

**CLECO POWER LLC
2004 RFP FOR GENERATING CAPACITY RESOURCES**

STAFF COMMENTS

AUGUST 30, 2004

A. Background

Cleco Power LLC (CP) is issuing a Request for Proposals (RFP) to acquire potentially up to about 800 MW of long-term capacity resources pursuant to the Louisiana Public Service Commission's (LPSC) Market Based Mechanisms (MBM) General Order. Subject to certain limited exceptions, this General Order requires that all acquisitions of long-term generating capacity by jurisdictional utilities be subject to a "market test," in the form of an RFP. If affiliates are permitted to bid (or self-build/self-supply resources are to be considered), an Independent Monitor must be retained to ensure an absence of bias in the design of the RFP, bid evaluations and all aspects of utility conduct of its RFP. Staff's role is to provide coordination and oversight of the process, as well as to provide consultation on both technical and policy issues.

The 2004 RFP follows an unsuccessful RFP effort in 2003 that eventually was cancelled due to a range of capacity offers that CP judged to be unsatisfactory. As a result, CP instead has opted for a 500 MW one-year contract (for calendar 2005) with a Calpine Corporation subsidiary. Approval of that one-year contract is presently pending before the LPSC. The 2004 RFP effort seeks products similar to last year's RFP but places much greater emphasis on obtaining "up front" information on transmission deliverability for resources not connected to the Cleco grid, provides an expanded (and better researched) set of self-build options and more

heavily weights the need for base load resources. Staff previously expressed concern over CP's energy cost volatility and gas dependency if more "stable fuel" capacity is not acquired, and we therefore agree with CP's attention to this concern.

Since the early part of this year, Staff has worked very closely both with CP and its Independent Monitor (IM) in the design and presentation of its RFP. Staff and the IM also jointly agreed upon an IM scope of work which was posted for stakeholder review on the LPSC website. Staff has made literally dozens of suggestions to clarify and improve the RFP, most of which have been adopted by the Company or otherwise resolved. For this reason, our Comments do not take issue or express disagreement with the RFP package. Rather, the primary purpose of our comments is to identify information gaps, risks in the process and potential pitfalls as the process goes forward.

After extensive discussion with the LPSC Staff and the IM, CP issued its draft RFP on April 15, 2004 for review by potential bidders and other interested parties. Staff invited questions and comments and conducted a Technical Conference at the LPSC offices in Baton Rouge on May 13. CP provided an overview presentation of its planned RFP (including its underlying Integrated Resource Plan) and a "post mortem" on the unsuccessful 2003 RFP. Staff and interested parties asked a number of questions (later submitted in writing) and offered some comments. Staff also requested that interested parties, at their option, submit written comments in order to facilitate a collaborative process.

It quickly became apparent that a contentious issues for some potential bidders was the requirement to submit requests for transmission studies to the local transmission provider (in most cases Entergy) by May 27, 2004. In response to bidder objections (as well as our own concerns), Staff and the IM sought additional time for the transmission study requests. The study request date was extended to June 11, with an expected date for finalizing the RFP of June 28. After the mid May technical conference, Staff submitted questions to CP (written and oral) on a number of issues but particularly to obtain clarification on the evaluation methodology and self- build costs. The former lacked clarity, and the latter was seriously incomplete. By mid to late June, Staff and the IM concluded that insufficient progress had been made by that time to permit the issuance of the final RFP. Given the circumstances at the time, CP, Staff and the IM mutually agreed to an extension of approximately two months to complete work on those areas of the RFP. Along within that extension, the deadline for submitted transmission study requests was changed to August 2, 2004. During this delay period, CP has answered Staff and potential bidder questions that previously had not been answered (or inadequately answered), greatly clarified its evaluation methodology, made progress on self-build costs and improved the draft RFP. The delay period also has extended the period for bidder comments (though none has been received) and questions. In fact, questions may be submitted in writing through October 22, 2004.

