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To: Sandy Buchanan
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Date: July 16, 2008

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Re: Response to APPA Letter
on Tax-Exempt Bonds

This memo responds to the arguments raised by the American Public Power Association (APPA) in its letter of June 19, 2008 to the Treasury Department. The letter takes exception to New York City Comptroller William C. Thompson's request to the Treasury Department to review the use of tax-exempt financing for coal-fired power plants¹.

The APPA Argument in Brief

APPA argues that there is no need for a Treasury Department review of the use of tax-exempt bonds for coal-fired power plants. The role of public power in meeting the nation's need for electricity requires the use of this critical tool to support the use of coal, nuclear, hydro and natural gas fired generation plants. Credit rating agencies have determined that the public power sector is strong. Limitations on the use of tax-exempt bonds would require expensive financing alternatives. These more expensive alternatives would place unacceptable financial burdens on local governments and consumers. Public power is responding to the cost challenges posed by future regulatory risks created by new greenhouse gas emissions. Local government and rating agency reviews of individual plants ensures that high-risk deals are unlikely. Furthermore, coal's abundance in certain regions make it the most efficient and affordable source of fuel for new power generation.

The Response to APPA in Brief

The APPA letter helps to stimulate a discussion on the issue, and that is all to the better. The response however misunderstands the problem and the urgency that is involved.

- The response miscasts the issue. The issue is whether it is sound financially, and from a public policy view to continue the use of tax-exempt bonds for new coal plants. There have been no objections raised about the use of these bonds for other forms of generation.

¹ On July 8, 2008 California State Treasurer Bill Lockyer sent a letter to the Treasury Department requesting a review of the use of tax-exempt bonds for new coal plants.

- Public power finances will remain strong as long as financial decisions are based on sound analysis and reasonable assumptions regarding individual projects. The APPA letter ignores the full set of financial risks facing new coal plant financing. Construction and fuel costs are rising at an unprecedented pace and regulatory changes will impose even greater stress on coal plant operating budgets. It is cumulative financial risk that is likely to trigger dysfunction in the repayment of these project revenue bonds.
- Public power entities have not considered CO2 risk as an industry group, nor have individual public power authorities undertaken a transparent accounting of the full range of financial risk posed by future greenhouse gas regulatory regimes.
- Local governments and credit agency checks on the investment process are insufficient in today's economic climate. A review of the record in the Meigs County, AMP-Ohio project suggests that the normal due process system proved unreliable. State power officials brushed serious warnings aside as they worked to convince local officials of the merits of the deal.
- Unlike some of the nation's most prestigious investment banks and the federal Rural Utilities Service, the rating agencies have not adopted an enhanced diligence process to address these mounting market problems. The rating agencies of late are plagued by a series of failures resulting from inadequate analytical models and business practices that have systematically understated risk. Responsible investors have adopted extra diligence precisely because of these lapses in the nation's credit underwriting. Faith in the rating agencies' judgment is not the solution. It is the problem. Reliance on the rating agencies in the absence of extensive independent analysis regarding the prudence of investment in coal plant bonds is simply not a good idea.
- While APPA states that energy demand will rise according to a national standard, it is clear that many states, particularly those in the Midwest that are moving forward with new coal plants have significantly weaker demand, and are therefore better positioned to take advantage of precisely the alternatives stressed by an enhanced diligence model --- energy efficiency and renewables. Instead of public subsidies boosting struggling local economies, support for coal plants is increasingly likely to create facilities that are a drag on regional economic activity.
- A series of complex questions have emerged in the current environment that need to be addressed regarding the use of publicly subsidized bonds for coal fired power plant development.

Miscasting the Issue

From the APPA letter:

In today's political climate, the uncertainty of federal regulation and cost will affect all sources of power. Nuclear, natural gas, hydropower, wind, solar and coal all have risks and uncertain costs associated with their use in electricity production. However, limitations on state and local governments' ability to fund power plants through tax-exempt financing would require other methods of raising revenues to offset increased financing costs, (increased property, sales, and other local taxes), and/or a reduction in essential services --- an unacceptable option when that service is electricity

Comptroller Thompson's letter to the Treasury is quite precise in scope and limited to the use of tax-exempt bonds for new coal fired generation. His letter asks the Treasury Department for

“ ..A thorough review of the financial and environmental risks associated with the use of tax-exempt financing for coal-fired power plants.”

Thompson's letter cites three financial factors that are currently clouding the economic feasibility of these projects.

Attached you will find a copy of a report recently prepared by Synapse Energy of Cambridge, Massachusetts. It highlights sky rocketing increases of construction costs for new coal plants with no relief in sight. Regulatory uncertainty over CO2 emissions further clouds the investment horizon. Plants constructed under current rules will incur new financial obligations to curb greenhouse gases. Other recent reports on the price of coal suggest a new higher price floor is altering cost assumptions of coal plants.

Credible project underwriting requires the acquisition and analysis of firm financial data. The current market frustrates acquisition of this essential information. The Synapse study identified the trend of rising construction costs. In May, an industry update by the Cambridge Energy Research Associates (CERA) was published. Construction cost increases are so dramatic and the turbulence in the market so pronounced that obtaining hard data on construction costs is very difficult. Coverage in the Wall Street Journal² of the CERA report concludes with the following paragraph:

The analysis is of interest because it is difficult to get solid cost data until after plants have been built. Even then, data aren't always available.

