

**AUSTIN ENERGY'S TARIFF PACKAGE: §
UPDATE OF THE 2009 COST OF §
SERVICE STUDY AND PROPOSAL TO §
CHANGE BASE ELECTRIC RATES §**

**BEFORE THE CITY OF AUSTIN
IMPARTIAL HEARING EXAMINER**

AUSTIN ENERGY
2016 MAY 31 AM 8:54

**DIRECT TESTIMONY
OF
CYRUS REED**

ON BEHALF OF PUBLIC CITIZEN AND SIERRA CLUB

**May 27, 2016
(Supplementing Corrected Position Statement/Presentation on the Issues)**

1 **1. INTRODUCTION**

2 **Q. PLEASE STATE YOUR NAME AND ADDRESS.**

3 A. My name is Cyrus Reed and I live at 4205 Avenue F in Austin, Texas.

4 **Q. WHO IS YOUR CURRENT EMPLOYER AND WHAT IS YOUR POSITION?**

5 A. I am the Conservation Director at the Lone Star Chapter of the Sierra Club. I have been
6 Conservation Director for approximately 10 years.

7 **Q. ON WHOSE BEHALF ARE YOU TESTIFYING?**

8 A. I am testifying on behalf of Public Citizen and Sierra Club.

9 **Q. WHAT IS YOUR EXPERTISE AND EXPERIENCE?**

10 A. I have a Master's of Science Degree in Community and Regional Planning and a Master's of
11 Arts Degree from Latin American Studies from the University of Texas Austin from 1994. I
12 have a PhD from the University of Texas in Geography from 2007.

13 After receiving my Master's Degrees, I worked for ten years for the Texas Center for Policy
14 Studies, an environmental policy organization. Over the last 10 years, I have worked as
15 Conservation Director of the Lone Star Chapter of the Sierra Club. As Conservation Director,
16 I have advocated for more robust energy efficiency and demand response programs in Austin
17 and throughout Texas for at least 10 years. At the legislature, I was part of the stakeholder
18 groups that advocated for, negotiated and helped pass both HB 3693 by Representative Straus
19 in 2007 and SB 1125 by Senator Corona, both of which increased energy efficiency programs
20 and goals for the State of Texas, as well as subsequent rulemaking at the Public Utility
21 Commission to implement those roles. I have also been an advocate and participant in both
22 legislation and city proceedings to raise minimum energy codes in Houston, El Paso,
23 Brownsville, Corpus Christi, Austin, San Antonio and Georgetown among other
24 municipalities, first to raise the minimum construction standards to the 2009 IECC and most
25 recently the 2015 IECC.

26 I am also a member of ERCOT, and serve as a consumer representative to the Reliability
27 Operations Subcommittee, and am a participant in many working groups, including the
28 Demand Side Working Group and the Emerging Technology Working Group. As such, we
29 frequently review proposals and ideas to expand the role of demand response in the ERCOT

1 market, including the Emergency Response Service (ERS), Spinning and Non-Spinning
2 Reserves and efforts to open up the market for DR, including Loads in SCED.

3 I have also been an active participant in the efforts at Austin Energy to raise their energy
4 efficiency and demand reduction goals, first as a member of the 2009 Generation Resource
5 Planning Task Force, then as a member of the 2014 Generation Resource Planning Task Force,
6 of the Low Income Consumer Assistance Task Force, and most recently, as Vice-Chair of the
7 Resource Management Commission. As such, I have familiarity with Austin Energy demand
8 reduction programs, budgets and goals.

9 As an advocate, I also played a key role in the formation of the Austin Energy Resource,
10 Generation and Climate Protection Plan to 2025. Thus, I am familiar with the assumptions, in
11 terms of budgets and programs, made when setting the goals in the plan.

12 **Q. HAVE YOU PROVIDED AN ATTACHMENT THAT DETAILS YOUR**
13 **EDUCATIONAL BACKGROUND AND PROFESSIONAL EXPERIENCE?**

14 A. Yes. I provide this information in Exhibit CR-1 to my testimony.

15 **2. ENERGY EFFICIENCY SERVICES (EES) FEE**

16 **Q. GIVEN THAT THE EES IS SET ON AN ANNUAL BASIS, WHY ARE PUBLIC**
17 **CITIZEN AND SIERRA CLUB RAISING THE EES FEE ISSUE IN THIS RATE**
18 **CASE?**

19 A. We are raising the issue of the structure in the EES fee because Austin Energy is proposing
20 major changes in the EES fee rate and structure.

21 **Q. WHAT IS AUSTIN ENERGY PROPOSING IN REGARDS TO THE EES FEE?**

22 A. In its tariff package, Austin Energy proposed charging all customer classes except special
23 contract customers, the lighting class, high-load primary voltage and transmission level
24 customers a similar EES rate to support its programs. Under its initial filing, AE proposed a
25 2017 EES rate of \$0.00246 per kilowatt hour for residential and secondary voltage customers,
26 with a slight discount for primary voltage and transmission-level customers, based on lower
27 transmission losses. They are not proposing to charge an EES to special contract customers,
28 the lighting class or high-load primary voltage or transmission level customers.

29 **Q. DO YOU SUPPORT THIS APPROACH?**

30 A. We largely support this approach. We support Austin Energy's proposal to implement a
31 standard EES fee for all customer classes. However, we believed the EES should also be
32 charged to high-load primary voltage and transmission-level customers and those classes

1 should also have access to the programs. We believe all customer classes should pay the fee,
2 and all customer classes should have access to programs to reduce demand and energy use or
3 add renewable generation.

4
5 **Q. WHY ARE DEMAND REDUCTION PROGRAMS AND GOALS IMPORTANT?**

6 A. Austin Energy has been, and continues to be, the leading utility in Texas in terms of energy
7 efficiency savings, advanced building codes, demand reduction, onsite solar generation and
8 many other programs. Our programs and goals are essential to our future vision of this utility,
9 and help create jobs, innovation, new technologies, economic development, all while reducing
10 emissions, and promoting rate stability for our customers and a healthier community and
11 planet.

12 **Q. WHAT GOALS DOES THE AUSTIN CITY COUNCIL REQUIRE AUSTIN ENERGY**
13 **TO MEET THAT ARE IMPACTED BY THE EES FEE?**

14 A. Austin Energy is required to meet the goal established in the Austin Energy Resource,
15 Generation and Climate Protection Plan to 2025, at a minimum. Those goals include
16 achieving 110 MW of local solar by 2020, including 70 MW of customer-sited solar, as well
17 as 200 MWs of total local solar by 2025, with 100 MW customer-sited.

