REPORT FROM

OFFICE OF PUBLIC ACCOUNTABILITY

Date: August 28, 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: Power Purchase Agreement Between Southern California Public Power Authority and 62SK 8ME LLC, and associated inter-related agreements with the Department of Power and Water

HISTORY

The above referenced Power Purchase Agreement (PPA), called "Springbok," has been modified since first transmitted to the Office of Public Accountability (OPA) for review on May 6, 2014, removing a pre-payment for energy that OPA found unreasonable. In the absence of pre-payment, OPA has withdrawn its analysis of the initial transaction, conveyed by draft report June 16th to DWP management for consideration. The current proposed transaction was received late on August 22nd, and may not be the final version.

INTRODUCTION

With the important caveat concerning review time, OPA finds that the Springbok transaction is reasonable, *provided* execution of options to buy or assume debt are first authorized by the Board of Water and Power Commissioners (Board), if not also by City Council, as the latter may direct under Section 245 of the City's Administrative Code. Because debt assumption decisions can occur on 10 days' notice, OPA herein specifies the type of information that would be needed for a reasonably informed decision to assume debt.

Because of policy issues raised in this transaction and other recent transactions, OPA also recommends the following:

1. Changes to the procurement process;
2. Improvements to the transaction review process;
3. Evaluation by the Board of the level of ownership in the renewable portfolio.

SCOPE OF REVIEW: THE STATUS OF AN EVOLVING REVIEW PROCESS FOR MAJOR RENEWABLE CONTRACTS

OPA would prefer to be in a position where deference can be accorded to the price outcome of a competitive process. Recommendations herein are motivated by this goal.

The existing procurement process with the Southern California Public Power Authority (SCPPA) was developed before OPA's creation, and these recommendations are not an implied criticism of how it evolved over prior decades. DWP's recent changes in management and oversight have significantly improved OPA's access to information. However, the limitations below remain, and can be easily remedied as future transactions are brought before the Board.

OPA has four areas, described below, where a rudimentary level of review was not possible.

1. DWP selected this project and chose to engage in extensive post-bid negotiations with this developer following a submission of bids placed on a shorter list of less than 12 bidders. OPA has requested both the scoring from this last round before selection and the documented bids. The purpose of this information is to ensure that the deference requested for the competitive process is supported by the facts, which remain unverified at this time.

2. OPA sought a complete identification of all principals in the transaction, which ordinarily includes those parties that may obtain the earliest profits from the power purchase in the form of a gain on land sale. OPA has been unable to conclude that the principals to this transaction are all known and identified to DWP. The operative governing documents of the project company were not reviewed. The land purchase option was not reviewed. Certain equity participants are not likely to be present until after a transaction is authorized, and no reference to them is intended. Agreements preventing circumvention are a commercially reasonable method for ensuring access to such records of projects in early stages of development, which would facilitate such a review of key principals.

3. Due to these limitations, OPA cannot therefore vouch for the existence of standard checks for conflicts of interest that would be appropriate for government entities considering ownership of generating facilities and land, whether through exercise of options or assumption of debt. Requirements that would apply if DWP did the procurement are not required by this procurement process, as far as OPA knows. In particular, no sworn statement of compliance with Los Angeles Municipal Code on lobbying, which requires specified disclosures, is apparently required.

4. Claims that the options to purchase the project were obtained at no ratepayer cost could not be verified. This problem can be readily remedied if all bidders are required to bid a price with and without options that the buyer has standardized before the request for proposals issues. OPA knows of no current facts likely to render exercise of Springbok's purchase options reasonable at the lowest possible (floor) price. However, this difference of opinion is not an obstacle to approval, so long as the option exercises (including the option to assume any project debt) are Board reviewed. If so, long range forecast assumptions embedded in these options can be reviewed at that time. More reasonable hedging practices are readily available, if price protection is the purpose. Nothing unique about this project's land, permit, or relative proximity to the DWP transmission obviates better priced or less claim-burdened alternatives for all future years to come. The insistence that this location is uniquely endowed only heightens the concerns stated above.

OWNERSHIP: EXISTING POLICY PARAMETERS ARE UNCLEAR, WHICH IS ENABLING UNREASONABLE CONCENTRATIONS OF OWNERSHIP RISK WITHOUT IDENTIFIED BENEFIT

The DWP Board's policy on the combined level of ownership and options-to-own renewable generators is as follows:

> "On or after January 2, 2011, a minimum of 75% of all new eligible renewable energy resources procured by LADWP will either be owned or procured by LADWP through an option-to-own, either directly or indirectly (including through joint powers authorities) until at least half of the total amount of eligible renewable energy resources by Megawatt-hour (MWh) is supplied by eligible renewable energy resources owned or with an option to own either directly or indirectly (including through joint powers authorities) by LADWP." Renewables Portfolio Standard Compliance and Enforcement Program, Amended December 2013, emphasis added.

