October 26, 2006

State of Delaware
Public Service Commission

IN THE MATTER OF INTEGRATED RESOURCE PLANNING FOR THE PROVISION OF STANDARD OFFER SUPPLY SERVICE BY THE DELMARVA POWER & LIGHT COMPANY UNDER 26 DEL. C. SECTION 1007(c) & (d): REVIEW AND APPROVAL OF THE REQUEST FOR PROPOSALS FOR THE CONSTRUCTION OF NEW GENERATION RESOURCES UNDER 26 DEL. C. SECTION 1007(d)	)))))))))	**DOCKET NO. 06-241**
IN THE MATTER OF THE PROVISION OF STANDARD OFFER SUPPLY TO RETAIL CONSUMERS IN THE SERVICE TERRITORY OF DELMARVA POWER & LIGHT COMPANY (Filed on August 1, 2006)	)))))	**DOCKET NO. 04-391**

COMMENTS OF NRG ENERGY, INC. ON THE INDEPENDENT CONSULTANT'S FINAL REPORT REGARDING DELMARVA POWER & LIGHT COMPANY'S PROPOSED RFP

I. INTRODUCTION

NRG Energy, Inc. ("NRG") is pleased to offer its comments to the Delaware Public Service Commission ("PSC" or the "Commission") on the "Final Report regarding Delmarva Power & Light Company's Proposed RFP" ("Final Report"), and prepared for the Commission by the consulting team of New Energy Opportunities, Inc., Merrimack Energy Group, Inc., La Capra Associates, Inc. and Edward L. Selgrade, Esq. (collectively, the "Independent Consultant"). The Final Report provides detailed comments on a Compliance Filing and Proposed Request for Proposals ("RFP"), filed with the Commission on August 1, 2006 by Delmarva Power & Light Company ("Delmarva") in the above-captioned dockets. NRG has been an active participant in the

subject proceedings. NRG has participated in the August 18, 2006 Public Workshop, and has submitted Initial Comments on August 17, 2006, Supplemental Comments on August 31, 2006 ("Supplemental Comments"), comments dated October 2, 2006 ("Initial Report Comments") on the "Initial Report Regarding Delmarva Power & Light Company's Proposed RFP" ("Initial Report"), dated September 18, 2006 and comments dated October 6, 2006 ("Markup Comments") on the "Independent Consultant Markup of September 27, 2006 to Delmarva Proposed RFP" ("Markup").

II. COMMENTS OF NRG

A. General Comments

NRG finds the Final Report to be generally consistent with the Report and would accordingly offer many of the same comments as are found in the Supplemental Comments and Markup Comments. However, there are certain issues raised by specific language in the Final Report which, although they may amplify or provide further detail regarding issues raised in the Initial Report, nonetheless appear troublesome to NRG based on the possible interpretations of such language. These items are the subject of the detailed comments below.

Again, NRG wishes to thank the Independent Consultant for its efforts in preparing the Final Report and to thank the Commission for the opportunity to offer these comments.

B. Variable Interest Entity Treatment

In the RFP, Delmarva has stated that it will not select a proposal which will subject it to the requirements of FASB Interpretation No. 46(R), *Consolidation of*

Variable Interest Entities ("FIN 46(R)" or the "Statement").[1] As the Independent Consultant points out, this position arises from the concern that if Delmarva's power purchase agreement ("PPA") is deemed to be a "variable interest" within the meaning of FIN 46(R), the Statement could require Delmarva to consolidate on its financial statements the finances of the generating entity that serves as the counterparty to such contract.[2] The RFP requires all bidders to "supply Delmarva with all the information necessary to make" assessments "for appropriate accounting and/or tax treatment."[3] The Independent Consultant has concluded that Delmarva may properly consider the applicability of the Statement as a threshold requirement but recommends that Delmarva clearly state what information it will require in order to make the FIN 46(R) assessment and what standards it will use to do so.[4]

NRG contends that while it is acceptable to assess the applicability of the Statement to each proposal, a finding that the requirements of FIN 46(R) do apply should not automatically disqualify a bid. The impact of "Variable Interest Entity" ("VIE") treatment on Delmarva must be evaluated on a case-by-case basis. The Statement's requirements as they may apply to the PPA depend on the proposed terms of the PPA and on the structure of the entity that will serve as the Seller under the PPA. Appropriate PPA terms could be developed in tandem with the structure of the Seller to mitigate or even nullify the effects of VIE treatment on Delmarva. In any event, under most reasonable contracting scenarios, FIN 46(R) is not likely to mandate the consolidation result contemplated by Delmarva.