B. Bidder Comments

To date, Staff has received only very limited comments on the draft RFP and CP's description of that process and none since the RFP delay was announced at the end of June. The

vast majority of the comments dealt with transmission issues and the logistics of transmission studies. The commenters include:

- Plum Point Energy Associates, LLC (2 sets)
- Caterpillar Power Generation Systems
- Peabody Energy
- Sempra Energy Resources
- Mr. Gad Cohen (by email)

(1) **Plum Point**

Plum Point submitted the most extensive comments stating that (a) CP discriminates against bidders outside of its control area (since the transmission study requirements do not apply to either generators connected to its grid or to self- build); (b) it is improper and unfair to require “fixed” pricing for the “stable price” product since this is not required of self- build; (c) the credit/collateral requirements are unnecessarily stringent; (d) the evaluation methodology overstates transmission costs; (e) Cleco should arrange for network transmission service rather than point-to-point; (f) the “debt equivalence” (or imputation) factor is improper. Plum Point’s earlier on comments of May 21, 2004 focused only on the transmission issues. In addition, to reiterating its earlier points on transmission, Plum Point recommended that the System Impact Study requirement be eliminated and that a third-party study of the bids using Promod IV be performed in its place.

(2) **Caterpillar**

Caterpillar recommends that in conjunction within its planning an RFP process CP give consideration to distributed generation (i.e., units 15 MW or less) and demand-side management programs. It appears that this is ruled out in the RFP since minimum size bids are 50 MW.

(3) **Peabody Energy**

Peabody considers the System Impact Study requirement to be onerous, particularly for Peabody's Midwest projects since this could involve multiple third-party transmission providers. Peabody instead suggests that transmission service issues be deferred until the contract negotiation stage.

(4) **Sempra Energy**

Sempra does not object to the transmission study requirement but requires information on acceptable delivery points on the Cleco grid. Sempra further requests that the deadline on the submission dates for the study be pushed back until after Sempra receives the information that it needs.

(5) **Gad Cohen**

Mr. Cohen's comments were submitted informally by e-mail without identification of the organization he represents. He requested that the transmission study requirement be either pushed back or delayed to allow more time.

C. Staff Response to Comments

Staff responds first to the transmission issues raised by all commenters, and we then respond to the other issues raised by Plum Point and Caterpillar. Staff agrees with CP that transmission availability (and potentially upgrade costs) for projects not connected to Cleco's grid is a key threshold issue that must be addressed. Indeed, the bidders and commenters generally acknowledge the importance of this issue but disagree to some degree over procedures. While this issue, unfortunately, places an additional requirement on many bidders, it is not discriminatory, as Plum Point claims. The requirement is identical for all similarly situated bidders (and self- build). The bidder must demonstrate at the indicative bid stage the feasibility of delivery to the Cleco grid. From there, a Cleco study will be performed to evaluate any potentially required Cleco grid upgrades.

The complaint regarding the May 27 date (Staff and the IM also opposed this deadline) has been addressed. It has been pushed back to August 2 and is nothing more than a deadline for submitting a study request. We are sympathetic to Peabody's concern regarding multiple transmission providers, but the requirement is a limited one of a study request. Understandably, CP does not believe that it can wait until the negotiation stage to address this issue because it will run the risk of creating a short list of projects that turn out not to be feasible. Based on the experience with the 2003 RFP, we agree with CP there is a necessity of considering transmission feasibility before defining the short list.

Plum Point questions whether CP is properly accounting for transmission costs in its evaluation, raising some valid analytic points. But Plum Point may have misunderstood the draft

RFP (which itself may not have been sufficiently clear). For PPAs, there is no evaluation of (non-Cleco) transmission costs (merely technical feasibility and timing), because all such costs are solely the seller's responsibility. The non-Cleco transmission costs are relevant for the evaluation of asset sales, and we believe that the revised RFP clarifies that the evaluation will fully and properly account for FERC-approved cost assignment practices.

