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COMMISSIONER JAMES D. BOYD
CALIFORNIA ENERGY COMMISSION
1516 NINTH STREET
SACRAMENTO, CA 95814-5512

Dear Commissioner Boyd:

Central California Power has had an opportunity to review the "Recommendations for a Bioenergy Plan for California" and wishes to compliment the Energy Commission for the production of a fine report. Within the "Summary of Recommendations" contained within the Executive Summary the four policy objectives stated could begin to provide a base from which to launch a sustainable Biomass Industry.

In policy objective 1., the statement "create the necessary impetus for investment in new facilities that use California's abundant biomass resources", how specifically would this be accomplished?

Policy objectives 2., 3., and 4. could help stimulate interest in biotechnology but two basic requirements must be met:

- 1. Capital is required to build new facilities.
- 2. The biomass industry needs added revenue to survive. At present biomass facilities are closing their doors due to a shortage of revenue.

With regard the "high priority recommendations for 2006 with respect to biomass

- 1(b).Targeting the development of 1500MW of new biopower by 2020 is admirable, however at present the industry is suffering from a shortage of revenue. In addition, the capital markets are loathe to lend to the electric power industry at this time.
- 1(c). Directing an agency to develop an integrated and coordinated plan to create a favorable regulatory environment that will enhance opportunities for sustainable bioenergy development is a necessary undertaking.
- 1(d). A most excellent suggestion. Biomass is the only renewable electric power generation industry that actually cleans up an environmental impact. It's value is not only one of providing a renewable form of energy, it rids the landscape of a polluting or even dangerous nuisance mess
- 1(g). Another excellent suggestion.
- 2(a). Excellent, if the capital markets can be provided a level of comfort to induce project finance and an added revenue source could be created perhaps the added research and grant funding programs would not be necessary.
- The suggestions noted in section 3. may help stimulate positive progress in building a sustainable biomass industry.

During the Workshop the writer suggested providing the financial community with a level of comfort necessary to stimulate a funding appetite. The suggestion of low interest financing with tax incentives and /or participation for the portion of the project connected with collection and fuel processing was included. While it is possible to issue debt through agencies like the California Pollution Control Financing Authority and the California Infrastructure and Economic Development Bank, each has their own set of qualifying criterion which may preclude the financing of renewables, particularly of the project type and it may be necessary to modify some of the criterion in order to be more accommodative to financing biomass renewables. In addition, the writer suggested a means of adding revenue to an industry already beset with heavy financial woes. "Allow the biomass generators the right to market any emissions reduction credits (ERCs) they may accrue through collection of the wastes that comprise their fuel source.

Long term contracts are essential for the financing of generating facilities where the repayment of any indebtedness incurred to finance the facilities is totally dependent upon the revenues produced from the facility or project (project financing). There are a myriad of concerns associated with project financings and accordingly, it is difficult to obtain

investment grade ratings for project financings unless some enhancement is obtainable from a third party and typically the third party is reluctant to provide the enhancement unless the output contract is very sound. The output contract should be of a term which would provide for the orderly repayment of debt needed to finance the Project and is reflective of the economic life of the project.

Debt issued to finance a power project is typically structured on a non-recourse basis. As such, the debt would be represented by obligations payable only from project revenues and perhaps by other limited pledged revenues and assets (investment income and reserve funds) and not from other sources of funds of the project owner. Non-recourse financing is always challenging, particularly when based on the credit of a to-be-built generation facility which has no operating history or little, if any, equity contribution. It is necessary that participants structure the project financing to address in advance investor concerns about the risks that they are being asked to undertake. Foremost in their minds is the stability of the income stream to assure orderly and uninterrupted repayment of their investment. Here is where the terms and conditions of the long term contract are very important. Not only must the contract include a reliable income stream, but that income stream must demonstrate ability to provide coverage cover debt service each year by a reasonable margin of say, in excess of 1.75 times as a hedge against unforeseen contingencies.

Prior to the operation of the project, no revenues will be generated and as such, interest must be capitalized for the construction period and past the testing for full operation. Ample capitalized interest must be provided for in the event of construction delays, of say six months, depending upon the size of the project. Capitalized interest adds to the overall size of the debt which is subsequently repaid from the future net operating revenue of the project.

