

VIEWPOINT

Financing Utility Assets In Today's Regulatory Environment

by Mark Zvonkovic

About half of the electricity used annually in the U.S. comes from coal, a mineral four times more abundant domestically and significantly cheaper than the second most used generation feedstock, natural gas. Natural gas generates about 20% of our electricity. Despite its preeminence as a feedstock, coal is the utility industry's bad boy, being a significantly worse polluter than natural gas. Recent advancements in technology relating to clean coal, which the **Natural Resources Defense Council** (NRDC) calls a "misnomer," arguably bridge the pollution gap between coal and natural gas. The costs for clean coal technology, however, reduce substantially the cost advantage coal enjoys and raises an element of completion and operation risk that will affect providers of capital to new coal-fired projects. As a result, in planning to meet customer demand for electricity in the next decade, utilities must perform a delicate balancing act for their environmental, financial and end-user constituents.

Many utilities will be evaluating their existing coal-fired generation capacity in light of recently proposed clean air requirements. The currently high prices of natural gas may create a financial incentive to keep existing coal-fired generation plants in service rather than replace them with new gas-fired generation. Under the phase-in of clean air requirements, these plants will require the expenditure of significant capital over the next few years for pollution control equipment in order to remain in operation. Industry estimates of the cost of installation of such equipment range from \$300 to \$400 per kilowatt.

Unfortunately, the last five years have also muddied the financing waters for utilities, regardless of whether their choice is new construction or the addition of pollution control devices to existing plants. Ten years ago, utilities would raise capital for generation by adding debt to their balance sheets and then earn a return on their capital through the cost of service provisions in their rates. Deregulation in some states caused generation assets to move off the balance sheets of utilities to non-regulated merchant owners; utilities then based the generation component of their costs in market based rates.

Today, the migration to merchant facilities has slowed and the regulatory environment is murky, making utilities hesitant to disturb favorable rates with a new rate case necessitated by the incurrence of large amounts of capital. In addition, regulators are far more likely to examine in any rate filing the financial risk associated with future compliance with new air quality standards directed at coal-fired plants and the prudence of expending capital for coal-fired generation as opposed to combined cycle natural gas plants. Of course, new financings and new rates by a utility will also give rise to a re-examination of outstanding debt by the rating agencies. All of these considerations were probably in part responsible for the recent decision by **Allegheny Energy** to seek legislation that will allow it to recover the cost of pollution control equipment through a surcharge to its customers as opposed to a rate change.

Five years ago a utility may have also considered an off-balance sheet financing for pollution control equipment through a special purpose entity that finances the equipment on a non-recourse basis and then supplies the pollution abatement service through a contract with the utility. **Enron's** demise, however, led to the adoption of FASB Interpretation No. 46, which tests SPEs by a stringent set of "variable interest entity" standards that make it far more difficult to keep non-recourse debt off

a sponsor's balance sheet. While FIN 46 does not make off-balance sheet financing impossible, it may make a qualifying SPE less appealing to a utility that is not accustomed to relinquishing control over plant assets and paying to a third party SPE sponsor equity returns for taking greater risk on the project.

The combination of FIN 46 and deregulation concerns may also lead to hybrid financings that involve consortiums of utilities, customers and suppliers. Such is the case with last year's financing of pollution control upgrades for **Tucson Electric Power's** Springerville generation facility. To finance approximately \$100 million for such upgrades, TEP entered into an arrangement with **Tri-State Generation and Transmission Association** and **GE Capital Structured Finance** under which GE will construct and be the majority owner of a new 400 MW coal-fired unit at Springerville, with a structured lease obligation financing of approximately \$950 million of debt and equity being supported by a long-term lease of the

facility to Tri-State and long term commitments for capacity from several sources, many of them Tri-State's existing customers. For its part, TEP entered into a power purchase contract for 5 years for 100MW and construction and financing for the new unit included the pollution control upgrades for TEP's units 1 and 2.

Financing of utility generation assets for the remainder of the decade will probably not follow the historic approach of floating a bond issue and filing a rate case. The uncertain regulatory environment, volatile gas prices, heightened air quality concerns and new accounting rules must all be weighed in a utility's decision of how to meet its generation needs in the future.

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