18 In addition, Austin Energy is required to reduce total demand by at least 800 MW by 2020
19 (from 2007 levels), with at least 100 MW coming from demand response. Finally, Austin
20 Energy is required to achieve at least at total of 900 MW of demand reduction by 2025, and is
21 also required to achieve another 100 MW of demand reduction by 2025 for a total of 1,000
22 MW, if programs, technologies and budgets allow. The EES fee funds the many of the
23 programs that Austin Energy has implemented to enable it to meet these goals.

24 **Q. DO PUBLIC CITIZEN AND SIERRA CLUB SUPPORT FUNDING DEMAND**
25 **REDUCTION PROGRAMS AT AUSTIN ENERGY THROUGH A PER-KILOWATT-**
26 **HOURLY FEE?**

27 A. Yes. We support this approach, since it provides transparency to all customers that a portion
28 of their bill is funding these incentives and programs. Because we believe these programs are
29 both part of our policy as part of the Austin Energy Generation Resource Plan, and also help
30 support our climate commitments and also help customers reduce their bills and costs, it
31 makes sense to create a per-kilowatt charge that all customers should pay. We believe all
32 customer classes should share in the cost and the benefits of these programs.

33 **Q. DO OTHER UTILITIES IN TEXAS USE A SIMILAR FEE TO FUND DEMAND**
34 **REDUCTION PROGRAMS?**

1 A. Many do. Thus, all investor-owned Transmission and Distribution Utilities in Texas are
2 required to run energy efficiency and demand reduction programs under statute. All of these
3 utilities set yearly budgets to meet their energy efficiency goals and through a PUC process
4 set a yearly EECRF (Energy Efficiency Cost Recovery Fee) that is ultimately approved by the
5 PUC. This is similar to the approach taken by Austin Energy and City Council, whereby
6 Austin Energy proposes an annual budget for these programs, and proposes an EES. Both the
7 budget and EES are then approved by City Council.

8 **Q. WHAT IS PUBLIC CITIZEN AND SIERRA CLUB’S POSSITION ON THE ENERGY**
9 **EFFICIENCY SERVICES FEE (EES)?**

10 A. We believe that the EES fee should be assessed to each customer class evenly on a per
11 kilowatt-hour basis. Furthermore, we believe that some current customer classes that do not
12 pay the EES should pay the EES, including the high-load transmission and primary voltage
13 customers. This would ensure broader demand reduction programs, so that all customer
14 classes would have access to these clean energy options in the areas of energy efficiency,
15 demand response, onsite solar generation and even potentially electric and thermal storage.

16 We can save customer’s money, keep the utility financially strong, meet both our initial and
17 long-term goals, and keep the system more reliable by adopting our proposal, which shares
18 the costs and benefits of the program.

19 **Q. WHAT DO YOU KNOW ABOUT WHETHER OR NOT LARGE COMMERCIAL**
20 **AND INDUSTRIAL CUSTOMER PAY FEES TO FUND DEMAND REDUCTION**
21 **PROGRAMS AT AUSTIN ENERGY AND IN THE DEREGULATED ERCOT**
22 **MARKET AND WHY ARE THOSE POLICIES IN PLACE?**

23 A. In the competitive market, some larger customers, such as industrial users, or commercial
24 users connected to an industrial customer do not pay fees to fund demand reduction programs.
25 And Austin Energy’s current policy is not to charge high-load customers the Energy
26 Efficiency Services fee.

27 In the competitive market, it was lobbying efforts by the large industrial customers in recent
28 years that caused the PUC to discontinue the EES fee for industrial customers. Previously,
29 industrial customers did pay these fees. Austin, as a utility owned by the people of Austin,
30 does not have to follow PUC and legislative policy.

31 **Q. HOW DOES AUSTIN ENERGY PAY FOR DEMAND REDUCTION PROGRAMS,**
32 **INCLUDING FOR ENERGY EFFICIENCY AND ON-SITE SOLAR?**

33 A. The vast majority of Austin Energy’s budget for demand reduction programs, including
34 energy efficiency and demand response incentives and rebates, rebates and incentives for

customer-sited commercial and residential solar, administrative costs for these programs, and the Austin Energy Green Building program comes from revenues generated by the Energy Efficiency Service Fee, which is part of the Community Benefit Charge (CBC).

There can also be some state or federal funding or grants that assist in meeting the utility's demand reduction goals. In addition, approximately \$1 million per year out of the Customer Assistance Program (CAP), another component of the CBC, helps to fund the low-income weatherization program.

3. FAYETTE POWER PROJECT RETIREMENT

Q. WHAT IS YOUR POSITION ON THE RETIREMENT OF AUSTIN ENERGY'S PORTION OF THE FAYETTE POWER PROJECT AND CREATION OF A CASH RESERVE TO PAY OFF THE DEBT OWED ON AUSTIN ENERGY'S PORTION OF THE PLANT?

A. The Austin City Council has adopted the Austin Energy Resource, Generation and Climate Protection Plan to 2025, which requires the creation of a cash reserve to pay off the debt owed on Austin Energy's share of the Fayette Power Plant so that Austin Energy can retire its share of the plant by 2023. The appropriate venue for the creation of this reserve is the 2016 Rate Case, since Austin Energy's board of directors – the Austin City Council – has committed to ending Austin Energy's use of coal by 2023. Creating an account to collect the money over the next six years will allow the utility to pay off the remaining debts when they become callable in 2022.

Q. WHY SHOULD AUSTIN ENERGY RETIRE ITS PORTION OF THE FAYETTE POWER PROJECT IN 2023?

A. During the process and conversation of adopting the 2025 Generation Plan, it was revealed that one of the main obstacles to retiring our share of the Fayette Power Plant was the outstanding debt we owe on the plant. It was both Austin Energy and the City of Austin's legal division's opinion that seeking to retire our share of the power plant before the debt we owed became "callable" would be problematic and potentially open the utility up to legal issues (see Exhibit CR-2). The date that Austin Energy informed the community that the debt would become callable was October of 2022. Therefore, the solution was to continue to use and operate the coal plant until the debt became callable, at which point Austin Energy would pay off the debt and begin the retirement process.

