

**IN THE UNITED STATES OF AMERICA  
BEFORE THE  
FEDERAL ENERGY REGULATORY COMMISSION**

**Duke Energy Moss Landing LLC )      Docket No. ER98-2668-000**  
**Duke Energy Oakland LLC        )      Docket No. ER98-2669-000**

**Affidavit Of Charles A. Smart**

1            My name is Charles A. Smart and I am the Chief Financial Officer for the California  
2 Independent System Operator Corporation (ISO). My business address is 151 Blue Ravine  
3 Road, Folsom, CA 95630. As the Chief Financial Officer of the ISO, I am responsible for  
4 preparing fiscal records and financial reports, formulating and administering the overall  
5 financial and accounting plans, policies and practices, and forming relationships with lending  
6 institutions, financial stakeholders and the financial community.

7            The purpose of this affidavit is to address certain arguments made by Duke Energy  
8 Moss Landing, LLC and Duke Energy Oakland, LLC (collectively referred to as Duke) in  
9 their Answer filed in the captioned proceedings on May 28, 1998. Specifically, Duke claims  
10 that in order to avoid the payment risk associated with a utility that does not pay a must run  
11 invoice, the ISO should either accumulate reserves or obtain a letter of credit through which  
12 the must run owner will be protected from nonpayment by the utility to the ISO.

13            **Temporary Financing**

14            On December 6, 1996, the ISO Restructuring Trust (Trust) established a revolving  
15 line of credit (Credit) at Bank of America, N.T. & S.A. (BoFA) with a maximum credit limit  
16 of \$191,000,000 for the purpose of funding the startup and development costs associated  
17 with the development of the ISO (Infrastructure). The Credit is guaranteed by the three  
18 investor owned utilities (IOUs) in California—Pacific Gas & Electric Company (PG&E), San

1 Diego Gas & Electric Company (SDG&E) and Southern California Edison Company (SCE).  
2 The Trust initiated all draws on the BofA Credit and disbursed funds to pay all Infrastructure  
3 expenses. On December 24, 1997, the maximum credit limit was increased to \$215,000,000.  
4 As of June 1, 1998, the Trust had drawn \$206,000,000 on the Credit.

## 5 **Permanent Financing**

6 On April 23, 1998, the Board of Governors of the ISO (Board) approved the structure  
7 of the ISO's permanent financing. The ISO was authorized to issue a maximum of  
8 \$310,000,000 in tax exempt, variable rate demand bonds (VRDBs) through the California  
9 Economic Development Financing Authority. The VRDBs would be backed by a direct pay  
10 letter of credit (LOC). And, the ISO would purchase an interest rate swap to hedge the daily  
11 interest rate of the VRDBs to a ten years interest rate.

12 On May 5, 1998, the ISO issued \$101,600,000 in VRDBs and on May 15, 1998, the  
13 ISO issued \$199,800,000 in VRDBs for a total issuance of \$301,400,000.

14 The syndication of banks (Syndication) providing the LOC placed restrictions on the  
15 use of the VRDB proceeds, and required that all VRDB proceeds be placed in a trust account  
16 at Bankers Trust. The Syndication will permit the ISO to use \$76,872,000 of VRDB  
17 proceeds for working capital and completion of the ISO's Infrastructure. The remaining  
18 \$224,528,000 of VRDB proceeds will be restricted and used as collateral for the LOC until  
19 the two requirements listed below have been completed:

- 20 1. The Federal Energy Regulatory Commission (FERC) must issue an  
21 order approving the uncontested settlement of the Grid Management  
22 Charge (GMC) in Docket No. ER98-211-000.
- 23 2. The ISO and the three IOUs must execute agreements approved by the  
24 unanimous consent of the Syndication whereby the individual IOUs  
25 agree to pay all must run invoices submitted by the ISO. And, the ISO  
26 and any new owner (Owner) must execute an agreement approved by

1 the unanimous consent of the Syndication whereby the new Owner  
2 agrees that it will not have recourse to the ISO in the event that  
3 payment has not been received from the IOU.

4 On June 1, 1998, FERC issued an order approving the uncontested settlement of the  
5 Grid Management Charge.

6 On April 1, 1998, the ISO, SCE and the new Owners signed the SCE Principles of  
7 Agreement (SCE Agreement). In the SCE Agreement SCE agreed to pay all must run  
8 invoices submitted by the ISO. And, the new Owners agreed that they do not have recourse  
9 to the ISO in the event that payment has not been received from SCE. *See* Exhibit 1.

10 On April 28, 1998, the ISO and SDG&E signed the SDG&E Principles of Agreement  
11 (SDG&E Agreement). In the SDG&E Agreement SDG&E agreed to pay all must run  
12 invoices submitted by the ISO. And, any future Owners will have to agree that they do not  
13 have recourse to the ISO in the event that payment has not been received from SDG&E. *See*  
14 Exhibit 2. Thus far, PG&E and Duke have refused to negotiate a similar agreement.