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[1] RFP § 2.2.2, pg. 7.
[2] Final Report, pg. 29.
[3] RFP § 2.2.2, pg. 7.
[4] Final Report, pg. 30.

There are multiple deal structures that could avoid the impact of FIN 46(R). In light of these facts, the Commission should adopt a simple approach to address the Statement. Delmarva and the Independent Consultant should assess the applicability of FIN 46(R) to each proposal and determine whether such treatment would have an adverse impact on Delmarva's financial statements. Only in the event that Delmarva finds that such treatment for a particular proposal will adversely affect its financial statements, shall Delmarva provide a written justification of such finding as suggested by the Independent Consultant.[5] NRG posits that this is the best way to resolve this issue at the "front end of the process" as the Independent Consultant correctly suggests.[6]

1. Purpose of FIN 46(R).

In order to fully understand this issue, the Commission must consider the context from which the Statement has emerged. Long before the issuance of FIN 46(R), accounting principles required an enterprise to consolidate on its financial statements the balance sheet and income statement of a subsidiary in which it exercised a controlling financial interest by means of a majority ownership of the subsidiary's voting stock.[7] These pre-FIN 46(R) accounting rules, however, did not clearly mandate consolidated reporting of other business organizations, like partnerships and limited liability companies, that can be similarly controlled by an enterprise through arrangements other than stock ownership.[8] This loophole allowed Enron and other companies to create a number of off-book special purpose entities to avoid the reporting of assets and liabilities for which they were ultimately responsible, delay reporting losses that had been incurred

[5] *Id*.
[6] *Id*.
[7] *See generally* Accounting Research Bulletin No. 51, *Consolidated Financial Statements*.
[8] *See* FIN 46(R), p. 8.

and report gains that were illusory.[9] FIN 46(R) is designed to close this gap and improve the financial reporting by enterprises involved with "variable interest entities."

2. Application of FIN 46(R) Requirements to a PPA.

FIN 46(R) states: "An enterprise shall consolidate a variable interest entity if that enterprise has a variable interest (or combination of variable interests) that will absorb a majority of the entity's expected losses, receive a majority of the entity's expected residual returns, or both."[10] A multi-step process is needed to navigate the contours of FIN 46(R) and determine whether a particular contractual or equity interest in an entity implicates the consolidation requirements embodied in the Statement. The inquiry must focus on the unique facts and circumstances of each case and the structure of the entity that is potentially subject to consolidation.[11]

In order for FIN 46(R) to apply, all of the following factors must be satisfied:

- the independent, self-sustaining "business exception" must be determined to be inapplicable;
- the particular contractual or equity interest at issue must be determined to be a "variable interest";
- the entity that is potentially subject to consolidation must be determined to be a "variable interest entity"; and
- the reporting enterprise (here, Delmarva) must be determined to be the "primary beneficiary" of the entity.[12]

a. *The Business Exception*

[9] *Id.* at 59.
[10] *Id.* at 15.
[11] *Id.* at 31.
[12] *See id.* at 4-7.

A contractual or equity interest in an independent, self-sustaining business generally does not fall within the scope of FIN 46(R).[13] This exception is not available if: (1) the reporting enterprise (*i.e.,* Delmarva) participates significantly in the design or redesign of the entity; or (2) the entity is designed so that substantially all of its activities either involve or are conducted on behalf of the reporting enterprise or its related parties.[14] Thus, if the Seller is an independent business that owns several power plants, contracts with multiple utilities, and directly serves as the seller pursuant to a PPA, the business exception likely would apply. If, by contrast, the Seller is a single purpose entity that owns the new generation resource and serves as the seller pursuant to a PPA, FIN 46(R) could be implicated if either of the aforementioned conditions exists. To the extent that the Seller chooses to retain the risks and rewards of sales of energy, ancillary services and other by-products, the Seller would clearly be conducting significant business activities on its own behalf. Because the structure of responding entities will vary on a case-by-case basis and the activities of these entities also will vary, each proposal must be individually examined to determine whether or not the business exception applies.

