



Resource Procurement: Best Practices for States and Utilities

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Overview

**Growing
commitment
to new
generation**

**Greater role for
state regulators
in determining
prudence**

***How to maximize consumer benefits
through good decision-making***

Today's Subject

- Procurement Policy Goals
- Public Policy Considerations
- All Sources Will Contribute
- Essential Elements
- Debt Equivalence
- Conclusion

*Maximizing consumer supply benefit and
managing risk*

Public Policy Goals

- Full Range of Resources
 - Lowest Cost for Utility Customers
 - Environmental Acceptability
 - Market Tests
-
- *Results in Consumer Benefits*
 - New entry intensifies competition
 - Downward pressure on costs
 - Increased reliability

Best possible deal for customers

Competitive Procurement

Maximizes Public Benefits

- Reduces affiliate preference
- Reduces transmission market power
- Improves price discovery and market liquidity
- Improves risk allocation
- Improves access to capital markets

Many Exciting New Approaches

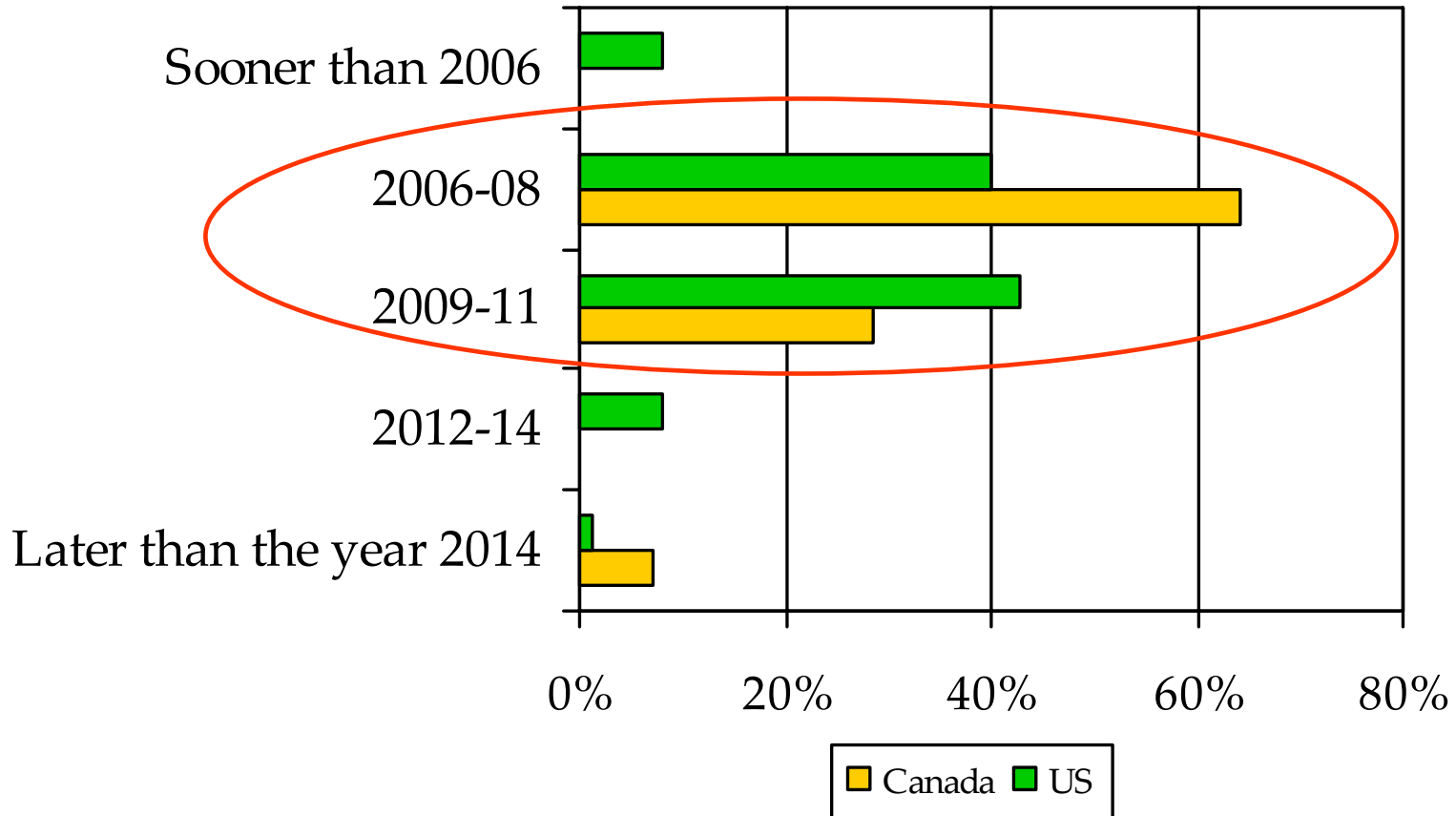
The GF Energy Survey Says ...