Even signed contracts between utilities or public power authorities and power plant developers are not valid indicators of construction price under current conditions.

The uncertainty of any new federal regulatory regime to curb greenhouse gas emissions stems from the recent scientific consensus regarding the course of climate change and the indisputable contribution of coal plants to the problem. Any company or public power entity that adds a coal plant to its energy portfolio is adding a long-term liability to its balance sheet.

Dramatically rising coal prices globally and within the United States have occurred starting in the fourth quarter of 2007. Price increases in most coal sectors in the United States have taken place during the first two quarters of 2008. Spot prices for Central

² Smith, Rebecca, *Costs to Build Power Plants Pressure Rates*, Wall Street Journal, May 27, 2008.

Appalachian, Northern Appalachian and Illinois Basin coal have risen over 100% over the past year. The price of PRB coal (western coal) has risen by upwards of 40%. Major coal producers in the United States see these increases as a function of demand and expect the same demand pressures to alter the nation's coal price landscape for at least the next decade.

The APPA response ignores the cumulative financial risk that is at the core of the concern over the use of private activity bonds for coal plants. When problems occur with three critical factors in the production and operation of new coal plants at once, typical solutions prove ineffective. For example, all other things being equal, the impact of rising construction costs are manageable by creative use of debt. Such an approach, which might result in a plant taking on more short-term debt, is impractical when there is also a need for large capital investments to comply with future regulatory requirements. If the nation's public power organization has such a weak grasp of current economic factors involved with new plant construction, what must be the quality of financial assumptions going into current official statements?

Public Power has not addressed the financial challenge posed by future climate change regulation.

From APPA's letter:

APPA and its members understand that future climate change legislation could affect the cost of coal-fired electricity.....

American Municipal Power (AMP)-Ohio, the entity mentioned in Mr. Thompson's letter, carefully considered the cost of potential CO2 regulation as part of its planning and feasibility analysis for the coal-fired plant it is proposing. Fitch gave AMP-Ohio's project revenue bonds a rating of "A" in May 2008.

Comptroller Thompson's letter cites two power plants, both in Ohio, the Prairie State project and the Meigs County plant.

It is questionable whether the Prairie State project, a tax-exempt project sponsored by multiple issuers, presented to investors a full explanation of the CO2 risk. Prairie State's projection in at least one official statement appears to rely on a CO2 risk model that assumes a very low cost for new carbon regulations. This does not give investors access to information regarding the full range of financial risk associated with the plant.

The Northern Illinois Municipal Power Agency (NIMPA) issued an official statement dated August 2007 that contained the following sentence:

NIMPA projects its annual all-in cost for the project to be approximately \$42 million. Based on expected average annual energy in the amount of 960 MW, the busbar cost is expected to be in the range of \$44 Mwh. ³

³ Northern Illinois Municipal Power Agency (NIMPA), \$303,575,000 Power Project Revenue Bonds, Series 2007A, and \$15,175,000 Power Project Taxable Bonds, Series 2007B (Prairie State Project). Official Statement, August 15, 2007

A study⁴ from a prominent investment advisor released over one year prior to the date of this official statement describes the risk to investors of new CO2 regulations.

Given the wide range of these estimates, we have based our calculations of the impact of a mandatory system of allowance purchases on the low end of the ranges estimated by Charles River Associates and the National Commission on Energy Policy (\$9 per ton of CO2) emissions allowances in the European Union (\$28 per ton) and one-sixth the price estimated by the Energy Information Administration (\$55 per ton). Our calculations may be thought of therefore, as estimating the minimum likely impact of a national cap on GHG emissions similar to McCain-Lieberman.

Exhibit 8 illustrates the impact which a CO2 allowance price of \$9/ton would have on the average cost of coal and gas-fired generation in the United States at currently prevailing fuel prices. We estimate that the average cost of coal-fired generation would rise from approximately \$33/MWh currently to \$ 43MWh..... Exhibit 9 illustrates a scenario where U.S. CO2 emissions prices rise to the levels currently prevailing in the European Union (\$28/ton); as can be seen there, the cost of coal-fired generation is estimated to rise from \$33 to \$64/MWh.....

While the Bernstein report does not extend the calculation using the Energy Information Administration's (EIA) \$55/ton estimate, this would have driven the cost of electricity from \$33 per ton to approximately \$125/MWh. APPA cites the EIA as an authoritative source for energy information in its letter.

What this short discussion of one sentence in one official statement indicates is that NIMPA officials did not provide the full range of financial risk associated with potential GHG regulations. When the Bernstein group sought to portray risk it did not present one number, it presented a range of numbers. The study specifically stated its preferred method, and identified the fact that it was the "minimum" price assumption. The report stated there were other valid methodologies. Bernstein presented those methodologies and quantified them.

It is a valid question whether the Prairie State bond document would meet a full disclosure standard.

The AMP-Ohio project, which is slated for Meigs County in Ohio, and is the subject of the APPA and Thompson letter, also has not addressed the full range of risks related to CO2, nor has it effectively grappled with the cumulative financial risk outlined in the Thompson letter.

In response to the growing risks of financing new coal plants, and the lack of any national policy, financial services and energy industry leaders worked together with environmental groups to develop a set of enhanced due diligence principles. On February

⁴ Bernstein Research, *U.S. Utilities: The Prospects for CO2 Emissions Limits in the United States and their Implications for the Power Industry*, April 19, 2006.