b. *The Creation of a Variable Interest Through a PPA*

FIN 46(R) defines a "variable interest" as a "contractual, ownership, or other pecuniary interests in an entity that change with changes in the fair value of the entity's net assets, exclusive of variable interests."[15] Although this definition may appear confusing and seemingly circular, it is clear that a fixed-price capacity contract or an output contract for energy, standing alone, would not constitute a variable interest

[13] *Id.* at 11.
[14] *Id.*
[15] *Id.* at 9.

because the resulting payments would not "change with changes in the fair value of the entity's net assets. . . ." If, however, the Seller were to share with Delmarva revenues derived from the entity's participation in the energy or capacity markets, this feature might give rise to variability within the meaning of FIN 46(R). But variability alone does not mandate consolidation because three additional criteria are required: (1) the variability must be significant;[16] (2) the Seller must be a variable interest entity; and (3) Delmarva must be the primary beneficiary of the risks and rewards of the Seller.

c. *The Seller as a Variable Interest Entity*

The Seller will be subject to consolidation by a variable interest holder only if it possesses one or more of the following characteristics:

- The Seller's equity investment at risk is not sufficient to permit the entity to finance its activities without additional subordinated financial support provided by any parties, including the equity holders;
- The Seller's equity investors lack one or more of the following essential characteristics of a controlling financial interest:
    - The direct or indirect ability to make decisions about the entity's activities through voting rights or other similar rights;
    - The obligation to absorb the expected losses of the entity; or
    - The right to receive the expected residual returns of the entity.
- The Seller's equity investors have voting rights that are not proportional to their economic interests.[17]

[16] FIN 46(R) (page 13) provides that the consolidation requirement would not apply if an enterprise's interest in an entity is "not a significant variable interest. . . ."
[17] FIN 46(R), p. 4.

While the Seller can structure itself to avoid becoming a variable interest entity by not triggering the second and third items above, the determination of the adequacy of the equity investment involves a variety of quantitative and qualitative factors that must be considered within the factual context of each case.[18] An investment that is sufficient for one generating entity may not be sufficient for another. Furthermore, there are many ways to avoid the application of FIN 46(R) and, thus, Delmarva and the Independent Consultant must carefully review the information submitted by bidders for VIE purposes in order to whether or not a particular proposal meets the above-mentioned criteria. In fact, even if a particular bidder would satisfy all of these criteria, Delmarva still will not likely emerge as the primary beneficiary of the generating entity.

d. *Only the Primary Beneficiary Must Consolidate*

A variable interest entity can have several variable interest holders, including equity investors and financing institutions. FIN 46(R) provides, though, that only one variable interest holder – the primary beneficiary – must consolidate the finances of the entity.[19] It explains that "[t]he primary beneficiary of a variable interest entity is the party that absorbs a majority of the entity's expected losses, receives a majority of its expected residual returns, or both, as a result of holding variable interests. . . ."[20] Consequently, even if a Section 12 capacity contract is awarded to a generating entity that is a VIE, Delmarva would only consolidate the finances of the generating entity if any variable interest that culminates from a revenue-sharing arrangement discussed in Section II.B.2.b. overshadows the risks and rewards that are borne by the equity investors. The likelihood of such a result is nil.

[18] *Id.* at 13-14.
[19] *Id.* at 16.
[20] *Id.*

Even if, for some unforeseeable reason, it is concluded that FIN 46(R) mandates consolidation with respect to a particular proposal, NRG recommends that such proposals still be considered in the RFP process. Then, as part of the bid evaluation process, Delmarva should consider any adverse economic consequences of VIE treatment, after considering the capital structure and projected earnings profile of the entity subject to VIE, along with the overall costs and benefits of the self-build option and other proposals. This will ensure that otherwise worthy bidders are not arbitrarily precluded from participating in this RFP process.

e. *Summary*

It is extremely unlikely that a PPA awarded to a generating entity will necessitate consolidation of the entity's finances on the books of Delmarva. Thus, the Delmarva should not automatically disqualify bidders for the purpose of avoiding FIN 46(R). Such an approach would limit the flexibility of bidders to submit innovative proposals and to structure their business entities in a manner that serves legitimate business purposes.

3. Recommendation for Addressing FIN 46(R)

Delmarva and the Independent Consultant should conduct a detailed evaluation of how FIN 46(R) relates to the proposed project structure of each proposal. This will reveal any accounting concerns based on the specific terms of the PPA and the planned structure of a particular generating entity. This approach is sound because it would prevent an obscure accounting rule that is not likely to apply from sidetracking the bidding and evaluation processes by not precluding worthy bids.

