Commission Staff Report

COMMISSION MEETING DATE: February 22, 2023

SUBJECT: Approval to Explore the Merits and Risks of an Energy Prepayment Transaction

AGENDA CATEGORY: Discussion/Action

FROM:	Monty Hanks Assistant General Manager/CFO	**METHOD OF SELECTION:** *N/A*
Division:	Commission	
Department:	Commission	

IMPACTED MEMBERS:

All Members	☐	**City of Lodi**	☒	**City of Shasta Lake**	☐
Alameda Municipal Power	☒	**City of Lompoc**	☒	**City of Ukiah**	☐
San Francisco Bay Area Rapid Transit	☐	**City of Palo Alto**	☒	**Plumas-Sierra REC**	☐
City of Biggs	☒	**City of Redding**	☐	**Port of Oakland**	☒
City of Gridley	☒	**City of Roseville**	☐	**Truckee Donner PUD**	☐
City of Healdsburg	☐	**City of Santa Clara**	☒	**Other**	☐

If other, please specify ______________________

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RECOMMENDATION:

Approve Resolution 24-XX authorizing the General Manager to direct staff to explore the merits and risks of a prepayment bond transaction regarding the Geysers Power Purchase Agreement. Staff will return to the Commission with a recommendation to continue moving forward or to discontinue this effort.

BACKGROUND:

The spread between tax-exempt and taxable bond yields offers the opportunity for tax-exempt entities like NCPA Members to structure prepay transactions to lower the cost of electric supplies to member retail customers. An energy prepayment is a long-term financial transaction available for municipal utilities that enables a meaningful power procurement cost savings opportunity. Over the past two decades, 100+ municipal gas prepayment bonds have been issued with a value totaling over $70 billion. More recently, prepaid electricity transactions have dominated the market with 10 energy prepayment transactions totaling almost $10 billion completed in the last few years with several Northern California Community Choice Aggregators (CCAs) leading this effort.

The utility (or utilities) participating in a prepaid energy transaction enjoy a 5-10% discount on their power purchase agreement (PPA) prices for the duration of the PPA agreements, with longer duration prepaid PPAs enjoying larger discounts due to the time value of money and bond yield differentials. In addition, energy prepayment transactions are not viewed as debt of the public power utility participants because the utility's only obligation is to pay for energy received. There is no claim on a municipal utility by the energy prepayment bondholders who purchase non-recourse municipal tax-exempt bonds; bondholder recourse is only with the Counterparty that received the prepayment, an entity that is typically a highly rated major commercial bank. These prepay structured transactions to arbitrage the yield differential between tax-exempt bonds and taxable bonds by the commercial bank – such transactions have been reviewed by the Internal Revenue Service (see Legality below).

The recent 12-year Geysers PPA entered into by NCPA, on behalf of Participating members, offers a unique opportunity for participating members to benefit from a prepaid structured transaction. The benefit is preliminarily estimated at ~$6/MWh discount, equivalent to ~$60+ million in retail ratepayer savings over the 12-year term of the PPA.

Geysers PPA Agreement

In December 2022 with Resolution 22-124, the Commission approved the Purchase Agreements between Geysers Power Company and the Northern California Power Agency (NCPA), and the Third Phase Agreement for Purchase Agreements. This action authorized NCPA to purchase, on behalf of the Participants, renewable energy products and resource adequacy capacity from Geysers Power Company beginning January 1, 2025, and continuing through December 31, 2036. The first two years' contract quantity is 50MW delivered on a 7x24 basis. In the remaining ten years, the contract quantity increases to 100MW delivered on a 7x24 basis. The value (or cost) of the PPA is more than $750 million. The Participants and their respective participation percentages include:

