

24 • Inclusion of a corporate profit element for a Contract is outside the mainstream
25 for utility regulation;
26

27 • The requested remuneration of $37 million (2018 NPV) is about 40 percent

1 of the estimated $91 million in customer net benefits of the proposed project;
2

3 • The valid basis for remuneration of some reasonable amount is that the Company is
4 advancing state objectives in providing a beneficial transaction for ratepayers in
5 support of important policy goals as defined by the ACES statute.[15]
6

7 Mr. Kahal's conclusions appear to fall within two general areas: (1) the form and measure
8 of risk created by the Contract; (2) the form and measure of a reasonable level of
9 remuneration.

10 **Q. Are there points on which you and Mr. Kahal agree?**

11 A. Yes, there are. For example, Mr. Kahal acknowledges that the Company voluntarily has
12 collaborated with the State of Rhode Island and the Commission, providing a beneficial
13 transaction for utility customers and advancing important policy goals under the ACES
14 Act. Mr. Kahal also acknowledges that the Project likely could not go forward without the
15 participation of a creditworthy utility such as Narragansett, although he incorrectly
16 concludes it is not the Company itself that makes the Project feasible, but its customers.[16]
17 Although he believes the Company's voluntary collaboration warrants some consideration,
18 he provides neither a proposed Remuneration rate, nor a construct for developing one.
19 Rather, Mr. Kahal refers to the Division's principles, discussed earlier.

[15] Memorandum Supplement, April 12, 2019, at 1.

[16] *See*, Direct Testimony of Matthew I. Kahal, at 9 -11.

1 **Q. Please summarize the key areas in which there remain differences between you and**
2 **Mr. Kahal.**

3 A. As noted above, Mr. Kahal's conclusions fall in the two general areas of (1) the form and
4 measure of risk associated with the Contract, and (2) the form and measure of
5 remuneration. Regarding the risk associated with the Contract, I disagree with Mr. Kahal's
6 views that: (1) the Contract is a market price hedge provided by ratepayers to the Project,
7 for which the Company simply is a "conduit", facing no meaningful incremental risk and
8 requiring no incremental compensation; (2) the Company's primary role is to serve as a
9 "passive" administrator of funds and counterparty to the Contract, without exposure to
10 incremental risk; and (3) the implications of the extent to which rating agencies may, or
11 may not, impute debt on the Company's balance sheet in connection with the Contract.

12 As to his views regarding the form and measure of remuneration, I disagree with Mr.
13 Kahal's conclusions that: (1) the Company's proposed Remuneration is an incremental
14 "return" to equity investors, and outside the mainstream of utility regulation; (2) the
15 Company's proposal constitutes double-recovery of capital costs; and (3) the proposed
16 Remuneration Rate is unreasonable relative to expected savings and the Company's current
17 equity base.

18 Lastly, although not specifically included in Mr. Kahal's testimony, I am concerned with
19 Division's position that remuneration should be directly tied to some measure of benefits
20 created by the Project.

1 ***A. The Contract as a Market Hedge with No Risk to the Company***

2 **Q. Do you agree with Mr. Kahal's view that the Contract is a hedge on market prices**
3 **with no incremental risk to the Company?**

4 A. No, I do not. Although Mr. Kahal speaks of the Contract as a "hedge" against market
5 prices, he does not see the Remuneration Rate as a hedge against the risks brought on by
6 large fixed financial obligations. Like hedge instruments designed to offset specific risks,
7 the requested Remuneration Rate in this case provides a hedge against potential risks to the
8 Company's credit quality by mitigating certain of the cash flow timing, balance sheet, and
9 credit quality risks that large, fixed obligations create. Left unmitigated, those risks
10 (discussed in more detail below) present the possibility of an adverse credit action, which
11 would increase the Company's cost of capital, and diminish its access to capital.

12 **Q. If a company incurs a credit rating downgrade, what challenges does it face in**
13 **restoring its credit quality?**

14 A. Generally, the effects on a company depend on the extent of the downgrade. In the case of
15 a single-notch downgrade within the investment-grade categories, the company will incur
16 a somewhat higher cost of debt and equity while it works to restore its credit rating. The
17 challenges associated with a downgrade become more acute when capital markets become
18 constrained. Then, the costs and terms under which companies might acquire capital
19 become increasingly difficult. The process to restore a credit rating can take several years:
20 in addition to strengthening the necessary credit metrics, investors may require a company
21 to establish a track record of improved financial performance and demonstrate renewed

1 financial metric stability to substantiate an increase in rating back to the original level.

2 As discussed below and in my Direct Testimony, the Remuneration Rate not only provides
3 a degree of cash flow stability that is important to rating agencies, it conveys the strong,
4 positive message that the regulatory environment in Rhode Island remains supportive of
5 utilities' credit quality. The importance of that support cannot be understated; as my Direct
6 Testimony explained, fully 50.00 percent of the factors Moody's considers in their rating
7 determination process relate to the nature of regulation.

8 **Q. Do you agree with Mr. Kahal's position that the Company simply can file for rate**
9 **relief to address increased capital costs if the Company's credit quality is degraded**
10 **in connection with the Contract?**

11 A. No, I do not. Although the Company may seek rate relief to recover increased capital costs,
12 the better approach, for customers and investors, is to avoid that degradation in the first
13 place. As discussed above, the implications of an adverse rating event go beyond the
14 incremental cost of capital - they include the ability to efficiently access capital during
15 constrained markets. Like other utilities, the Company does not have the option to defer
16 acquiring capital during market contractions. Consequently, the loss of credit quality is a
17 significant concern. Because restoring credit quality is a long-term process, that concern
18 is long-lived.