4, 2008, Citigroup, JP Morgan and Morgan Stanley announced the Carbon Principles. The principles are an enhancement to the investment banks due diligence process for energy lending. The principles embrace a portfolio approach to lending asking prospective borrowers to disclose their programs for energy efficiency, renewables and steps to mitigate greenhouse gas as part of any review of a new coal fired plant. The press release announcing the collaboration states:

The need for these Principles is driven by the risks faced by the power industry as utilities, independent producers, regulators, lenders and investors deal with the uncertainties around regional and national climate change policy.”⁵

All participants in the process acknowledge that the Principles are a “first step”. The lack of a national consensus in the form of new law and regulation makes them useful. The ultimate impact of the Principles on actual emission reductions is not clear. The Principles cover projects sponsored by public and private investor owned utilities. The Principles contain the following statement of exemption for public power projects:

The signatories believe this process to be a “best practice” for public power entities, including, municipally-owned utilities, joint action agencies, state public power utilities and rural electric cooperatives, given that many if not all the same climate-related risks pertain to generation projects financed by these entities. Therefore they will encourage these entities to undergo the full review including evaluating the financial sensitivity of plants proposed by such clients to the full costs of mitigating their CO2 emissions. Within six months of adopting the Principles, the Financial Institutions will work with these entities and environmental stakeholders to determine the appropriate enhanced diligence process for public power investments.⁶

During the course of events leading up to the vote by the Cleveland City Council regarding the Meigs County plant, AMP-Ohio the issuer received a letter from JP Morgan, its underwriting bank and a signatory of the Carbon Principles.

The letter⁷ states:

The Carbon Principles that JP Morgan and other Wall Street banks recently adopted advance a set of principles for meeting energy needs in the United States that balance cost, reliability and greenhouse (GHG) concerns. We know AMP-Ohio is well aware of these concerns.

Please note that the enhanced due diligence standards developed for IOU’s do not apply to public power. Over the next few months, we will be working with public power entities like AMP-Ohio to determine what form of enhanced diligence is needed, if any, with respect to public power securities offerings in light of the Carbon Principles.

⁵ Citigroup Press Release, *Leading Wall Street Banks Establish the Carbon Principles*, February 4, 2008.

⁶ *Carbon Principles*, Op Cit, p. 3.

⁷ Letter from Gene R. Saffold, Managing Director, Head of Tax Exempt Investment Banking, J.P. Morgan Securities, Inc. to Marc Gerken, President and CEO, American Municipal Power-Ohio, Inc., February 7, 2008.

We know this is the same type of evaluation many utilities undertake on their own, especially forward-thinking utilities like AMP-Ohio. Underwriters are also required to undertake due diligence to ensure there is appropriate disclosure of risks for any security that they offer. The principles formalize the types of inquiries underwriters are already required to undertake. Please be aware we are not contemplating any “credit scoring” type of system for carbon risk.

These practices do not establish any specific performance criteria for any particular public power project, but are useful benchmarks against which the degree of risk will be discussed. We recognize AMP-Ohio’s proactive management, strong contract structure, member base and diversified resource portfolio provides strong credit protection to investors.

We are familiar with the Prairie State project and AMP-Ohio’s feasibility study completed by RW Beck. We are also aware of AMP-Ohio’s plans for AMPGS and hydroelectric projects and the extensive due diligence AMP-Ohio undertakes on its own with respect to all of its projects. Based on this, nothing has come to our attention preventing JP Morgan from serving as lead underwriter on AMP-Ohio’s bond offerings for these projects in light of our adoption of the Carbon Principles. Nothing contained in the principles prevents us from underwriting debt or providing financing for AMP-Ohio’s projects or is intended to do so.

JP Morgan has a long-standing commitment to AMP-Ohio, as lead underwriter and lead credit provider. We continue to stand by AMP-Ohio. This relationship is very important to the firm and we consider it a privilege to be part of AMP-Ohio’s team.

It appears that the writer of the letter believes that the six month process JP Morgan and the other banks were about to undertake to devise new diligence standards for public power projects would result in no change in the standards for review or additional disclosure to investors. This is precisely because “These practices do not establish any specific performance criteria for any particular public power project”. Does this mean that a presentation of the full range of financial risks related to carbon emissions would not be part of any future enhanced diligence? If JP Morgan were to be believed, the above statement in the NIMPA official statement would be sufficient disclosure.

The Carbon Principles are not only about substantive decision-making on the pricing of carbon risk, it is also about improving transparency in the investment process. At minimum, improvement in the transparency of the reviews conducted by AMP-Ohio with regard to alternatives to coal plants and the full range of pricing scenarios would be part of any new diligence process. JP Morgan may have access to this information, but their attestation as to AMP-Ohio’s forward-looking practices is no substitute for full disclosure and allowing investors and prospective partners to make their own decisions.

This JP Morgan letter was the subject of an article in the Wall Street Journal⁸. The article states, in part:

The guidelines have made it easier for public utilities to continue pursuing coal-fired plants, even as investor-owned utilities back away from them.