Q. WHO ESTABLISHED THE POLICY TO RETIRE AUSTIN ENERGY'S PORTION OF THE FAYETTE POWER PROJECT AND END AUSTIN'S USE OF COAL BY 2023?

1 A. The Austin City Council, which serves as the board of directors for Austin Energy,
2 established this policy. On December 11th, 2014, City Council adopted the Austin Energy
3 Resource, Generation and Climate Protection Plan to 2025 (Exhibit CR-3), which includes a
4 commitment to retire Austin Energy's portion of the Fayette Power Project by 2023. It was
5 passed on a 6-1 vote. No subsequent decisions have been made that change this policy.

6 **Q. WHAT DOES THE AUSTIN ENERGY RESOURCE, GENERATION AND CLIMATE**
7 **PROTECTION PLAN TO 2025 SAY ABOUT THE PROCESS FOR RETIRING**
8 **AUSTIN ENERGY'S PORTION OF FAYETTE?**

9 A. The plan says two things. First, it stated: "The Plan adopts and acts immediately on:
10 Supporting creation of a cash reserve fund for Fayette Power Project retirement. Reserves
11 would be approved through the budgeting process and targeted to retire Austin's share of the
12 plant beginning in 2022. Retiring Austin's portion of Fayette is contingent upon cash
13 available to pay off debts and other costs associated with retirement while maintaining
14 affordability."

15 Second, in describing the coal retirement process, the Generation Plan states: "Austin Energy
16 will strive to retire its share of the Fayette Power Project as soon as legally, economically and
17 technologically possible. While Austin Energy should continue to talk with LCRA about
18 retiring Units 1 and 2 as soon as economically and technologically feasible, Austin Energy
19 will explore negotiation with LCRA for control of one unit to chart a path toward an early
20 retirement of Austin Energy's share of Fayette starting in 2022."

21 Thus, City Council had adopted a plan which requires a cash reserve account be set up to be
22 able to pay off the debt when it becomes callable.

23 **Q. DO PUBLIC CITIZEN AND SIERRA CLUB OFFER ANY OTHER EVIDENCE TO**
24 **SUPPORT THE STRATEGY OF CREATING A DEBT DEFEASEMENT RESERVE**
25 **ACCOUNT?**

26 A: Yes. First, we are relying upon the expertise of Paul Chernick, who has entered pre-filed
27 testimony in this case and will be our expert on the issue of a debt defeasement account to pay
28 off Austin Energy's debt associated with the Fayette Power Project. Second, Mr. Tom
29 Sanzillo of the Institute for Energy Economics and Financial Analysis, has provided a report
30 entitled *Paying Off Austin Energy's Coal Plant Debt: Careful Planning, and Setting A*
31 *Schedule Now Is the Best Course* as part of this rate case. We provide this as Exhibit CR-3
32 (attached).

33 **Q: HAVE YOU READ MR. SANZILLO'S REPORT?**

34 A. Yes.

1 **Q. DO YOU AGREE WITH IT?**

2 A. Yes.

3 **Q. IS THIS THE TYPE OF INFORMATION ON WHICH EXPERTS WOULD**
4 **REASONABLY RELY TO FORM AN OPINION ON THE SUBJECT?**

5 A. Yes.

6 **Q. HAS THIS REPORT HELPED INFORM YOUR OPINION?**

7 A. Yes.

8 **Q. WHAT DOES MR. SANZILLO'S REPORT ILLUSTRATE?**

9 A. It gives examples of other utilities that have used financial mechanisms to pay off debt in
10 order to retire plants that were no longer used and useful in a timely manner, while
11 maintaining excellent financial credit ratings. It also illustrates that tying the end of the plant
12 life to paying off the debt is a reasonable approach that will help mitigate financial and
13 environmental risk related to the plant. Mr. Sanzillo also points out that creating a stable
14 payment plan – such as a schedule to set aside cash reserves – would be a prudent policy that
15 would not affect the credit-worthiness of the utility.

Cyrus Reed

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Education

Bachelor of Arts in Comparative Literature & Certificate in Latin American Studies *June 1987*

Princeton University

Master's of Arts in Latin American Studies

May 1994

University of Texas at Austin

Master's of Science in Community and Regional Planning

May 1994

University of Texas at Austin

PhD in Geography

May 2007

University of Texas at Austin

EMPLOYMENT HISTORY

The Tico Times, San José, Costa Rica, 1988-1990

Staff Reporter for English-language newspaper in Costa Rica. Covered national and international issues for The Tico Times related to tourism, politics, agriculture, natural resources, etc.

Research Associate, Program Manager and Director, The Texas Center for Policy Studies, Austin, Texas, 1994-2005

Held a variety of positions with the Texas Center for Policy Studies, with a focus on environmental policy issues in Texas related to land use, energy and water and the US-Mexico border region.

Contract Lobbyist, The Sierra Club, Lone Star Chapter, Austin, Texas, 2005-2007

Contract lobbyist for the Lone Star Chapter of the Sierra Club on clean air and clean energy, including energy efficiency, renewable power, ozone mitigation programs and other issues during the 2005 and 2007 Texas legislative sessions.

Conservation Director, The Sierra Club, Lone Star Chapter, Austin, Texas 2007-present

Manage and direct programs and campaigns related to energy, air and water issues in Texas for Lone Star Chapter of the Sierra Club. Also chief lobbyist for Sierra Club at Texas Legislature, serve on advisory committees at Texas Commission on Environmental Quality, and am a member of ERCOT's Reliability and Operations Subcommittee. Member of 2009 and 2014 Austin Energy Generation Resource Planning Task Force, and current Vice-Chair of the Resource Management Commission for the City of Austin.

Awards & Recognitions

- 2014 Clean Air Through Energy Efficiency Conference Outstanding Non-Profit Organization
 - 2015 Orrin Bonney Award Environmental Awards, Lone Star Chapter Sierra Club
-

Memberships & Affiliations

Boy Scouts of America

Girl Scouts of America

NASA Soccer Coach



LAW DEPARTMENT MEMORANDUM

TO: Mayor and Council

FROM: Andy Perny, Assistant City Attorney, Division Chief – Austin Energy

DATE: 12/31/13

SUBJECT: Divestment or Retirement of Fayette Power Plant

Mayor and Council:

In response to Resolution No. 20130627-066, this memo discusses the more significant legal issues concerning the elimination of the Fayette Power Plant coal-fired generating capacity from the City's generation portfolio, whether by divestment or retirement. The legal concerns discussed relate to the City's participation agreement with LCRA, ERCOT protocols, the City Charter, and outstanding bonds. Other issues such as potential environmental liabilities, which exist regardless, are not included.

