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Vermont Hydroelectric Power Authority
112 State Street, Drawer 20
Montpelier, Vermont 05620-2601

June 17, 2004

Vermont Sustainable Energy Coalition
C/O Robert Walker
Sustainable Energy Resource Group
432 Ulman Road
Thetford Center, Vermont 05075

Re: Response to June 10 letter to the VRPSAA

Dear Bob:

Thank you for writing concerning your coalition's interest in the work of the Vermont Hydroelectric Power Authority ("VHPA"). As you know, the VHPA has been created by statute, in 30 V.S.A. Chapter 90. As the newly appointed interim manager, I will respond on behalf of the VHPA. The VHPA's statutory goals are to continue the work of the Vermont Renewable Power Supply Acquisition Authority ("VRPSAA"), and take actions towards the purchase of hydroelectric facilities in the region. On May 5, 2004 the VRPSAA announced an agreement with two Canadian companies, Brascan Corp. and Emera, Inc., to work together towards acquiring certain hydroelectric facilities in the region. The VRPSAA's rights under its agreement with Brascan and Emera will be assigned to the VHPA, which has the powers necessary to conclude the transaction, should we be successful.

This letter will try to respond to your concerns by outlining the process and discussing the decisions that have brought the State to this point in time, discussing the benefits and risks of the proposed transaction, and outlining how the VHPA plans to move forward.

Background and Process

The VRPSAA was created in the summer of 2003, and given the charge to investigate the feasibility of purchasing hydroelectric assets along the Connecticut and Deerfield Rivers, to prepare a proposal to purchase the facilities, including necessary negotiations, and to submit any proposal to the General Assembly for its consideration.¹

Lexecon, Inc. was retained by competitive bid to assist in the research, analysis and study preparation. Six meetings open to the public (at least partially) were held between June 2003 and April 2004, two of which were expressly to take public input (one in Montpelier and one in Wilmington). The VRPSAA also met four times in executive session to discuss specific financial analyses which, if public, could put the State at a disadvantage *vis a vis* competitors in a public sale process, and to discuss partnership proposals.

Two public presentations were prepared, and submitted by the VRPSAA to the General Assembly on December 1, 2003. They are available at <http://www.leg.state.vt.us/reports/04power/power.htm> and were distributed publicly.

To facilitate continuation of the VRPSAA's work, the General Assembly passed a section in the Budget Adjustment Act providing additional funding and guidance.ⁱⁱ The guidance manifests support for the VRPSAA's work, and authorized the Secretary of Administration to enter into a Memorandum of Understanding ("MOU") with potential partners, requires sign-off on any final deal by the General Assembly, and requires that the VHPA pay property taxes to municipalities as if it were an entirely private entity.

A unanimous decision was made by the VRPSAA to investigate a public/private collaboration based largely on the analysis done by Lexecon, the public portion of which is cited above. The bottom line was that Vermont alone had a 7.5% chance of success acquiring the facilities. At the request of the VRPSAA, Lexecon investigated which commercial entities interested in the facilities would be interested in a collaborative venture. The result was a series of meetings between the VRPSAA and five potential private partners. In an executive session on April 30 the VRPSAA chose Brascan and Emera, again unanimously, after careful consideration of the presentations by the potential partners. Michael K. Smith, the VRPSAA chairman, and the Secretary of Administration, then began the process of negotiating a "term sheet" and then an MOU outlining the VRPSAA's collaborative relationship with Brascan and Emera. Neither the term sheet, nor the MOU are public documents, as they contain business terms and information that would be of competitive interest to others who also may be interested in the facilities. Both the term sheet and the MOU were presented to and approved by the VRPSAA prior to their signing. The MOU was signed on May 5, 2004.