- Generation seen as most profitable business segment –pressure to return to ratebase
- Pressure is growing for new generating capacity to be in service in 3-7 years
- Coal/IGCC will be largest investment
- 92% believe long-term supply contracts are need to attract sufficient capital
- 89% believe there will be renewed competitive pressures in some or most states

Source: GF Energy 2005 Electricity Outlook

***Generation competition is
intensifying***

When New Capacity Required to be in Service



Today's Situation

- Recent focus on shorter-term power procurement (1-3 years)
- Longer-term procurement (3+ years) completes the portfolio model – provides financing vehicle for new infrastructure
- Competitive solicitation options range from price-only auctions to more extensive requests for proposals (RFPs)
- Options vary between states, depending on retail competitive framework

State Prudence Reviews

Prudence reviews allow PUC to consider

- Price
- Risk
- Reliability
- Environmental performance

Competitive solicitations demonstrate prudence

- By showing that a utility fairly evaluated its full range of utility and non-utility options

**Competitive solicitations
help confirm prudence**

State Prudence Reviews

- PUC may establish rebuttable presumption that an approved solicitation process results in a prudent investment or procurement decision.
- Shifts the burden of proof away to intervenors
- Expedites the regulatory review process
- Ensures utility cost recovery for contracts signed
- Obviates need for a “regulatory-out” clause in PPA power agreement

Credible Solicitations

Collaborative Process

- Local utility submits recommended approach
- Multi-day, commission-facilitated collaborative meetings
- State PUC resolves outstanding issues

Independent, Third-party Evaluator

- Performs independent evaluation of the bids
- Monitors communication between the utility, affiliate
- Benefit: Extra pair of “eyes”
- Recent solicitations - AZ Corp. Comm., MD PSC, NJ BPU

Credible Solicitations (cont.)

Fair Process Must:

- Be free from actual, apparent conflicts of interest
- Provide all bidders similar access to information
- Require full public review of the utility decision-making process

If the utility or affiliated entity participates, additional protections are required

- Use of an independent evaluator - reports to commission
- Separation of utility personnel - utility's proposal vs. evaluating bids
- Utility winner must honor its bid prices

Solicitation Format

Format and Product Types

- Requests for Proposals:
 - Includes price and non-price terms
 - Non-price terms can include capacity sizes, start dates, term lengths, pricing structures
 - Can be harder to compare
 - Manage risks over time
 - Can include demand response
- Price-only Auction:
 - Provides greater transparency
 - Limits exposure to regulatory risk

Solicitation Format

Six Key Issues

- Comparability for all bidders
- Transmission assessments of bidders
- Cost-plus offers versus pay-for-performance bids
- Bids with unequal lives
- Creditworthiness
- Balance sheet penalties

The State of Play

Eighteen States and DC Have Formal Competitive Procurement Rules or Guidelines

- West: Arizona, California, Colorado, Montana, Oregon, Utah
- Midwest: Ohio
- East: Connecticut, District of Columbia, Maine, Maryland, Massachusetts, New Jersey, Pennsylvania, Rhode Island
- South: Florida, Georgia, Texas, Virginia

**Four States Have Conducted RFPs (no formal rules)
– Louisiana, Nevada, New Hampshire, New York**

Three States Considering Rules – Arkansas, Illinois, Oklahoma

Debt Equivalence

Application of Debt Factor to Long-Term PPAs Designed to Impute Debt to Utility Balance Sheets

Originally Applied by S&P in 1990

- S&P believed utility-owned generation was disadvantaged vis-à-vis PPAs
- PPA creates risk by triggering an obligation on utilities to pay a minimum amount in the future
- S&P applies a risk factor to the future value of expected capacity payments in a long-term PPA
- Resulting dollar amount is added to bids from suppliers in competitive solicitations

Debt Equivalence (cont.)

- **S&P Views Debt Equivalency from Perspective of Bondholders, not Utility Shareholders or Customers**
- **State PUCs Can Address Issue from Perspective of Customers and Shareholders**
- **Issue Just Now Resurfacing at State Level after 12-Year Hiatus from PURPA QF Contracts**
- **As Competitive Procurement Grows, Debt Equivalency Will Become More Prominent**
- **Competitive Sector Believes Pendulum Today Has Swung Too Far Against PPAs**

Debt Equivalence (cont.)

Two Venues

- 1. Bid Evaluation: Comprehensive assessment of risks, costs and benefits of all options**
- 2. Cost-of-Capital: Preferred route in absence of full assessment and symmetry**
 - Imposing debt-like risk on PPAs, but not on the utility self-build option creates an unfair bias
 - Cost recovery of PPAs no more risky than cost recovery for rate-based generation – record of the past 20 years bears this out
 - COC proceedings evaluate the utility's financial position on a portfolio basis – the bid evaluation is a "one-off," single tranche of supply
 - Utilities have factors that decrease risk, as well as obligations that increase risk – COC proceedings are the best arena to balance these considerations, not the competitive bid evaluation

The Bottom Line

**1. Main Goal –
Best Possible Deal for Customers**

**2. Credibly Evaluate Full Range
of Resource Alternatives**

3. Well-Designed and Well-Managed Solicitations

Thank you

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