

# Energy Procurement Contracts:

## Operating Expense or Debt

### Special Report

#### Energy and Capacity Purchase Commitments

**The Role of Supply Contracts:** When analyzing the credit of investor-owned utilities, energy retailers, and merchant energy companies, Fitch Ratings views long-term energy or capacity purchase commitments as components of energy supply and operating expense, and not primarily as debt instruments, similar to existing financial reporting of normal commercial supply contracts under International Financial Reporting Standards (IFRS) and U.S. Generally Accepted Accounting Principles (GAAP).

**Commercial Contracts:** Fitch does not automatically adjust the debt of electric or gas utilities and others in the sector to reflect normal commercial purchase obligations as quasi-debt, and generally does not allocate portions of long-term contractual energy expense into interest and principal components.

**Some Contracts Viewed as a Debt:** Fitch may treat contracts of investor-owned utilities or energy retailers as debt-like obligations on an exception basis, including contracts that resemble a debt undertaking by the purchaser; operating leases, or capacity contracts and tolling agreements that resemble operating leases; and commercial contracts that commit the purchaser to an above-market purchase that cannot be recovered from pricing that the purchaser can realize in the market or through utility rates. See pages 2 and 3 for more about these types of contracts.

**Focus on Future Operating Costs:** When Fitch does not capitalize a long-term supply contract as a debt-like obligation, the resultant costs will be reflected in Fitch's forecasts of future operating expenses and operating cash flow. Key credit factors include the economic basis of the contract, the primary risks, and the risk-bearer in the transaction. Common risks in energy supply contracts include market price risk, operational/delivery risk, counterparty default, and regulatory or legal risk.

**Part of the Overall Supply Picture:** The contract may have a favorable, neutral, or unfavorable influence on the company's expected future operating margins, cash flow, and credit metrics. If the full supply portfolio puts the company in a favorable or unfavorable cost position, Fitch reflects this in its qualitative view of the company's business position and business risk. This is consistent with the way Fitch treats companies in all industrial sectors.

#### Related Research

Corporate Rating Methodology, Aug. 12, 2011

Operating Leases: Updated Implications for Lessees' Credit, Aug. 5, 2011

Rating Latin American Utilities, Power, Gas, and Water Companies, July 28, 2011

Rating North American Utilities, Power, Gas, and Water Companies, May 16, 2011

Rating EMEA Utilities — Sector Credit Factors, May 14, 2010

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## Contracts That Resemble Undertakings

U.S. public power utilities frequently purchase power from related generation utilities (either a joint action agency or generation and transmission cooperative) pursuant to debt-like power supply agreements. These agreements may obligate the purchaser on a take-or-pay basis, essentially supporting an undertaking of debt on behalf of the downstream distribution utilities. Fitch treats a percentage of the purchased power costs as a debt-like obligation in these cases, when calculating the purchaser's financial metrics. However, normal commercial contracts in this sector are typically treated as an operating expense, rather than capitalized as debt.

## Operating Leases and Similar Contracts

Fitch's rating criteria for all corporate finance sectors require the capitalization of a debt-like liability for off-balance sheet operating leases, often calculated as the higher of the present value of the remaining rental obligation under the contract, or a multiple, commonly eight times, annual lease rental. This is the case even if the lease costs are covered under a utility's tariff-adjustment mechanism, or as a part of the base tariff charged to customers. Fitch's guidelines for operating leases consider that some contracts that are not identified explicitly as operating leases are essentially operating leases, and Fitch's operating lease criteria is applied in those cases.

In some European countries and elsewhere, tolling or similar agreements that make power plant capacity available to integrated utilities are disclosed in the financial statements as an off-balance sheet commitment in the note regarding operating leases. The headline used for such commitments is at times labeled "Power Purchase Agreements." Tolling agreements are not energy purchase contracts, but permit the contractual party to make use of an asset required to generate electricity. Fitch treats such contracts like any other operating leases for analytical purposes.

If off-balance sheet commitments are entitled "Power Purchase Agreements" in the financial statements, it is necessary to enquire with the issuer what the economic nature of these contracts is, to qualify them either as energy purchase contracts that are not capitalized, or tolling agreements that are capitalized by applying the methodology for operating leases.

For Fitch's guidelines on lessees' obligations under operating leases, see the "Operating Leases: Updated Implications for Lessees' Credit" report, dated Aug. 5, 2011.