The 2004 General Assembly took the next step necessary to move the process forward and created the VHPA, an entity with the powers to issue bonds, and to own, operate and manage any interest the VHPA may acquire in the facilities. The new statutory language includes a purpose and goals that guide the VHPA's activities.ⁱⁱⁱ The language details the VHPA's authority, obligations and restrictions, and can be found at <http://www.leg.state.vt.us/docs/legdoc.cfm?URL=/docs/2004/bills/passed/H-767.HTM> in sections 101-103 of the bill.

Issues Raised in the June 10 Letter

As is acknowledged in your letter, a lot of hard work has gone into this effort, and we are much closer to a successful acquisition today than several months ago. That acknowledgement is appreciated, and the VHPA continues those efforts as we move towards the next steps in the process.

The letter expresses one serious concern about how the VRPSAA and the VHPA are proceeding, and makes some analyses of the issues such as financing, power sales, revenue potential and public input. I would like to respond with explanations of the benefits, risks and some of the intricacies that I hope will clarify why certain choices were made. This response cannot go into much detail on financing or valuation issues, as the public release of such information would be detrimental to the chances for a successful acquisition.

The one serious concern is that the VHPA will not be a majority owner of the facilities. The VRPSAA had made public statements that it would pursue acquiring at least a 25% interest in the facilities, with the opportunity to negotiate for a larger stake in the future. There are some strong reasons for this measured approach.

First, the facilities' owner is currently in bankruptcy, and any actions affecting the facilities are under the bankruptcy court's jurisdiction. There has been no public announcement by the bankruptcy court, debtor-in-possession or the creditors as to if or when the facilities will be auctioned, or, if they are, whether the fossil units will be separated from the hydro systems, or whether they will be sold as a "package." Any work done towards an acquisition is therefore somewhat speculative. Lexecon's conclusion was that the state had a 7.5% chance of success acting alone. It is unusual for a governmental entity to make significant resource commitments to speculative business ventures, with no expectation of a return, which would have been the case here had the State moved forward alone, or in the lead.

For the VHPA to seriously pursue an acquisition of the hydro facilities alone, or as a majority partner, it would be required to expend significantly more resources than have been made available by the General Assembly. Investment bankers and transactional attorneys would have to have been retained months ago, in addition to the current consultants, just to keep us up-to-date and in the running. While the VHPA is obtaining its own expert assistance, having partners allows the VHPA to utilize the partners' expertise that would otherwise had to have been contracted for much earlier, at significant cost.

Second, Lexecon's analysis of the valuation, and the purported strong interest in the facilities by major players in the power generation business (suggesting a competitive auction) led to a conclusion that the winning bid would likely be in excess of reasonable bonding capability of the VHPA. A transaction purchasing the entire hydro systems would be significant in comparison to Vermont's existing bonded debt. One unambiguous determination by the VRPSAA, codified in the VHPA authorizing statute, is that financing for any acquisition will not impact on the State's credit rating.^{iv}

Also, the tax code complexities of tax-free bonding would make it impossible for the VHPA to purchase 50% to 100% of the facilities, sell the output, and be able to maintain the tax-free status for the bonds. Tax-free financing can generally be used only for "public purposes," which likely do not include selling power wholesale to investor-owned or cooperative retail utilities, power marketers, or to all takers on the spot market. The market for municipal power sales is limited, and municipal utilities in the region have not indicated sufficient need for energy to justify the VHPA purchasing 50% or more of the facilities. (In fact, the expressed interest is less than 25% of the systems' capacities.) Backing bonds with the State's "general obligation" can also reduce financing costs, but doing so has serious implications for the State's bond rating, and would not be permissible under the language in 30 V.S.A. Chapter 90, establishing the VHPA. (See endnote iv.)

Third, an acquisition of less than 50% of the facilities still gives the VHPA more energy than is needed by Vermont electric utilities for at least the next eight years. Any energy not obligated under contracts between VHPA and Vermont utilities would have to be sold by contract to out-of-state utilities or on the wholesale market through ISO-New England. Being a seller in the current wholesale market, particularly one without significant experience that holds only one or two small (relatively) generating systems, entails risk. Many issues

arise: counterparty credit risk, operating reserves, operating capital (particularly since hydro facilities have a variable output, but financing payments are generally fixed), market price fluctuation, and others. The VHPA, acting alone, would have to purchase the expertise to manage these risks, either in house or contracted out, increasing its operating expenses.