THE PARTICIPATION AGREEMENT

The City's rights and obligations with respect to FPP are defined by the 1974 Participation Agreement between the City and the LCRA. Significant amendments to the 1974 agreement were made in 1980 and 1984, and several other minor letter amendments have also been made. Potential legal barriers to a sale, retirement or ramp-down of the City's share of FPP arise from (1) LCRA's right of first refusal regarding any sale to a third party, (2) obligations to maintain a minimum output of the City's share of the FPP facilities and to pay a fixed percentage of O&M regardless of the City's utilization of plant output, and (3) the prohibition against partition of the FPP facilities.

LCRA's Right of First Refusal

Article 23 of the 1974 Participation Agreement grants a right of first refusal to each party

with respect to any written contract entered into by the other party to sell its ownership interest in FPP (other than creation of a security interest or a merger or acquisition of a party's electric utility business). The provisions are mutual, but for purposes of this discussion it is assumed the City is the prospective seller. The right of first refusal provision contains several conditions that could be detrimental to any prospective sale transaction.

First, Section 23.2 would require the City to give the LCRA written notice of the proposed purchase price, terms, conditions and closing date for the proposed sale *seven months* in advance of the scheduled closing date. In other words, the City would need to negotiate a bona fide purchase offer with a closing date more than seven months after the execution of the contract, with notice to the potential buyer that LCRA has a right of first refusal, which if exercised, would result in the termination of the purchase contract. Upon delivery of the purchase offer to LCRA, pursuant to Section 23.3, LCRA would have *three* months to evaluate and determine whether to exercise its right of first refusal and match the offer. If LCRA chooses to purchase the City's interest, the sale to LCRA must be consummated within the seven month notice period provided for in Section 23.2. If LCRA fails to act within three months, it would be deemed to have waived its purchase option.

Should LCRA determine to pass on its purchase opportunity or not act within the three month period, the City and the third-party purchaser are required to close on the transaction within the initial seven month notice period in accordance with the terms and conditions of the contract presented to LCRA in the notice. Failure to do so results in the right-of-first-refusal clock resetting, and the City would be required to give LCRA a completely new seven month notice of intent to sell, with LCRA again having three months to re-evaluate whether to exercise its right of first refusal.

LCRA's right of first refusal presents two transactional obstacles to the City's successful solicitation and closing on a prospective sale of the City's ownership interest in FPP. First, the right of first refusal may discourage prospective buyers from investing the considerable time and resources required to perform the due diligence necessary to formulate a bona fide offer if they face the prospect of that offer simply being matched by LCRA, or it may cause prospective buyers to require a material break-up fee if LCRA exercises its right. Second, the seven month closing date and three month evaluation period granted to LCRA may chill offers altogether and reduce the possibility of receiving a fixed price offer because of the risk of changing energy and financial market conditions and environmental regulations that may occur during the waiting period.

Discontinuing or Ramping-Down use of City's Generating Capacity in FPP

The City Council resolution concerning FPP planning also requests an inquiry as to whether discontinuing or substantially ramping-down the use of the City's share of the energy and power output of FPP would be a feasible alternative. The short answer to this question is the City cannot unilaterally retire any part of the FPP facility, though it can potentially reduce usage of energy and power from its share of FPP, subject to certain minimum generation scheduling obligations. In either event, the City would have to continue to pay the costs of operating and maintaining FPP regardless

of the amount of usage of FPP by the City.

Because LCRA is both co-owner and project manager of FPP, and the City does not own an undivided share in any particular generator, the City does not have a contractual right to cause the shutdown of any part of FPP. Further, Section 7.3 of the 1974 Participation Agreement requires that each party schedule its Minimum Net Generation share, so that each unit runs at no less than the amount necessary for reliable operation. To the extent LCRA schedules less than its full share of the output of Units 1 and 2, the City could at any time be called upon to schedule whatever output amount LCRA deems necessary for the City to fulfill its Minimum Net Generation obligation.

Even if the City were able to reach an agreement with LCRA to exempt the City from the requirement to schedule Minimum Net Generation Share and in effect retire either Unit 1 or 2, there still remains the issue of operation and maintenance (O&M) costs for FPP. O&M costs are allocated to each party based upon generation entitlement share or percentage of nameplate capacity owned, and not on actual usage. Regardless of whether the City opts to dispatch its share of FPP, O&M costs will be allocated based upon a fixed ownership share. The City would remain liable for 50% of costs directly attributable to Units 1 and 2 and 33% of those costs attributable to FPP as a whole. Shutting down the City's share of FPP would result in significant on-going O&M costs with no offsetting revenue from power and energy sales.

An additional concern to be considered under a zero or reduced use scenario, is the argument that FPP would no longer be considered "used and useful" in the City's generation fleet or would have a significantly reduced "used and useful" allocation. This could cause a third party to argue that the City should not recover the O&M costs for FPP, or recover reduced O&M costs for FPP from ratepayers, which if sustained could shift the burden for payment of some or all of FPP O&M onto the City's general fund.

Re-structuring FPP Generation Unit Ownership Interests

Article 21 of the FPP 1974 Participation Agreement provides that each party waived its rights to partition any component of the Project. Accordingly, the City could not unilaterally seek to re-structure its undivided and split ownership interests in the FPP Generation Units. It would need the consent of LCRA to effectuate any such restructuring of its undivided interests in two generating units to a divided interest in one generation unit. LCRA may not have any incentive to agree to such restructuring absent exchange of other additional consideration from the City.

ERCOT REQUIREMENTS

Assuming the City is able to negotiate with LCRA to split FPP into two generation resources, those separated resources would have to obtain ERCOT approval to be registered separately. Assuming such approval were obtained, the City would then need to request approval from ERCOT to shut down the unit owned by the City. Procedurally, the City would need to notify ERCOT ninety

calendar days prior to the date it intends to cease operation of the resource.¹ The notification must include a City officer's attestation under oath that the resource is uneconomic to remain in service as currently designated.² There does not appear to be a mechanism to request a cessation of operation based solely on an owner's environmental protection determination. ERCOT would then study whether the resource needs to continue to generate to ensure reliable electric delivery throughout the ERCOT system grid. If ERCOT determines the resource is not necessary, it will give the City permission to shut it down. If ERCOT determines the resource is necessary, it will negotiate with the City to keep the facility running for a temporary period during which ERCOT pursues other ways to maintain reliability.