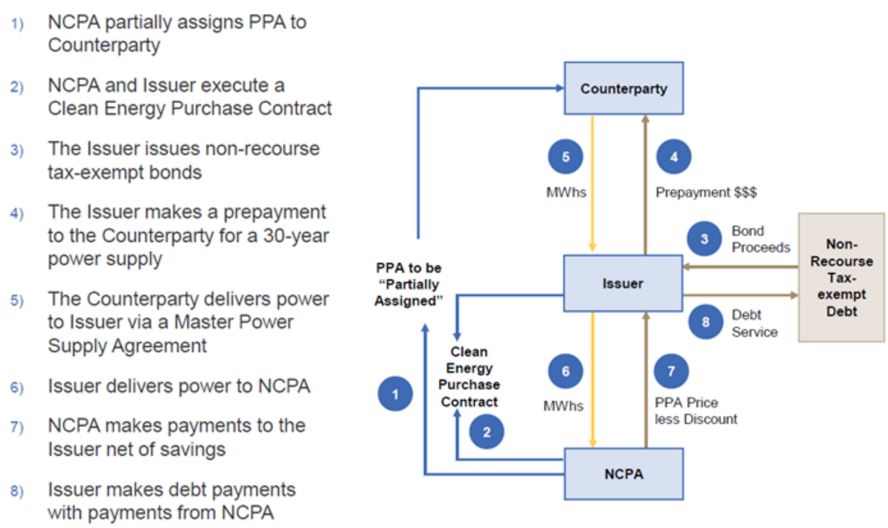
Table 3
Final Project Participation Percentages

Member	Project Participation Percentages	Project Participation MW (2025 - 2026)	Project Participation MW (2027 - 2037)
City of Alameda	5.0%	2.50	5.00
City of Biggs	0.4%	0.20	0.40
City of Gridley	0.6%	0.30	0.60
City of Lodi	10.0%	5.00	10.00
City of Lompoc	1.7%	0.85	1.70
City of Palo Alto	10.0%	5.00	10.00
Port of Oakland	2.3%	1.15	2.30
City of Santa Clara	70.0%	35.00	70.00
Total:	**100.0%**	**50.00**	**100.00**

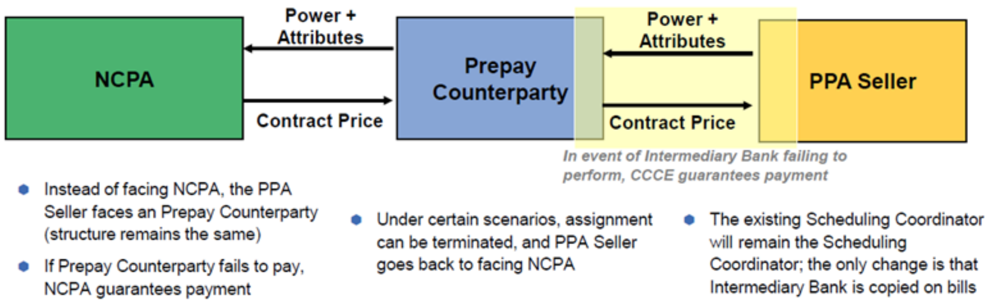
The “take and pay” agreements enable and obligate the Participants to take delivery of and pay for such electric capacity and energy and to pay NCPA for all costs it incurs for undertaking the foregoing activities as shown below.

Prepaid Energy Transaction
As mentioned earlier, the goal of an energy prepayment transaction is to reduce the cost of power purchases on quantities delivered under the prepay structure with minimal risk to the participants. The prepay structure enables publicly owned utilities to reduce their energy costs by financing the acquisition of long-term energy supplies with tax-exempt bonds. For decades, municipal utilities have used the prepayment structure as an industry standard practice to reduce costs for the purchase of natural gas.