## Changing Accounting Standards for Leases and Contracts

Under existing IFRS and U.S. GAAP accounting rules, energy procurement contracts are generally treated as operating expenses, not capitalized as an asset and liability. Changes are planned in both IFRS and GAAP accounting for operating leases that will require such leases to be capitalized as an asset and a related liability, and will classify some long-term contracts as capitalized leases.

The level of disclosure about such contracts will likely increase with this transition. Fitch analysts will compare the effect on credit metrics under the new and the old reporting methods at that time. Changes to ratings are unlikely to occur if there is no underlying economic change, unless the increased disclosure results in a new analytical understanding of the contracts' substance.

### Normal Commercial Energy Contracts

Fitch occasionally treats an energy contract as debt-equivalent or an adjustment to the balance sheet when all of the following conditions are met:

- A large and long-term contract is material relative to the company’s cash flow.
- Sufficient information about the contract is available to Fitch.
- The contract price is significantly above market value or Fitch’s model curve.
- The buyer has a low likelihood of recovering the contract cost from expected revenues from regulated utility customers or from contractual counterparties.

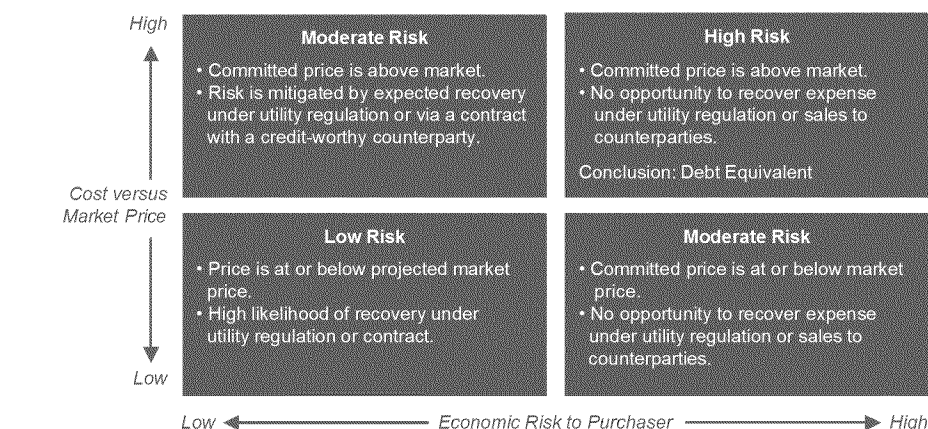
Very few contracts meet these conditions, and are treated by Fitch as debt-like obligations. However, when all of the above conditions are met, the amount of debt Fitch recognizes in its analytical ratios is determined annually or semiannually, based on the estimated present value of the unrecoverable over-market/model cost.

### Evaluating Major Contracts

To illustrate the conceptual framework of Fitch’s assessment of commercial energy contracts, a simple four-box diagram compares the price under contract relative to the expected market price on the vertical axis, and the likelihood of price recovery via utility rate-setting or contracts with counterparties on the horizontal axis (see “Assessing Major Energy Procurement Commitments” chart below). At the mid-point on the vertical axis, the power contract is equal to expected market price. In the lower boxes on the graph, the purchase price is below the expected market value, while in the upper boxes, the price is above expected market price.

The horizontal axis in the chart represents Fitch’s view of the buyer’s risk relating to recovering the full cost of the contracted purchase. Recovery may be achieved either under a utility tariff or under known contracts with credit-worthy counterparties. The risk of nonrecovery is lower for a utility if there is a process of adjusting rates regularly to match costs of power or gas purchases; the regulatory authority approved the contract or the process for contracting energy prior to procurement; and the contract was entered into through arms-length dealings with a third party provider, rather than an affiliate.

### Assessing Major Energy Procurement Commitments



Source: Fitch Ratings.

When the buyer is an energy wholesaler or retailer, the ability to recover the costs of above-market contracts is more assured if committed sales contracts or hedge contracts with counterparties of strong credit quality are in place. Full price exposure occurs if the buyer must depend on selling energy in a competitive market.

### Implications of the Analysis

In the case of an energy supply arrangement in the upper right-hand quadrant of the chart on page 3 (“High Risk”), price is above the forward market price or Fitch’s modeled value, and cost recovery is unlikely. This quadrant represents the realm of candidates for financial adjustment of the over-market or over-model present value as adjusted debt, if it is material.

In the bottom left quadrant (“Low Risk”), the purchase contract is beneficial to the buyer. It would be easy to remarket any surplus energy in the wholesale market without a loss or at a profit, and the buyer would lose out on a beneficial arrangement if the seller defaults and attempts to vacate the contract.