An agreement (a reliability-must-run (RMR) agreement) would state the terms on which the resource would continue to operate, and would normally have a term of between one month and one year. The City is not required to sign a RMR agreement, and may instead pursue an order from the PUC regarding whether the facility is necessary for reliability.³ If the City does enter an RMR agreement with ERCOT, within ninety days thereafter ERCOT must report to its board outlining an exit strategy from the RMR agreement, which strategy may include transmission upgrades, voltage control devices and the acquisition of interruptible load.⁴ ERCOT would reevaluate the necessity of any RMR generation annually.⁵ The RMR agreement, which covers the generator's cost of operating the facility and includes an incentive payment equal to 10% of non-fuel costs, is not intended to be a permanent solution to grid reliability issues.⁶ ERCOT's protocols call for it to minimize the use of RMR generation as much as practicable.⁷

THE CITY CHARTER

Article II, Section 7(b) of the Charter provides that:

... the council shall have no power to, and shall not: ... (b) Sell, convey, or lease all or any substantial part of the facilities of any municipally owned public utility, provided that the council may lease all or a substantial part of such facilities to any public agency of the State of Texas if the qualified voters of the city authorize such lease by adopting in a general or special election a proposition submitting the question and setting forth the terms and conditions under which such lease is to be

¹ PUCT Substantive Rule 25.502(e).

² ERCOT Nodal Protocols § 3.14.1.1(2).

³ *Id.* at § 3.14.1(1)(g); PUCT Rule 25.502(e)(1)..

⁴ *Id.* at § 3.14.1.4.

⁵ *Id.*

⁶ *See id.* at §§ 3.14.1.10, 3.14.1.13.

⁷ *Id.* at § 3.14.1(1)(c). ERCOT has encountered some resistance to the use of RMR agreements based on the premium paid to RMR owners for their continued operation. See Elizabeth Souder, *ERCOT might require, and pay, EFH to run coal plants slated to idle for the winter*, DALLAS MORNING NEWS, Sept. 26, 2012, available at: <http://www.dallasnews.com/business/energy/20120926-ercot-might-require-and-pay-efh-to-run-coal-plants-slated-to-idle-for-the-winter.ece>.

made.

This Charter provision is a flat prohibition against the sale of “all or any substantial part” of Austin Energy (or AWU). The difficulty is that the Charter does not define what is meant by the term “substantial part.” This creates a question of interpretation as to whether the City’s ownership interest in FPP would be considered a substantial part or not. Based upon dictionary references as well as the use of the word in other legal contexts it could mean “significant” or “material,” in which case someone could argue that it should be interpreted to prohibit the sale of the City’s FPP interest. The term could also mean, however, “almost all” or to a degree that would effectively result in a complete divestiture of the utility, which is also a common usage in other legal contexts. In the latter case, Section 7(b) would likely not be construed to prohibit the sale of FPP.

Legislative history is often used in interpreting legislative language. Section 7(b) appeared in its current form in the overhaul of the Charter that occurred in 1953. However, the restriction of the disposition of utility assets goes back much further. The first appearance of the restriction was in the Charter granted by the Legislature in 1899 (Charters were not adopted by vote until 1912). Article I, §1 of the 1899 Charter read that:

...the City shall not have power to dispose of any part of the water and light system of the City of Austin; the dam across the Colorado River, owned by the City, or any property now owned or used, or which may hereafter be owned or used as a part of said system, and which may be necessary or incident to the operation thereof.

This version stood in effect until 1938, when an election was held to modify the provision to allow the City to lease Tom Miller Dam to LCRA. The modified version read as follows:

...the City shall not have power to sell any part of the water and light system of the City of Austin, the dam across the Colorado River owned by the City, or any property now owned or used or which may hereafter be owned or used as part of said system, and which may be necessary or incident to the operation thereof; but the City Council shall have power on behalf of the City to lease to any public agency of the State of Texas, for such period and upon such terms and conditions, and subject to such provisions, including provisions as to improvement by the lessee of the property so leased and as to purchase by the City of improvements so erected, as the City Council may approve, all or any part of such electric light system, including such dam and the reservoir formed thereby and any other property desirable in the operation of the property so leased, provided, however, that the City shall not have power to lease the present steam generating plant of the City and any additions, the present electric distribution system for the distribution of electric current in the City of Austin, and any extensions thereof, and any transmission lines connecting said generating plant and said distribution system and the City shall not have power to lease its water purification plant and distribution system.

Both the 1899 and 1938 versions contained a clear prohibition of the sale of utility assets if they were “necessary or incident to the operation” of the utility. “Incident to” means simply that the asset is involved in operating the utility, so this is a fairly straight forward and broad prohibition. Further, the 1938 version expressly exempts “the existing steam generating plant” from the grant of leasing authorization, implying that the then-existing plant was considered to fall within the initial proscription of the council’s powers to sell utility assets. Unfortunately, the legislative history does not provide a dispositive interpretation for the current Charter language.

Accordingly, neither dictionary references nor the historical record can give full clarity to the meaning of “substantial” as used in the Charter. Case law can also be informative as to particular uses of language. At least one case provided that the term “substantial” was a relative term susceptible to different meanings according to the circumstances of its use, and that it must be examined in relation to its context and its meaning gauged by circumstances surrounding the matter in reference.⁸ In the case of *Prudholm v. State*,⁹ the Court stated that:

In common usage, “substantial” means “to a large extent”... Together with comparative words like “similar,” “majority,” or “probability,” the combination with “substantial” or “substantially” means something significantly greater than the modified word, whereas with absolute words like “complete,” “certain,” or “all,” the combination with “substantially” means something only slightly less than the modified word.

The *Prudholm* decision could lend support to the notion that “substantial,” as used in the Charter, means “only slightly less than the modified word.” In the Charter, the word “substantial,” while not directly paired with the word “all,” appears in the same clause. In fact, if the word were to mean only “material,” it would be redundant to say “all” at the outset. The provision could simply read that the Council has no power to sell any material or significant part of the utility without reference to the entirety. On the other hand, if the intent of the provision is to prevent sale of the entire utility, it is reasonable to put in a qualifier like “or any substantial part” to prevent a sale that is less than the whole but nonetheless effectively amounts to a complete divestiture.