19 Lastly, Mr. Kahal argues it is the customers, not the Company, who have the central role

1 in "absorbing all market risk in making the PPA possible."[17] Mr. Kahal's position therefore
2 assumes the Company's financial strength has little effect on its ability to cost-effectively
3 finance the Project, provided customers pay the Contract costs. I disagree. If the Company
4 had a below investment grade credit rating, the Project lenders would not look to it for
5 comfort, regardless of customers' obligations.[18] The Company has strong investment
6 grade ratings because of the capital provided by investors; the prudent management of that
7 capital; and the management of the risks associated with providing utility service. It simply
8 is unreasonable to assume, as Mr. Kahal's position does, that investors' capital, and the
9 Company's management of that capital, have no bearing on the Project's cost-effective
10 financing.

11 It also is important to recognize that neither the Project nor the Project's lenders have
12 recourse to the Company's customers. That is, in the case of default the lenders cannot
13 penetrate the Contract and pursue remedies directly from customers. Mr. Kahal's position,
14 however, appears to assume otherwise, that the Project lenders would have recourse to
15 customers, providing the same level of credit support as would recourse to the Companies.
16 Nowhere has Mr. Kahal shown that to be the case.

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[17] Direct Testimony of Mathew I. Kahal, at 25.

[18] That is, the existence of an off-take agreement is not sufficient to support cost-effective financing. Rather, the agreement must be with an investment grade counterparty. As S&P Global Market Intelligence noted, "S&P Global Ratings' two-notch ratings downgrade into junk status of Warren Buffett's huge 550-MW Topaz Solar Farm solar facility that supplies power to Pacific Gas and Electric Co., is one of the first visible knock-on effects of the utility's financial problems." S&P Global Market Intelligence, *Topaz Solar, a top power supplier to PG&E, downgraded to junk*, January 11, 2019.

1 ***B. Mr. Kahal's View that the Company is a "Passive" Administrator***

2 **Q. Please briefly summarize Mr. Kahal's position that the Company is a "passive"**
3 **administrator of the Contract.**

4 A. Mr. Kahal sees the Company's role as "administer[ing] the PPA on a continual basis over
5 its life, managing the monthly and day-to-day cash flows." He believes that as a passive
6 administrator, "the Company accepts no risks".[19]

7 **Q. Do you agree with Mr. Kahal that because the Company can recover the costs**
8 **associated with the Contract, it does not face additional risk?**

9 A. No, I do not. First, although Mr. Kahal reaches to S&P's discussion of its debt imputation
10 methodology to describe the Company as a "conduit",[20] he does not look to either S&P or
11 Moody's to develop a more complete perspective of the risks considered in developing
12 credit ratings, or of the uncertainties and costs created by large financial obligations for
13 equity and debt investors.

14 The Company will make payments under the contract based on its average daily cash flow.
15 Those cash flows reflect funds from customer payments, short-term borrowing, long-term
16 borrowings, and/or equity capital infusions. There is no means of tracing a given dollar of
17 cash flow from its source to its use; that is the fundamental principle of "cash fungibility."
18 It may be that customers are required to pay the Contract costs, but the Company's revenues

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[19] Direct Testimony of Matthew I. Kahal, at 25 – 26.

[20] Direct Testimony of Matthew I. Kahal, at 19, 23.

1 could experience variability and its cash requirements may increase for any number of
2 reasons. Regardless of changes in its operating cash flow, the Company's obligation under
3 the Contract remains.[21] As cash flow requirements associated with the Contract (and any
4 other subsequent agreements) increase, the Company's financial flexibility will be
5 adversely affected.[22] The additional business and financial challenges associated with the
6 financial obligation of the Contract would be considered by credit rating agencies. To the
7 extent the Contract has a negative effect on the various qualitative and quantitative analyses
8 performed by the credit rating agencies, it could put downward pressure on the Company's
9 credit rating.[23]

10 **Q. Do you agree with Mr. Kahal's position that the market pricing risk arising from the**
11 **Contract lies with customers, not the Company?[24]**

12 A. No, I do not. As discussed in my Direct Testimony, the obligation to make payments under
13 the Contract lies with the Company, regardless of revenue, cash flow, or access to financial
14 liquidity. Moreover, it is the Company that must provide safe and reliable service at just
15 and reasonable rates, take on significant obligations to do so, and must perform under its

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[21] Direct Testimony of Robert B. Hevert, at 16.

[22] *See*, Direct Testimony of Robert B. Hevert, at 16.

[23] Direct Testimony of Robert B. Hevert, at 18-27.

[24] Direct Testimony of Matthew I. Kahal, at 9.

1 contractual commitments.[25]

2 **Q. Is it your view that if the Company proceeds with the Contract, there is no burden**
3 **placed on its balance sheet?**

4 A. No. It is my understanding that the Company would accept the financial obligation
5 associated with the Contract provided the regulatory conditions surrounding its approval
6 are reasonable. From the perspectives of the Company and the Commission, the question
7 of reasonableness necessarily includes the Remuneration Rate. For the Company, the issue
8 is whether the Contract, together with the Remuneration Rate, places an unreasonable
9 burden on its financial profile. For the Commission, the question is whether the Contract
10 and Remuneration Rate enable the Project's cost-effective financing, produces net benefits
11 for customers and advances the public policy objectives contemplated by the ACES Act.

12 ***C. Imputed Debt and Credit Risk***

13 **Q. In his discussion of risk factors, Mr. Kahal states "it is highly unlikely that no debt**
14 **imputation would take place."[26] What is your response to Mr. Kahal's observation.**

15 A. First, Mr. Kahal cannot determine how the rating agencies will assess the Contract before
16 it is even executed. Regardless, rating-agency assessments of risk go far beyond their

[25] *See*, Pre-filed Testimony of Robert B. Hevert, at 17 – 18. Although the Company would receive recovery of Contract costs from customers, that recovery coexists with the Company's proposed Remuneration Rate. There remains potential negative cost recovery pressure of other facets of the Company's operations in a significantly different future energy price or economic environment. For example, the high fixed cost structure of the Contract will be a substantial portion of rates and in the event of economic decline there could be considerable pressure to reduce cost recovery of other portions of the Company's operations because of the high fixed cost structure of total rates created by the Contract.

