A Report on Future Bulk Power Purchase Decisions

(2nd in a series of reports to customers)

A Public Report to the Customers of the Northeast Nebraska Public Power District (NeNPPD) by the District's Board of Directors and Management

January, 2013

A brief summary:

This report, and the others that follow, discusses an expected contract proposal by the Nebraska Public Power District (NPPD), of Columbus, NE, for NeNPPD to underwrite the cost of planned modifications to NPPD's power plants. NPPD is in the process of of expanding their Cooper Nuclear Station and planning the addition of expensive pollution controls to their Gerald Gentleman Coal fired units. NPPD is the sole supplier of all electric power purchased by NeNPPD's customers.

It is the job of the NeNPPD Board of Directors, as your elected representatives, to decide among several possible options for purchasing bulk power for delivery to your farms, homes and businesses. We have confidence that NPPD has adequately studied the options for obtaining the best value from their existing power plants. This however, is only one consideration for the NeNPPD Board as we believe several other options for bulk supply may either now be available or will be available in the near future as a competitive market under jurisdiction of the Federal Energy Regulatory Commission is now in development. NPPD is now asking the local NeNPPD Board of Directors to consider a long term commitment. The timing of this request could permanently close the door on participating in this future marketplace so our decision is an important one.

Most people and companies in their lives do make long term commitments. We get married; we raise children, or pay mortgages. These long term decisions are useful to us, but are always made on a set of beliefs about the future. It compares in some ways to buying a home and financing it for 30 years. Depending on the price paid, the home's condition, one's ability to make the payments, the home's location, and the timing of the sale; then a good deal can be made. On the other hand, the financial crisis of 2008 fundamentally changed all assumptions previously used by people up to that time to buy a home. No longer does home ownership look like an investment that can't lose. Some issues before the NeNPPD Board are the uncertain state of federal and state policies about energy, financing, and the environment plus the rapid progress in new technologies that could in a few years make a major shift in any assumptions about the future.

As stated, we have confidence in NPPD's decisions about their power plants given their position today. Part of the evaluation by the NeNPPD Board will be to assure ourselves that NPPD hasn't let bias, short term pressures, or a misalignment between their self-interest and your needs be part of the larger implications of a long term commitment.

Assumptions needed to support a long term (25 to 35 years) exclusive contract

The contract now in force between NPPD and NeNPPD represents a standard arrangement found all over the country. For about 100 years, producers of power like NPPD, have been successful in meeting a universally growing demand for electric power by building ever larger generating plants and lowering cost to customers (as a percentage of household income) through economies of scale and prolonged life of power plants. The successful continuation of this type of contract depends a great deal everyone's confidence that the following conditions will be present in the future. A partial list of these conditions is:

- Monopoly status of NPPD for power supply over a geographic region
- Inability of other suppliers to access NPPD owned transmission lines to deliver competitor power supply to NeNPPD customers
- An ever increasing amount of sales over which fixed investments in plants can be spread
- Continued ability for local distribution wires to be universally available to serve a wide variety of loads
- That power sold at retail from central generating plants remains competitively priced compared to other fuels like propane, natural gas, and small renewable uses of wind and solar. Many customer loads at some point can and do switch fuels based on price.
- A political and legal environment that isn't disruptive to long term investments that will continue into the future.

Background

NeNPPD and NPPD are presently in the 11th year of a 20 year exclusive purchase contract. NPPD believes it necessary at this time to issue substantial new debt to make new investments in power plants. One of the plants is the Cooper Nuclear Station which first started operation in 1974 and recently secured an extended license to operate until the end of 2033 at which time the plant will have operated for 60 years. The other plant is the Gerald Gentleman Coal Plant which began operation in 1979.

There are several very real strengths to a long term exclusive supply contract with an entity (like NPPD) that owns and operates generating plants. By agreeing to underwrite <u>all</u> future expenses for NPPD, its exclusive customers like NeNPPD get a guarantee that the power output of these plants are dedicated to the needs of our customers. When cost and investments are low, this puts the NeNPPD ratepayer in a strong position. Also, because there is no limit on the amount of money spent by NPPD in meeting our customers' power needs, then the likelihood of curtailments due to a lack of generation capacity is small. In some market situations power supply is constrained and prices elevated.

NeNPPD's existing long term contract with NPPD is distinctly different than other similar contracts whereby local distribution power companies, like NeNPPD, agree to underwrite all future debt and expenses. This difference is that NeNPPD has neither equity in the power plants nor any governance rights as protection for guaranteeing NPPD's financial needs.

We estimate that the borrowing NPPD has identified (up to $1.4 billion) will result in a 10% increase imbedded in wholesale power rates over the term of the contract. NPPD's prices for wholesale power are good now and 10% does not present an unusual burden on the ratepayer. A 10% increase in wholesale power costs from NPPD is an additional $1,500,000 to NeNPPD annually at today's pricing or about an addition $160 per year per residential customer for each of the next 25 to 35 years for a present value obligation of about $3,135 (assumes an interest rate of 3% annually and a 30 year time frame).