Most of the cost the VHPA needs to recover by selling energy and other products will be financing cost. Should these facilities be auctioned, the winner will pay a market price based on the anticipated future revenue stream, which is based in large part on a forward price curve for the power market, which, in turn, is driven by the cost of natural gas. A state entity pays no income tax, and may have a lower cost of capital (although we do not know how other interested parties would finance, and therefore can not be certain a state entity has a significant advantage), but we would have to pay a price in the same range as any other purchaser.

One disadvantage to the VHPA, acting alone, is a lack of protection for our investment in times of lower than expected revenues or higher than expected costs. A substantial cash operating reserve is especially important for an entity owning only one hydroelectric system, as owning a large portfolio of geographically dispersed hydroelectric systems gives the owner the ability to spread out generation variations in one system with generation, and therefore revenues, from other systems. In an exceptionally dry year, for instance, the VHPA may see a decrease in revenue during the peak summer season (when prices are highest), but will still need to make payments to bondholders. This scenario may be unlikely, but the risk must be planned for, and mitigated.

In addition to the ownership percentage issue, it is evident that this potential acquisition is seen as a way to bring existing renewable resources to Vermont. At least two issues arise: First, Vermont utilities cannot be required to purchase power from these facilities, and will not purchase energy from the VHPA if it is not priced below other alternatives, as the utilities have an obligation to provide least-cost service to their customers. The VHPA cannot count on potential air quality, renewable energy or other benefits that may arise from the positive environmental attributes of existing hydro generation, we must have a plan that repays bonds with known sources of revenue. In short, increasing the VHPA's ownership interest to over 50% does not guarantee that energy from generation owned by the VHPA will be contracted to Vermont utilities, or that the VHPA will otherwise produce revenues that will flow to Vermont electricity customers.

The letter also makes the statement that "[i]f state guaranteed money is going to be used to acquire the dams, the state should control the distribution of their output." The VRPSAA and VHPA have as a primary goal the ability to control where its share of the output is sold, which does not necessitate functional control of the assets. The VHPA will first consider Vermonters' best interests when marketing its share, whatever the final percentage. It also is essential to understand that the State of Vermont is not providing tax revenue-based guarantees to any financing for these assets. Any bonds will be backed by the interest in the assets themselves and contracts for the sale of energy and other services.

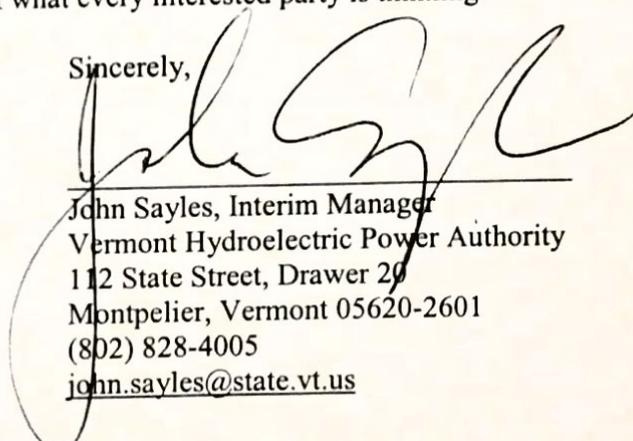
Strong citizen support was evident at the public hearings held on this initiative. Indeed, it is an exciting idea, and one that has merit, which is why so much work has gone into bringing it to fruition. It can be difficult, however, to explain in the press and at public forums the details of the benefits and risks, and the possible financial structure for the deal. This is an

area in which the VHPA needs to work harder. Also, the elected representatives appointed to the VRPSAA, representing a wide spectrum of Vermonters, both geographically and philosophically, unanimously agreed that the structure being pursued is the right one. Our collaborative venture agreement includes the right to negotiate for an increase in the VHPA's interest in the facilities at the time Vermont's utilities may have additional needs. The VHPA should, and will, continue to look for ways to increase the benefits from this project for Vermont's citizens. Opportunities are continually arising and we will be open to them.