[26] Direct Testimony of Matthew I. Kahal, at 19.

1 assessment of imputed debt. As explained in my Direct Testimony, those assessments are
2 complex and consider multiple qualitative and quantitative factors.[27] Consequently, even
3 if there is no imputed debt in connection with the Contract, that is not to say the rating
4 agencies or investors would conclude the Contract brings no additional risk.

5 To that point, Mr. Kahal refers to Moody's Investors Service's ("Moody's") 2017 "Ratings
6 Methodology" for electric and natural gas utilities.[28] In that report, Moody's notes that
7 "PPAs are recognized qualitatively to be a future use of cash whether or not they are treated
8 as debt-like obligations in financial ratios."[29] Moody's goes on to discuss various
9 considerations regarding PPAs, and their implications for credit quality, noting that "[i]f a
10 utility enters into a PPA for the purpose of providing an assured supply and there is
11 reasonable assurance that regulators will allow the costs to be recovered in regulated rates,
12 we may view the PPA as being most akin to an operating cost."[30]

13 In short, even if there is no imputed debt associated with the Contract, that does not mean
14 rating agencies or investors see no risk. Rather, business and financial risks beyond
15 imputed debt, including the uncertainty created by a departure from credit-supportive
16 regulatory practice, likely would be factored into the Company's overall credit profiles.

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[27] Pre-filed Testimony of Robert B. Hevert, at 18 – 29.

[28] *See*, Direct Testimony of Matthew I. Kahal, at 18.

[29] Moody's Investors Service, *Rating Methodology: Regulated Electric and Gas Utilities*, June 23, 2017, at 46.

[30] Moody's Investors Service, *Rating Methodology: Regulated Electric and Gas Utilities*, June 23, 2017, at 48.

1 **Q. What is your response to Mr. Kahal's position that imputed debt would not weaken**
2 **the Company's financial wherewithal, because it "would merely add an essentially**
3 **equal amount of equity to its capitalization and capital structure"?[31]**

4 A. First, there is no guarantee the Commission would approve an equal and offsetting increase
5 in the Company's equity ratio. Second, the Company is not "fully-protected". As
6 discussed in my Direct Testimony, utilities are high operating leverage companies whose
7 earnings are sensitive to changes in revenue. As my Direct Testimony also pointed out,
8 rating agencies are aware of operating leverage, and may consider the associated risks in
9 their credit assessments.[32]

10 As discussed later in my Rebuttal Testimony, the implications of additional financial
11 leverage go beyond "merely" adding equity to the ratemaking capital structure. Equally
12 important, Mr. Kahal's proposed solution – adding equity to the capital structure – adds
13 costs to customers. In short, Mr. Kahal's argument that "the Company is fully-protected
14 and compensated by the ratemaking process with customers picking up any added costs"
15 is overly simplistic.

16 **Q. Mr. Kahal indicates several reasons why a large, long-term Contract could adversely**
17 **affect a utility's credit quality or ratings. What were the reasons he cited?**

18 A. Mr. Kahal states several considerations that could cause a large, long-term Contract to
19 adversely affect a utility's credit rating:

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[31] Direct Testimony of Matthew I. Kahal, at 20.

[32] Pre-filed Testimony of Robert B. Hevert, at 25 – 27.

1 2 3 4 5 6 7 8

> The first question is whether the Contract adversely affects the utility's earnings or cash flow in any significant or detrimental way. Second, the credit rating agency could choose to treat the Contract or some portion of the Contract payments as a "debt equivalent" and impute some amount to the balance sheet for purposes of calculating credit metrics thereby weakening those metrics. Third, if the Contract reduces the utility's liquidity or financial flexibility by a substantial amount, this might have an effect on credit quality.[33]

9 **Q. Can the Contract adversely affect the Company's cash flow?**

10 A. Yes, it can. Mr. Kahal, however, argues the Contract cannot affect the Company's cash
11 flows "in any significant way":

12 13 14 15 16 17 18 19 20

> [t]he Company will be billed each month by the Seller for the monthly energy deliveries from the Project (on average about $13 million per month), and the Company within a very short period of time (e.g., within weeks) will receive payment for essentially that same $13 million from the energy market, RECs market (if applicable) and utility customers. Thus, while there may be a very short-term effect on cash flow (due to a short payment lag of possibly a few weeks), over the course of a year, the Contract has virtually no effect at all, and therefore there is no material effect on credit metrics".[34]

21 Mr. Kahal is correct that the Company will sell the energy from the Contract to the energy
22 market, but he incorrectly states that the proceeds will "essentially" be the same as the
23 monthly contract obligation of $13 million. However, there is no certainty regarding
24 energy market pricing. Rather, there is up to $13 million of monthly cash flow at risk
25 depending on the market electricity price. Further, the LTCRP tariff reconciles annually.
26 Therefore, Mr. Kahal's statement that there is a "very short-term effect on cash flow" is

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33 Direct Testimony of Matthew I. Kahal, at 17.

34 Direct Testimony of Matthew I. Kahal, at 17-18.

1 incorrect. In fact, there is a twelve-month lag on cash collections of the difference between
2 the market electricity sales price and the Contract purchase price. As noted below,
3 Moody's generally assigns a Baa rating (which is lower than the Company's Moody's
4 rating) for cost recovery delays of *less than one year* based on its Factor 2a: Timeliness of
5 Recovery of Operating and Capital Costs.

6 **Q. Mr. Kahal also assumes the Company's liquidity would not be materially affected by**
7 **the Contract. Do you agree?**

8 A. No. Mr. Kahal is incorrect that there is a "short period of time" between the payment of
9 the Contract's payment obligation and the collection "in full" from its customers. I noted
10 earlier that the annual reconciliation of the tariff mechanism can create considerable lag,
11 and coupled with energy market volatility, can cause meaningful financial liquidity
12 concerns.

13 Mr. Kahal further argues that the Company has access to the money pool and other parental
14 sources.[35] Although that is true, it also is true that the Contract obligation represents nearly
15 half of the Company's purchased power costs. Market volatility around an obligation of
16 that magnitude may have a meaningful effect on the Company's liquidity needs.

