DAYMARK® ENERGY ADVISORS

MEMORANDUM

TO: John Bell, Rhode Island Division of Public Utilities and Carriers

FROM: Doug Smith & Kathleen Kelly, Daymark Energy Advisors, Inc.

DATE: January 5 2023

SUBJECT: Review of Rhode Island Energy's Request for Approval of a Revolving Credit Facility - Docket No. D-22-13

Summary

At the request of the Rhode Island Division of Public Utilities and Carriers (RIDPUC) Advocacy Section, Daymark Energy Advisors, Inc. (Daymark) reviewed and investigated a number of potential issues regarding the submission.

In September 2022, The Narragansett Electric Company d/b/a Rhode Island Energy (RIE or The Company) filed an application for approval to join a revolving credit facility with the RIDPUC. Per the Company, the filing was made "in compliance with Condition No. 9 from the Division of Public Utilities and Carriers' Order No. 24322 issued on February 23, 2022, in Docket No. D-21-09." The Company is seeking Approval to Join a Revolving Credit Facility and anticipates establishing its initial borrowing sublimit under the Revolving Credit Facility at $250 million. However, the Company also seeks to have the ability to increase the sublimit up to $600 million without subsequent RI DPUC approval.

The Company indicated that the Revolving Credit Facility is necessary to provide sufficient liquidity for normal operations. Specifically, Mr. Henninger indicated that, "This allows the Company to make cash borrowings and issue letters of credit at interest rates commensurate with its own credit ratings. The Revolving Credit Facility also provides the opportunity to evaluate the implementation of a commercial program, which requires credit capacity to be in place as a "backstop." The use of commercial paper historically has provided for a lower cost of borrowing, subject to market conditions, and currently serves as the primary source of short-term financing for PPL Corporation's other utilities."[1]

[1] Responses to the Advocacy Section's First Set of Data Requests, AS 1-4.

Key issues

Having a line of credit (LOC) for funding ongoing operations of a business is standard practice. Therefore, the request RIE is making is not unusual by itself. Given the recently approved sale of the Company, several areas of potential impact to customers were examined to ensure that the type, size and general characteristics of the LOC were reasonable and in the best interests of customers.

Value of a LOC

Company witness Mr. Henninger introduces the need for this LOC in his testimony when he states that "Following the Acquisition, the Company must establish new lines of liquidity to ensure it has the necessary available access to cash to fund ongoing working capital and anticipated capital expenditures."[2] This is further explained by Mr. Henninger on page 6 of his testimony, when he lays out the purpose of establishing the LOC (lines 13 through 19) and page 10, where he discusses the benefits (lines 13 through 21). The need and intended use of the LOC is consistent with good company management. Any company needs sufficient liquidity to manage its business through a range of potential short-term futures. The Company is seeking to establish and use the LOC for reasonable operating purposes which have clear benefits to any company in its position.

Costs incurred due to the LOC

An LOC is not without cost, however. By the terms of the LOC, the Company will incur costs in two primary categories. To the extent that it uses the LOC, the Company will be charged interest as would occur for any debt instrument. In addition, the Company will be charged commitment fees for unused LOC capacity. In accordance with the Company's current credit rating, that charge would be 0.125% of the uncommitted sublimit annually. Assuming no use of the LOC, this charge equals $312,500 in the first year if the initial expected sublimit of $250 million was unchanged. It would be $500,000 at the "Company's most recent credit capacity"[3] of $400 million sublimit level. Finally, it would be $750,000 at the requests maximum sublimit level of $600 million. While these differences are not trivial, they appear to be reasonable costs to maintain the financial insurance that such access to liquidity provides. Also, the potential benefit of borrowing at lower cost through the use of commercial paper may provide some offset to the commitment fees.

It is also worth noting that as the LOC is used, the commitment fees decline. Therefore, the amounts listed above are likely to be higher than what is actually paid, as the point of the LOC is to provide liquidity through borrowing against that capacity.