Alternatively, a financing structure can involve the issuance of both senior lien bonds and subordinate lien bonds. Senior lien bonds generally have first call on project revenues after operating expenses. Subordinate lien bonds will be paid only if amounts are then available thereafter. This has facilitated the issuer's ability to obtain credit enhancements on the senior lien bonds, thus improving the marketability and price. The specific portion of senior to subordinate lien bonds will be transaction specific and will depend upon, among other things, (1) the willingness of the project participants to participate as long-term investors in the subordinate lien bonds and (2) the amount necessary to meet the required debt service coverage levels on the senior lien bonds. Purchasers of subordinate lien bonds are co-investing with bond investors and committing to the long term success of the project and provide a method to reduce the amount of senior lien bonds that must be sold and thereby reach the required debt service coverage level on senior lien bonds, enhancing their marketability. Regardless of the structure, the security is in the output contract which must provide the reliable source of revenue for an adequate period of time to assure full repayment of the debt incurred for the project.

A single source revenue stream dependent upon the sale of energy may be woefully inadequate to support the development of renewable energy facility, particularly a biomass plant. Essential to the success of a biomass operation is the revenue from emission credits that would be created from removable of greenhouse gases as an integral part of the process. To the extent that values can be established for the marketing of the emission credits, such added revenue would not only stabilize the income stream, but would greatly enhance the feasibility and therefore the incentives for biomass development. Depending upon the amount of revenues added to the income stream, project financing would become much less challenging to achieve success in the capital markets.

Recognition on the part of the state or federal government of the biomass process in the form of subsidies would also serve to enhance the level of comfort of the investing community for this form of renewable energy. Support with the collection and/or the anaerobic process by such governmental agencies would send a statement to the investor public that this is a viable renewable energy source that deserves attention and is a worthwhile use of funding, not only to replace costly fossil fuel dependency for energy, but to acknowledge the benefits of its environmental enhancements.

Both the CEC and the CPUC at this time are pursuing projects to effect a reduction in green house gas emissions. In addition, Air Quality Districts are continually seeking the reduction of polluting emissions. The Air Quality Districts issue a credit to entities that mitigate air pollution. While pursuing the reduction of greenhouse gas, the Agencies should prioritize the establishment of a marketing outlet (in effect a trading market). Further, the CEC and the CPUC could work in concert with Air Quality Districts to establish an overall emissions credit base, and permit the generators who collect the polluting wastes that fuel their generators to market their accrued credits. This suggestion could add needed revenue potential to the Industry at no cost to the ratepayer or to the State of California".

However there are other serious obstacles to generation funding. Recent Commission Decisions have opened the door to permit IOU's to obtain generation. For example:

- The Mountainview Power Project acquired by SCE as a wholly owned subsidiary from Sequoia Generating Company to enter into a cost based contract providing for recovery of investment, fixed and variable costs and a regulated rate of return over the full life of the contract
- Contra Costa 8: PG&E seeks the Commission's authorization to acquire the facility from Mirant Corporation as part of a settlement of claims related to the Mirant bankruptcy. PG&E also seeks a Certificate of Public Convenience and Necessity consistent with its intent to own and operate this facility as a utility owned plant subject to conventional ratemaking treatment.
- Otay Mesa Power Plant: The Commission authorized SDG&E to enter into a 10 year power purchase agreement with Calpine Corporation to purchase the output of this plant. Calpine is now in bankruptcy and it appears that SDG&E will take a larger role in completing construction and possible ownership of the plant.
- Diablo Canyon Power Plant and San Onofre Generating Station: The Commission authorized both PG&E and SCE to undertake steam generation replacement programs to correct for degradation of steam generators and to extend the useful lives of these utility owned nuclear plants.
- Palomar Energy Center:: SDG&E will purchase this 500MW plant from its affiliate Sempra under a Commission authorized turnkey arrangement. Cost recovery and ratemaking mechanisms were approved by the Commission which included the recovery of the cost and expenses that SDG&E incurred before actually acquiring the facility.

These utility acquisition's discourage Independent Investment in new generation. This pattern is not a formula for attracting sustained independent power investment in California or anywhere else. Equally significant is the fact that all of these plants will receive conventional cost recovery or a contract-based simulation of conventional cost recovery. This means ratepayers bear all of the risks and costs associated with constructing and operating these facilities. The state's electric market design and procurement practices have created an environment that fails to attract and sustain investment in new generation and have created a series of incentives for utilities that conflict with the actions needed to support new independent generation. This and the difficulty in obtaining long term contracts has not gone unnoticed in the financial community. Further, the revelation that some of the winners selected in ostensibly competitive RPS solicitations did not have locations or had not even taken the initial step of requesting interconnection studies suggests the possibility that contracts are being awarded to projects that have little probability of being constructed or of being constructed in anything resembling a timely manner. Also, the state's inability to implement a stable functioning market serves to deter investment.

