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WHY SHOULD THE OHIO ATTORNEY GENERAL BE ASKED TO INVESTIGATE THE PRAIRIE STATE DEAL?

By Tom Sanzillo, Director of Finance and David Schlissel, Director of Resource Planning Analysis

The Galion City Council is considering a resolution urging Ohio Attorney General Mike DeWine to investigate the circumstances and claims involved in the Prairie State coal plant deal. The events surrounding the development, marketing, and purchase of the Prairie State coal plant certainly warrant such an investigation.

The Institute for Energy Economics and Financial Analysis issued a report in August 2012 entitled, *"The Prairie State Coal Plant: The Reality vs. the Promise."* [i] Our report showed that the rates for power from the Prairie State plant were likely to be significantly higher than the market price of power for at least the next twenty years. High rates could cause significant hardships to Ohio residential ratepayers, small businesses, and cities across the Midwest.

AMP sent an 82-page packet of information to Galion city officials on August 9, 2013,[ii] apparently meant to refute the points in the proposed Galion City Council resolution. However, much of the information in the packet actually confirms the need for an independent investigation of what occurred during the development of the plant.

The federal Securities and Exchange Commission (SEC) has subpoenaed both Peabody Energy, the developer of Prairie State, and AMP in regards to the development of the plant. Such investigations are rare, and the municipalities participating in the Prairie State plant have a very legitimate interest in any findings of the SEC's investigation. However, the SEC's focus is primarily on protecting the investment community. The state attorney general is charged with protecting the interests of the ratepayers and the municipalities.

Here is why an investigation is warranted:

1) **The risks of rising costs of the Prairie State deal were hidden from the communities when they signed on in 2007. AMP failed to warn the cities of contemporaneous industry projections that costs could skyrocket.**

AMP includes sections of the RW Beck Feasibility study it commissioned in 2007 in its August 9, 2013 memo to Galion. AMP asserts that communities were fully informed of the specifics of the deal in 2007 because they had access to this report, and says, "*projected rates were presented with potential highs and lows."* A review of these projections, upon which AMP asked the communities to rely, shows they were way off the mark. For example, AMP's packet includes this chart from the RW Beck report:

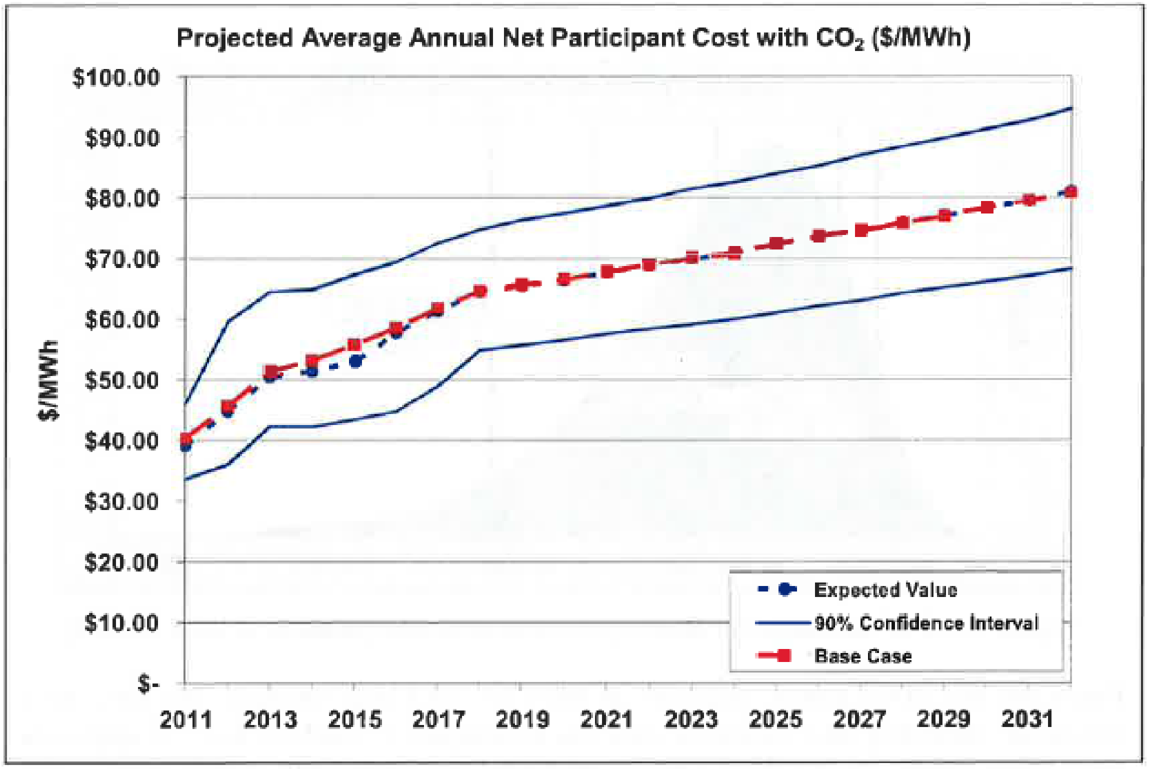


Figure 7-15 Net Participant Costs (with CO_2) at 90% Confidence Interval ($/MWh)

The chart shows the highest possible cost for electricity in 2013 to be approximately $65/MWH. In Beck's chart, prices only reach $85/MWH in the highest possible price scenario in 2025, with CO2 regulation. $85/MWH is the ACTUAL rate that Galion was charged in May and June of 2013. The amount charged to Galion does not include costs associated with CO2 regulation. The current price of electricity is far above that provided by AMP in their 2007 presentations. This issue taken alone warrants independent scrutiny.

Furthermore, the inclusion of this chart is somewhat deceptive, because it is based on the worst-case scenario of CO2 regulation (meaning that the Congress could vote at sometime to regulate carbon dioxide emissions from coal plants, thus making the plants more expensive to operate). However, Congress has not enacted any such legislation. If AMP had included the projections it gave cities in 2007 showing the costs WITHOUT C02 regulation, they would have shown the promised price of electricity to be lower than this chart.

The August 2007 Beck study stated,
" Based on our experience related to the construction and construction costs for coal plants similar to Prairie State, we have assumed that the total estimated construction costs reflected in the Base Case could vary by +6% or -8%."

This statement seriously lowballed these risks. The actual cost increase from the 2007 base level (which appeared to be $4.1 billion) is at least 20% (given current estimates of a $4.9 billion price tag).
City Council members may wonder whether it is fair to judge the 2007 estimates in hindsight. Could AMP, Peabody, and the other Prairie State developers possibly have known in 2007 that costs were likely to increase dramatically?

The answer is yes. During 2007, while AMP was proposing that cities sign on to the Prairie State deal, several major industry reports warned of the skyrocketing construction costs of coal plants. While these reports were no doubt closely watched by industry insiders, AMP and RW Beck did not provide this information to AMP's members.

In June 2007, Standard and Poor's issued a report entitled, "*Increasing Construction Costs Could Hamper U.S. Utilities' Plans to Build New Power Generation.*"[iii] In September 2007, the Brattle Group, one of the leading electric industry analysts, wrote a report entitled "*Rising Utility Construction Costs: Sources and Impact.*" [iv] The report was issued by the Edison Foundation, an affiliate of the Edison Electric Institute, the trade association for electric utilities in the United States. The report's leading substantive sentence was:

> "*The rate increase pressures arising from elevated fuel and purchase power prices continue. However, another major cost driver that was not explored in the previous work also will impact rates, namely, the substantial increases in the costs of building utility infrastructure projects*."

And AMP itself, in a May 2007 filing with the Ohio Power Siting Board for their proposed (and later cancelled) Meigs County coal plant[v], noted that the price increases then being experienced in the expected construction costs of coal-based electric generation "are staggering." AMP noted that "Price increases of 10% in a single six month period are being reported. Using this data and similar data on other projects as an estimate, a one month delay in a $2 billion project is over $33 million."

AMP failed to include any of this information while it was urging Galion and other cities to sign take-or-pay contracts for Prairie State, and instead provided them with a report that estimated the construction costs would go up by 6% at most.

During the period from 2007 through 2010, both AMP and Peabody canceled other coal plants that were too expensive, and the industry as a whole cancelled more than 75 proposed coal plants across the United States. Professional due diligence would have required AMP and Peabody to provide frequent updates to municipal partners during the project development process. Why didn't AMP, Peabody, and the other Prairie State owners reconsider their participation in Prairie State in light of these risks?