In the upper left quadrant (“Moderate Risk”), the contract is at an above-market or above-model price, but the buyer has a high likelihood of cost recovery. This could be due to a commodity-price adjustment in a tariff or favorable off-take contracts. Fitch does not impute a debt-like obligation in this case, but the risks to monitor are the credit of the off-take contract party or the consistency of tariff regulation.

In the lower right quadrant, (another “Moderate Risk” quadrant), the buyer has a poor chance of recovery of above-market or above-model costs, but the costs of this contract are projected to be economically advantageous to the buyer. Fitch does not capitalize a contract liability. The company is sensitive to both the credit of the seller and changes in the market price environment, since it has no protection in the marketplace, either from tariff pass-through or hedging contracts with strong counterparties.

See the Appendix on page 6 for some historical and recent examples.

### Renewable Energy Contracts and Tariffs

Many jurisdictions have public policy mandates that require utilities to purchase energy from renewable energy sources such as wind, solar, or geothermal resources. Such obligations may take several forms: contracts for the purchase of energy that meets the legal or regulatory mandates, or a standard tariff, sometimes called a “feed-in tariff,” that requires a utility to connect with and purchase any qualifying energy that is offered to it at a standard price. The purchase prices in either case are typically in excess of the prevailing market price for conventional energy, and consumers are indirectly providing a subsidy to the power producers.

When all utilities or competing suppliers in the same market are subject to the renewables mandate, and utilities that comply with the mandate are not placed at competitive or economic risk as a result, Fitch treats the purchase obligation as an operating expense, and does not capitalize the obligation as a debt. This is consistent with the Moderate Risk box in the upper left quadrant of the “Assessing Major Energy Procurement Commitments” chart on page 3.

### Adjusted Financial Ratios

In those cases in which Fitch treats an energy purchase contract as a debt-like obligation, the adjustment to debt is the present value of Fitch’s estimate of the unrecoverable above-market or above-model value of future payments at a discount rate equivalent to the entity’s cost of

debt. A similar amount is added to assets as a deferred asset, which must be amortized over the remaining life of the contract.

The uneconomic or above-market portion of the ongoing periodic payments under the contract is removed from operating expense and allocated into an amortization component and an interest component, at the same interest rate used to calculate the present value.

Fitch would typically reconsider the economics of a rated entity's energy and capacity contractual portfolio as a part of a routine periodic credit review. A reassessment could occur because a company enters into, terminates, or restructures a substantial commitment.

### **Dealing with Limited Information**

Fitch often does not have details about the terms and conditions of long-term supply contracts, as is frequently the case in European, Asian, or Latin American markets. One example is the case of gas take-or-pay contracts that European utilities have entered into with Russian, Norwegian, or African suppliers. The agency would not have insight into the precise volumetric off-take profile, the differential between the contract price and the market value, or Fitch's model curve in such a circumstance. It would not be feasible to apply the adjustment to leverage and interest cover ratios outlined in the previous section.

Fitch would still be able to identify companies that have entered into uneconomic contract terms, because the long-term commitments feed through into operating expense. These companies would typically display weaker margins compared with peers, or in comparison with margins implied by wholesale price levels. This shortcoming would be reflected in Fitch's business profile assessment, the projected margins of the affected companies, and ultimately in their Fitch issuer default ratings.

Fitch also notes that large gas suppliers tend to have a portfolio of long-term gas procurement contracts in place, and are somewhat protected from exposure to one or a few temporarily uneconomic commitments. This beneficial diversification effect mitigates the limitations inherent when contract terms lack transparency, and in most cases, it justifies treating related energy supply contracts as an operating expense.

## Appendix — Examples

Some historical or recent examples illustrate the application of Fitch's approach.

### TXU Europe plc — Above-Market Contracts

TXU Europe plc declared bankruptcy in 2002 as a result of material power purchase contracts and tolling agreements at above-market prices that the buyer (TXU Europe) could not recover from selling power in the wholesale or retail market. The magnitude of power commitments under contract was substantial relative to the total size of TXU Europe's business and equity. In 2001–2002, Fitch valued the portfolio of tolling contracts as debt equivalents. To relieve itself of the uneconomic contracts, TXU Europe would have had to buy its way out of the contracts at a total cost that was similar to the present value calculation that Fitch applied to value the debt equivalence of such contracts. Contract counterparties would not negotiate discounted settlements to terminate or restructure the agreements, because they believed that TXU Europe's parent would provide financial aid to its subsidiary, despite the lack of any parent guarantee or undertaking. TXU Corporation's management ultimately put the subsidiary into bankruptcy rather than use corporate resources to satisfy these contractual creditors to the detriment of shareholders and other corporate claims.