The Charter could be interpreted to mean “all or substantially all” rather than “all or any substantial part.” Prior charter versions do clearly prohibit the sale of a generation plant. The question remains whether the 1953 revision to the sale prohibition was meant to be a substantive rewrite rather than a recodification or clarification. At least with respect to the lease provision, the 1953 enactment was a substantive revision. It could be argued that moving from a “necessary or incident to” standard to an “all or any substantial part” standard was substantive as well. The 1938 language was certainly clearer.

⁸ *Lone Star Gas Co. v. Howard Corp.*, 556 S.W.2d 372 (Tex.App. - Texarkana, 1977)

⁹ 333 S.W.3d 590 (Tex.Crim.App. 2011)

The purpose of the above exercise is not to resolve what the Charter means in the context of a sale of the City's ownership interest in FPP, but to illustrate the inherent uncertainty surrounding the meaning of "substantial" when contemplating a sale of the City's FPP interest. Buyers want reasonable certainty when considering an investment of the magnitude of a purchase of the City's interest in FPP, particularly certainty that the City has the legal authority to sell its FPP interest. This kind of uncertainty may easily chill many potential buyers from considering a bid due to the risk that a court could either intervene to restrain a closing, or the worse risk that a court would undo the transaction after closing. Other potential buyers would certainly weigh the potential risk and impose a significant price reduction to compensate for assuming that risk.

Even if a buyer could be found that would make an acceptable offer to the City, such an offer may also leave open the door to a court challenge by parties interested in seeing that the City not sell off the project. Such potential challengers could include customers who view coal as a source of cheap energy, as well as environmental groups who want to see FPP shut down and recognize that a sale will likely result in the continued operation of FPP.

BOND ISSUES

The City currently has approximately \$175 million of non-taxable debt outstanding and attributable to FPP, mainly due to the recent scrubber project. The majority of the debt was issued in the form of revenue bonds, while some is attributable to federally-subsidized Build America Bonds issued pursuant to the American Recovery and Reinvestment Act. All of these bonds are subject to IRS regulations concerning private use of the financed assets.

Private-use restrictions would likely trigger the need to defease the entirety of the debt issuances that were associated with FPP in the event FPP were sold to a non-governmental entity. These restrictions could also cause the forfeiture of \$30.6 million in federal subsidies attributable to the Build America Bonds.

Retiring the City's share of FPP could impact Austin Energy's rates and may also create a need to defease debt. Under the Public Utility Regulatory Act¹⁰, a utility may include invested capital in its rate base that is used and useful for the provision of electric service. In contrast, a plant that is no longer used and useful may be removed from rates and the utility not allowed recovery of its investment. Under the scenario in which the City were to shut down FPP during the 2015-2018 timeframe, the City would still be liable for the debt associated with the asset.

One potential alternative that would allow the City to meet those debt obligations and *possibly* obtain cost recovery would be a situation where the City defeases itself from the bonds underlying the debt. Under this scenario, the City would draw upon reserve funding equivalent to its outstanding debt. These funds would be provided to a trustee who would establish an escrow which

¹⁰ PURA does not directly govern the City's retail electric rates, but which could be applied by the Public Utility Commission of Texas in the event of an appeal by outside ratepayers.

would fund payments on the bonds. Because the bonds are not callable, it would be necessary for them to be paid over their existing lives. Rates would then be adjusted to allow AE to replenish its reserves over an optimal period. This is a simplified and preliminary description of the scenario.

There are many other factors that should be considered before proceeding. Notably, more research and analysis, including the impact of the tax-exempt status of the outstanding bonds, would need to be completed before determining whether this option is legally viable.



May 27, 2016

MEMORANDUM:

Paying Off Austin Energy's Coal Plant Debt: The Best Course is to Plan Carefully and Set A Schedule Now

Submitted by Tom Sanzillo, Director of Finance, Institute for Energy Economics and Financial Analysis, on behalf of Sierra Club and Public Citizen

Background

The Austin City Council has adopted an Austin Energy Resource, Generation and Climate Protection Plan to 2025. The plan updates an earlier 2020 plan and represents the culmination of a series of planning initiatives and City Council actions over the last several years. The plan dedicates AE to a program that emphasizes four central energy values: 1) Clean; 2) Affordable, 3) Reliable and 4) Excellent Service.¹

A key component of the plan is closure of the Fayette coal plant by 2022. The plan, quoted below, sets out a timeline for closing Austin Energy's portion of the plant, identifies alternative energy sources, and adopts policies to enhance Austin's economic growth potential. To achieve these objectives, attention must be paid to both the development of alternative sources of energy and the management of existing debt on the plant.

The Fayette Power Project provides roughly 25 percent of Austin Energy's current energy routinely at costs below market prices which produce revenues that reduce customer bills. Reducing and ending Austin Energy's use of coal is contingent on paying off the debt associated with environmental investments that Austin Energy has made in the plant. The 2025 Generation Plan continues to establish a ramp down in production in 2020 to achieve established carbon goals, and anticipates the retirement process in 2022, if funds are available. The recommended Plan will require the establishment of a cash reserve retirement account in advance of the retirement to be funded with available cash as part of the annual budgeting process.

¹ <http://austinenergy.com/wps/wcm/connect/461827d4-e46e-4ba8-acf5-e8b0716261de/aeResourceGenerationClimateProtectionPlan2025.pdf?MOD=AJPERES>

As part of this rate setting review,² the issue of how to operationalize this aspect of the energy plan is now before Austin Energy, the City Council and the public. Developing a carefully crafted cash defeasance strategy for Austin Energy's portion of the Fayette Power Project debt is integral to the successful management of this component of the Plan.

Coal plant retirement is a nationwide phenomenon,³ with over 200 plants being retired around the U.S. Over the course of most of the last decade, regulated utilities, merchant generators and public power authorities and cooperatives have had to wrestle with the effects of an aging coal fleet, new environmental regulations, competition from alternative fuels, and a shift in public opinion away from coal-fired power. How to manage the financial, environmental and policy issues of coal plant retirements is a front burner issue.⁴ Communities and companies are forging strategies to meet the environmental, legal, financial and political challenges posed by the broader energy transition implied by the move away from coal.