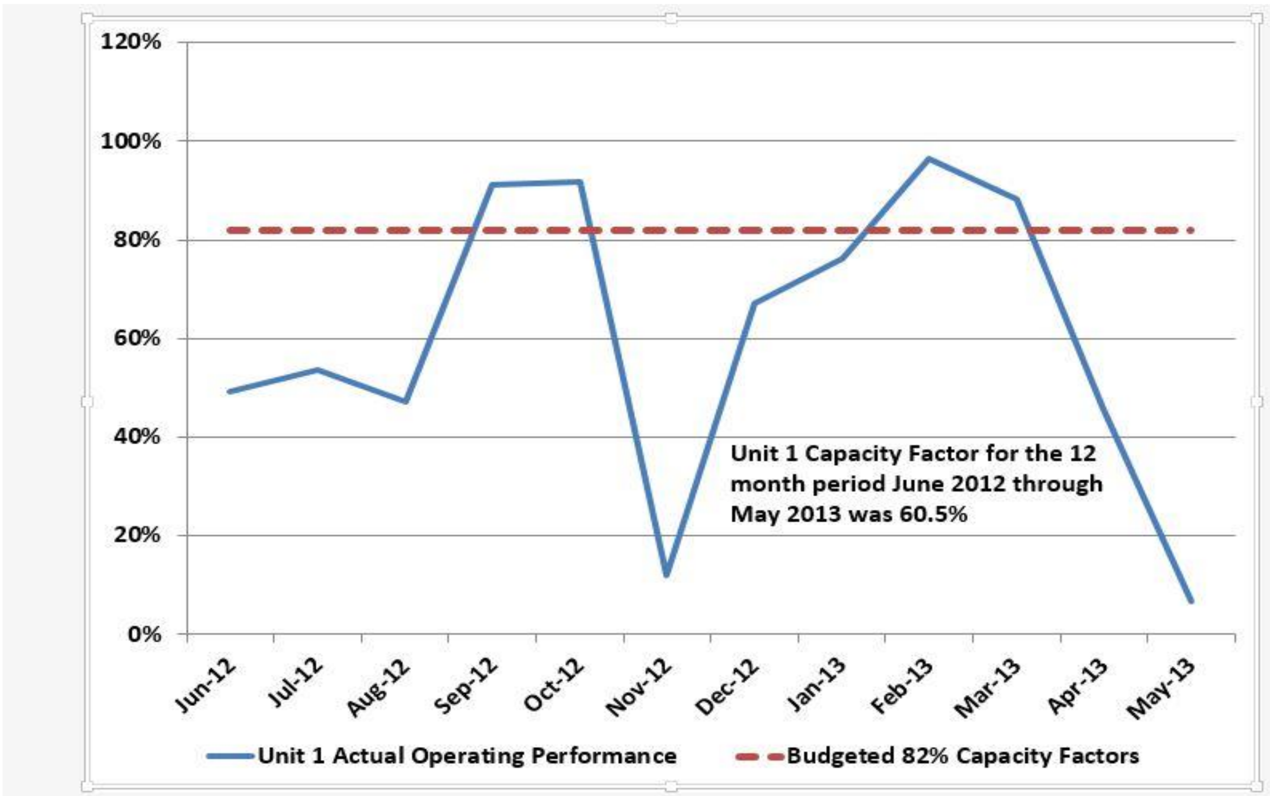
2) **The operating performance of the Prairie State plant is far below expectations, causing rates to go even higher**