Regulatory deadlines prohibited any analysis of the current RPS ownership policy when the Board adopted it December 2013. However, since then DWP has accelerated its plans to own (or option) far more than half of the RPS portfolio, and current plans are for 92% owned or optioned resources. In part due to review of this transaction, OPA recommends a mid-course check on this policy, and its interpretation, before more negotiations conclude.

DWP's expressed view of the policy allowing "at least half" ownership is that it is not a prohibition to owning or optioning all renewables, because it intended to describe a minimum, not a maximum. OPA is concerned that policy clarification will come too late to preserve the downward rate potential embodied in a portfolio that is truly diversified, with not substantially more than 50% ownership, including options.

Reasonableness, as a standard, does not require perfect foresight. Therefore, reviewing the portfolio does not equate with picking out the individually favorable and unfavorable decisions of the past. Absent clear and convincing evidence to the contrary, past decisions should be presumed made on the best information available at that time. Similarly, it is not reasonable to find some amount of renewable

ownership has acceptable rate impacts, simply because those rate impacts are less than previously forecast, or options became more affordable than ever before.

Ratios of ownership higher than 50% can cause adverse ratepayer impacts because ownership costs more, and has cost significantly more than reasonable experts would have predicted in 2010, when this policy was first (reportedly) adopted. It also eliminates diversification and the opportunities for future offsetting rate decreases from non-owned renewables with staggering terms. It creates potential stranded costs for a future generation of ratepayers. Even if the ownership (and option) premiums are smaller, other equally important objectives like jobs and flexibility should be considered, and balanced by policy that adapts as well as incorporates known pitfalls.

The motivation underlying DWP ownership has precedent in its favor. Hydro-electric resources in the past were successfully secured for generations of Angelinos, were unique or limited in their siting opportunities, and were of disproportionate historic and financial advantage. These important features of the past are not particularly predictive of the future, or pertinent to today's non-hydro renewables. Significant changes in resource types, location, and pricing are widely expected to make the next decade quite different.

DWP plans to own (or option) 92% of renewables is at best a contradiction to adopted policy, and at most controversial over-weighting. In 2009, voters narrowly rejected 400 MW of DWP owned solar in Proposition B. DWP's recent procurement activity substantially exceeds the level of utility ownership that was rejected. Options to own only two projects, K Road Moapa Solar and Sempra Copper Mountain, together exceed 460 MW of solar.

To the best of OPA's knowledge, the trigger in the above policy of 50% of the actual production was met in 2012. DWP responses to data requests indicates that in 2012 approximately 50% of the energy (MWh) in the portfolio was from DWP owned (or optioned) projects, and cost 40% (or 43%) more than the energy purchased from third parties. Some portion of this "premium" to own can be explained by the year projects became commercially operational: older "vintage" in a context of rapidly declining renewable pricing is assuredly lifting this premium above historic norms. Nevertheless, over many decades, ownership has tended to cost more. Utilities have provided demonstration projects at small scale for new technologies not yet commercial, and some have even excelled in managing those risks. Both publicly owned and investor owned utilities tend to have far more difficulty with larger projects when mature technology changes or becomes obsolete in less than 20 years: over-weighting is a hazard to be avoided with large, interconnected infrastructure.

Because DWP does not require bidders to submit bids that distinctly price the commodity, with and without one or more options, it never collects the information that could support conclusions about the option costs, and whether the benefits are commensurate. Further, no information supports the conclusion that many options are more valuable than one, if price protection is the purpose. The initial contract can lock-in price for the full contract term, and there are good examples of price protection in the form of options to extend the term at a fixed price. DWP engages in extensive bilateral negotiation

of non-comparable goods, a phenomenon generally in the commodity seller's best interests. A party that wants to know what something novel is "worth" will seek bids for the feature, and attribute little value to prices unless there is robust participation.

Robust participation of novel contract features in this industry is possible, but takes an investment of effort in working with the supply chain, often through several iterations of *formal bidding*. These iterations set a clear product definition for what the buyer wants sellers to price, take prices from all eligible bidders, and revises the bid package if participation is too thin, based on bidder's feedback. Post-bid "innovations" in product definition arising from negotiations have an unfortunate tendency to fail in delivery. This outcome is due to a competitive consequence called the "winner's curse," which in this context can stretch economics beyond a breaking point that is only clear in hindsight. A fair competitive process, which refines and rebids until there are at least five bona fide offers, is the prudent way to avoid illusory benefits, while pressing for innovation. Such a process is one OPA could find adequately transparent, and likely to yield fair outcomes to ratepayers. It is likely to be faster, as well.

In conclusion, DWP has spent a great deal of ownership premium in the early years of building a renewable portfolio. Ratepayers have already paid 40% extra to hit the 50% ownership target, and should be benefitting from more abundant and cheaper selection of non-owned resources that simply were not available earlier. OPA's opinion is that, in this context, premiums over 5% cannot provide commensurate value to ratepayers because of the long run nature of these commitments, and the rapid changes now affecting generating resource technology. Preserving diversification and flexibility is more important, and valuable, than ever.