15 Consequently, the only remaining requirement restricting access to \$224,528,000 of  
16 VRDB proceeds is PG&E's refusal to agree to pay all must run invoices submitted by the  
17 ISO, and Duke's refusal to agree that it will not have recourse to the ISO in the event that  
18 payment has not been received from PG&E.

### 19 **Must Run Payment Risk**

20 Just as the ISO is a "passthrough conduit" for imbalance energy and ancillary service  
21 payments, it is also a passthrough conduit for must run payments. The must run payments  
22 flow from the Participating Transmission Owner ("PTO") through a must-run trust account  
23 managed by the ISO to the Owner of the reliability must run unit. When the PTO is also the  
24 Owner, the ISO does not have any must run payment risk (Payment Risk) since any payment

1 default by the PTO would be offset against the corresponding payment to the Owner. When  
2 the reliability must run unit is sold to a new Owner, the ISO does have Payment Risk since  
3 any payment default by the PTO would not be offset against the corresponding payment to  
4 the new Owner.

5 The amount of the must run payments is very large. The annual cash flow of  
6 payments is estimated to be between \$855,000,000 and \$2,000,000,000. The annual ISO  
7 budget is only \$152,710,000. The ISO has no source of funds to cover non-payment for any  
8 reason. If a PTO defaults in its payment and the new Owner demands payment from the  
9 ISO, then the ISO would be forced to default in its payment to the new Owner.

10 The ISO does not have any Payment Risk in performing its duties as an agent for  
11 imbalance energy and ancillary service payments in the market and should not have any  
12 Payment Risk in performing its duties as an agent for must run payments. The ISO is  
13 essentially an escrow agent facilitating invoicing and payments between the seller and buyer  
14 of must run generation and should not be forced into default due to a PTO default of its  
15 payment obligations.

16 It would be highly unreasonable for the ISO to be forced to accept the Payment Risk  
17 and additional financing costs when the seller and buyer of a must run generation unit reap  
18 the benefits of the transaction. It would also be highly unreasonable for other entities, *i.e.*,  
19 users of the ISO grid, to bear the additional financing costs because PG&E and Duke will not  
20 agree to terms similar to those in the SCE Agreement and the SDG&E Agreement. *See*  
21 Exhibits 1 & 2.

22 Duke has suggested that the ISO should have established a reserve to cover the  
23 contingency of a default in payment. In lieu of such a mechanism, Duke suggests that the

1 ISO provide each must run Owner with a letter of credit and give each Owner a security  
2 interest in the ISO's account receivable for the amounts a utility owes for must run service.  
3 If the ISO defaults on its payment to the Owners, the owners could collect the amounts owed  
4 from the proceeds of the letter of credit and the security interest before collecting directly  
5 from the ISO. Neither suggestion is feasible.

6 First, the accumulation of reserves to support Payment Risk will necessarily increase  
7 the Grid Management Charge (GMC) at the expense of all those who are assessed the GMC.  
8 Given the amount of a letter of credit that Duke proposes to require of the ISO, if the ISO had  
9 to accumulate an equivalent \$75,000,000 reserve in one year to cover Duke, the 1998 GMC  
10 would increase by approximately \$0.3846/MWh ( $\$75,000,000/195,000,000$  MWh) or 49%.

11 Second, the ISO is not able to issue a letter of credit to an Owner due to the fact that,  
12 based on my discussions with various banks, no bank would issue a letter of credit on behalf  
13 of the ISO since there is no source of repayment. Two potential sources of repayment using  
14 GMC revenues and market revenues from imbalance energy and ancillary services are  
15 unavailable. All ISO GMC revenues are restricted to fund operations and debt repayment.  
16 All market revenues from the imbalance energy and ancillary services markets are assets of  
17 the market participants and unavailable to the ISO for any use.

18 Consequently, the ISO cannot agree to any arrangement that forces the ISO to bear  
19 any Payment Risk from third parties for must run payments. The assumption of any Payment  
20 Risk degrades the ISO's credit position and increases the ISO's cost of financing, and  
21 ultimately the GMC.

22 As for Duke's suggestion that it be permitted to have a security interest in the ISO's  
23 accounts receivable for PG&E, such a suggestion is feasible. Indeed, in the Principles of

1 Agreement that the ISO has reached with SCE Owners, SCE and SDG&E, similar protection  
2 is provided. *See* Exhibits 1 & 2.

3 In that same vein, Duke has also stated that if it shields the ISO from liability for its  
4 nonpayment, Duke would be left without any recourse for payment in the event of a payment  
5 dispute between Duke and PG&E. It claims that because it would not be in privity with  
6 PG&E, it could not sue PG&E for breach of contract if PG&E fails to pay the ISO.  
7 However, if PG&E and Duke executed an agreement with the ISO similar to the SCE  
8 Agreement and the SDG&E Agreement, then Duke, as a third-party beneficiary, would be  
9 given the ability to take action against PG&E. *See* Exhibits 1 and 2. Additionally, under the  
10 agreements, PG&E would agree to make a payment, even if there existed a dispute, thus,  
11 decreasing Duke's risk further.