Assumptions about NPPD's expected terms for a new long term contract

We believe NPPD will offer NeNPPD (and all other bulk power customers of NPPD) a new contract with the following terms:

- An enforceable length of 25 to 35 years
- Only one cancellation provision which will require a buy out of the remaining debt obligation as pro-rated and assigned by NPPD. This may be a known quantity at the time of the agreement.
- No performance measurements will be adopted by NPPD nor any guarantees of cost control or caps on future rate increases.
- No equity in the plants' assets will be offered to NeNPPD (but to be fair the power output of all NPPD plants is essentially earmarked for our use)
- No voting voice in the governance of NPPD other than the election of NPPD directors by popular vote during general elections.
- An identical contract will be offered to all of NPPD's wholesale power customers

Inherent risks of such a long term arrangement (and other considerations)

While this kind of contract has been in place for decades, it can (and has) shifted costs and risk between the local purchasers of NPPD power. A partial list of financial risk includes:

- There is no exit from the contract should our needs change, or should NPPD's performance degrade or the assumptions on which 'hoped for' benefits do not materialize. Costs only go up.
- Cost is socialized in a way that faster growing local electric systems may receive more of the benefits of plant upgrades than slow growth systems. It appears that a projection of NeNPPD's future load growth relative to the NPPD system would be a useful measure.
- NPPD is asking for a contract term that may exceed the life of the plant investments being made. For example, Cooper Nuclear station has a life of about 15 years shorter than the planned debt.
- This type of contract underwrites not only the debt incurred by NPPD, but 100% of all future expenses. NeNPPD and other parties to this kind of contract will underwrite all of NPPD's future expenses (not just debt) with no performance guarantees or limits on NPPD's spending power or authority. The concern is that at various times in the future NPPD may be better or worse managed. History indicates that at one point in the past the Cooper Nuclear Station was nearly a failure. NeNPPD would be expressing a near certainty in NPPD's management for the life of the contract.
- Future costs cannot be predicted for the term of the new contract. In fact, the term is expected to be so long that a financial analysis by NeNPPD is probably not even possible. Here we are just 10 years into the present contract of 20 years and NPPD needs additional borrowing authority requiring payment guarantees from customers. We predict that NPPD will again be borrowing in about 10 years from now. Shorter term business projections have a greater degree of accuracy.

- The culture of a large bureaucracy has a definite cost. This is easily observable in many of our institutions. Once created bureaucracies never go away, never reduce their size of staff, never shrink their mission and create new projects. While NPPD may not be able to affect overall power cost by simply reducing controllable expenses, the broadening of mandates over time does likely add a measurable cumulative cost to a family's electric bill. NPPD's mission statement is so broad, (*To improve the quality of life for all Nebraskans*) that a wide range of activities can be and have been funded with rate payer money beyond what is required to run an efficient power company. Such latitude over decades of politically inspired leadership generally results in a public power entity losing its reputation as lowest cost. The Tennessee Valley Authority (another government chartered producer) once claimed as a purpose for its existence, to be the 'yardstick for the nation' demonstrating the true cost of producing power absent the profit motive. TVA paid no taxes, paid no dividends to stockholders, borrowed funds at below market rates (due to its government ownership), spread its peaks across two time zones, had most economies of scale /operating advantages and still moved from the lowest cost producer for wholesale power in the nation to above average cost in the region, if not the nation. While this isn't a purposeful condemnation of public governance of large organizations, it is a long term business risk to our customers. TVA had long term contracts and with that security for years managed itself to short term objectives. The NeNPPD Board of Directors has to evaluate whether central planning by a group with no financial skin in the game will outperform shorter term market based prices or other contracts with a shorter term.
- No opportunity to blend several suppliers to mitigate future risk. NPPD is asking for all or nothing.
- Once this kind of contract is executed NPPD has zero financial risk for any aspect of their business. In the past monopoly environment this risk was not much considered because there were no options for alternative supply from other power companies. Today there may be a variety of companies to supply NeNPPD's loads making this a new and real consideration.
- Many small electric distribution companies, like NeNPPD, believe that having NPPD control the supply decisions eliminates the risk of incorrect thinking at the local level. This is one of the main 'philosophical' distinctions of any decision about the contract NPPD is expected to offer: Over the long term will NPPD, with its advantages, outperform market competition. No doubt the yearly amounts of NPPD price increases will tend to be muted, but may not necessarily be less over the long term. Again, there is really no evaluating the future 25 to 35 years, but study of past historical trends of companies that moved to market pricing seems appropriate.
- The timing of this contract renewal could eliminate forever supply options from other companies in a future deregulated wholesale market. Such a market is developing and all indications are that national policy will require open access of transmission lines with customer choice of suppliers. Nebraska has been slow compared to the rest of the nation in participating in a Regional Transmission Organization (RTO) although within the last couple of years has joined the Southwest Power Pool RTO. One of the many functions of an RTO is to allow competition to set the price of power and to insure that individual companies like NPPD can't block the delivery of power based on protectionism (called open access of Transmission lines).
- Faith in how the money is to be used is a consideration. The NeNPPD Board as well as the NPPD Board and management have to believe in the long term future economic viability of the Cooper and Gentleman generating plants and the expected total benefits of a long term contract.

Closing Thoughts

The reader should remember that the scope of this paper does not address the risks inherent in other supply options. There will be other future reports in the next several months for that purpose.

The reader should be made aware that shorter term contracts, pricing based on competitive markets, contracts which blend supply and cost options or the purchase of equity in other plants all have the risk. As the laws of Nebraska are now written, the ultimate consumer has exposure to all risk of any supply decision. This is why NeNPPD's Management and Board of Directors are devoting the time and effort to explore several other options. The Board and Management of NeNPPD repeat to all readers that we ultimately may be very pleased to sign a new long term agreement with NPPD, but feel obligated to critically evaluate all options before reaching that conclusion. *The expected NPPD proposal will be the constant against which the risk and benefits of all other options are compared.*

We believe there needs to be understanding by our customers of these decisions and we seek customer input. Any questions and comments about the contents of this paper are welcomed and should be addressed to: Mark C. Shults, General Manager, NeNPPD, PO Box 350, Wayne, NE 68787, 800-750-9277, mark.shults@nnppd.com. Copies of both reports to date are available on our web page at www.nnppd.com.