One way to support an increase in the VHPA's interest in these facilities is to support the VHPA/Brascan/Emera collaborative venture, and to continue building support throughout the State for the idea that increasing the State's role in this project is a good investment now, and for the future.

I hope this discussion clarifies why and how the VRPSAA and VHPA are on the current path and moving forward in this manner. I would like to invite you, and all the members of the Vermont Sustainable Energy Coalition, to sit down with me, individually or as a group, and discuss these issues in more depth. While there may not always be consensus, it is useful to have a complete understanding of what every interested party is thinking.

Sincerely,



John Sayles, Interim Manager
Vermont Hydroelectric Power Authority
112 State Street, Drawer 20
Montpelier, Vermont 05620-2601
(802) 828-4005
john.sayles@state.vt.us

cc: Michael K. Smith
VRPSAA members
Harry Goldgut, Co-Chairman & CEO, Brascan Power Corp.
Wayne Crawley, VP Corporate Development, Emera, Inc.
Jim Coyne
Prescott Hartshorne

ⁱ **Excerpts from Section 38 of Act 63, the 2003 Capital Bill**

(a) A Vermont Renewable Power Supply Acquisition Authority shall be created to prepare due diligence and feasibility studies regarding the purchase of hydroelectric dams and related assets on the Connecticut and Deerfield Rivers and, with the consent of the governor, to enter into negotiations necessary to prepare a proposal for the purchase of the dams, to be submitted to the General Assembly for its consideration.

....

(c) The Authority shall prepare two studies as follows:

(1) A study of the financial and technical issues involved in a purchase of the hydroelectric dams on the Connecticut and Deerfield Rivers; and

(2) A study of the principal policy issues implicated by such a purchase, if it were authorized, including:

(A) administrative and structural options for the ownership of the facilities and the sale and distribution of their power output, which might include ownership through the creation of a limited purpose state public power authority; by the Vermont Public Power Supply Authority; by one or more Vermont utilities; or by a public-private partnership.

(B) alternatives for disposition of the power output of the facilities, including wholesale and retail sales within and outside the state and use of the power within a portfolio to support advanced and renewable energy technologies, and the impacts of these alternatives on the credit-worthiness of the state and the ability of Vermont utilities to access investment capital on reasonable commercial terms.

(d) The Authority may consult with other state, municipal, or private entities

(e) The Authority may obtain, use, and develop commercial and financial information of a proprietary nature whose public release could jeopardize the position of the State of Vermont and its agents in negotiations or other efforts to present recommendations for the Legislature to purchase the facilities on advantageous terms. The Authority may also obtain, use, and develop information for the same purposes that is entitled to proprietary treatment to protect the commercial or trade secret interests of others. All information not exempt from public inspection under 3 V.S.A. § 317 shall be available to the public, including any reports and recommendations received by the Authority, which may be redacted as necessary to accomplish the purpose of this subsection.

....

ii Section 5 of Act 80, the 2004 Budget Adjustment Act.