As an ancillary matter, OPA is unable to discern an appreciable number of jobs associated with operating more solar and wind generation, if owned. OPA perceives a larger shortfall of labor for non-generation functions that is not being met at present. If skilled labor is to be in short supply, it may be best utilized on supporting backlogs in distribution maintenance.

RECOMMENDATIONS

The Springbok Transaction

1. OPA recommends that the Board approve the proposed PPA and related transactions, with the following caveats (a, b) and conditions (c, d):

    a. The OPA has not confirmed that the bid documents support the selection of this competitor;
    b. The OPA has not conducted an independent conflicts check or identified all principals;
    c. The option to assume the debt or purchase the project is subject to Board approval;
    d. Before seeking authorization to assume project debt, the DWP pursues in good faith: (i) the flexibility and time needed from regulators to replace renewable resources when failures of third parties occur, (ii) the prices of land of equivalent usefulness near the

same interconnection, and the cost estimates for permits and rights of way needed to rationally evaluate those alternatives, and (iii) a reasonable assessment of all other claimants to the property or facility, whether secured or not, with an estimate of the distress costs involved in a "work out" of the project debt. (Work outs resolve all claims of the project company, often without formal bankruptcy proceedings.)

General Policy Recommendations Concerning Procurement Practices

2. OPA recommends that DWP publish in its SCPPA requests for proposals that winning bidders will, before the transaction is placed before the Board or City Council, be required to sign under penalty of perjury the Los Angeles Ethic Commission's forms CEC 50 and 55, and an equivalent sworn statement for SCPPA.

3. OPA recommends that DWP clarify its bidding requirement that bidders have previously completed at least one utility scale project, to ensure that the bidding firm, not individuals, satisfies this requirement.

4. OPA recommends that DWP publish with the requests for proposals the weights assigned to the key criteria it will use to select a smaller number of bidders. This practice is well-established as improving the transparency and outcomes of competitive processes in this and other industries.

General Policy Recommendation Concerning Future Options To Own Renewables, If Any

5. If ownership options are included in subsequent power purchases, OPA recommends that the Board adopt the following two-part framework. This framework addresses only options to purchase assets, not options to purchase power for extended terms.

    a. **Standard purchase option**: OPA supports as reasonable an option to purchase the facility and land exercisable at the end of the industry-accepted useful life of the generating equipment, taking the form of a right of first refusal that matches the price of a "long-arm" transaction.
        i. *Long arm transactions* are further defined in case law, but in general are with unrelated parties, arise from robust efforts to market the asset, and are free of conflicts of interest with DWP.
        ii. In this context, *long arm transactions* also require *transmission access* to support buyers' valuations. The transmission of generation must be subject to the same terms generally available to third parties who desire to "wheel out" of DWP's system, to support a long arm transaction's valuation.
        iii. *The useful life* of the generating equipment is the maximum term for which original (post-construction or initial operation) financing can be obtained.

Written accounting standards of longer duration must objectively state that duration in years, and not depend upon expert interpretations.

b. **Unique option**: Should DWP wish to procure options that are unique or deviate from established industry standards in power procurement, DWP should show:
    i. Renewable prices forecast to the year of the latest exercisable option to own and 20 years beyond, to quantify the benefits of subsequent ownership;
    ii. A verifiable bidding process by which at least five bidders submitted bids with and without the options to own, which were specified fully in the RFP;
    iii. An analysis demonstrating that the option described above in (a) is not in fact the least cost option;
    iv. A cost-benefit analysis of the option(s) that evaluates declining, flat, and inclining price scenarios in the 20 years after the latest exercisable option; and
    v. A calculation of the benefits that outweigh paying for the depreciation on the asset a second time and the lost diversification, and constitutes in DWP's opinion a clear and convincing basis for choosing to concentrate ownership.

General Policy Recommendation Concerning Renewable Portfolio Composition

6. OPA recommends the Board review the portion of the renewables portfolio that is a reasonable maximum level of owned and optioned resources, and set expectations of the quantitative information it will require to evaluate the mix of owned, optioned and purchased renewables. DWP's historical bias towards vertical integration of generation may be harming DWP's flexibility to adapt to better opportunities of the next 25 years and beyond.

General Policy Concerning Pre-Payment Of Renewables

7. OPA has similar specific recommendations to offer in the event DWP wishes to proceed with a pre-pay transaction in the future. OPA recommends that the Board instruct DWP management to solicit OPA's input on pre-pay transactions before bids are received for them, or negotiations initiate. Very limited forms of this transaction fall within reasonable parameters, and would occasion significant adjustment to producers' expectations of holding company structures.

Matters Of Clarification

8. The Springbok transaction OPA was provided does not include in the scope of liquidated damages (payments for unreplaced shortfalls) any payment for excess energy. The Board report states such damages include the Excess Energy Price, which has the potential to generate a positive credit to the producer, instead of an amount owed from the producer.

9. The transaction OPA was provided contains an Excess Energy Price of $23.80/MWh, not $17.10/MWh, as stated on in the Board report.

cc: The Honorable Eric Garcetti, Mayor
Miguel Santana, Chief Administrative Officer