17 **Q. Mr. Kahal indicates that the Company's portrayal of the $3.21 billion financial**
18 **obligation as burdensome is "highly misleading".[36] Do you agree?**

19 A. No, I do not. Mr. Kahal fails to consider the magnitude of the Company's financial

[35] Direct Testimony of Matthew I. Kahal, at 19.

[36] Direct Testimony of Matthew I. Kahal, at 10.

1 obligations under the Contract relative to its existing energy supply obligations. Nor does
2 he consider that companies disclose the nominal dollar amount of long-term commitments
3 because those amounts are material to investors.[37] Mr. Kahal may find that information
4 "misleading", but the investors that rely on it do not.

5 **Q. What percent of electricity sales does the Contract represent?**

6 A. The annual deliveries to the Company under the Contract are estimated to be 1,631,795
7 MWh or $161 million.[38] In 2017 the Company sold 3,868,162 MWh of electricity and its
8 purchased power expense was $337.43 million.[39] As a percent of 2017 electricity sales
9 and purchased power expense, the Contract represents 42.19 percent and 47.71 percent,
10 respectively. Importantly, the Contract represents nearly half of the Company's current
11 purchased power expense.

12 **Q. Do rating agencies consider qualitative risks such as generation diversity and**
13 **timeliness of regulatory recovery?**

14 A. Yes, they do. For example, Moody's indicates "[i]ssuers that have concentration in one or
15 two sources of generation, especially if they are threatened or challenged sources, will incur
16 lower scores."[40] Moody's assigns 5.00 percent of its rating to Generation and Fuel

[37] Because they are disclosed in SEC documents, the nominal lifetime commitments under long-term contracts is a relevant measure to investors. *See*, Pre-filed Direct Testimony of Robert B. Hevert, at 14.

[38] Direct Testimony of Matthew I. Kahal, at 5.

[39] 2017 FERC Form 1 page 304 (electricity sales) and page 321 (purchased power).

[40] Moody's Investors Service, *Rating Methodology, Regulated Electric and Gas Utilities*, June 23, 2017 at 17.

1 Diversity.[41] As a result of the Contract, over 40.00 percent of the Company's electric
2 supply will be sourced from one generator.

3 In addition, Moody's puts 12.50 percent weight on its Factor 2a. "Timeliness of Recovery
4 of Operating and Capital Costs", for which the following corresponds to a Baa rating:

> 5 Fuel, purchased power and all other highly variable expenses are generally
> 6 recovered through mechanisms incorporating delays of *less than one year*,
> 7 although some rapid increases in costs may be delayed longer where such
> 8 deferrals do not place financial stress on the utility.[42]

9 That criterion specifically states that, for a Baa rating, fuel and purchased power expenses
10 are recovered at delays of less than one year. Under the Company's Long-Term
11 Contracting for Renewable Energy Recovery Reconciliation Provision ("LTCRP") tariff,
12 however, the threshold timing for reconciliation adjustment is an annual basis, implying
13 that up to 12.50 percent of the Moody's rating for Factor 2a related to the Contract may be
14 considered below a Baa rating.

15 Because the LTCRP tariff recovers the net cost of the Contract after market recovery, the
16 Company will have exposure to market-pricing risk and potentially be required to carry
17 large amounts to fund the Contract. If electricity prices fall, the Company may be forced
18 to carry a large portion of the Contract cost for an entire year, before rates are adjusted. As
19 discussed later in our Rebuttal Testimony, the implications of carrying that cost may be

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[41] *Ibid*, at 4.

[42] Moody's Investors Service, *Rating Methodology, Regulated Electric and Gas Utilities*, June 23, 2017 at 14.

1 significant for the Company's financial liquidity requirements.

2 **Q. Are you aware of any utilities that have had their ratings downgraded in connection**
3 **with long-term Contracts?**

4 A. Yes, Moody's downgraded Hawaiian Electric's credit rating, principally due to the large
5 financial obligations and regulatory concerns associated with the company's renewable
6 Contracts:

> 7 HECO's rating was downgraded to Baa2 senior unsecured from Baal on
> 8 August 3, 2016, reflecting the strained relationship with its regulators and
> 9 interveners as it strives to replace its fossil-based generation with renewable
> 10 sources. We expect there to be continued friction with regulators and
> 11 interveners because HECO is expected to implement, through its utility
> 12 operations, ambitious public policy goals, such as achieving a 100%
> 13 renewable portfolio standard by 2045. These demands would be challenging
> 14 for any utility in the US but only more so for a company the size of HECO,
> 15 which only has about 460,000 customers.[43]

16 Tayne Sekimura, Chief Financial Officer of Hawaiian Electric addressed the risks
17 associated with PPAs, explaining that:

> 18 The cost of financing an [Independent Power Producer's, or "IPP's"]
> 19 project is based on the primary credit support of the utility, which is the off-
> 20 taker, and other factors such as loan-to-value, debt service coverage,
> 21 project/technology risk, regulatory support and terms of the IPP contract. In
> 22 addition IPPs are concerned about future Company ratings downgrades
> 23 affecting their project viability. A deterioration of the Company's credit
> 24 quality would increase the IPP's financing costs and, in turn, would increase
> 25 the purchased power costs that are ultimately passed onto the Company's
> 26 customers. The investment grade credit rating of a utility, which is the off-

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[43] Moody's, *Credit Opinion: Hawaiian Electric Company, Inc.,* August 8, 2016, page 1.

1 taker, often serves, at minimum, as a threshold item that is required by
2 investors when deciding whether or not to finance an IPP's project.[44]

3 In my view, the Hawaiian Electric downgrade, and the implications of that downgrade,
4 reflect the numerous business, operating and financial risks discussed throughout our
5 Rebuttal Testimony, and further supports the Company's proposed Remuneration Rate of
6 2.75 percent.

