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Witness: Matthew P. Fallon
Request from: Public Utilities Regulatory Authority

Question:

(CAPITAL STRUCTURE) Application, Ex. CL&P-REVREQ-2, Sch. D-1.0. For the following questions, provide unlocked Excel workbooks with formulas intact, including all assumptions, worksheets, and working spreadsheet models to verify the computations:

a. Provide the optimal or target capital structure for the Company.
b. If the proposed 53.86% common equity capital structure is not optimal, then explain how it is in the best interest of ratepayers.
c. Provide a worksheet that clearly depicts the components of the target structure. Compare it to the proposed ratemaking capital structure.
d. Explain how the Company plans on moving towards its target and/or optimal capital structure over the next five years.

Response:

a. The Company has a target equity ratio of 53.86% because this is the level of equity capitalization that the Company views as necessary to maintain adequate credit ratings to support the business and deliver a reasonable cost of capital to customers, given the Company's obligations for financial stability. The ratings agencies do not provide the Company with a specific target level and, instead, the Company routinely evaluates its financial costs, commitments, revenues and other factors in order to identify a capitalization balance that will be viewed positively by the credit-rating agencies through their intensive rating process. The outcome of this rate case proceeding will be a critical input to the rating agencies process. Whether rating agencies view the outcome of this proceeding as supportive of the Company's credit ratings will be a function of the overall revenue requirement authorized by PURA (rather than a single component of the revenue requirement) and the overall capital recovery support environment. However, the rate-case outcome related to the authorized capital structure for ratemaking will matter as it is a key component of the overall revenue requirement and is a component that is interpreted as a signal of the regulatory climate.

   Currently, CL&P has a target capital structure with an equity ratio of approximately 53.86%. CL&P's assessment of its operating environment is that an equity ratio of approximately 53.86% is consistent with those in place at other similar utilities and is appropriate to enable the Company to maintain its financial integrity thereby providing access to capital at

competitive rates under a variety of economic and financial market conditions. In that regard, utilities generally do not have the option to avoid raising external funds during periods of capital market distress. Capital-intensive companies are financed with a view on the risks and funding requirements associated with their assets and operations. Additionally, companies operating within a given sector are likely to have comparable financing requirements, face common financing constraints and have comparable financing practices. For this reason, CL&P assesses its capital structure relative to prevailing industry practice, comparative to other utilities with similar financing requirements and business risks.

The reason that the credit-rating agencies pay attention to capital structure is that utilities have a public-service obligation to provide safe and reliable service to customers and therefore require the ability to access capital markets in the provision of that service. The credit-rating agencies view capital structure as a pivotal element in that analytical construct. For example, as discussed in ALLCO-136, Attachment 1 – Moody's Ratings Methodology, 50 percent of the overall ratings weight is derived from Moody's assessment of Regulatory Framework and Ability to Recover Costs and Earn Returns. An appropriate level of equity capitalization is a critical element of this analysis.

More specifically, 40 percent of the overall ratings weight is based on Moody's assessment of Financial Strength, with 7.5 percent of that 40 percent attributed to Capital Structure. Given that relatively material weighting (for a singular component of the revenue requirement), the Company's target capital structure, as it relates to the Company's proposed total revenue requirement, is maintained in a manner to be supportive of the Company's credit ratings, which provides a tangible benefit to customers in the form of reasonable capital costs and assured liquidity.

b. As discussed in subpart (a), the Company has a target capital structure with an equity ratio of approximately 53.86%. This capital structure appropriately balances the interests of customers with the Company's need to maintain financial strength and access to capital on reasonable terms. Over the past few years, the Company has carried a higher equity ratio as necessary to finance long-term deferrals for RAM and storm costs. More specifically, the Company has had to fund approximately $1 billion in deferred catastrophic storm costs. Carrying substantial unrecovered balances requires the Company to finance those costs and, all else being equal, places pressure on credit metrics. However, the Company recognizes that this higher equity ratio is not appropriate as a long-term capital structure for distribution ratemaking and is not generally aligned with capital structure of other operating utilities across the industry, including the Company's own affiliates. For ratemaking purposes, therefore, the Company is working to issue incremental long-term debt to bring the equity ratio toward its target level. Conversely, the Company's assessment is that a lower equity ratio (particularly one that is materially lower) would weaken its financial position and could impair its ability to maintain credit ratings that support access to debt capital on reasonable terms. That outcome would not

benefit customers. The Company must finance substantial and continuing capital investment, and more debt necessarily increases fixed interest and repayment obligations. At a time when interest costs have increased and competition for capital remains significant, increasing debt beyond an appropriate level would not simply substitute lower-cost debt for higher-cost equity. It would increase financial risk and could ultimately increase the cost at which the Company is able to finance investments required to serve customers.

c. Please refer to Schedule D-1.0 for a worksheet that depicts the components of the Company's target capital structure.

d. Although CL&P has a target equity ratio of approximately 53.86%, the actual ratio will vary around the range naturally over time due to normal variations in cash flows that arise in the course of doing business. Over the next five years, to manage the Company's actual capital structure toward the target capital structure of approximately 53.86% equity, CL&P will evaluate the timing and amount of its long-term debt issuances, equity infusions from Eversource Energy, and dividends to Eversource Energy. Those financing decisions will reflect the Company's cash requirements, capital investment needs, financial condition, and then-prevailing capital-market conditions.