12 PG&E claims that its transfer of RMR facilities to Duke will not alter the ISO's  
13 financing arrangements from the *status quo* because it has not yet agreed to a "non-recourse"  
14 arrangement. To the contrary, the ISO's financing arrangements will be negatively affected  
15 by a transfer to Duke because, as previously stated, when the PTO is also the Owner, the ISO  
16 does not have any Payment Risk since any payment default by the PTO would be offset  
17 against the corresponding payment to the Owner.

## 18 **ISO Credit Impact**

19 In August 1997, I engaged J.P. Morgan Securities, Inc. (JPM) as the ISO's financial  
20 advisor. In April 1998, JPM issued a request for proposal (RFP) to world class banks for the  
21 LOC portion of the ISO's financing. The responding banks were requested to bid on a  
22 financing structure with Payment Risk and a financing structure without Payment Risk.

1 Significantly, no bank submitted a bid with Payment Risk. As a result, the ISO had no  
2 alternative other than to structure its permanent financing with no Payment Risk.

3 Due to the potential size of a PTO payment default, as previously stated, the  
4 Syndication requires that PG&E, SDG&E and SCE agree to pay all must run invoices  
5 presented by the ISO even if the PTO disputes the invoice. Any dispute would be  
6 adjudicated through the arbitration process. In addition, the Syndication requires that all new  
7 Owners agree that there will be no recourse to the ISO if the ISO has not received payment  
8 from the PTO. These negative covenants are set forth in Exhibit 3, which excerpts the LOC  
9 reimbursement agreement (Reimbursement Agreement).

10 If the ISO does not comply with these negative covenants, then the ISO will be in  
11 default of the Reimbursement Agreement and be subject to severe financial consequences.  
12 Excerpts from the Reimbursement Agreement that describe defaults and remedies can be  
13 found in Exhibit 4. One possible consequence could be that the Syndication would give  
14 notice that all drawings, all loans and all interest thereon, are immediately due and payable. In  
15 addition the Syndication could give notice of a mandatory tender for the purchase of all  
16 outstanding VRDBs.

## 17 **Financial Cost To The ISO**

18 In discussions with the Syndication concerning the possibility that the ISO would be  
19 forced to assume Payment Risk due to the inability of the ISO to reach agreement with  
20 PG&E and Duke, I believe the Syndication will seek to reduce their exposure to the increased  
21 credit risk of an ISO default by requiring the following actions:

- 22 1. The Syndication would require that the \$76,872,000 used for working capital and  
23 completion of the Infrastructure be paid in a fully amortized, one year, term loan in  
24 1999 at a substantial increase in interest rates. A LIBOR-based risk premium of 4.5%

1 would be assessed in addition to the tax-exempt interest rate. The additional interest  
2 cost is estimated to be at least \$1,729,620 ( $\$76,872,000/2 \times 0.045$ ) on an annual basis.

3 2. The 1999 GMC would have to be increased in order to pay off the \$76,872,000 in  
4 principal and associated interest and fees. In addition, \$15,472,000 in capital  
5 expenditures (1998 capital expenditures of \$6,322,000 and 1999 capital expenditures  
6 of \$9,150,000) would also have to be financed by the 1999 GMC since the VRDB  
7 funds would be restricted and would not be available for capital expenditures. This  
8 would increase the 1999 GMC by \$0.4736 MWh ( $\$92,344,000/195,000,000$  MWh)  
9 which would represent a 60.48% ( $\$0.4736/\$0.7831$ ) increase over the 1998 GMC of  
10 \$0.7831/MWh.

11 3. Until this issue is resolved the ISO, will be making interest payments on the  
12 \$206,000,000 in temporary financing as well as the \$301,400,000 in permanent  
13 financing. As an offset to these interest expenses the ISO will earn interest income  
14 from the investment of the \$224,528,000 of restricted VRDB proceeds. The net  
15 negative spread between the interest rate paid and the interest rate earned is estimated  
16 to be \$2,060,000 ( $\$206,000,000 \times 0.01$ ) on an annual basis.

17 Until the Payment Risk issue is resolved, the Syndication will not release the  
18 restricted VRDB proceeds of \$224,528,000 to the ISO. The ISO will not be able to pay the  
19 Trust Notes totaling \$206,000,000. The Trust will not be able to pay down the BofA balance  
20 of \$206,000,000. And, the three IOUs' guarantees, totaling \$215,000,000, will not be  
21 released.

22 If this Payment Risk issue is not resolved to the satisfaction of the Syndication, the  
23 ISO may be required to use all restricted VRDB proceeds to retire the outstanding VRDBs.  
24 This would cause the ISO to initiate a new permanent financing at a later date at a higher  
25 cost.