The Financial Environment

Austin Energy is a financially well-positioned provider of electricity and services.⁵ The median income of Austin is 45% higher than the national average⁶. Revenues are strong, debt levels manageable and overall net margins positive. The cost structure of Austin Energy is stable.⁷ AE's rates are stable⁸ and competitive.⁹ Austin Energy's utility bonds are rated AA by Standard and Poor's.

² http://austinenergy.com/wps/portal/ae/rates/2016-rate-review/2016-rate-review/!ut/p/a1/jdBdS8MwFABg37KLxY5ST-M3sVY2k5rN5hbzY1EydrA1pQsruCvt5sgKBtb7g48L-fkRQLVSHRyrvxptOnk5jCL5A3ncYTvAU8hySjgeTrjcTknNI5G8DoCIJtKHEhRpdUDFMtqyapHDhkPr8yfeQwu5adXLCC25GWDRc9d6-tubVBNACe-IU75Vu21Gg6Mde8hHZlVa2WVDT7t-P_WuX5354EHwzAEjTHNRgUfZuvBqUhrdg7VfyValXE88rek7DIMgdFFUQHMMCxu_oMTLf6A8zX125f660mtqLstNjTmvgFOfMBE/dl5/d5/L2dBISEvZ0FBIS9nQSEh/

³ "According to Sierra Club's Beyond Coal Campaign, 233 coal units have retired or announced they plan to retire throughout the United States, representing more than 100,000 MWs. Information from <http://content.sierraclub.org/coal/victories>, May 27th, 2016.

⁴ <https://www.eia.gov/todayinenergy/detail.cfm?id=25272>

⁵ <http://austinenergy.com/wps/wcm/connect/72ed7af3-f2cc-43d4-97f0-d8041323612a/2014AustinEnergyAnnualReport.pdf?MOD=AJPERES>

⁶ <http://www.electricitylocal.com/states/texas/austin/>

⁷ <http://austinenergy.com/wps/wcm/connect/29f18bbd-b1f0-4a88-8fd0-1679564c034f/2014AnnualPerformanceReport.pdf.pdf?MOD=AJPERES>

⁸ http://austinenergy.com/wps/portal/ae/about/reports-and-data-library/data-library/energy-use-and-sales/!ut/p/a1/jZFNU8lwEIZ_C4ccS5bgR8dbiU6pgNVhLLUXZyvpX0xlOkmKg7_eVi6louxMDrt5n303G5rRIGYKt3WJrtYKZZ9nV6_AfDblwKLwmvkQhHwyu0weRo_LUSd4ORTed_EtREmcBPGMQ8jHZ_InIoD_-PsZDJhZ8EVJswZd5dWqQDRdo0NP1rBs6OpUMKUO6-1wkO19ixKYXswUPnY70AjCmGEGbam20jIXHNDgAC21tVqzw7f9IbAe2MJNN04IN216E6uW0fAiL5ov5ofOhP4PsdPx0pbR9NjJ7qi2V_vfoKLY8EvH7MXnN58s3IOP-ZTuZ0Xy6gcDD4BQikQ8g!/dl5/d5/L2dBISEvZ0FBIS9nQSEh/

⁹ <http://www.electricitylocal.com/states/texas/austin/>

Options

Austin Energy's Board of Directors have made a decision to set aside the cash needed to retire the debt on the Fayette Power Project when it is retired. They have targeted a date that corresponds roughly to when the debt becomes callable. The adoption of a cash defeasance plan is perhaps the most prudent method available and reflects on the City's positive growth environment and attention to its credit rating. Other methods such as refinancing the debt or a combined cash and debt scenario or asset sale have proved unattractive for various financial and policy reasons. Linking the debt retirement to the operational life of the plant will eliminate any future revenue drain on the system once the plant is closed, and Austin Energy and City Council would be wise to begin this process as soon as possible. In addition, putting the debt on future ratepayers when the plant is no longer used and useful could cause legal or rate challenges.

Austin's cash reserve plan must build funds sufficient to retire all debt obligations on the plant by the end of 2022, the planned retirement date. Upon the completion of this aspect of the energy plan, the Fayette Power Project's indebtedness will no longer be either a direct or indirect charge on Austin's balance sheet. Any cash reserve build up needs to be monitored regularly for the duration of the accrual period in order to ensure targets are being met. Once the plan is announced, Austin needs to adhere to its benchmarks in order to meet the 2022 goal.

There are a number of rate and accounting options that Austin can use to help meet the cash defeasance objective. Which of these the Austin City Council decides to use will relate to their level of comfort with these mechanisms.

A number of cities, authorities, utilities and state public service commissions have developed ways to retire existing assets that are carrying ongoing debt burdens. Two examples that illustrate some of the types of accounting and rate actions that Austin could use are illustrated below, although these options are not meant to be a comprehensive list.

1. Long Island Power Authority (LIPA) - Retirement of Shoreham Plant and Evolution of Large Debt Burden

LIPA serves Nassau and Suffolk counties in New York State. Nassau County, just east of New York City, is the 13th most affluent county in the United States. During the 1960's, the Long Island Lighting Company (LILCO), a publicly traded corporation, launched a plan to develop the Shoreham Nuclear Power plant. By the time the plant completed construction in the 1980's, public opposition prevented it from opening.¹⁰ In 1998, LIPA merged with LILCO and floated a 30 year, \$6.73 billion bond to pay the debt on the plant, which had become a non-revenue producing asset.¹¹

¹⁰ <http://www.osc.state.ny.us/audits/audits/9596/95d38.pdf>

¹¹ <http://www.lipower.org/pdfs/company/investor/1998A.pdf>

LIPA's objective was to manage the debt over time. The Board of LIPA was specifically interested in accelerating the retirement of the debt, and planned to use cash flow from its operations to accomplish this task. By reducing the principal more rapidly than the bonds had originally called for, LIPA could save on interest payments (which ultimately would have to be covered by ratepayers) in both the short and long term. Under the 1998 bond issuance, the initial flow of funds to pay back the bonds and accelerate debt reduction was carried out under LILCO's rate design. It also relied upon a number of credits and adjustments to LIPA and its rate payers. Funds to pay debt service and reduce the debt were collected by LIPA through the monthly billings and then allocated internally to various fund accounts.

