SOUTHWESTERN ELECTRIC POWER COMPANY

2005 RFP For Intermediate and Long-Term Resources
Under the LPSC Market-Based Mechanisms Order

PRELIMINARY COMMENTS OF THE LPSC STAFF ON THE DRAFT RFP

I. Overview

On September 12, 2005, Southwestern Electric Power Company (Swepco or the Company) submitted a Draft RFP informational filing pursuant to the Louisiana Public Service Commission's (LPSC's) Market-Based Mechanism General Order. Swepco is an operating utility subsidiary of American Electric Power Corporation (AEP) serving portions of Louisiana, Texas and Arkansas. Swepco also has significant wholesale requirement loads under long-term contracts. The long-term RFP seeks up to 1,500 MW of new capacity – peaking, intermediate and baseload – beginning in the 2008 (peaking) or 2010 (baseload) time frame. Swepco also has more immediate needs that it seeks to fill with intermediate capacity (one to three year capacity), up to 500 MW.

The draft filing was developed with extensive input from the designated Independent Monitor (IM) and submitted for Commission Staff and interested party review. In that regard, a Technical Conference on the RFP was conducted on October 25, 2005 in Shreveport. This included presentations by Swepco/AEP and LPSC Staff, as well as a question and answer/ comment session. Interested parties were invited to submit questions on the draft RFP, with questions and answers posted on the Swepco RFP website. To date, 56 questions and answers have been posted on the website and are publicly available. Potential bidders also were invited to submit comments on the RFP to Staff, either formal, written comments or informal feedback, with a deadline of November 11, 2005. As of this writing only one party, Calpine Corporation, has chosen to submit written comments. (On October 31, Calpine also provided Staff with informal comments and questions.) Staff is not aware of any other party or potential bidder that has sought to provide informal comments on the draft RFP.

Calpine's comments have focused on several areas:

- The limitations in the RFP on submitting alternative bid configurations from the same resource.
- Credit/collateral requirements that Calpine believes are excessive.
- Swepco's proposal to factor debt imputation into the bid evaluation process.

In addition, Calpine states that a number of questions it submitted have not yet been fully answered.

Staff notes that this is the first competitive solicitation developed by Swepco under the Commission's MBM General Order and Swepco's first effort in many years to acquire other than short-term resources. The draft RFP represents an excellent first effort concerning competitive resource acquisition. However, there are certain areas, as noted by Calpine and Staff's comments, where the draft is incomplete or where modifications or clarifications may be warranted.

Staff's comments discuss the merits of the issues raised by Calpine, and we urge that Swepco exercise some flexibility (while appropriately protecting ratepayers) in order to foster active market participation in the RFP. In addition, additional information and clarity is needed concerning the evaluation process, both for the long-term and intermediate-term RFPs.

II. Summary of Calpine Arguments

Calpine's formal comments of November 11, 2005 raise the following issues concerning the RFP.

(1) Calpine notes that while all bidder/Staff questions on the draft have been responded to, not all questions have been fully answered. This includes questions 40, 46 and 47, which address credit requirements.

(2) Calpine disputes the risk exposure amounts and the logic in the underlying methodology used to determine credit amounts in Table 5.4. Calpine claims Swepco has misapplied S&P default rates, and its use of a 50 percent market movement assumption is arbitrary. Calpine does not object to the concept of a credit requirement but instead urges that it be based on actual risk of loss. Calpine does not present a specific recommendation and requests that a workshop be conducted.

(3) Swepco's proposed evaluation methodology incorporates debt imputation for PPAs. This recognizes that rating agencies treat PPA capacity charges – to some extent – as debt equivalents for credit rating purposes, inducing the utility to add equity to its balance sheet. Calpine's argument is that this adjustment is an overly

narrow view of risk and will improperly skew the evaluation process in favor of self-builds and/or affiliate purchases. Again, Calpine seeks a forum to address this issue.

The above three issues were discussed in some detail in Calpine's formal comments. The October 31 informal comments raised several additional issues although they were only briefly mentioned:

- Calpine asked that the AEP internal code of conduct be posted.
- Calpine expresses concern regarding Swepco's reliance on its own internal transmission analysis in the bid rankings since the SPP's determination could differ.
- Swepco should clarify that capacity charges need not be levelized but can escalate.
- Swepco should clarify its non-price weightings.
- Calpine believes that Swepco's procedure of only considering (up to two) Alternative proposals if the Base proposal is short-listed is too restrictive. Bidders should have greater opportunity to develop independent, alternative proposals for a given resource.
- Calpine raises questions regarding ancillary services.