How Does a Prepay Work?
Typically, a municipal energy prepayment bond involves tax-exempt bonds issued by a conduit entity. The proceeds from the bonds are channeled through the conduit entity (municipal bond issuer - TBD), which buys the energy and immediately resells it to the utility or utilities. The conduit entity is set up as a non-profit and is, therefore, able to issue tax-exempt bonds. A pictogram of a typical is shown below:



To summarize, a tax-exempt public electricity supplier (e.g. PPA Participants), a taxable financial counterparty, and a municipal bond issuer (NCPA conduit) enter into a long-term supply agreement called a Clean Energy Purchase Contract to pre-purchase wholesale zero-emission clean electricity from sources like solar, wind, geothermal, and hydropower. The municipal bond issuer issues tax-exempt bonds to raise the funds for the transaction, flowing the funds to the financial counterparty. The financial counterparty utilizes the bond funds and provides a discount to the PPA Participants on the power purchases based on the difference between the taxable and tax-exempt rates.



Legality

Prepayment transactions are legal and codified in US Tax Law. Initially, the IRS issued rules allowing tax-exempt natural gas prepayments and Congress enacted legislation specifically allowing the transactions under the National Energy Policy Act of 2005; Section 1327.

As mentioned earlier, this prepayment structure has been utilized since the 1990s with over $100 billion of transactions completed to date. These have largely historically been utilized for natural gas procurement. The table below details prepayments that have been completed by public utilities in California including a few members of NCPA.

Date	Amt. ($000)	Issuer	Description	Beneficiary
06/2006	230,845	Vernon Nat. Gas Fin Auth	Nat Gas	City of Vernon Elec
01/2007	209,350	Roseville Natural Gas Fin Auth	Nat. Gas	City of Roseville Elec
05/2007	757,055	Northern Ca Gas Auth No. 1	Nat. Gas	SMUD
09/2007	887,360	Long Beach Bond Fin Auth	Nat. Gas	City of Long Beach
10/2007	504,445	So. Ca. Pub. Power Auth	Nat. Gas	Multiple MOUs
10/2007	251,695	Long Beach Bond Fin. Auth	Nat. Gas	City of Long Beach
08/2009	901,620	M-S-R Energy Authority	Nat. Gas	MID/Redding/SVP
10/2009	514,160	So Ca Pub Power Auth (Windy Flats)	Elec (Wind)	LADWP, Mult. MOUs
04/2010	778,665	Cal. Statewide Comm Dev Auth	Nat. Gas	SMUD
2010/11	394,700	So Ca Pub Power Auth (Milford 1 & 2)	Elec (Wind)	LADWP, Mult. MOUs
12/2018	539,615	Northern Ca Energy Auth	Gas/Elec	SMUD
Total	**$5,969,510**			

The prepayment structure is now being applied towards renewable energy (electricity). Thus far, 6 other CCAs have either executed or are in the process of completing a similar structure. CCAs have completed a total of 10 transactions to date for a par amount of over $8 billion.

Date	Amt. ($000)	Issuer	Description	Beneficiary
09/2021	1,234,720	California Community Choice Fin Auth	Elec (Green)	SVCE, EBCE
11/2021	602,655	California Community Choice Fin Auth	Elec (Green)	MCE
06/2022	931,120	California Community Choice Fin Auth	Elec (Green)	EBCE
12/2022	459,640	California Community Choice Fin Auth	Elec (Green)	Pioneer
01/2023	841,550	California Community Choice Fin Auth	Elec (Green)	SVCE
02/2023	998,780	California Community Choice Fin Auth	Elec (Green)	CPA
06/2023	958,290	California Community Choice Fin Auth	Elec (Green)	CPA
08/2023	997,895	California Community Choice Fin Auth	Elec (Green)	EBCE
10/2023	647,750	California Community Choice Fin Auth	Elec (Green)	CCCE
12/2023	1,038,285	California Community Choice Fin Auth	Elec (Green)	MCE
Total	**$8,710,685**			

Comparison of Prepayment Structures (Natural Gas vs. Electricity)
A prepaid electricity transaction retains many of the features common to tax-exempt natural gas prepayment transactions. Some, but not all, of these similarities include:

- A financing conduit of NCPA issues the Bonds, the interest on which is exempt from federal and State of California income taxes, to prepay for up to thirty years of commodity deliveries [Note: the proposal presented to NCPA is for a twelve-year deal];
- The proceeds of the Bonds are used to finance the prepayment; and
- If a project participant (or participants) qualified electricity requirements decline such that the participant(s) can no longer use the prepaid electricity, it has the right to request the supplier remarket the prepaid electricity.