C. Operational Period Security Requirements

Currently, the RFP provides for an unlimited collateral requirement to cover the replacement costs of the PPA over a two-year forward period.[21] Without restating NRG's position on the uncapped nature of this posting requirement, we now would like to demonstrate that to not limit the amount of such collateral is very uncommon in today's marketplace. Furthermore, the cap suggested by the Independent Consultant, $200/kW, is also not consistent with other long term PPAs currently in the market. As several commenters have argued, lowering this security requirement to a manageable level is essential to soliciting the bids that will best fulfill the policy objectives of EURCSA.

1. Cap on Collateral Requirement during Operational Period

Delmarva's proposal for a limitless security requirement for replacement energy is totally inconsistent with other RFPs currently in the marketplace. Typically, utilities recognize that generating entities, particularly special purpose entities, will not be able to obtain necessary financing to develop new generation resources if they are overly burdened with excessive collateral requirements. This is why other utilities have produced sound methodologies for determining the proper amount of security to require generators to post. For example, PacifiCorp's current RFP provides a clear, coherent methodology for how its security requirements have been produced.

Under the PacifiCorp RFP, the amount of any credit support required is be determined based upon (a) the Credit Rating in the Credit Matrix of either the Bidder or the entity providing credit assurances on behalf of the Bidder, (b) the size of the project, (c) the type of Eligible Resource and (d) whether the utility has a security interest in the

[21] RFP § 3.4.1.4, pg. 20.

Bidder's assets.[22] Such an objective approach avoids the appearance of a utility preferring a self-build option by providing a cogent rationale for arriving at a particular collateral figure. As currently structured, Delmarva's RFP offers no indication of any limit on security requirements upon start up and no justification whatsoever as to why such a potentially excessive obligation is imposed going forward.

Delmarva should adopt objective criteria, such as those employed by PacifiCorp to arrive at a reasonable figure for the collateral requirement during the operational period. This will increase the transparency of the RFP process, which in turn may increase the number of bids. Transparency is of particular importance to bidders that will be utilizing a projected financed special purpose entity, because of the particular challenges they face in obtaining financing. Moreover, the use of an objective methodology will most certainly result in a "hard" number for the collateral requirement.

2. Independent Consultant's Proposed Cap

While we commend the Independent Consultant for its conclusion that a maximum amount of collateral security is appropriate for this RFP, the recommended cap far exceeds what is required in other PPAs currently in the market. It is important to note that, as is the case with Delmarva in the RFP, the Independent Consultant provides very little basis for how it has determined the appropriate amount of security. The Independent Consultant claims that it has reviewed "other recent RFPs," but only cites one to support its $200/kW figure.[23] Again, it is unacceptable to propose a collateral requirement without providing a sound basis for it.

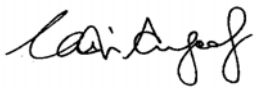
[22] PacifiCorp RFP, App. B, pg. 56.
[23] Final Report, pg. 34.

PacifiCorp's current RFP demonstrates how a more detailed analysis of risk can yield more reasonable required collateral amounts. Under the PacifiCorp RFP, the collateral requirement for a PPA supported by a security interest in a 600 MW generating facility and where the generating entity has the lowest investment grade rating would be $54,511,000.[24] If the generating entity is below investment grade, the requirement would be $104,511,000.[25] If such a PPA were not supported by a security interest in the subject facility, the corresponding collateral requirements would be much higher. This example clearly demonstrates that (i) it is essential that Delmarva utilize a sound and transparent methodology that considers a variety of factors to determine the proper level of performance security and (ii) the required security amount cannot be limitless. To do so will open this RFP process to a wide range of bidders, particularly what is likely a very large number of bidders who will be using a project-finance structure.

III. CONCLUSION

In summary, NRG believes the Independent Consultant's Final Report has improved upon Delmarva's RFP, but that the further changes addressed herein are required for the RFP to succeed in realizing EURCSA's objectives of low and stable prices for SOS customers, the promotion of fuel diversity and improving the reliability of power generation in the State. NRG looks forward to its continuing to participate as the RFP nears its conclusion.

Respectfully Submitted,



Caroline Angoorly,
Vice President & General Counsel, NE

[24] PacifiCorp RFP, App. B, pg. 56.
[25] *Id*.