III. Staff Comments

A. Short Intermediate RFP

There were very few questions and comments concerning Swepco's short to intermediate (one to three year) RFP. However, Staff's review finds this RFP to be somewhat incomplete. In particular, there is no specification of credit requirements and the evaluation methodology is not well explained. This should be remedied in the final RFP. The RFP states that bids can be disqualified for a "material deficiency" (not defined), but there does not appear to be a cure process to allow correction of such a deficiency.

The RFP schedule contemplates bids due on January 9 with winning bid selections on January 23. It is not clear that a short-list notification to bidders on January 16 adds anything to the process.

B. Long-Term RFP Comments

Much of Staff's discussion will focus on the issues raised by Calpine in its comments. However, there are several other aspects of the RFP that should be noted.

(1) Evaluation method. The long-term draft RFP goes into considerable detail regarding the evaluation methodology including a description of the various non-price factors. Responses to questions have indicated that the actual weighting for the non-price factors will be included in the final RFP, and Staff agrees that this information should be provided.

While there is a full discussion of the evaluation methodology in the draft, there are some areas that would benefit from clarification. The draft does not clearly explain exactly how the analysis of the price component will be conducted, i.e., what economic metric and modeling methods will be used as the measure of cost effectiveness in both the first and second rounds. Although the analytic details of the price evaluation need not be in the RFP (since it would result in revealing confidential data), this information should be shared with Staff. We look forward to discussing the price evaluation protocols further with the IM and Swepco. The draft clearly states that non-price factors will initially have a 40 percent weight but does not make clear how these criteria are used in the final decision (i.e., short list evaluations).

In the initial round evaluation, Swepco separately evaluates three products -- peaking, intermediate and baseload (i.e., solid fuel). In final selection, the three product types may "compete" with each other through a portfolio analysis. However, in the initial round, the separate bid rankings should be limited to these three categories, e.g., for intermediate capacity PPAs should be able to compete with self-build and asset purchases, not just other PPAs.

(2) Product Offering Flexibility. To encourage both participation and bidder creativity, Staff would prefer that the RFP err on the side of flexibility. Intentionally or unintentionally, it appears that the RFP may have given the impression that it restricts the ability of bidders to submit alternative proposals from the same resource. Such restrictions are not needed, nor are they beneficial to customers. Of necessity, bidders will have only a limited understanding of how their bids will be treated in the evaluation methodology and what configuration of their resource (e.g., size offered, pricing structure, contractual arrangement such as PPA versus asset purchase) works best for Swepco and provides the most value for ratepayers. Given this limitation, it follows that the best strategy (for the bidder, Swepco and ratepayers) is

to allow the bidder the flexibility to submit several (mutually exclusive) bids from the same generation resource. Based on recent discussions between the Company and Staff, Swepco has clarified that bidders are free to submit alternative base bids from the same resource provided they are willing to pay required bid fees. The RFP should be clarified on this point to ensure bidders understand.

The RFP appears to require that asset purchases come from existing (currently operating plants) and not plants under construction. This would seem to be an unnecessary restriction, particularly in light of the fact that the capacity is not needed (under the long-term RFP) before 2008-2010. Swepco has explained to Staff that it regards plants not yet completed as excessively risky, and it therefore chooses to retain this restriction. Moreover, it may not be realistic to require that an existing asset sale not close until 2010 or 2011, as the RFP appears to require. Staff understands this latter requirement will be relaxed in the final RFP.

Another restriction is that bids must be for commitments of not less than 20 years. While it is certainly reasonable for the RFP to state this as a preference, Swepco may wish to consider offers of less than 20 years (e.g., 15 years) if the pricing and the resource are compelling.

(3) Record retention policy. Whether or not reflected in the RFP, Staff recommends that Swepco/AEP retain all records supporting any RFP decisions pertaining to bid evaluations, rankings and project selection. This retention should continue at least until all regulatory decisions are completed (including any appeals). This should be retained in a form that would permit Staff review.

(4) Bid posting requirements. The draft RFP specifies the posting of collateral when bids are submitted. Swepco apparently has reconsidered, and this no longer is a requirement. Staff agrees with Swepco's decision on bid posting requirement and believes this will encourage participation.

(5) Ongoing Credit Requirements. For PPAs, Swepco requires substantial credit requirements on an ongoing basis as part of the PPA requirement. This is most likely to significantly impact suppliers that are not investment grade and/or do not have an investment grade parent. Staff believes such credit requirements are necessary to protect ratepayers in the event of PPA default. This is because default could cause the utility to incur transactions costs to replace the resource, and more importantly, the default is most likely when the contract is below market, causing ratepayers to incur a replacement cost premium. (For this reason, Swepco should permit to flow through to ratepayers all forfeited collateral in the even to default.)