AMP-Ohio's press release on June 20, 2008 regarding its successful bond sale of a portion of the Prairie State deal singled out JP Morgan for special thanks. "I want to recognize the efforts of JP Morgan of New York for the job they did for us in underwriting and price."⁹

The Treasury Department might want to review the way the Carbon Principles were used by JP Morgan in the days leading up to votes taken by a number of local government officials. This new, enhanced diligence protocol was adopted by investment banks to assist its investor owned utility and merchant clients. The principles temporarily exempted public power projects pending further discussions. Before new public power protocols are adopted, both the Prairie State and Meigs County plant would go to market with JP Morgan as lead underwriter. JP Morgan could improve AMP-Ohio's market access because of its privileged position in the ongoing diligence negotiations to devise a public power protocol. JP Morgan officials actually improved the chances of positive outcomes at local governments because of their insider knowledge.

Is there an appearance of impropriety created by this sequence of events? Are investors receiving a full description of the range of CO2 risks, or are in access only given to that information which meets the shifting standards and loopholes in the standards created by this new voluntary investment regime?

Local Government and Credit Rating oversight is insufficient in the current climate.

On June 27, 2008, the Executive Director of Ohio Citizen Action forwarded to the Treasury Department a letter chronicling the events surrounding the Meigs County plant. Attached to her letter were five consultant reports pointing out the financial risks associated with the plans to build the Meigs County plant. The Synapse study included with the letter makes a strong case for more complete disclosure of CO2 risks.

Further, the Scott Balice report submitted with the OCA letter provided information that suggested the cost of construction, CO2 emissions, interest rates and fuel costs were all understated. If the model used by AMP Ohio was adjusted to reflect the rising cost

⁸ Smith, Rebecca, *Banks Hope to Expand Carbon Rules to Public Utilities*, March 20, 2008.

⁹ AMP-Ohio, *Bond Sale for AMP-Ohio Portion of the Prairie State Project A Success*, June 20, 2008.

environment, the cost of electricity went from approximately 6 cents per kwh to over 11 cents per kwh.¹⁰

The Scott Balice Group identified several risks in AMP-Ohio's financial analysis. The risk analysis strongly suggested that the actual cost of electricity that would be charged by the Meigs County plant would be higher than AMP-Ohio was disclosing to local governments. The substantive issues raised by the Balice study were never responded to in a meaningful manner. AMP-Ohio gave no specific assurances that the price of electricity presented by its consultants would be the real price of electricity paid by municipal electric systems once the plant was in operation. These reports offered other warnings, but no changes in the contracts or terms of the bond transaction that local governments were made.

The APPA letter states that local governmental processes provide an essential check on the level of review for these transactions. After local governments deliberate, they sign a contract. The legal contract strengthens the integrity of the investment. APPA also professes concern for the fiscal stability of local governments.

Thus, if a project was very high risk, a local government would have great difficulty securing financing. In addition, the very principles of local control – open meetings and decision-making, public disclosure of information, and accountability to locally elected officials --- mitigate high risk outcomes.

This statement gets much of the process backwards. Local governments sign contracts with public power utilities. Those legally binding, signed contracts **are** the investment facts that the credit agencies rely upon. The rating agencies pass judgment on the creditworthiness of the deal and the public power authority. The actual process is, at best, secondary.

This point is critical. A recent statement by Fitch on Amp-Ohio provides a positive rating for the Prairie State project. Four of the nine factors relate to: long-term contracts for electricity purchases; financial stability of the local participants; 25% step-up provision to mitigate individual participant default and AMP's long-term relationship with its members (the local participants).¹¹ In essence, the willingness of local governments to stand behind the deal is vital to its credit rating.

Local decisions to sign the contract drive the underwriting process, not the other way around as implied in the APPA letter. Local officials rely heavily on power professionals from their state power authorities. This is particularly true in the current environment when rising costs and uncertainty regarding CO2 emissions are important parts of the equation. Local officials look to the expertise of state power officials to negotiate these

¹⁰ Scott Balice Strategies, *Review and Quantification of Certain Financial Risks of American Municipal Power – Ohio, AMP Generation Station, February 1, 2008, p.11*

¹¹ Fitch Ratings, *Fitch on American Municipal Power-Ohio*, March 15, 2008. It is of note that this rating statement does not mention assessment of climate risk at all. Given the large potential cost impacts already outlined in this memo, one wonders how strongly the rating agencies are considering it, and how insistent the power authorities are in making clear they are “carefully” considering it.

rapids of change. If the state power authorities have not adequately considered the risks, it is difficult for a local official to have the resources or time to assess the risk on their own. .

When the AMP-Ohio Meigs County situation is reviewed it is plain that only one local government, Cleveland, had the resources to secure its own independent analysis of the plant (analysis by Burns and Roe for Cleveland Public Power). No other local government out of the 70+ communities that signed on conducted such an analysis. Furthermore, as evidenced by the Ohio Citizen Action letter, the Cleveland City Council was the only legislative body to commission its own analysis (analysis by Ion Consulting). The local legislative bodies were responsible for authorizing the cities to sign the contracts. However, the Cleveland City Council only received its independent analysis a few days before the final decision by the City Council to finalize its participation.

Ohio Citizen Action and its consultants have noted flaws in the underwriting process and financial assumptions regarding the Meigs County case. The actual way in which other contract signoffs from local governments were secured for coal-fired plants become is a reasonable line of inquiry for Treasury officials.