A prepaid energy transaction also contains certain differences to tax-exempt natural gas prepayment transactions. Some, but not all, of these differences include:

- The Participant(s) assigns certain rights and obligations under the assigned PPA(s) and in many circumstances, must use reasonable efforts to assign additional PPAs in the future;
- Assigned electricity will be delivered by the Electricity Supplier to NCPA under the Mast Power Supply Agreement. NCPA will then deliver such assigned electricity to the project participants under the Clean Energy Purchase Contract; and
- To the extent the assigned PPA(s) provide an aggregate amount of electricity greater than the amount prepaid, such electricity will be delivered to the project participant and associated payments are not part of the prepaid transaction.

Risks
The proposed deal structure, utilizing a financing conduit of NCPA to issue non-recourse municipal bonds, significantly minimizes the risks to the NCPA Members who are Geysers PPA Participants. Non-recourse means the bonds are not secured or guaranteed by the referenced entity (NCPA or the Project Participants). Potential remaining risks, including volumetric, counterparty/financial, and regulatory are low and managed through the deal structure. Volumetric risk is the risk that the PPA Seller fails to provide the required energy volumes to sustain the transaction. This risk is sufficiently managed in three ways. First, NCPA is proactively scheduling only a portion of the contract volumes of the assigned PPA into the prepay to hedge against potential under-generation. Next, the deal structure allows the Participants to substitute or add additional PPAs to the prepay transaction to sustain the required volumes of delivered energy. Finally, the Master Supply Agreement will provide a mechanism to

backstop under-generating developers in the event of an outage or other unplanned event. Even if the Prepay Counterparty fails, the recourse to the bondholder is to the Prepay Counterparty and not to NCPA or its members.

Counterparty/financial risk exists should the Prepay Counterparty experience distress and fail to service its obligations. NCPA and the Participants expect to select a Prepay Counterparty through a rigorous RFP process to hire a seasoned investment bank with demonstrated experience in the commodity business and prepay transactions.

Regulatory risk, though low, may materialize should the IRS change its guidance for the treatment of energy prepay transactions. Since the IRS issued rules informing the structure of these transactions 30 years ago, well over 100 such bond issuances have successfully delivered savings to their communities. If regulations do change, NCPA would assess the continuing viability of the structure and, if necessary, withdraw. Under those circumstances, NCPA would continue under the original terms of its PPA with only the downside of unmaterialized savings.

Unlike CCAs which get approval from the California Public Utility Commission (CPUC), municipal utilities must receive approval from the California Energy Commission (CEC) to preserve the renewable attributes of a PPA to meet the clean energy goals. While the CPUC has already approved prepay energy transactions for the CCAs, the CEC has yet to officially adopt similar approvals. However, it is expected the CEC would take the same position as the CPUC largely due to a recent CEC letter provided to Anaheim Electric regarding a similar type of transaction.

Lastly, it is important to note that the energy prepayment is <u>non-recourse</u> to NCPA and the Participants. Should a termination event occur, the Prepay Counterparty is obligated to make a termination payment which will be used to repay the bondholders. This is the only source of repayment funds available to investors in the event of a termination event. The revenues of the Participants are not pledged to repay the bond investors and rating agencies do not count prepay transactions as debt or fixed costs of NCPA or the NCPA Members who are Geysers PPA participants.

In summary, each of these risks has been identified and mechanisms have been formulated to shield NCPA and the PPA Participants from being adversely impacted. A case in point, during the 2008 financial crisis, Lehman Brothers was the counterparty of several prepayment transactions. Upon Lehman's bankruptcy, the bondholders settled directly with Lehman as opposed to the Issuer of the bonds. The issuer of the transaction(s) was not liable to the bondholder but rather lost the benefit of the discount or savings when reverting to the original terms of the PPA agreement.