7 **Q. Do the Contract payments have any implications for the Company's cash flow and**
8 **need to access short-term capital?**

9 A. Yes, they do. It is important to keep in mind that payments for all obligations, fixed or
10 otherwise, are made from day-to-day cash flow. Those daily cash requirements are a direct
11 result of the timing associated with the receipt and disbursement of cash attributable to
12 various operating and investing activities. Cash management, a fundamental part of
13 corporate treasury management, focuses on the overall daily cash needs of the utility; each
14 specific cash outflow is not financed independently by a specific cash inflow. That is,
15 because cash is fungible, daily cash requirements are not traceable to any specific need.
16 Consequently, the cash flow required to fund payments under the Contract may vary, even
17 though the LTCRP provides for cost recovery.

18 As noted earlier, the LTCRP includes an annual reconciliation, after market recovery. To
19 the extent market prices fall, the Company may be required to fund the difference until

[44] Docket No. 2016-0328, Testimony of Tayne S. Y. Sekimura, at 41

1 rates are adjusted, with potentially significant implications for its cash flow requirements.
2 The Contract, and any future contracts to which the Company may become a party under
3 the ACES Act, therefore would require increased short-term borrowing capacity to fund
4 timing differences between payments under those agreements, and the collection of
5 receivables from customers. Over time, higher short-term debt balances would complicate
6 long-term financing decisions normally focused on paying down short-term debt balances
7 and funding long-lived utility assets. Increasing short-term debt balances also may
8 diminish the Company's ability to preserve the short-term financing flexibility needed to
9 fund unexpected liquidity needs, such as weather events or operating incidents, or to
10 finance ongoing utility operations and investments during volatile or constrained capital
11 markets.

12 **Q. Is financial liquidity a factor considered by investors and rating agencies in assessing**
13 **utility risk profiles?**

14 A. Yes, financing flexibility and financial liquidity are important considerations for capital-
15 intensive utilities, whose free cash flows tend to be modest, and at times negative.[45]
16 Because they cannot depend on operating cash flows to fund unexpected liquidity needs, it
17 is extremely important to preserve efficient access to short-term financing. As the cash
18 flow requirements associated with the Contract and any subsequent agreements increase,
19 the Companies' financial flexibility will be adversely affected, potentially to the detriment

[45] Free cash flow represents cash flows from operations less capital investments.

1 of customers. As Moody's explains:

2 Liquidity analysis is a key element in the financial analysis of electric and
3 gas utilities, and it encompasses a company's ability to generate cash from
4 internal sources as well as the availability of external sources of financing
5 to supplement these internal sources. Liquidity and access to financing are
6 of particular importance in this sector.[46]

7 In summary, Mr. Kahal's view that the Contract is not likely to create meaningful risks is
8 narrowly focused, and misplaced.

9 ***D. The Remuneration Rate as An Incremental Equity Return***

10 **Q. What is your response to Mr. Kahal's observation that the Company's proposed**
11 **Remuneration Rate effectively represents a 90-basis point increase to the authorized**
12 **ROE?[47]**

13 A. I have several concerns with Mr. Kahal's premise. First, nowhere has the Company
14 suggested it is seeking a return, and nowhere does the ACES Act condition remuneration
15 on some measure of a return. As stated in my Direct Testimony, "the Company is not an
16 equity participant in the Project and is not making an investment on which it would earn a
17 return."[48] That is consistent with Mr. Schrag's observation that "the Company has no
18 'natural incentive' to undertake this activity".[49] Even though investors supply the capital
19 that supports the Company's credit rating (and the Project's ability to be financed),

[46] Moody's Investors Service, *Regulated Electric and Gas Utilities*, June 23, 2017, at 25.

[47] See, Direct Testimony of Matthew I. Kahal, at 12.

[48] Pre-filed Direct Testimony of Robert B. Hevert, at 7.

[49] Memorandum Supplement, April 12, 2019, at 3.

1 investors receive no benefit whatsoever for the use of their capital for this purpose. The
2 Remuneration rate simply provides a degree of compensation for that use. There is no
3 cause for Mr. Kahal to be "puzzled"[50] by that commonsense position.

4 Second, Mr. Kahal's observation that the proposed Remuneration rate is equivalent to a
5 90-basis point equity return simply highlights the very large size of the Contract's financial
6 obligation relative to the Company's equity base. As Mr. Kahal observes, in Docket No.
7 4770 the common equity portion of the Company's rate base was approximately $371.80
8 million. By comparison, the Company's lifetime obligation under the Contract is $3.21
9 billion, or **8.63 times** the equity base. As noted above, an obligation of that order represents
10 a material, disclosable commitment that creates considerable risks for both debt and equity
11 investors.

12 Mr. Kahal cannot point to the Remuneration payment relative to the Company's equity
13 base to argue it is too high and at the same time dismiss the risks created by an obligation
14 nearly nine times the equity base as "doubtful" and "likely to be easily manageable". I
15 simply cannot agree with Mr. Kahal's lack of concern with the risks associated with a
16 financial obligation he rightly considers "enormous".[51] As discussed throughout my
17 Rebuttal Testimony, the risks to equity and debt investors from a financial commitment

[50] See, Direct Testimony of Matthew I. Kahal, at 23.

[51] Direct Testimony of Matthew I. Kahal, at 15.

1 many times the size of the Company's equity base are significant, far from "doubtful", and
2 if left unattended, would place the Company, its investors, and its customers in a financially
3 disadvantaged position.

4 **Q. Do you have any other observations regarding Mr. Kahal's argument that the**
5 **proposed Remuneration Rate represents a 90-basis increase to the Company's Return**
6 **on Equity?**

7 A. Yes. Although I disagree with his portrayal of the Remuneration Rate as an increment to
8 the authorized ROE, the costs to customers associated with an increased equity ratio (as
9 Mr. Kahal suggests) or Return on Equity to offset the negative effects of an adverse credit
10 rating event could *easily* outweigh the 90-basis point increment Mr. Kahal calculates.
11 Given the magnitude of the $3.21 billion obligation relative the Company's roughly $729
12 million rate base, if debt is imputed the equity ratio required to offset the imputed debt
13 amount would be *well above* even the 56.29 percent equity ratio applied by Hawaiian
14 Electric.