The underlying fiscal conditions of local governments are germane to this discussion. While municipal electric systems derive revenue from local ratepayers who are also local taxpayers, the municipal government and electric system are technically, and legally separate. The rating agency press release and project contract documents give an impression if electricity costs rise to levels that are unacceptably high to consumers then local governments will step in with their taxing authority to pay the costs (and taxpayers will receive tax increases).¹²

A memo prepared by TR Rose Associates, a financial consultant for Ohio Citizen Action cites a provision in the standard contract between AMP-Ohio and prospective participants in the Meigs County plant. The consultant's comment follows citation from the contract.

Section 5(I) states: "No Participant shall be required to make payments under this Contract except from the revenues of its Electric Systems and from other funds of such system legally available therefore. In no event shall any Participant be required to make payments under contract from tax revenues, or any other source of funds other than its Electric System's funds, but it may elect, in its sole discretion to do so."

It is unclear what conditions would cause an Electric system to use "tax revenue" to pay its obligations under this contract. Various open-ended liabilities created by this contract however make this statement worrisome. At minimum any electric system, or municipal government that has certain common interests with a municipal electric system, would be required to take public

¹² The APPA letter includes public power authorities within the family of municipal bonds. Public power authorities issue a form of revenue bonds backed by project revenues. Municipal general obligation bonds are backed by the full faith and credit of the taxing authority. The substantive rights and responsibilities of the parties involved are quite different. For a recent discussion of the distinction between bond types and some of the implications see: California Debt and Investment Advisory Commission, *California Debt Issuance Primer Handbook*, www.treasurer.ca.gov/cdiac/debtpubs/handbook.pdf

actions in order to raise revenues necessary to pay a liability stemming from this contract. Such an action would require the appropriate authorities to propose, discuss and vote on any such revenue actions prior to imposition. The contract, as written, seems to imply that an electric system could independently elect to tax without additional public actions.

Are such ambiguous statements regarding the availability of future tax increases included in underlying contract documents in order to provide assurances to investors or rating agencies that full taxing authority of the jurisdiction is tacitly behind these transactions? Of course, the full taxing power is not behind these deals. It would require additional budgetary actions of the local government, not the electric system. Why are such provisions included in a contract? If bond underwriters, rating agencies and investors are sophisticated enough to discount such statements, why does an issuer insist on them as part of the contractual arrangement. How many local officials know they are tacitly granting future tax increases when they make these decisions?

Such questions go right to the heart of past bond deals that went bad and resulted in protracted litigation and disruption to the bond markets.

One example, *In re Washington Public Power Supply System litigation* (U.S District Court of Arizona). This case involved a \$2.25 billion bond transaction for the construction and operation of a power plant.

In the offering documents, it was represented that payment of principal and interest on the bonds by WPSS was guaranteed by the 88 public utilities in the Pacific Northwest which stood to benefit from the construction of the power plant. Due to massive cost overruns and questions about the need for and feasibility of constructing the power plants, construction of the plants was terminated. Faced with the prospect of the public honoring their guarantees utilities brought court proceedings to invalidate them, which were successful.¹³

On the day of the Cleveland City Council decided to go forward with its participation, Councilmember Matthew Zone, Chair of the Utilities Committee, asked if the contract it was about to agree to could be amended to give participating municipalities a right to revisit participation in the project once final costs were determined. AMP-Ohio officials stated this would not be possible.

APPA's letter cites current rating agency actions as a reason that investors should have comfort with these plants.

Given the events described above, what disclosures have been made to the rating agencies about the full range of CO2 risks faced by these projects? What standards did they apply in giving their ratings? Do these standards move closer to those outlined in the Carbon Principles? Or are they simply the lesser form of diligence that has been acceptable in prior offerings because past financial conditions presented a less risky scenario?

Of course, one cannot disregard the current problems that confront the rating agencies.

¹³ www.blbglaw.com/cases/washingtonpower.html

An editorial offered by the Wall Street Journal puts the problem in extraordinary terms:

How badly do the major credit-rating firms have to perform before investors stop using their services? This is a trick question, because investors aren't allowed to stop using them --- State and federal regulations that lock in the rating oligopoly remain untouched by recent "reforms".

A recent Business Week opinion revisits the problems experienced by investors at the hands of the nation's three primary rating agencies. The lesson for investors is that they need to do their own diligence as well as continue to rely upon the rating agencies. This issue of the use of private activity bonds for coal-fired plants is another example where normal due diligence is outstripped by the complex pace of economic events.

The Treasury Department has oversight responsibility for the administration of the nation's large bond portfolio of which coal-fired plants is a small part. The extra diligence warranted for these investments is not taking place, notwithstanding APPA's statements.

APPA also states the following:

The municipal bond market has consistently been low-risk and reliable and remains so today.

The letter goes on:

Mr. Thompson cites the fact that the Rural Utilities Service (RUS) has suspended low-interest loans to rural electric cooperatives for coal-fired power plants. However, that is because RUS lacks a mechanism to reflect the risks associated with such plants. These risks for public power utilities, though, are already taken into account and determined by credit rating agencies.

Large investment banks have decided that an enhanced protocol is required to assess, quantify and manage risk given the new economic realities presented by global warming. The Rural Utility Service (RUS) has removed itself from the market as well because financial conditions are so volatile that underwriting assumptions are, at best, speculative. The risk to the taxpayers is too great for the Rural Utility Services to continue making publicly subsidized loans.

These entities, using new tools to assess risk have arrived at a very different place than APPA. APPA appears to be using the same analytical tools that reflect, at best, a limited review of the financial challenges created by new market conditions.