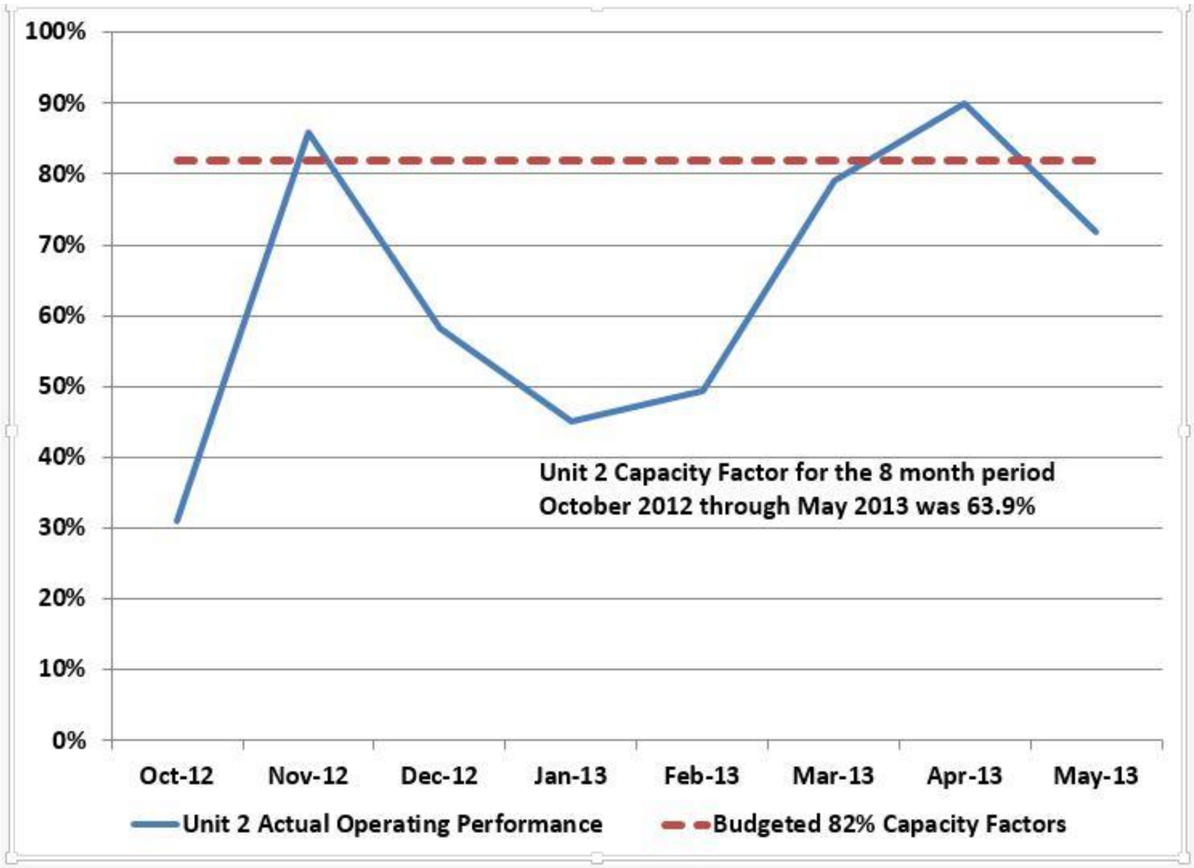
While most new plants experience a shakedown period, the problems at Prairie State appear to go significantly beyond the traditional "shakedown" mode. When the communities signed on to participate in the plant, and throughout the development phase, AMP budgeted for the plant to have an 82% capacity factor. However, according to a June 17, 2013 memo that AMP filed with the Municipal Securities Rulemaking Board[vi], both units have been performing far below this level. According to the memo, the average capacity factor for the units thus far is 62%.

The June memo disclosed that Unit 1 will be shut down for "an extended outage in the fall of 2013 for maintenance and upgrades to correct additional design and construction deficiencies," and that Unit 2 will be shut down for a similar extended outage in the spring of 2014 for the same reason.

If the plant has design and construction deficiencies, less than a year after going on line, who is responsible? Were the municipal owners, who took full care and custody of the plant from Bechtel in November 2012, sold a faulty product? Who will have to bear the financial brunt of these mistakes?

The charts below, prepared by the Institute for Energy Economics and Financial Analysis, show the capacity factors for Unit 1 and Unit 2 through May 2013.