15 The effect on the ratemaking Rate of Return would not end there. As noted earlier, and in
16 my Direct Testimony, fixed obligations tend to increase either operating or financial
17 leverage. Whether operating or financial, the effect of leverage is to increase the variability
18 of income and, therefore, risk. As my Direct Testimony explained, the relationship
19 between operating leverage, income variability, and investors' required Return on Equity

1 (“ROE”) has long been addressed in published research.[52] Because the investor-required
2 ROE increases with operating leverage, it also is reasonable to conclude the ROE would
3 increase along with the equity ratio. The result, of course, is an even higher cost to
4 customers.

5 **Q. What conclusions do you draw from that assessment?**

6 A. Mr. Kahal’s reference to a 90-basis point return increment is misplaced and overly
7 simplified. Because the Contract obligation is over eight times the Company’s equity base,
8 the adjustment needed to offset imputed debt that may be associated with that obligation
9 would far outweigh the 90-basis point increment Mr. Kahal calculates. The proposed
10 Remuneration Rate serves as a means of mitigating that risk, and that cost. Simply put, the
11 90-basis point increment Mr. Kahal calculates is likely to cost customers far less than the
12 “remedial action”[53] of increasing the ratemaking equity ratio.

13 ***E. Remuneration as a “Double Recovery” of Costs***

14 **Q. Please briefly summarize Mr. Kahal’s argument that the proposed Remuneration**
15 **Rate constitutes a “double recovery of costs”.[54]**

16 A. Mr. Kahal argues the proposed Remuneration Rate would constitute “double recovery”,
17 reasoning that “any adverse effects that do occur (with cash working capital increase or a

[52] *See*, Pre-filed Testimony of Robert B. Hevert, at 28.

[53] Direct Testimony of Matthew I. Kahal, at 10.

[54] Direct Testimony of Matthew I. Kahal, at 16.

1 need for a thicker equity ratio to strengthen credit quality) would be fully paid for by utility
2 customers. In fact, such utility customer payments, if needed, would provide NEC
3 additional return on equity".[55] I disagree.

4 As discussed earlier and in my Direct Testimony, the Company has not made an equity
5 investment in the Project. Nonetheless, as the Division recognizes, the Company's credit
6 profile - including its investor-supplied capital structure - enables the Project. The
7 Company's credit profile is not an unlimited resource, and its use for purposes beyond
8 financing rate base assets is not recovered in the ratemaking process. Mr. Kahal's
9 construction of the Remuneration Rate as an incremental return is misplaced. It is
10 compensation for the use of a limited resource without which the Project would not be
11 developed.

12 Mr. Kahal argues the Company "is already being fully compensated for its balance sheet
13 capital to the extent that the capital supports utility rate base through the normal ratemaking
14 process." He goes on to note that the "equity capital supporting rate base receives the
15 Commission-authorized ROE", concluding "this capital does not require a second return
16 through the Remuneration Rate."[56] His position appears to be that the Company's capital
17 is an unlimited resource that may be used for purposes beyond funding utility assets. I

[55] Direct Testimony of Matthew I. Kahal at 22.

[56] Direct Testimony of Matthew I. Kahal, at 23.

1 strongly disagree.

2 The Company would be obligated to make payments under the Contract regardless of its
3 cash flows or financial liquidity. From the equity investor's perspective, that claim on cash
4 flow is senior to its claim. That is, the Contract is an additional, "enormous" claim on cash
5 flow that stands between the equity investor and the dividends they would receive. Mr.
6 Kahal may dismiss the risks associated with those payments as "manageable", but he
7 cannot say with any degree of certainty that the Company's cash flows will never be
8 diminished to the point that its ability to fund dividend payments will be compromised.
9 Even if that possibility is small, it is material to investors. And as additional contracts are
10 layered on over time, the equity investor's position becomes subordinate to increasing
11 claims. It simply is unreasonable to assume that risk is of no consequence to the investors
12 that supply over one-half of the capital funding the Company's utility assets.

13 Lastly, although it is true the Company is compensated for the capital supporting its utility
14 assets, it also is true that capital now would be used for a second purpose – to support the
15 Contract and the Project. Mr. Kahal's approach would deny investors compensation for
16 that use. In my view, and in my experience, the financial community would not view that
17 outcome as "just and reasonable".

1 ***F. Reasonableness of the Proposed 2.75 percent Remuneration Rate***

2 **Q. Is the 2.75 percent Remuneration Rate within a reasonable range of estimates?**

3 A. Yes, it is. Based on the net benefits analysis discussed in my Direct Testimony[57], I show
4 the Remuneration Rate could be as high as 13.59 percent before breakeven financing cost
5 benefits are realized for customers relative to a merchant generation facility. Because the
6 Company's credit quality and balance sheet strength enable these cost-effective benefits to
7 be achieved for customers, the 2.75 percent Remuneration Rate represents a reasonable
8 level of remuneration for the Company as a result of its voluntary efforts to advance the
9 goals of the ACES Act.

10 **Q. Have any other regulatory jurisdictions awarded a 2.75 percent Remuneration Rate**
11 **for renewable contracts?**

12 A. Yes. On April 12, the Massachusetts Department of Public Utilities (the "DPU", or the
13 "Department") issued Order D.P.U. 18-76/18-77/18-78 related to the procurement of
14 renewable energy contracts under Section 83C of the Green Communities Act. In that
15 order, the Department awarded a 2.75 Remuneration Rate for the selected Contracts.[58]

[57] *See,* Direct Testimony of Robert B. Hevert, at 29-44.