APPA limits its assessment of the problem as RUS' inability to price carbon risk. APPA believes that the bond market is better at addressing the risk related to CO2 emissions even though the bond community has not taken this issue up as a professional group, nor adopted any public protocols. Received wisdom based on faith should be left to those with appropriate training.

To put it bluntly, the normal underwriting process is using outdated assumptions and modeling tools. The interest rates, to the degree they are determined relying on these models, need to be reviewed.

The APPA letter offers an incomplete description of the RUS rationale for its decision to impose a moratorium. The United States Department of Agriculture, Rural Utility Service provides loans for new power generation to rural electric cooperatives.

The Rural Utilities Service, established by the Federal Crop Insurance and Department of Agriculture Reorganization Act of 1994, administers the electricity and telecommunications program that was operated by the former Rural Electrification Administration (REA) and the water and waste disposal programs that were operated by the former Rural Development Administration (RDA). Within USDA, RUS is located in the Rural Development mission area. The Rural Electrification Act of 1936, as amended, provides the basic statutory authority for the electricity and telecommunications programs, including the authority for guaranteed loans to be made by the Federal Financing Bank (FFB) of the Treasury.¹⁴

Three types of loans are offered by RUS to support electricity generation and transmission: (1) Direct loans at five percent interest rate – “hardship loan rate”, (2) Direct loans with rates tied to an index of municipal borrowing rates – “municipal structure loans”, and, (3) Guaranteed loans – RUS guarantees either FFB or commercial loans.¹⁵

In February 2008, Congressman Henry Waxman (D- California) made a formal inquiry of the Rural Utility Service. The letter requests information and asks RUS administrators to address the risk associated with financing coal-fired plants.

Private sector investment banks and many electric power providers are recognizing that significant regulatory carbon controls are highly likely to be imposed in the near future, and they are accounting for those costs in their financial calculations. We are concerned, however, that RUS may not be applying similar safeguards when it loans out taxpayer dollars. Encouraging new uncontrolled coal-fired power plants to be built without adequately accounting for future carbon control costs raises the risk of both loan defaults and large unanticipated rate increases for rate-payers. Obviously, recouping carbon-related costs through large rate increases would harm economic development, which is the central purpose of the RUS program, while extensive defaults would threaten RUS’s ability to continue providing these loans.¹⁶

¹⁴ GAO/RCE-97-82 *Rural Development: Financial Conditions of the Rural Utilities Service’s Loan Portfolio*, (April 1997). The GAO has detailed the history of RUS lending in a series of audits and testimony to Congress. The audits detail specific issues related to delinquencies, defaults and workouts. See: GAO/T-RCED-97-198: *Rural Development: Financial Conditions of the Rural Utilities Service’s Electricity Loan Portfolio*, July, 1997; GAO/T-AIM-98-123: *Rural Utilities Service: Risk Assessment for the Electric Loan Portfolio*, March 30, 1998; GAO/AIMD-00-115: *Financial Management: USA Faces Major Financial Management Challenges*, March, 2000; GAO/AIMD-00-288 *RUS’s Loan Restructurings*; GAO-04-647: *Rural Utilities Service: Opportunities to Better Target Assistance to Rural Areas and Avoid Unnecessary Financial Risk*, June 2004

¹⁵ For full program description see: rus website (get cite

¹⁶ Waxman, Henry, *Letter to the Honorable James M. Andrew, Administrator, Rural Development Utilities Program, United States Department of Agriculture*, February 14, 2008.

On February 19, 2008, the RUS Administrator informed the General Manager of Southern Montana Electric Cooperative, Inc. that it could not move forward with the Highwood Generation Station project. The letter to the cooperative discussed the general issues facing RUS, and informed the cooperative that no further baseload generation loans would be forthcoming at least through 2009. The letter states:

I have been closely and carefully monitoring the developments with the proposed Highwood Generation Station. The inherent risks associated with compounded delays make the situation more problematic as well as increasing the cost of the plant which will be passed on in the form of higher member rates raise concerns about financial feasibility

Additionally, as you know, the Agency is precluded from financing base load generation plants in Fiscal Year 2008 and I suspect that will be the situation in Fiscal year 2009. Costs will continue to increase throughout this period.

With all the facts considered: No base load generation loans probably through 2009; continued cost increases further exacerbated by the added time to reach loan approval; the feasibility of the project with extra time and additional cost; and the uncertainty of the litigation now filed compels me to inform you the Agency will not be able to finance the proposed Highwood Station Plant.

Add to the above facts concern exists that approximately 40 percent of Southern Montana's capacity in the proposed plant is not under contract through the entire term of the proposed financing from the Agency.

Disclosure of this application denial and the larger issue of an effective moratorium on new lending have prompted press attention.¹⁷ The Washington Post article states:

Though the last loan for a generating plant was made in 2006, rural cooperatives have applied for \$1.2 billion in loans to cover all or part of four more coal-fired plants, including controversial ones in eastern Kentucky and southern Illinois. Two other cooperatives recently shelved their projects and withdrew their RUS loan applications. And last month the RUS informed the Southern Montana Electric Generation and Transmission Cooperative that the agency was rejecting its application for a coal plant loan, citing new agency policy, rising construction costs and the lack of customers for much of the proposed plant's output.

The RUS administrator, James M. Andrew, said in the letter that it "is not funding loans for new base load generators until the Agency and the Office of Management and Budget can develop a subsidy rate to reflect the risks associate with the construction of new base load generation plants."

