CITY OF LOS ANGELES

CALIFORNIA

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ERIC GARCETTI
MAYOR

Date: May 28, 2015

To: The Honorable City Council

From: Frederick H. Pickel, Ph.D.,
Executive Director/Ratepayer Advocate

Subject: Council File No. 14-1232-S1 - Springbok II: Power Sales Agreement, Agency Agreement, Real Estate License Agreement, and Amended and Restated Real Estate License Agreement

On May 19, 2015, the Board of Water and Power Commissioners ("DWP Board") adopted as amended the above referenced Power Purchase Agreement (PPA), called "Springbok II," with the Southern California Public Power Authority (SCPPA) and the associated inter-related agreements with the Department of Water and Power (DWP).

The attached report, dated May 14, 2015, represents the Office of Public Accountability's (OPA) report to the DWP Board, and the General Manager, on the "Springbok II" matter.

Inasmuch as the "Springbok II" PPA, and the associated inter-related agreements, are before the City Council for its consideration, the OPA report is submitted for your review. In the event you have any questions regarding this matter, please contact the OPA at 213-978-0220 or fred.pickel@LAcity.org.

Attachment: OPA Report on Springbok II dated May 14, 2015

cc: Honorable Mayor Eric Garcetti
Councilmember Felipe Fuentes, Chair, Energy and Environment Committee
Sharon M. Tso, Chief Legislative Analyst
Miguel A. Santana, City Administrative Officer
Marcie L. Edwards, General Manager, Department of Water and Power

REPORT FROM

OFFICE OF PUBLIC ACCOUNTABILITY

Date: May 14, 2014

To: The Board of Water & Power Commissioners
Marcie L. Edwards, General Manager, Department of Water & Power

From: Frederick H. Pickel, Ph.D., Executive Director/Ratepayer Advocate
Camden Collins, Deputy Director/Ratepayer Advocate

Subject: Springbok II: Power Sales Agreement, Agency Agreement, Real Estate License Agreement, and Amended and Restated Real Estate License Agreement

HISTORY

Renewable power is required by the Global Warming Solutions Act of 2006. The Department of Water & Power's (DWP's) current plans and actions to comply are sometimes distilled and described as 33% renewable power by 2020. In December, 2013, the DWP Board adopted a required policy statement implementing the law, "Renewables Portfolio Standard Compliance and Enforcement Program" (RPS Policy).

The above referenced agreements pertain to a solar farm project, called "Springbok II." It is owned by 63**SU** 8ME LLC, and represents the culmination of several years of negotiation by DWP. The first request for proposals leading to this transaction occurred January, 2012. Since then, a solar facility owned by 62**SK** 8ME LLC, entered into similar agreements to provide renewable power to DWP. This project was "Springbok I." DWP is the only SCPPA member participating in Springbok I and II.

OPINION

The Springbok II Power Purchase Agreement (and related transactions) are reasonable in their terms and conditions, and constitute a fair deal for ratepayers. The risks associated with execution of these agreements are moderate, and mitigation of those risks has been sufficiently provided for in the agreements and Board resolution. This opinion depends upon the proposed Board resolution: the DWP Board would approve purchase option exercise or stepping into ownership, when and if those events occur. OPA's recommendations for due diligence before assuming ownership remain unchanged and are incorporated herein by reference. (OPA Report, August 28, 2014, Springbok I, recommendation 1(d).)

OPA's recommendations concerning ethics issues during review of Springbok I in 2014 have been acted upon by DWP and made effective for Springbok II.

OPA's recommendation to bid projects with and without purchase options has also been acted upon since Springbok I, shortly before a Board presentation on October 21, 2014. With the limitations noted below, those results provide a market price and establish clearly that ratepayers are not paying material amounts for these options to purchase the facility and land.

The DWP's presentation to the Board on October 21, 2014 clarified DWP's interpretation of the RPS Policy. OPA further explored the distinction DWP intends between the percentage of the portfolio optioned, and the percentage of the portfolio owned. OPA's concerns arise only if and when the ownership share of the portfolio exceeds 50%. Current management informs OPA that it does not expect to exceed this level of ownership in the near term. Consequently, OPA's objections have been adequately addressed at this time.

Option Floor Price Risk

OPA's sole remaining objection pertains to its assessment of risk that is associated with the floor prices in the option to purchase. Because this risk does not manifest until such time as DWP would seek to exercise its option to purchase or step-into ownership, OPA does not object to the Board or City Council approval requested. OPA's opinion is that the floor prices in the options are not reasonable.

The floor prices bear no relationship to any market price, fair or otherwise. The floor prices are appropriate for highly leveraged speculators, like Goldman Sachs. Such parties are willing to use leverage and make returns well over 20% by speculating on whether the site will produce power, and for which buyer, many years off in the future after the initial power purchase agreement is terminated.

This type of negotiated floor leads to what is called "intangible valuation" of the site. Generally, intangible value comes from ratepayers paying for the power, and hence intangible value would rarely be a fair price for the same ratepayers who have already provided a profit on all the producer's costs, including development. Exceptions tend to prove the rule and involve forms of unfair competition or inter-generational inequity -- asking ratepayers in the future to pay more, so ratepayers today could pay less. If you take into account a tax credit and the accelerated depreciation, a producer cost which writes the asset "down" faster, and one is re-paying for the same costs in a manner even more adverse to the public.

Writing generating assets "up" is what traders and "flippers" do. The market at the option exercise dates is illiquid, making this type of leveraged speculation possible. The terminal (end of contract) floor price, which would return over a 20x profit on the land, establishes some special value of the site not supported by the balance of plant or interconnections. There are sound fundamental reasons banks will not conduct project finance lending on terms longer than those of Springbok II (i.e., 30 years, if extended). Attributing intangible value in periods past the power purchase agreement directly flouts this risk management practice. Under duress, these high floor prices have potential to harm, not help, ratepayer's interest in exercising its rights to purchase or step-into ownership.

OPA continues to recommend to DWP in future negotiations that it use neither floors nor ceilings to constrain what the fair market price may be at the time of exercise. No outcome adverse to ratepayers could occur because option exercise is not required. All else equal, the counter-party relationships should prove more stable.

SCOPE OF REVIEW

The Office of Public Accountability (OPA) has reviewed the following transaction documents provided: the Power Sales Agreement, the Agency Agreement, the Real Estate License Agreement (with 63SU 8ME), and the Amended and Restated License Agreement (with 62SK 8ME). No audit work and no direct bid verification was conducted in connection with reviewing these transactions. DWP answered all inquiries of OPA concerning these agreements.

cc: The Honorable Eric Garcetti, Mayor
Miguel Santana, Chief Administrative Officer
Sharon Tso, Chief Legislative Analyst