[58] *Petition of NSTAR Electric Company, d/b/a Eversource Energy for approval by the Department of Public Utilities of two long-term contracts for procurement of Offshore Wind Energy Generation, pursuant to Section 83C of An Act Relative to Green Communities, St. 2008, c. 169, as amended by St. 2016, c. 188, § 12*, D.P.U. 18-76; *Petition of Massachusetts Electric Company and Nantucket Electric Company, each d/b/a National Grid for approval by the Department of Public Utilities of two long-term contracts for procurement of Offshore Wind Energy Generation, pursuant to Section 83C of An Act Relative to Green Communities, St. 2008, c. 169, as amended by St. 2016, c. 188, § 12*, D.P.U. 18-77; *Petition of Fitchburg Gas and Electric Light Company, d/b/a Unitil for approval by the Department of Public Utilities of two long-term contracts for procurement of Offshore Wind Energy Generation, pursuant to Section 83C of An Act Relative to Green Communities, St. 2008, c. 169, as amended by St. 2016, c. 188, § 12*, D.P.U. 18-78, April 12, 2019, at 72.

1 **Q. Would a significant departure from the 2.75 percent Remuneration Rate approved**
2 **by the DPU be relevant to investors?**

3 A. Yes, it would. The Vineyard Wind project in Massachusetts is similar to the Project in this
4 case. It is reasonable to conclude investors would expect the issue of remuneration to be
5 treated in a consistent manner between the two regulatory jurisdictions. In large measure,
6 that is because the issues are fundamentally the same. In both cases, the utility accepts a
7 large, fixed financial obligation, without which the renewable energy projects likely would
8 not be built. As in Massachusetts, Rhode Island has identified renewable wind projects as
9 a means of advancing public policy goals. And like the Vineyard Wind project, those goals
10 are not achievable without the utility's strong financial profile, which itself relies on the
11 capital provided by both debt and equity investors.

12 Further, the consistency of regulatory treatment is an important factor in determining
13 regulatory risk and creditworthiness. Investors and rating agencies would view a departure
14 from prior practice as non-threatening if there were a new and extenuating circumstance
15 that had arisen since the Massachusetts contracts were approved. Absent such a change in
16 circumstances, it is more likely the financial community would see a reduction in the
17 Remuneration Rate, relative to what was approved by the MA DPU, as a sign of
18 deterioration in the regulatory environment and, therefore, an increase in regulatory risk.
19 That increased risk would extend beyond the Contract, affecting the Company's ability to
20 cost-effectively raise the long-term capital needed to finance utility assets, and the short-
21 term liquidity needed to fund utility operations.

1 **Q. Mr. Kahal asserts your support for the proposed 2.75 percent Remuneration Rate is**
2 **"entirely qualitative".[59] Is Mr. Kahal's assertion correct?**

3 A. No, it is not. Mr. Kahal observes that my Direct Testimony included an "extensive
4 analysis" of the project financing benefits enabled by the Company's credit profile and
5 balance sheet.[60] It is fair to say that analysis is quantitative. Mr. Kahal argues the analysis
6 is not relevant because it is "purely hypothetical". I strongly disagree with Mr. Kahal on
7 that point.

8 As explained in my Direct Testimony, my analysis directly addresses one of the principal
9 objectives of the ACES Act, to:

> 10 [s]ecure the future of the Rhode Island and New England economies, and
> 11 their shared environment, by making coordinated, *cost-effective*, strategic
> 12 investments in energy resources and infrastructure such that the New
> 13 England States improve energy system reliability and security, enhance
> 14 economic competitiveness by reducing energy costs to attract new
> 15 investment and job growth opportunities; and protect the quality of life and
> 16 environment for all residents and businesses.[61]

17 The Division does not dispute my position that but for the Company's credit profile, the
18 Project's feasibility would be in doubt. As noted earlier, Mr. Schrag rightly refers to the
19 "unique, necessary, and important role in the development and execution of the PPA."[62]
20 Consequently, there is no dispute that without the Company's strong credit profile, the

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[59] Direct Testimony of Matthew I. Kahal, at 12.

[60] Direct Testimony of Matthew I. Kahal, at 24.

[61] Pre-filed Testimony of Robert B. Hevert, at 5, citing § 39-31-2 of the ACES Act. [*emphasis added*]

[62] Memorandum Supplement dated April 12, 2019, at 1-2.

1 Project would be in doubt, and the policy objectives it advances – including the ACEs Act's
2 "cost-effective" standard - would be compromised. That is, the threshold question of
3 whether the Project would be feasible but for the Company's credit profile is settled.

4 The analytical issue, then, is to estimate the value the Company's credit profile brings to
5 the Project's financing. The analytical structure applied to address that issue is based on a
6 simple question: To what extent does the Company's credit profile likely reduce the
7 Project's financing costs relative to an uncontracted "merchant" facility? Mr. Kahal does
8 not dispute that structure, nor does he dispute its underlying assumptions, input, or finding
9 that the financing benefits are approximately five times the proposed Remuneration Rate.
10 Rather, he views the premise as hypothetical, apparently because he does not see the
11 likelihood of a merchant offshore wind facility.

12 Whether or not Mr. Kahal sees that likelihood, however, is not the point. If a merchant
13 facility is unlikely because it would require all-equity financing at a high required return,
14 the benefit the Company's credit rating brings is a more balanced capital structure with
15 lower costs of capital. That is the benefit the analysis measures. Because financing benefit
16 is aligned with the ACES Act's "cost-effective" objective, it is highly relevant to the issue
17 of benefits created by the Company's credit rating.

18 **Q. Does the fact that the financing benefit must be estimated diminish its worth or**
19 **relevance?**

20 A. No, it does not. Financial analyses are not always deterministic; they often require methods
21 to estimate the measure of value, risk, costs, etc. Mr. Kahal, too, understands that not all

1 financial parameters are directly observable and must be estimated. As he explained in
2 Docket No. 4770:

> 3 Although the *concept* of the cost of equity may be precisely stated, its
> 4 quantification poses challenges to regulators. The market cost of equity,
> 5 unlike most other utility costs, cannot be directly observed (i.e., investors
> 6 do not directly, unambiguously state their equity return requirements), and
> 7 it therefore must be estimated using analytic techniques.[63]

8 The same applies here. The concept of financing benefits may be precisely stated (see
9 above), but its measure cannot be directly observed. Just as Mr. Kahal applied analytical
10 techniques to estimate the Cost of Equity in Docket No. 4770, I have applied analytical
11 techniques to estimate the financing benefit in this proceeding.