As to the use of network service (for third-party transmission), we believe that firm point-to-point service is more standard. However, Staff would not object to the former if during due diligence and negotiations an advantage for Cleco customers using this approach could be shown. Regardless of how transmission service is arranged, the seller under a PPA remains responsible for all costs of delivery to Cleco's grid. Once the supplier delivers the power to the Cleco grid, CP must arrange for network service on its own grid (to be paid by CP customers).

With regard to Sempra, we understand that its concerns have been fully addressed. CP has provided the requested information on delivery points, and the deadline has been pushed back from May 27 to August 2 (for study request). Sempra did not object to the requirement for a study per se, only the timing and information needs. We believe that this also addresses Mr. Cohen's concern regarding May 27.

Caterpillar raises an interesting issue regarding the potential benefits of distributed generation (DG) and demand-side management. With regard to the latter, it is our understanding that CP has entered into interruptible service agreements with one or more industrial customers. The present RFP in no way interferes with CP's potential consideration of DG. Although the

RFP specifies a 50 MW minimum, resources below 35 MW are exempt from the RFP requirement, and DG proposals can be submitted to CP at any time. In fact, this RFP would provide a convenient time for such proposals, although CP has the flexibility to use more streamlined review procedures, outside the RFP itself.

Plum Point has raised several concerns outside of the transmission areas that Staff believes are valid. Energy bids associated with the “stable price” (i.e., base load) resources should not have to be fixed. In response to Staff questions, CP has acknowledged that some form of fuel price indexing (as long as it is reasonably standard and well-defined) would be potentially acceptable. We believe that the final RFP language (as well as the written response to Staff) now makes that clear.

The credit/collateral requirement (limited to PPAs) is a much more difficult issue. Plum Point is correct that CP’s 18 months is somewhat arbitrary and that any credit requirement probably should apply only to the capacity charges. However, Plum Point’s suggestion that the credit requirements be based on “independent forward market prices” is probably impractical. This is because there are no generally accepted forward market prices extending out 15 to 25 years.

Staff believes that ratepayer exposure for default or non-performance under a long-term, third-party PPA is substantial and that reasonable credit protections are essential. Ultimately, this item must be negotiated to provide a workable resolution, and CP’s 18 months may be a useful guideline or starting point. In place of long-term forward prices (which do not exist), CP

may also wish to compare the PPA cost to the cost of self- build, with the difference being an indication of potential ratepayer exposure. The use of escalating capacity charges which start out low and increase over time also could be used as a tool to mitigate ratepayer exposure to potential seller default.

Finally, Plum Point makes some valid criticisms of the debt equivalence or imputation procedure. Again, this applies only to PPAs. In that regard, CP only very recently has posted on its website a numerical example of how this calculation would be performed. Staff does not at this time understand the numerical example, and we believe that it may be flawed. For example, Plum Point is correct that the cost calculation should be based on the difference between the cost of debt and cost of equity, not the cost of equity by itself. We agree, however, with CP's RFP that "debt equivalence" should be taken into account in some reasonable manner since potentially this is a very real financial cost to CP and its customers. Staff intends to work with Cleco and the IM to develop a fair and practical procedure, taking into account Plum Point's analytic comments, prior to the bid submission date. Any agreed upon procedure will be made publicly available.

D. Other Staff Concerns

On August 13, 2004, CP submitted to its website a revised write up of its evaluation methodology (Section 4 of the RFP). This revision provides a far clearer description than the original draft and addresses two key questions of Staff (a) the role of non-price factors in the evaluation; and (b) whether (and how) resources in different product categories can compete.

Based upon this general description, Staff concludes that Cleco's evaluation framework is reasonable.

(1) Evaluation Analysis Data Inputs

At this point in time, Staff's understanding of the evaluation methodology is largely limited to what is provided in the revised RFP and responses to questions -- the same information that potential bidders presently have. Staff does not yet have CP's data input assumptions that will be used for production costing analysis, nor do we have the financial assumptions to be used for revenue requirement analysis. It is important that this information be provided to Staff with opportunity for Staff feedback before the date of bid submittal.