### Aquila, Inc. — Tolling Agreements Resembling Leases

Aquila, Inc.'s merchant energy marketing business contracted for tolling rights to long-term capacity from various gas-fired combined cycle power facilities. A glut of capacity in the region and higher natural gas prices combined to reduce the value of Aquila's capacity obligations in 2005–2006. Fitch treated Aquila's obligation to pay for power capacity from the Elwood power facilities as an uneconomic contract that was not recoverable in the wholesale power market, and valued the debt equivalent in December 2005 at approximately \$240 million. Aquila announced in June 2006 that it would pay approximately \$220 million to transfer its obligations and rights under the contract to an energy marketer. Aquila sold or wound down its merchant energy businesses in 2006–2007, and sold its utilities in 2008, ceasing to exist as an independent entity.

### U.S. Qualifying Facility Power Purchase Contracts

Many utilities in the 1980s and 1990s were required by U.S. law (Public Utility Regulatory Policy Act of 1978, or PURPA) and state policies to enter into contracts with owners of qualifying facilities (QF) at prices that eventually proved to be substantially above market. Utilities challenged the validity of the law and the enforceability of the contracts, with no success. State regulatory commissions were forced by federal law to provide tariff recovery of the contract costs. Fitch is unaware of any cases in which a utility was barred from passing the costs of QF contracts on to customers in its rates. Such contracts were generally in the upper left quadrant of the Assessing Major Energy Procurement Commitments chart (above-market, but with a high likelihood of regulatory recovery). Fitch did not treat the contracts as debt-equivalents, but as unsustainably high operating expenses in many cases. When utilities were burdened by a high proportion of QF power contracts at prices above market energy prices, the inflexibility and high costs of the contracts raised the utilities' power expenses and raised the utilities' business risk. Fitch took that higher business risk into consideration when rating the utilities' credit.

**Tenaga Nasional Berhad (Malaysia) — Excess Contracted Generation Capacity**

Tenaga faces a significant excess of generation capacity. It has been utilizing only half of the total capacity available to it, including owned and contracted capacity of power producers under long-term power purchase agreements. The fixed-capacity payments to generators for the unutilized portion, nearly half of total contracted capacity, are significant, at approximately \$750 million in 2010. Fitch treats these payments on unutilized contractual capacity as debt equivalents (adding \$6 billion to Tenaga's total unadjusted on-balance sheet debt of \$6.6 billion at fiscal 2010).

**Silicon Valley Power (Santa Clara, CA) — Debt-Like Undertakings**

Silicon Valley Power (SVP) provides electric service within Santa Clara's city limits. The retail electric utility is composed of generation, transmission, and distribution facilities. However, SVP also participates in power projects developed by joint power agencies (JPAs) and receives a significant share of its energy through these relationships. SVP's obligations to these JPAs are take-or-pay, and must be paid regardless of whether energy is actually received by SVP. Fitch factors into its analysis financial metrics for SVP that include these debt-like obligations, and metrics based on its audited financial statements. SVP reported direct debt that was a relatively low 27% of total capitalization in fiscal 2010. Adjusting for these off-balance sheet debt obligations, SVP's leverage increases to approximately 56%, which is high, but still in line for the rating category.

**Iberdrola, SA (Spain) — Feed-In Tariffs for Wind Energy**

Spanish vertically integrated utilities such as Iberdrola have invested heavily in renewable generation capacity, notably wind. Wind generation benefits from guaranteed dispatch at a feed-in tariff that consists of a regulated price or market price plus premium. The end-consumer should ultimately pay for the difference between the wholesale market price and the price to which renewable energy generators are entitled. Fitch treats the costs related to the dispatch of wind energy to the distribution companies as a pass-through item, and refrains from capitalizing these expenses in line with the prevailing approach outlined in this report.

The Spanish electricity sector has been marked by a structural tariff deficit in recent years, which utilities have had to fund on their balance sheets. However, the deficit is gradually being securitized, despite difficult market conditions. Fitch consequently does not include the tariff deficit in its debt calculation, but nevertheless notes that the sector's cash flow profile and working capital dynamics would benefit from pricing that offers a better reflection of market reality, a 2013 target.

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