An RUS spokesman would not say when the OMB closed the lending window for baseload plants; the agency gave no hint of the policy change until its letter to Southern Montana Electric on February 19.

The agency also conceded yesterday that it had not considered potential costs that could result from climate-change legislation that most commercial banks, utilities

¹⁷ Mufson, Steven, *Government Suspends Lending for Coal Plants: Risks Cited to Economy, Environment*, Washington Post, March 13, 2008. See also. Karl Puckett, *Rural Utilities explains funding pullout and Coal-fired power plant projects feel heat from rising costs, environmental concerns*, Great Falls Tribune, March 4 and 13, 2008, respectively.

and other businesses consider when considering energy projects. “Since there is no clear consensus on what emission standards will be enacted and associated costs, attempting to make decisions on loans absent a factual base is speculative at best,” Andrew said.

....A budget expert who asked not to be identified to protect his relationship with clients noted that the RUS was also glossing over the difficulty of passing costs along. Power generation co-ops are separate from distribution co-ops, which in the past have forced some generators into bankruptcy, rather than pass along higher costs.

The RUS letter and subsequent statements by the agency highlight more than just the cost of CO2 emissions. The agency also identifies rising costs of construction and operation, a limited demand (at least in the area under consideration) and the impact of litigation on climate risk. A full review of the use of federal subsidies for coal plants would explore with RUS officials in more detail the events leading up to its decision and the specific underwriting issues it was facing as applicants for coal plants came forward with credit packages.

Use of national data on electricity demand forecasts distorts the reality that all power plant production is local and regional in nature.

APPA states that the need for electricity will rise by 30% by 2030 according to the Energy Information Administration. No one would dispute that electricity needs must be met. No one would disagree that tax-exempt financing will play a role in meeting those needs. What is at stake in this discussion is how needs are met using private activity bonds.

The case of AMP-Ohio is a good place to continue this discussion. While AMP-Ohio presented the need for electricity, it overstated the need as part of its presentation to the public.

One analyst¹⁸ that reviewed AMP-Ohio’s analysis of load growth stated:

On behalf of AMP-Ohio, R.W. Beck, Inc. prepared a 20-year load forecast for each member of AMP-Ohio. The reports were delivered in February 2007. The reports showed peak demand of 2,454 MW in 2006 for the members, increasing to 2,947 MW in 2013 and to 3,360 MW in 2027. Thus, it is assumed that demand will grow at an average annual rate of 2.65% between 2006 and 2013 and at an average annual rate of 0.94% between 2013 and 2027, for an average annual growth rate of 1.50% for the period 2006 to 2027.

We do not have the detail on the assumptions used in making the demand forecasts contained in the Power Supply Plans for the members. However, we question whether such demand forecasts adequately consider basic trends in the economy. In addition, it appears that the plans may ignore the “macro” changes in demand for power, such as the implementation of efficiencies and conservation measures. The 2008 EIA Regional Projections for Electrical Load Growth projects regional electrical load growth, 2005 to 2030, of 0.64% for the Midwest Region, East North Central, including Indiana, Illinois, Michigan, Ohio and Wisconsin. It should be noted that the

¹⁸ Scott Balice Strategies, *Review and Quantification of Certain Financial Risks of American Municipal Power – Ohio, AMP Generation Station, February 1, 2008, p.6.*

2008 projected growth in demand is lower than the 2007 projection for that region of 0.90%. We understand that projections of load growth must take into account a number of local demographic and economic factors, including projected population growth or decline, employment forecasts, manufacturing, service and/or retail base and any forecasted changes in their level or mix. In addition, the forecast must take into account the demand side management programs and application of new efficiency technologies and conservation measures, which will reduce the demand for power.

Furthermore, the Energy Security and Climate Stewardship Platform for the Midwest, 2007, of the Midwestern Governors Association, endorsed by the governors of eight Midwest states, including Ohio, and the Province of Manitoba, calls for energy efficiency improvements of 2% of regional annual retail sales of electricity by 2015, and an additional 2% in efficiency improvements every year thereafter. The Platform also contains goals for increasing use of renewable resources, calling for 10% of electricity consumed in the region to be from renewable resources in 2015, 20% in 2020 and increasing to 30% in 2030. The implementation of these goals could significantly impact the demand for electricity and the choice of generation for development. It is not clear to what extent, if at all, the Platform was considered in the development of the power supply plans for the municipalities.

In any event, it should be noted that using the EIA projection of growth in demand of 0.64%, the aggregate demand in 2027 would be 2,806MW, as compared to the forecast demand of 3,360MW in the Feasibility Study. That is a difference of 554 MW, which is nearly 60 percent of the net capacity of the AMP Generating Station.

When AMP-Ohio responded to this quantitative critique, it simply dismissed it based on AMP-Ohio's 30 years of experience.¹⁹ Alternatives to the coal plant were also proposed. These alternatives were grounded in sound energy planning principles.

There are a number of alternatives to the proposed AMPGS Project that should be investigated before a community makes a 50 year "take-or-pay" contractual commitment to purchase energy and capacity from the plant. These alternatives include energy efficiency and demand side management programs, renewable resources, purchasing or contracting for energy and capacity from underused gas-fired power plants in the region, and, if necessary building new gas-fired capacity.²⁰

The Balice Study shows there is less of a need for electricity than RW Beck projected. A better demand forecast would show that Ohio's slow growth economy is producing electricity demand that can be met by something short of a 960 MW plant in the case of Meigs County, and a 1600 MW plant in the Prairie State example.

