ATTACHMENT

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Advantages of the WMECO PSNF proposal

2. There Are Many Advantages To The Refinancing of WMECO's PSNF Liability.

In addition to the likely return to WMECO's customers of excess investment income at the time the fund is dissolved, there are several other important advantages to refinancing WMECO's PSNF liability.

First, refinancing will allow costs charged to current customers to reflect the costs of providing service to these customers. The PSNF liability, obviously, relates to the period in time in which WMECO held substantial nuclear generating assets. Pursuant to Department policy and the Electric Utility Restructuring Act of 1997, WMECO has divested its generation assets, including its nuclear generation assets. WMECO is now truly a transmission and distribution company. Tr., p. 52. However, under the present method of treating the PSNF liability, current customers are responsible for interest charges each year on this nuclear generation-related liability. Tr., p. 66. By setting the PSNF liability aside and funding it separately, the Department will be recognizing that the Company has divested and no longer is in the generation business and that, to the extent possible, current customers should not be responsible for the costs or benefits enjoyed by past customers when WMECO was in the nuclear generation business. Exh. WM-1, p. 5.

Second, reflecting the PSNF liability in its current form has skewed WMECO's capital structure to a significant extent, and borrowing to finance the PSNF liability will go a long way to rectifying this problem. Using an amount of the proceeds of the long term debt issuance will allow WMECO's debt/equity allocations to be more appropriately aligned and to track more closely non-ratemaking (or rating agency) debt calculations, which currently treats the PSNF liability as debt. Exh. WM-1, pp. 6-7. WMECO's witness, Mr. Cahoon, explained how the situation developed.

Mr. Cahoon testified that prior to restructuring WMECO owned significant generation resources and was a significantly larger company in terms of assets. Tr., p. 49. At that point, in 1998, WMECO's debt/equity allocation, including the PSNF portion, was approximately 64%/36%. The PSNF liability made only a small

difference in the debt/equity allocation viewed by the rating agencies because overall WMECO's assets were greater and the level of the PSNF liability was less. At that time, the debt/equity allocation viewed from a non-ratemaking perspective was 68%/32%. Tr., pp. 49-50.

By the end of 2002, however, WMECO had divested its generation and had become a much smaller company. Tr., pp. 48, 65. In addition, the PSNF liability had grown somewhat. As a result, ratemaking and non-ratemaking debt/equity allocation had diverged significantly. Tr., pp. 49-50. By December 2002, WMECO's debt/equity allocation, from a non-ratemaking perspective was 55%/45%, which is considered within the appropriate range for a company such as WMECO. Tr., pp. 50-51. However, because the PSNF liability is not considered debt from a ratemaking perspective, the ratemaking debt/equity allocation was approximately 25%/75%. *Id.* Holding this level of debt is "much too low"[1] and it is unlikely the Department would accept such a high level of equity over the long term because equity is more expensive than debt and a higher equity level means high costs to customers. Exh. WM-1, p. 6; Exh. DTE-IR-1-4.

While some discrepancy between the ratemaking and non-ratemaking perspectives is acceptable, the huge discrepancy that exists now is not. Although rating agencies and others view the Company as holding 55% debt in its capital structure, and this level of debt is consistent with what is needed to maintain the targeted BBB+/A3 senior unsecured credit ratings, the ratemaking view is that the Company is holding only approximately 25% debt. Exh. WM-1, p. 6; Tr., pp. 49-51.

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[1] It is much too low because it is a misrepresentation to show that WMECO is financing its operations with 75% equity. This is simply a result of the present treatment of PSNF. Tr., pp. 50-51.

On one hand, then, the Company has an appropriate capital structure and should be attempting to maintain roughly that structure. On the other hand, the Company has a capital structure weighted far too heavily toward equity and should be attempting to increase its debt position. However, if the Company were to try to increase its debt position in the current environment by issuing a substantial amount of bonds, it may be viewed by the rating agencies as increasing its debt to too high a level (at present, as shown above, the rating agencies see WMECO's debt level as within a reasonable range), and potentially negatively affecting its BBB+/A3 ratings. *See* Exh. DTE 1-3.

This problem is largely resolved pursuant to the Company's proposal. Because the PSNF liability is already viewed as debt by the rating agencies, borrowing to finance this obligation will not affect the rating agencies debt/equity allocation. *Id*. Conversely, such a borrowing will affect WMECO's ratemaking debt-equity ratio. Taken in combination with the replacement of short term bonds, the borrowing will increase ratemaking debt to approximately the same general level as non-ratemaking debt. Tr., pp. 50-52. This result will allow the Company to manage its financial affairs into the future without being "whipsawed" between the rating agencies view of the Company's debt levels and the ratemaking view of the Company's debt level. Such a result is clearly in the best interests of WMECO's customers.

Third, it is to customers' advantage to finance the PSNF liability in the current low-interest environment. Tr., pp. 66-67; Exh. DTE 1-1. No one knows exactly when the DOE will require payment of the PSNF liability. But when the payment is required, customers will be impacted because the PSNF liability will no longer be a credit to rate base and the Company will have to borrow to pay the DOE

(through DRI). *Id.* Given the virtual certainty that the DOE will require the PSNF fees and WMECO will have to access the financial markets, it makes obvious sense to access the markets now when interest rates are at an historic low. To wait until the DOE actually requests the funds means that WMECO will have little or no choice as to timing of the issuance and the interest rates may well be significantly higher than at present. Customers would be responsible for those higher rates. *Id.*

Fourth, related to point three, above, it is to customers benefit to shed the interest accrual risk on the PSNF liability now, before rates rise. Currently, customers are charged each year the interest obligation on the PSNF liability. This interest is now at a low level. However, as interest rates rise, and the PSNF liability increases, the interest obligation for which customers are responsible may increase significantly. By financing the PSNF liability and establishing a trust fund, customers will avoid responsibility for these increased interest costs. Tr., p. 67.

Fifth, the PSNF liability is growing each year as interest accrues. Tr., p. 49. It goes without saying that, all things being equal, it is preferable to finance a smaller amount than a larger amount. By financing the PSNF liability now, WMECO would be financing the smaller amount at low rates and avoiding any need to finance a larger amount in the future.

Sixth, financing the PSNF liability will decrease WMECO's average cost of capital, thereby reducing future charges to WMECO's customers. Exh. WM-1, p. 7. As Mr. Cahoon testified, it is estimated that WMECO's average cost of capital will drop (because of the increased percentage of debt), by virtue of its proposed long term financing, from 15.12% to 11.84%, grossed up for taxes (it would decrease from 9.79% to 8.28% before taxes are figured in). Tr., p. 54. The low interest rates currently available for debt make such a dramatic reduction possible. Tr., p. 66.

As the Department is aware, a reduced average cost of capital, overall, is a significant benefit to customers. Exh. DTE 1-8; Tr., p. 54. Instead of paying 15.12% to finance the Company's capital, that number drops by several percentage points. Obviously, any time customers can pay less for WMECO's cost of capital, customers benefit. This benefit will become most tangible when WMECO files its next general rate case. At that time, the choice would be to have customers pay the approximately 15% average cost of capital or to attempt to refinance somehow the PSNF liability then. However, it is unclear how the timing of such a financing meshes with a rate case. And, even more importantly, all the parties know that interest rates are at historically low levels now; they may rise to much higher levels in the future – thus precluding the type of savings that would be realized from a financing now. Tr., pp. 65-67.

Accordingly, for all the reasons set forth above, the financing of the PSNF liability is reasonably necessary to accomplish a legitimate utility purpose and should be approved.