Existing incentives favor financial commitment by IOUs to utility owned or utility affiliated projects. While some competitive RPS solicitations have been implemented since the passage of SB1078, the bulk of the new resources being constructed today or that are moving toward approval to begin construction in California have been approved outside of the competitive procurement framework. As a result, these are the projects that advance to the Commission for approval. The utilities therefore have little financial incentive to promote the open, transparent, competitive solicitations the Commission selected as the primary vehicle for procurement. Examples of these incentives are:

- The earnings of the regulated utilities are derived from the rate of return applied to the rate base. The generating plants that are added to rate base help boost the utility's earnings.
- Utilities payments under contracts with IPPs are passed through directly to ratepayers and the utility earns nothing on these contracts.
- Contracts with utility affiliates produce earnings for both the parent and the affiliate/seller.
- The current tools to protect against abusive self dealing or affiliate transactions including the Independent Evaluator (IE) and the Procurement Review Groups (PRG) are inadequate. The IE is paid by the utility which immediately raises the question of the IE's true independence. At least one utility's PRG includes representatives of the Coalition of Utility Employees who may have their own reasons for supporting utility sponsored projects.
- CAISO has taken the task of ensuring that shortages of supply are avoided, at least in the short term. The costs of CAISO's procurement are spread to all transmission customers. An individual utility has less incentive to take action on its own to guarantee against a supply shortage on behalf of its rate payers if another entity performs that function and spreads the cost more broadly.
- The timing of procurements is at the sole discretion of the IOUs. This discretion raises the possibility that utilities might time procurement to fit the development schedules of utility or affiliate sponsored projects.

In combination, these incentives explain to some degree why the Commission's procurement policies have failed to attract the degree of investment required. To attract the desired level of investment, the incentives must align with the sought solution. The Commission in D.04-12-048 stated that all-source solicitations, where utility sponsored projects would have to compete directly with IPP proposals would be the preferred mode, bilateral contracts would be permitted on a case by case basis. In practice the reverse has proven to be the case. This experience points out that more transparency is required.

Existing practice has raised some fundamental questions relative to implementation of the Commission's RPS procurement program.

Regulatory and Market Design Uncertainty also inhibit Investment in New Generation. The Commission has an important voice on market design issues. The current design scenario has not produced the desired investment participation. It is crucial to establish stable policies that ensure the start of a functioning capacity market for the purchase of short, medium and long term capacity. It is crucial to establish a functioning market for tradable RECs and ERCs, as a compliment to installed generation needed for RPS compliance.

Commission Policies should be targeted to allocate the capital IOUs are spending on generation to shift to spending on needed infrastructure. There is only so much investment capital available. California will have a much better prospect of attracting investment capital if the needs of transmission and distribution investment are met. With present policies the IOUs are spending capital that would be better utilized on transmission and distribution infrastructure than on generation, thus competing with funding needed by IPPs to build new generation while leaving the immediate needs of infrastructure in abeyance. Independent capital could be made available if these obstacles to independent investment were overcome. These determents not only increase the unwillingness of independent capital to invest in California's generation, the policies shift generation risks away from private capital markets and onto California's ratepayers.

CCP offers a series of recommendations to improve the climate for new gewneration investment in California:

- Reaffirm that all source solicitations are the preferred mode of procurement and stop allowing exceptions to the rule.
- Improve the RFO and Evaluation process to ensure equitability between the IOUs and the IPPs
- Utilize the Agencies (CEC and CPUC) authority to improve market design.
- Take advantage of the private independent capital markets' willingness to provide finance for new generation if the current obstacles are overcome, free up utility capital to improve transmission and distribution infrastructure.
- Review and tighten affiliate transaction rules for procurement-related transactions.

Despite the Commission's call in D.04-12-048 for procurement to proceed through open, transparent and competitive all source solicitations, actual utility procurement has responded to the economic incentives inherent tin the Commission's ratemaking policies. To avoid a repeat of the utilities former monopoly on generation and the right to re-impose significant risk associated with utility-owned generation on ratepayers, the Agencies must make a number of policy decisions for immediate implementation. Retaining the status quo will produce the same former result; little new independent investment in California energy, few long term contracts that support new generation and a continuation of the supply related problems that have ravaged California for several years. CCP most respectfully suggests the Agencies align their regulatory policies to meet the intended goals. Further CCP urges the Agencies to carefully examine its recommendations on how to stimulate new independent generation.

Respectfully submitted,

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