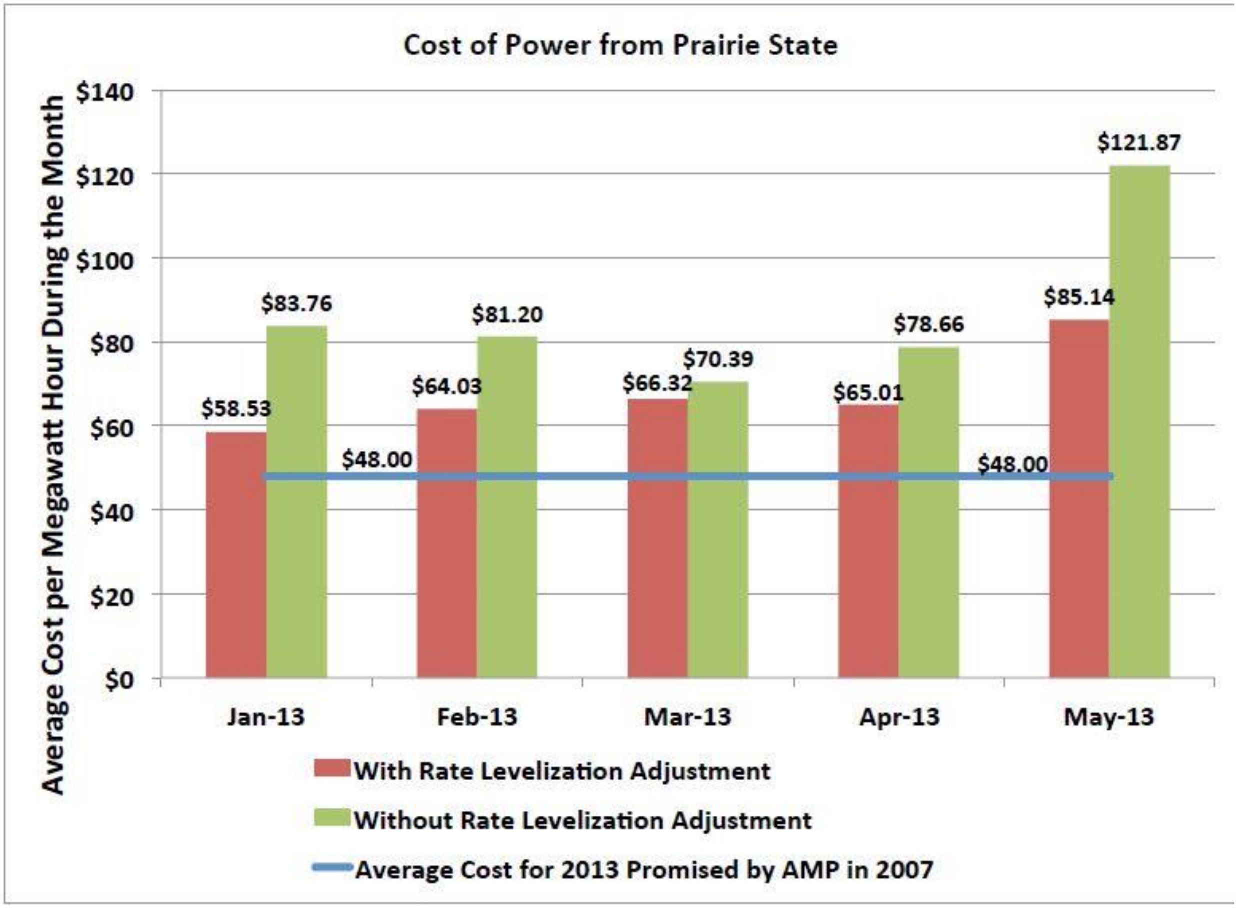


In order to attempt to make the rates more palatable for the communities, AMP has decided to rely upon unused bond proceeds and reserve and contingency funds for rate levelization.[vii] *Even with the levelization, the May bill for Galion was $85/MWH, more than twice the cost of Prairie State replacement power.* Replacement power costs are what the private market would charge for the same electricity coming from the Prairie State power plant. Without the rate levelization, Galion's bill for May would have been $121/MWH.

We estimate that AMP has thus far spent at least $20 million to tamp down rising rates. The rates remain too high. IEEFA has repeatedly asked for a business plan from AMP that shows how its current budget actions will help the plant move toward the business plan offered when Galion considered the investment in the first place. AMP has never provided such an updated plan. When do the reserve funds run out? How much is the real cost of electricity now and what will it be then?

In August, AMP filed a disclosure statement with the Municipal Securities Rulemaking Board[viii], showing that the federal sequestration has caused AMP to lose $634,156.38 in payments from the Build America Bonds. AMP says it will "recover the funds necessary for working capital from future billings to its members that are participants in the Prairie State Project."

The chart below illustrates the bills that Galion received from AMP for Prairie State power from January through May 2013.



The bills from June and July for Galion were not publicly available at the time of this analysis. But bills from other AMP communities show that the rates continued to be high, at $85/MWH in June with no rate levelization applied, and $78/MWH in July with rate levelization applied. Without the levelization, the July bills would have been $111/MWH.