Other companies that have demonstrated success in the energy efficiency area see it as a beginning from which even greater achievement is possible.

For example, the most recent annual report from Pacific Gas and Electric states:

Equally important, we are taking actions in the meantime to prepare our company and our customers for the future. This includes continuing to aggressively drive advances in energy efficiency and extending our renewable energy commitments.

¹⁹ Letter from Marc Gerken, President and CEO AMP-Ohio to Sandy Buchanan, Executive Director, Ohio Citizens Action, February 13, 2008, p.3.

²⁰ Synapse Energy Economics, Inc., *The Risk of Participating in the AMPGS Coal Plant*, February 13, 2008.

This leadership has put PG&E in a strong position. Last year, Innovest Strategic Value Advisors, a top evaluator of investor risk and value related to sustainability issues, issued a report that ranked PG&E environmental leadership (EcoValue index) is the top 25 percent of all utilities in its peer group.

Through energy efficiency, we plan to meet 50 percent or more of the growth in energy demand in our service area over the next ten years.

A recent investor presentation by Melissa Lavinson, PGE Director of Federal Environmental Affairs and Corporate Responsibility, April 30, 2008 discussed PGE's performance and forward-looking goals²¹.

PGE's Energy Efficient Investments

- Over the past thirty years, our customer energy efficiency programs have:
 - Saved enough electricity to power 18 million homes;
 - Avoided the need to build approximately 24 power plants;
 - Prevented more than 125 million tons of carbon dioxide emissions from being emitted into the atmosphere.

PGE's program goals over the next 10 years are to reduce load by 2500 MW and develop a Demand Response Program that reduces peak electricity demand by 5%.

Issues and questions related to the use of tax-exempt and taxable bonds to subsidize the creation of coal-fired power plants.

Public Policy

1. Coal fired-power plants are the largest emitters of greenhouse gas in the world. Should these plants be favored with publicly subsidized financial advantages?
2. Should new coal plants be granted financial advantages at a time when the national government is poised to adopt new regulatory rules to control emissions? Is federal willingness to support coal-fired plants with public subsidies in this environment a defacto strategy to allow these plants to become operational without CO2 emission controls? Does support now almost ensure future exemption from controls in order to avoid dysfunction in the bond market, and losses for the United States government?
3. Given that the United States Department of Agriculture, Rural Utility Service, a federal agency with over 70 years of experience financing rural electrification has enacted a moratorium on financing coal-fired plants, why are public subsidies through the tax code for coal-fired coal plants appropriate? What are the substantive differences in public policy objectives and the risk to taxpayers?
4. Has the introduction of quasi-voluntary industry standards regarding carbon mitigation strategies favored public power projects? Is this advantage, combined with public subsidizes from private activity bonds, sound policy?

²¹ Lavinson, Melissa, Director, Federal Environmental Affairs and Corporate Responsibility, *Energy Efficiency as a Resource*, April 30, 2008.

Financial Policy

1. Given the extraordinary rise in construction prices for coal-fired power plants, what are the appropriate standards of disclosure to stakeholders in the bond process? What types of quantification and characterization of future risk are appropriate?
2. What is the appropriate way for issuers to inform the investment community and other participants about the range of financial risk related to prospective regulation of CO2 emissions?
3. Given the extraordinary rise in coal prices and recent price volatility, what are the appropriate range of cost assumptions and characterization of future risk related to coal-fired power plants?
4. Given the cumulative impact of cost increases and regulatory uncertainty, what is the most appropriate way for issuers to inform investors and other participants of the risks?
5. What constitutes an authoritative source for information regarding coal plant costs and risks given the extraordinary changes in the market and the difficulty long term lenders like RUS and investment houses are having adhering to objective standards of diligence?
6. When an issuer provides information to a municipal electric system regarding the final price of electricity it will pay as a result of its purchase of a fixed number of megawatts from a proposed coal fired power plant, what are the appropriate price ranges that should be provided to avoid any appearance that such price quotes are misleading?

Diligence

1. Should issuers adopt a uniform set of enhanced protocols that is accessible to investors? Who should be responsible for the protocol – the boards of public authorities, the financial advisor, counsel or staff?
2. Should credit rating agencies adopt a uniform set of enhanced protocols to evaluate coal-fired power plant risk? Should protocols be made accessible to the investment public?
3. Should underwriters adopt a uniform set of enhanced protocols that are accessible to the investment public and other participants?
4. Are bond documents being developed in a manner that meet disclosure standards given the dramatic changes in the markets? What risks are there that rapidly changing market conditions are undermining the ability of issuers to meet disclosure standards?
5. What standards should local elected officials use to determine prudence and reasonableness regarding coal-fired power plants given the challenges of providing accurate financial information in the current climate?
6. How should the staff of issuers and underwriters conduct themselves when making public statements regarding policy or facts that pertain to a specific project? How do they avoid the appearance of impropriety given shifting

standards and the voluntary initiatives that some firms are taking upon themselves to address risk?

7. Is the normal oversight of local government review a meaningful check on the disclosures of power authorities and coal plant developers given the extraordinary complexity of market conditions? Is the risk of lawsuits from local governments heightened by the lack of any new set of protocols in the processes governing the disclosures that are made to local officials?