Q. Does an unconditional debt guarantee influence the riskiness of debt and therefore the appropriate risk premium amount? Please provide a complete explanation of your answer.

A. The unconditional debt guarantee reduces the riskiness of the debt to the debt holder. With the guarantee, the debt holder has a much greater assurance that he will receive the interest payments and a return of his principal. The degree of assurance is dependent on the financial strength of the guarantor.

The availability of the debt guarantee also permits the utility to assume a higher degree of leverage than a utility which has no such access. However, the existence of the debt guarantee does not protect the equity holder. If the debt guarantee is triggered, the debt holder will likely be kept whole, but in the event of what would otherwise be a default on the debt, the equity holder’s investment will already have been impaired. Consequently, the reduction in the riskiness of the debt to the debt holders due to the guarantee does not decrease the appropriate equity risk premium to the equity holder as long as no compensation for the equity risk has been reflected in the debt guarantee fee. As discussed in response to PUB-52 NLH, that is not the case.