3) **The information provided by AMP from "independent" sources to support the Prairie State deal, particularly the Moody's December 2012 report, is out of date and contains serious factual errors.**

In the packet sent to the Galion City Council, AMP included a December 2012 analysis from Moody's entitled, "*Prairie State Generation Project; An Economic Asset Which should Support Owner's Willingness to Meet $4.5 billion obligation to bondholders*." The inclusion of this Moody's analysis raises major questions:

- The report concludes with this statement: *"Since commercial start dates, both units have been operating at levels higher than their nameplate capabilities, with Unit 1 at 812 MW and Unit 2 at 817 MW. Performance tests indicate the units are also operating more efficiently than expected, about 1% better than the contract guarantees."*

However, as the AMP March 2013 and June 2013 memos acknowledge, the plant's actual performance has been far below its "nameplate capabilities." Has AMP provided Moody's with the updated data on the performance of the plant? Has Moody's revised or updated its reports with this actual data?

- The Moody's report contains a number of misstatements concerning the August 2012 IEEFA report and its methodology (while Moody's does not name IEEFA, the organization is the only one that has published an extensive financial critique of the project.) For example, they say that the IEEFA study does not take into account capacity payments, when it fact it does, citing an all-in price for the Prairie State plant. In the time period since the publication of the IEEFA report in August 2012, PJM capacity payments have plummeted and are likely to stay low (a risk IEEFA pointed out).

- Organizations, such as AMP, frequently pay Moody's to issue their reports. McClatchy business journal has reported on the severity of industry criticism of Moody's for some of its ratings.[ix]

4) Municipalities throughout the Midwest are experiencing financial hardships as a result of the Prairie State deal

Galion is not the only city finding itself facing higher costs of electricity due to its ties to Prairie State. The city manager of Marceline, Missouri declared the plant a "toxic asset. " On August 20, 2013 Marceline divested its holdings in the plant. A number of Missouri towns, who bought into Prairie State with the plan of selling the power on the open market, are draining their reserves because they have to sell it at a significant loss. The three cities in Northern Illinois who make up the Northern Illinois Municipal Power Agency – Batavia, Geneva, and Rochelle—found they had underbudgeted the electric expenses by $4.5 million for the first six months of 2013, and have had to raise their rates. Batavia tried to sell its share of the Prairie State plant but could not find a suitable buyer.

On March 13, 2013 Moody's downgraded the Paducah Electric Plant Board's credit rating, in part due to its "off balance sheet" take-or-pay contract for the Prairie State plant.[x]

In the meantime, the cost of market power continues to be low, and recent auctions have shown that the capacity market prices, which influence the cost of market prices, will also be lower than what AMP had predicted. If cities across the Midwest start to run out of money, defaults are bound to occur**. All of these factors will continue to make the cost of Prairie State power more expensive than what AMP members were told when they signed on to this power plant, underscoring the need for an independent investigation by the Ohio Attorney General.**

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[i] Available at: https://docs.google.com/file/d/0B_qWeYLAqoq1NFhvNy1teWc3VDQ/edit

[ii] Available at: : https://www.dropbox.com/s/wqebdkzalq3kxuz/AMP%20Additional%20Notes%20RE%20Prairie%20State%20%28Galion%29%20%2808.09.2013%29.pdf

[iii] Prabhu, Aneesh and Pratt, Terry A., "*Increasing Construction Costs Could Hamper U.S. Utilities Plans to Build New Power Generation*," Ratings Direct, Standard & Poor's, June 2007

[iv] Chupka, M.W. and G. Basheda, "*Rising Utility Construction Costs: Sources and Impacts*". The Brattle Group, prepared for the Edison Foundation, September 2007

[v] AMP Power Siting Board Application for AMPGS plant, Case #06-1358-EL-BGN, Section OAC 4906-13-05, at page 4.

[vi] Available at[vi] http://www.emma.msrb.org/EA532576-EA414808-EA811658.pdf

[vii] Gerken, Marc S., and John W. Bentine, Memorandum to AMP Prairie State Participants, , March 15,2013, available at https://www.dropbox.com/s/2ino9kxxwkfizzu/Prairie%20State%20Update%20%283-15-13%29.pdf

[viii] Available at http://emma.msrb.org/ER694511-ER538734-ER940233.pdf

[ix] Hall, Kevin G.*, How Moody's sold its ratings and sold out investors***,** October 18, 2009**.**

[x] Moody's, *Moody's downgrades Paducah Electric Plant Board's (KY) electric revenue bond rating to A3 from A2,* March 13, 2013.