[2] Direct Testimony of Tadd Henninger, page 5 of 12, lines 19-21.
[3] Direct Testimony of Tadd Henninger, page 9 of 12, line 6.

Potential impacts

On the basis of the benefits and costs itemized above, the LOC is a reasonable tool to provide the Company with the liquidity to manage its business. To test for unexpected impacts to customers, the following potential impacts were identified and reviewed to determine if there was unreasonable exposure to ratepayer impacts.

Potential impact on credit rating

The first potential impact reviewed was the potential to influence the credit rating of the Company. Mr. Henninger, in response to the Advocacy Section's First Set of Data Requests, stated that, "The Company does not anticipate any impacts to its credit ratings or financial metrics resulting from a borrowing capacity of up to $600 million."[4] This appears reasonable. First, as noted above, Mr. Henninger has pointed out that the Company's most recent credit capacity was $400 million. Second, strong access to capital is generally a net positive for credit ratings. Mr. Henninger makes this point in his response to AS 1-2 when he states that, "In fact, the Company expects the available borrowing capacity of up to $600 million to be viewed positively by the rating agencies' assessment of liquidity." There is no reason to believe that the LOC's impact on the Company's credit rating would impact customer costs.

Potential impact on long-term WACC

A second potential impact to customers would be an influence on the long-term weighted average cost of capital (WACC) of the company. In response to AS 2-2, the Company confirmed that the most recent approved WACC in the Company's most recent base distribution rate case (Docket No 4770) will continue to be used until the next base distribution rate case, so there will be no impact to customers until that time.

Potential impact on debt AFUDC rate

The third potential impact investigated was the potential for a change in debt capacity to impact the Allowance for funds used during construction (AFUDC) rate. In responding to AS 2-3, Mr. Henninger confirmed that the current AFUDC rate was based on the long-term debt rate times the ratio of long-term debt to total debt, stock, and equity. This means that the establishment of the LOC will not impact the AFUDC rate upon approval.

Potential future increases in actual sublimit and/or borrowing against the LOC

The final potential impact considered was the use of the LOC itself. While the amount and type of borrowing appears reasonable given the reasons above, the use of the debt instrument will impact the Company's operations and balance sheet. This is not a concern in and of itself, but bears watching as the frequency or magnitude of changes to the initial parameters of the agreement (increases in sublimit, use

[4] Responses to the Advocacy Section's First Set of Data Requests, AS 1-2

of funds, rollover of open position, extension of the agreement) could all indicate areas of interest for regulators or other stakeholders.

Potential Impact on Rates

A key consideration of any borrowing is potential impact on rates. Besides the potential indirect impact on rates implied in the impacts reviewed above, interest rates directly impact future rates as well. Interest rates have been rising for the past year and are up sharply since the Company was acquired in May 2022. This rise in rates will have an impact on future distribution rates if the trend does not reverse. That is independent of the LOC, however.

With respect to the LOC, Mr. Henninger indicated that, "Under the Revolving Credit Facility, the Company will pay an interest rate of LIBOR (London Interbank Offered Rate)or a comparable transition rate of SOFR (Secured Overnight Financing Rate) plus an applicable margin based on the Company's credit rating as reflected on the pricing grid on Page 9 of the testimony. The Company does not anticipate any modification to the Company's base distribution rates until the Company files a new base distribution rate case with the Rhode Island Public Utilities Commission, which is expected no sooner than three years from the May 25, 2022 closing date on which PPL Rhode Island Holdings, LLC acquired the Company."[5]

Conclusion

The main value of a LOC is to provide insurance against potential cash flow outcomes that could prove challenging to manage without a ready source of capital. The LOC will provide strong value to the Company in ensuring sufficient ability to respond to changing financial futures at a reasonable cost. There is no reason to believe that the establishment of the LOC with the requested sublimit of $600 million will harm customer interests. We recommend approval of the request.

[5] Responses to the Advocacy Section's First Set of Data Requests, AS 1-5.