(2) Self- Build

It is clear that CP places substantial emphasis on its self-build options in the event that its needs are not fully met by the market. In light of its experience in 2003, Staff believes that such emphasis to be understandable and reasonable. However, at this point in time, Staff has received only limited cost data on these various options -- specifically, a detailed engineering cost study of the Teche repowering option. No data on any other option has been supplied to Staff. It is imperative that Staff receive this information as soon as practicable, and in any event, no later than the bid due date. All such costing analysis and technical descriptions must be complete and in a form that complies with the MBM order.

The pricing of any self-build project must be at regulated cost of service (or no higher than cost of service) and in that regard it is extremely important that self-build project cost

estimates not be understated. In that regard, Staff recommends the inclusion of an appropriate “contingency” factor in the final cost estimate.

While not a requirement, Staff requests that CP fill out a full set of the bid forms for each self-build option (and supply those completed forms to both Staff and the IM). Self-build projects are not, of course, “bids” in the usual sense of the term (i.e., CP has no pricing discretion), but the submission of the completed bid form will ensure that the Evaluation Team and the IM have all information needed by the bid submission deadline to determine whether any self-build option should advance to the short list for its product category. It also will help ensure a level playing field for bid evaluations. It is Staff’s understanding that all self-build cost estimates will include the full cost of any needed Cleco transmission upgrade, and all such self-build options will be located on the Cleco grid, eliminating the need for evaluation of non-Cleco transmission costs.

(3) FERC Approvals

It is Staff’s understanding that any affiliate purchase also will require FERC approval and may be subject to the standards enunciated under Edgar, Allegheny and Ameren. The last two are very recent FERC orders pertaining to affiliate PPAs and affiliate asset acquisitions, respectively, and describe utility RFP procedures apparently acceptable to the FERC. Because the Allegheny and Ameren decisions are so recent, it is difficult to predict whether the FERC would approve any affiliate transaction under CP’s instant RFP procedures. While Staff believes CP’s procedures and IM oversight to be entirely appropriate to prevent affiliate abuse or undue discrimination, we do not note some differences with Allegheny/Ameren (which appear to be

examples of acceptable procedures, not hard and fast requirements). Hence, FERC approval may provide a significant risk for CP, absent the regularity clarity that we would want. CP is responsible for taking the FERC approval risk into account as it conducts this RFP, and where possible, CP should take reasonable and appropriate actions to mitigate this risk.

Similarly, there are FERC regulatory approval risks associated with any asset acquisition, even one involving a non affiliated third party. For example, Oklahoma Gas & Electric (OG&E) went through a protracted FERC approval process to acquire NRG's McLain unit, and obtained approval only after agreeing to certain market power mitigation measures. Given the OGE/McClain experience, CP also must be mindful of the FERC approval risk for asset acquisitions.

E. Staff's Concluding Remarks

Staff has been working closely with CP and the IM for the past six months on the design of the RFP, and the final RFP package addresses most of Staff's concern. The RFP package is clear and is designed to be both fair and commercially practical. However, much work remains to be accomplished prior to the bid submission. Three areas of additional work include: (a) refine and correct the debt imputation procedure; (b) complete cost analysis/revenue requirement impacts for self- build options and submit this information to Staff and the IM; and (c) develop and provide Staff and the IM with detailed production cost, financial and revenue requirement data inputs and assumptions so that Staff can fully understand and comment on the evaluation methodology. We anticipate that there may be additional review of the credit/collateral requirements as well.

Staff has not received any stakeholder RFP comments since the beginning of June. We invite CP, the IM and interested parties, at their option, to respond to Staff's Comments. We also urge potential bidders to continue to track CP's RFP website for updates, answers to newly submitted questions and potential amendments as the RFP process continues.

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