Proposal Submitted to NCPA
Most prepay transactions are very complex when structured for 20 to 30 years. They generally require Put Bonds and Commodity Swap providers to achieve savings of +/- 10% and require replacing the original PPA with a similar-sized PPA (or PPAs) upon expiration to match the maturity length of the outstanding bonds.

However, a preliminary prepaid energy structure currently being reviewed creates a unique opportunity. The transaction is sufficiently long enough to generate a large prepayment and more importantly, matures/terminates with the expiration of the Geysers PPA. There is no need to procure a new PPA or PPA(s) to "fill the bucket" unlike a 20 or 30-year transaction. In addition, the short transaction allows for it to be sold as an amortizing structure rather than a put bond structure eliminating premiums to investors. The transaction amortizes across tenors characterized by low muni/taxable ratios, producing greater spread differentials, and the cost of issuance (COI) is amortized over the term of the transaction rather than over the put bond tenors. This removes significant third-party expenses, the potential need for commodity swap counterparties, and future market uncertainty.

NCPA Member Interest
For the past several years, a few NCPA members have urged NCPA to investigate the prepay structure on their behalf. In September 2019, NCPA held a workshop educating various members on the Clean Energy Savings Initiative (CESI) but the lower bond yields and lack of suitable PPAs to prepay had hampered NCPA staff from exploring this option in earnest.

PPA Participant Meetings
At the direction of the Finance Committee, NCPA has held individual meetings with the significant share participants (SVP, Palo Alto, and Lodi) representing 90% of the Geysers PPA. Those members expressed interest in NCPA to continue exploring the prepayment opportunity.

Next Steps
If approved, NCPA and member staff plan to undertake the following steps over the next three months:

1. Explore the merits of the prepay structure for the Geysers PPA, risks, and mitigation measures;
2. Explore Bond Issuer options by discussing with bond counsel if a financing conduit may need to be created similar to how the CCAs formed the California Community Choice Financing Authority as the Issuer;
3. Project Participant communication with their governing bodies; and
4. Report to the NCPA Commission and recommendation of the next step(s), if any

Future Steps
If staff recommends proceeding with a prepayment transaction and the NCPA Commission approves (April/May), it is anticipated to take 4-6 months for staff to prepare. NCPA will need to secure professional assistance to complete the work necessary to develop, draft, and finalize the Prepaid Energy transaction documents. Professional assistance includes bond counsel, tax counsel, issuers counsel, disclosure counsel, financial advisor, and any other consultant needed to support the completion of the prepayment transaction. The professional assistance generally works contingent upon a bond sale however, a rating agency or agencies will need to formalize a review of the proposed transaction. Their fee could be as high as $400k but any expenses incurred will be funded/reimbursed from the bond sale.

The prepaid energy transaction “package” would require each Participant’s City Council and/or Board to approve the transaction before approval by NCPA’s Commission and before any bond sale.

FISCAL IMPACT:

Rates as of October 2023 showed an estimated savings (or discount) of ~$6/MWh from the contract price, equivalent to ~$60 million in retail ratepayer savings over the 12-year term of the PPA. This is net of all cost of issuance expenses.

ENVIRONMENTAL ANALYSIS:

This activity would not result in a direct or reasonably foreseeable indirect change in the physical environment and is therefore not a "project" for purposes of Section 21065 the California Environmental Quality Act. No environmental review is necessary.

COMMITTEE REVIEW:

At the November 14th meeting, staff presented the Geysers prepaid energy proposal to the Finance Committee. The Committee recommended that NCPA staff schedule individual and/or group meetings with the Geysers PPA participants to continue evaluating this unique opportunity.

At the February 13th meeting, staff presented an overview of a prepayment transaction to the Finance Committee. The Committee recommended the Commission approve the action to explore the merits and risks of prepaying the Geysers PPA.

Respectfully submitted,

RANDY S. HOWARD
General Manager

SR: xxx:24