12 As noted above, the Division does not dispute that the Company's balance sheet and credit
13 profile enables the Project's cost-effective financing, and Mr. Kahal has no quarrel with
14 the analytical structure I applied. Consequently, there should be no concern that the
15 estimated financing benefits are relevant to the Commission's consideration of the
16 Company's proposed Remuneration Rate.

17 **Q. Do you have any further observations regarding Mr. Kahal's concern with qualitative**
18 **information?**

19 A. Yes. At page 18 of his testimony, Mr. Kahal refers to Moody's Investor Service's June
20 2017 Ratings Methodology. In discussing its approach to utility credit assessments,
21 Moody's explains the importance of qualitative factors. As Moody's explains,

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[63] Docket 4770, Direct Testimony of Matthew I. Kahal, at 32. [emphasis in original]

> This rating methodology explains our approach to assessing credit risk for regulated electric and gas utilities globally. This document does not include an exhaustive treatment of all factors that are reflected in our ratings *but should enable the reader to understand the qualitative considerations and financial information and ratios that are usually most important for ratings in this sector*.[64]

Mr. Kahal also refers to the same report by Standard & Poor's ("S&P") discussed at pages 19 to 23 of my Direct Testimony. As I note in my Direct Testimony, S&P considers a number of qualitative factors, including the regulatory environment. The point simply is that although Mr. Kahal argues (incorrectly) that my position is based on qualitative factors, he fails to recognize the importance of qualitative assessments in financial assessments, including credit rating determinations.

G. Tying Remuneration to Expected Project Benefits

Q. Please now summarize the Division's position regarding the Remuneration Rate and the Project's expected benefits.

A. Among the principles the Division provided to assess the proposed Remuneration Rate is the question of whether there "is a clear nexus between the design of the proposed remuneration and the expected benefits".[65] The Division suggests that "[a]s proposed by the Company, there is not." The Division then "recommends reforming the remuneration to better correlate with the benefits."[66] Although the Division wishes to correlate

[64] Moody's Investors Service, *Ratings Methodology: Regulated Electric and Gas Utilities* June 23, 2017, at 1. [emphasis added]

[65] Memorandum Supplement, April 12, 2019, at 3.

[66] Memorandum Supplement, April 12, 2019, at 3.

1 Remuneration with benefits, it neither defines the benefits, nor explains the legal or policy
2 basis by which the two would be correlated. I understand Remuneration in Rhode Island
3 has been awarded to the Company under the LTCS in the past for accepting the financial
4 obligations created by long-term renewable contracts. As discussed throughout my
5 Rebuttal Testimony, the proposed Remuneration Rate also reasonably advances the goals
6 set forth in the ACES Act. My understanding, then, is that Rhode Island law has not
7 correlated remuneration with benefits in the context of procuring long-term renewable
8 contracts.

9 If the Division wishes to correlate remuneration with benefits, it should focus on the
10 benefits over which the Company has reasonable control. As noted earlier, the Company
11 cannot manage or maximize the economic and environmental benefits created by the
12 Project over its 20-year life. Rather, it is by extending its strong credit profile and balance
13 sheet to enable the Project's cost-effective financing that the Company plays the "unique,
14 necessary and important role" the Division recognizes. The financing benefits derived
15 from that role, which were estimated in my Direct Testimony, suggest the Remuneration
16 Rate could be as high as 13.59 percent, about five times greater than the Company's 2.75
17 percent proposal.[67] That is, the 2.75 percent proposed Remuneration Rate represents about
18 20.00 percent of the benefits created by the Company's active and prudent management of
19 its balance sheet and credit profile.

[67] Pre-filed Direct Testimony of Robert B. Hevert, at 35.

1 ## III. SUMMARY AND CONCLUSIONS

2 **Q. Please summarize your conclusions regarding the Company's proposed 2.75 percent**
3 **Remuneration Rate.**

4 A. As discussed in my Direct Testimony, the Company's balance sheet is not an unlimited
5 resource that can be continually encumbered at no incremental cost, and with no
6 degradation of credit quality. There also is little doubt that a financial obligation nearly
7 nine times the size of the Company's equity balance adds both operating and financial risk.
8 The fact that customers will pay the cost of the Contract does not diminish the value the
9 Company brings, or remove the risks to debt and equity investors. If it were the case that
10 the Company bears no risk, there would be no need for its strong investment grade rating.
11 But the Division recognizes the unique role the Company's credit profile brings to the
12 Project, and to the public benefits the Project creates.

13 The Division also recognizes the need for current and future collaboration with the
14 Company to address the "threat of climate change and need to decarbonize the electric
15 sector over the coming decades"[68]. The Company's ability to collaborate and create
16 further public benefits is constrained by its credit profile. That profile depends heavily on
17 the supportiveness and predictability of the regulatory environment. As discussed
18 throughout my Direct and Rebuttal Testimonies, the Commission's decision in this
19 proceeding will have a direct bearing on the financial community's views in that regard.

[68] Memorandum Supplement dated April 12, 2019, at 2.

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1 That is particularly the case in light of the recent Order by the Massachusetts DPU.

2 In short, if approved, the proposed 2.75 percent Remuneration Rate will provide the
3 financial community and the credit rating agencies with a perspective that the Commission
4 reasonably balances the interests of both customers and investors. Mr. Kahal's testimony
5 has not caused me to change my recommendation that the proposed 2.75 percent
6 Remuneration Rate is reasonable and appropriate.

7 **Q. Does this conclude your Rebuttal Testimony?**

8 A. Yes, it does.