CVEC comments on Analysis Group Financing Assumptions

April 2019

Comments on Analysis Group Presentation from 3/26/2020

- Based our Advanced Power's recent experiences in financing new generation in NYISO and other ISOs, we find that the Analysis Group financing assumptions presented on 3/26 2020 need to adjusted based on the below comments:
  - Return on equity for new build in New York should not be decreasing but moving higher as the investment communities' views of market and regulatory risks to New York gas fired generation resources have increased significantly over the last four years.
  - The debt assumptions for new build gas generation needs to assume significant forward hedging to obtain the debt terms proposed by Analysis Group. There are no lenders in the market that would provide debt to a new gas fired generator without at least 5 years of contracted revenues to provide debt coverage.
  - If a hedging assumption is not incorporated into the NetCONE costs, the debt leverages need to be decreased or interest rates significantly increased to account for the risk of debt unsecured by contracted revenues.

Cricket Valley Energy

Return On Equity Assumptions Should Move Higher

- Analysis Group is recommending a reduction in return on equity from 13.4% to 12.75%.

- The view of the investment community is that risks to equity returns in New York gas fired generation market have significantly increased over the last 4 years, contrary to the findings of Analysis Group

- Investors are demanding equity risk premium for gas fired generation for the following reasons:

  1. Subsidization of resources in the NY market skewing competitive outcomes (Nuclear ZECs, renewables, off shore wind, energy storage)
  2. CLCPA law will increase competition from subsidized resources and prevent gas fired operations beyond 2040
  3. Uncertainty over future CO_2 pricing policy (disruptive to forward energy markets and ability to hedge)
  4. Capacity market uncertainty due to ongoing PSC resource adequacy docket
  5. Recent bankruptcy of gas fired generation assets in NYISO (i.e Empire Generating)

- Discussions with existing and potential equity investors in CVEC do not exhibit any appetite to invest at equity return rates of 12.75% in New York gas fired generation assets.

- Also the return on equity should focus on project company financing, not corporate equity, as IPP projects are commonly project financed and therefore riskier requiring a higher return on equity.

- Return on equity rates for investing in New York gas fired assets should be higher than 13.4%. We recommend a rate in the 15-17% range based on current risk premium demanded by project company equity investors to compensate for state policies and market conditions that are generally unsupportive of steady predicable returns of gas fired generation in New York State.

Debt Assumptions are Overly Aggressive

- Analysis Group is recommending D/E ratio of 55/45 and rate of 6.1%

- Based on Advanced Power's experience with transactions in the debt markets, the debt market would not support a transaction at Analysis Group's proposed leverage and rates without a significant amount of hedging to provide contracted revenues to support the debt service.

- To support the assumptions from Analysis Group, the NetCone assumptions need to assume the costs of hedging for the term of the loan. Commonly construction + 5 years.

- Hedges used for recent new construction have included Revenue Puts, Heat Rate Call Options (HRCO) or NetBacks. Each of these hedge transactions has costs to the generator

  1. Revenue put – Upfront transaction costs paid at financial close
  2. HRCO – Credit support costs during term, reduced energy margins from forward curves
  3. Netback – Credit support costs during term, reduced energy margins from forward curves

- Advanced Power recommends that Analysis Group incorporate hedging costs into the NetCone calculations for the DCR process. These costs should be reflected in either upfront costs for a revenue put or ongoing costs for HRCO or netback in the form of credit support and discount the forward curves.

- If a hedging assumption is not used, Advanced Power recommends a higher debt interest rate that reflects unrated junk debt with no secured revenues. Based on the historical volatility of the energy and capacity markets, a rating agency would not assign a rating to this debt and a significant premium in interest rates would be demanded by the issuer of this debt.