The issue here is not whether credit is appropriate, but whether the amounts proposed by Swepco (e.g., on Table 5.4 of the RFP) are excessive. Calpine's comments heavily criticized both the Swepco methodology to develop its requirements and the end result as unreasonable, with the required dollar amounts being onerous. Calpine believes such requirements will discourage bidder participation. Calpine, however, does not recommend an alternative standard, only further discussion of this issue.

Staff believes that a credit requirement to some degree is needed to protect against the costs that could be imposed on ratepayers as a result of contract default. For example, for a long-term PPA, ratepayer exposure mostly would be limited to the difference between the contract pricing and a self-build cost for a comparable resource. It is not clear that Swepco's credit methodology necessarily provides the "right answer" for the appropriate amount of ratepayer protection. However, it also appears that Calpine may have misunderstood the RFP's requirements believing them to be far more onerous than they actually are. For example, Table 5.4 shows a maximum requirement for a triple C company to be $72 per MW, i.e., $36 million for a 500 MW intermediate plant. Calpine's comments cite to a much higher figure. The RFP could clarify this issue through the use of numerical examples.

Staff would like to encourage RFP participation and avoid unnecessary barriers to competition. We believe some flexibility on this issue may be appropriate and it could benefit from further discussion. The specific form of credit protection ultimately may be an issue for final PPA negotiation. In addition to credit amounts stated in the RFP, Staff would encourage Swepco to consider as potentially acceptable alternative means of providing credit protection or security provided that those means are fully protective of ratepayers. However, bidders should nonetheless consider the cash collateral amounts specified in the RFP to be the requirement in the absence of a mutually-agreeable alternative.

(6) Debt Imputation. There is considerable debate nationwide over the appropriateness of incorporating of debt imputation cost in evaluating long-term PPAs, as

Swepco has proposed. The Calpine comments vigorously argue that this adjustment, using the S&P formula, is inappropriate on several grounds.

Staff is concerned that the adjustment is overly narrow, particularly when comparing a PPA with a self-build project (the application where this adjustment likely makes the largest difference) because it ignores the risks -- cost of capital, credit and ratepayer costs -- associated with cost of service pricing required for self build. Importantly, a self-build cost estimate is not binding, unlike a PPA. At the same time, at least one major credit rating agency, S&P, does appear to impute PPA capacity charges as debt for its credit rating purposes, and this could be a cost element for ratepayers. For this reason, Staff does not recommend that Swepco ignore the issue.

At this point in time, Staff recommends that Swepco calculate the debt imputation "penalty" for each bid, but not use this metric to screen out the bid from the short list. The evaluations should be performed both with and without this factor to determine whether it meaningfully alters bid rankings and project selections. If it does not, then the issue is moot, and no further discussion or determination is needed. If it does have an effect on the short list rankings or portfolios, then we urge Swepco to consult with Staff and the IM on its final evaluations and project selections. Final selection of projects is not purely the result of mechanical applications of criteria but instead involves business judgment. The weight given to debt imputation may be one factor among several influencing final decisions, including risks inherent with self-build cost estimates.

(7) Self-build projects. Swepco has made clear that self-build projects will play an important role in its competitive solicitation process, and Staff supports utility efforts to identify these options. It is the purpose of the MBM Order to ensure that the utility selects self-build projects only if the market is unable to offer more attractive options under a properly structured RFP that efficiently exploits market opportunities. In this RFP, Swepco provides only generic information on its self-build options (as noted by potential bidders), but for good reason. The work on self-build is being conducted on an entirely separate basis from the RFP process itself in order to help maintain the independence and objectivity of the RFP team. Staff believes this independence improves the integrity of the RFP process and is a positive aspect of the RFP.

The downside to this arrangement is that Staff has less information at the present time on the self-build options than it normally would. Therefore, Staff intends on conducting separate discussion with members of the “self build team” to obtain a better understanding of the attributes of these projects before their submission in the RFP. We encourage the IM to also proactively investigate the self-build options.

IV. Conclusion

The foregoing are Staff’s preliminary comments on the Swepco draft RFP, and we look forward to discussing these issues both with Swepco and stakeholders. There are certain issues, such as the evaluation methodology and bidder flexibility, that could benefit from additional clarification in the RFP. Certain issues raised by Calpine which include credit requirements and debt imputation, warrant further discussion and possibly amendments to the RFP. Staff’s interest is in ensuring that market participation in the RFP is encouraged with artificial (or unnecessary) impediments avoided. At the same time, the ultimate goal of the process is to identify and procure the resources having the most value to Swepco customers, regardless of ownership, under arrangements protective of customers.

Staff may update or supplement these comments, as appropriate.

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