(a) There is appropriated from the general fund the sum of \$100,000.00 in fiscal year 2004 to the secretary of administration for costs of the Vermont renewable power supply acquisition authority for work regarding the purchase of all or part of the Connecticut River hydroelectric system consistent with the intent of Sec. 38 of No. 63 of the Acts of 2003. Up to an additional \$150,000.00 in general funds is hereby appropriated, contingent on emergency board approval, for use by the authority for this purpose in fiscal year 2005. Any funds appropriated and not expended or spending authority not used in fiscal year 2004 shall carry over in fiscal year 2005. The General Assembly hereby manifests its support for the work of the authority and authorizes the secretary of administration to negotiate a memorandum of understanding with a qualified partner seeking to bid on the assets of the hydroelectric system, setting forth potential partnership terms, including the commercial intent of the parties, approach to the bankruptcy or auction proceedings, possible coordination of supporting resources, and determination of ownership interests. No binding commitment may be made by the secretary on behalf of the state to enter into any partnership or purchase such assets without the prior approval of the General Assembly or the joint fiscal committee if the legislature is not in session. An ownership interest in any assets of any part of the hydroelectric system by the state or by any state authority or other state entity shall not alter the obligation of the owner to pay the full amount of the property taxes to any Vermont municipality in which the assets are located that would be due if the assets were entirely privately owned.

iii Sections 101 of the 2004 Capital Bill, Findings, Purpose and Goals section.

30 V.S.A. chapter 90 has a section stating finding, purpose and goals:

§ 8051. FINDINGS, PURPOSE, AND GOALS

(a) The General Assembly of the state of Vermont finds:

(1) Potential exists to purchase an interest in hydroelectric power stations along the Connecticut and Deerfield Rivers located in Vermont, New Hampshire, and Massachusetts.

(2) The General Assembly created the Vermont Renewable Power Supply Acquisition Authority (VRPSAA) in Sec. 38 of No. 63 of the Acts of 2003 to investigate such a purchase and the VRPSAA has taken actions towards that goal.

(b) Therefore, it is the purpose of this act to create an entity with the authority to finance, purchase, own, operate, or manage any interest in the hydroelectric power facilities along the Connecticut and Deerfield Rivers located in Vermont, New Hampshire and Massachusetts, and to sell the electric energy under the control of the authority from those facilities at wholesale to authorized wholesale purchasers. The purchase and operation of an interest shall be pursued with the following goals:

(1) To promote the general good of the state;

(2) To stimulate the development of the Vermont economy;

(3) To increase the degree to which Vermont's energy needs are met through environmentally-sound sustainable and renewable in-state energy sources;

(4) To lessen electricity price risk and volatility for Vermont ratepayers and increase system reliability;

(5) Not to compete with Vermont utilities;

(6) To ensure that the credit rating of the state will not be adversely affected and Vermont taxpayers will not be liable should the project fail because of the failure to produce sufficient revenue to service the debt, the failure of a partner, or for any other reason; and

(7) To cause the project to be operated in an environmentally sound manner consistent with federal licenses and purposes.

^{iv} 30 V.S.A. §8051 (b)(6): "To ensure that the credit rating of the state will not be adversely affected and Vermont taxpayers will not be liable should the project fail because of the failure to produce sufficient revenue to service the debt, the failure of a partner, or for any other reason; . . ."

30 V.S.A. §8051 (1): ". . . No indebtedness shall be issued by the authority without the written approval of the state treasurer, which approval shall be given if, based upon his or her investigation, the state treasurer has certified that:

(A) none of the nationally-recognized credit rating agencies that rate general obligation debt of the state of Vermont has concluded that such indebtedness will be included as part of the state of Vermont's net tax-supported debt computation, as prepared by such rating agencies; or

(B) the financing structure and flow of funds for such indebtedness will not result in such indebtedness being counted as net tax-supported debt, or its equivalent, on the state of Vermont's debt statement, as prepared by any of the nationally-recognized credit rating agencies that rate general obligation debt of the state of Vermont."

30 V.S.A. §8058: "(b) In addition to any other statute affecting the authority, no bonds shall be issued under this section without the prior approval of the governor or designee. . . ."

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(d) No financing or security document, bond, or other instrument issued or entered into in the name and on behalf of the authority under this chapter shall in any way obligate the state to raise any money by taxation or use other funds for any purpose to pay any debt or meet any financial obligation to any person at any time in relation to a facility, project, or program financed in whole or in part by the issue of the authority's bonds under this chapter"