By 2013 LIPA had reduced the original LILCO debt. However, LIPA had needed to borrow additional amounts over the years and its aggregate debt level had actually increased to \$7.58 billion.¹² Electricity rates at LIPA remained among the highest in the nation. LIPA then agreed to hire a consultant to forge a strategy to improve the management of its debt among other issues.¹³ LIPA and the legislature of the State of New York adopted a restructuring law that allowed LIPA to turn over \$2 billion in remaining debt to the Utility Debt Securitization Authority (UDSA), a special purpose vehicle.¹⁴

The UDSA was able to float a bond and then impose a Restructuring Charge on the LIPA consumers --- a surcharge that would underwrite the debt and secure an attractive credit rating. The surcharge was an effective lien on the revenues of LIPA and it was subject to a True-Up Adjustment. The True-Up Adjustment created a set of safeguards to ensure that LIPA was meeting its internal obligations to maintain rates at levels that would provide for timely and full payment of debt service.

When Moody's rated the bond issuance (AAA) it identified the following as the strengths of the deal: the commitment made by the New York State Legislature, LIPA's various commitments to insure timely and full payment, the True Up monitoring mechanism and the strong, diversified economy in Nassau and Suffolk County. Standard and Poor's offered a AAA¹⁵ rating based on a similar analysis.

- **Implications for Austin**

LIPA's debt challenge was far greater than Austin Energy's. Two important substantive considerations and a series of technical lessons from LIPA's experience can be applied to AE's cash defeasance strategy.

Substantively, the City of Austin and its surrounding area, like Nassau and Suffolk County, has a strong, diversified economy. A growing economy translates into a customer base that is

¹² https://www.osc.state.ny.us/reports/pubauth/lipa_by_the_numbers_7_2015.pdf

¹³ <http://www.wnyc.org/story/272337-long-islands-power-problems-mean-big-paydays-wall-street-firms-sandy/>

¹⁴ <http://www.lipower.org/UDSA/docs/OfficialStatement2013T&TE.pdf>, See page 2 of the Official Statement for a more detailed discussion of the new surcharge and safeguards used to insure the proper segmenting and accounting of revenue.

¹⁵ <http://commodity-market-news.com/sp-asgns-utility-dbt-scrztzn-auth-ser-2016a-bnds-prelim-rtgs.html>

capable of managing the sometimes complex transactions required during a period of change and innovation. In addition, like LIPA's decision to retire its nuclear plant, Austin Energy is retiring the coal plant as a policy decision. The Austin City Council is seeking to achieve a number of goals under its new energy strategy. One of those goals is an improvement in Austin Energy's long term environmental risk.

The lessons learned from LIPA that may be applicable to Austin are several-fold:

- Although LIPA's debt burden was significant, the Authority did not initially alter its existing rate design. It managed for over a decade with basically the same rate design it received from LILCO. LIPA, like Austin Energy, has control over its rate design and setting.
- Once the decision to shutter the plant was made, a clear plan for payment of obligations was necessary, including benchmarks, monitoring and strong guarantees from the governmental bodies involved and board of the authority. LIPA's recent actions allowed it to achieve a AAA rating. A plan to develop a cash defeasance mechanism within Austin Energy's operations should not lower or raise its bond rating. The actions are more credit-neutral as the debt repayment is already secured under existing bond and agreement, and AE's actions simply change the method of payment. If Austin Energy were to adopt the policy to retire the plant with no identified replacement energy and no method of payment for the debt balance upon plant retirement, then the City could run the risk of a credit negative opinion.
- LIPA's story also offers a cautionary note. The Authority's original plan was to accelerate the retirement of Shoreham's debt. It achieved some of that goal, but new needs surfaced and maintained upward pressure on rates. Austin is in a much better position than LIPA to achieve its financial objectives. Austin Energy maintains a AA- rating¹⁶ in large measure due to its well-managed debt portfolio. LIPA has an A- rating because it is heavily leveraged.¹⁷ LIPA's history has also been controversial and scandal-plagued.¹⁸

2. PacificCorp Carbon Plant

PacificCorp is a regulated utility in the Northwest United States with generation capacity and retail customers. Like many utilities, it is confronting the long-term legacy debt from investment in coal plants. In 2012 the company moved forward with plans to retire its Carbon County, Utah plant, because it had concluded that retrofits were uneconomic.¹⁹ The company also appealed to the Oregon PUC for approval to expense the remaining depreciation of the plant

¹⁶ http://www.bondsonline.com/Todays_Market/Credit_Rating_News_.php?DA=view&RID=41519

¹⁷ <http://www.lipower.org/pdfs/company/investor/S&P%2011-2015%20Rating.pdf>

¹⁸ <http://www.crainsnewyork.com/article/20121118/POLITICS/311189979/the-governors-scandal-strategy>

¹⁹ <http://snakeriveralliance.org/wp-content/uploads/2013/10/Putting-Down-a-Coal-Plant-Retiring-a-Utility-Asset.pdf>

provides background policy context to the PUC decision and implications.

(\$55 million) into its rates. The Commission approved the request and the plant closing moved forward²⁰ as part of a much larger rate revision.

Regulated utilities often do not organize their finances according to strict uniform property accounting standards. Debt is usually managed at the corporate level. That was true in this case, where the actions regarding the Carbon County plant were part of a much broader set of rate revision decisions.

- **Implications for Austin**

The Austin City Council plays the role of utility regulator for Austin Energy. In the Carbon County case, the utility regulator acknowledged the need for cost recovery when a coal plant was being retired so that the utility could manage its financial exposure. This regulatory acknowledgement accepts the good faith investment made by the utility over time in the coal plant and the need to retire the plant based on a new set of calculations driven by a decision point to upgrade²¹ or retire the plant.

Conclusion

Austin City Council's adoption of a cash defeasance plan represents the most prudent financial strategy available for Austin Energy. By linking the retirement of the plant as an energy resource to debt retirement, Austin Energy and the Austin City Council remove a number of potential financial risks. Austin is also managing its environmental risk by eliminating the Fayette Power Plant. The key going forward is careful design, management and monitoring of the cash set-aside. Creating the debt defeasement account, Identifying cash benchmarks, and creating a stable schedule are all needs which must be met to maintain investor confidence in an otherwise solid plan.

²⁰ <https://apps.puc.state.or.us/orders/2012ords/12-493.pdf>

²¹ <http://archive.slttrib.com/story.php?ref=/slttrib/news/56919729-78/coal-power-carbon-plant.html.csp>