CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Rick Bruneau
Lori Mitchell

SUBJECT: SEE BELOW

DATE: October 23, 2023

Approved

Date 11/3/23

SUBJECT: AUTHORIZING THE DEPARTMENTS OF FINANCE AND ENERGY TO EVALUATE THE FEASIBILITY OF ENERGY PREPAYMENT TRANSACTIONS

RECOMMENDATION

a) Authorize the Departments of Finance and Energy to evaluate the feasibility of reducing San José Clean Energy power purchase costs by financing energy prepayment transactions through the California Community Choice Financing Authority, a Joint Power Authority and conduit issuer of tax-exempt bonds.

b) Adopt a resolution authorizing the Director of Finance, the Director of Energy, the Assistant Director of Finance, and the Assistant Director of Energy or their designees to join the California Community Choice Financing Authority, if necessary, including execution of any required documents and payment of membership fees under City Manager authority, subject to the appropriation of funds.

SUMMARY AND OUTCOME

As of September 30, 2023, the Department of Energy has procured $4.19 billion in power products since 2018 to ensure reliable, cost-effective, and stable delivery of electricity to San José Clean Energy (SJCE) customers and to comply with regulatory requirements. This portfolio includes long-term power products that are estimated to cost approximately $2.41 billion in purchase commitments spanning through 2045. Staff has learned of a financing mechanism through a conduit issuer of tax-exempt bonds, the California Community Choice Financing Authority (CCCFA), which could potentially yield a reduction in the cost of long-term power purchase agreements. The proposed financing mechanism would involve prepaying eligible power purchase agreement obligations via the CCCFA issuing tax-exempt bonds on behalf of the City of San José (City). Approval of the recommended actions in this memorandum would enable staff to evaluate the benefits, costs, and risks of the energy prepayment transaction. If the evaluation determines an energy prepayment transaction would be financially beneficial to the City, staff will return to the City Council with the required agreements for consideration and approval.

BACKGROUND

In May 2017, the City Council unanimously approved the formation of SJCE, a community choice aggregator[1], which launched service to most businesses and residents in the City service area by February 2019. The sourcing and delivery of electricity to SJCE customers is a joint effort by SJCE and the Pacific Gas and Electric Company. SJCE sources electricity from clean resources like solar and wind, while Pacific Gas and Electric Company delivers that electricity, maintains powerlines, responds to power outages, and provides customer billing. SJCE pays for electricity generation from clean resources through fixed- and variable-priced power purchase agreements of different durations.

Since its inception, SJCE has employed various strategies to mitigate power cost volatility and reduce the costs of its power purchase agreements. These strategies include procuring standard blocks of energy (e.g., 25 megawatts of power, 24 hours per day, for a full calendar year as well as purchasing for certain months and certain hours of the day, as needed), buying energy in medium and long-term contracts, load shaping through rate design (time-of-use rates), and utilizing other demand-side management tools.

Energy prepayment financial transactions have been used to reduce the costs of natural gas procurements since the 1990s; this financing mechanism is now being applied to renewable energy purchase agreements. Various community choice aggregators have entered into these transactions to reduce the cost of eligible power purchase agreements under favorable market conditions. **Table 1** below demonstrates the over $7.7 billion in electricity prepayment transactions to date facilitated by the CCCFA.

Table 1. Electricity Prepayment Transactions By CCCFA

CCAs/Participant	Closed	Total ($ Million)
East Bay Clean Energy[2] and Silicon Valley Clean Energy	9/23/2021	$ 1,234.72
Marin Clean Energy	11/24/2021	602.66
East Bay Clean Energy	7/12/2022	931.12
Pioneer Community Energy	1/4/2023	459.64
Silicon Valley Clean Energy	1/27/2023	841.55

[1] California is one of 10 states that have enabled the creation of local electricity-purchasing cooperatives, called community choice aggregators, that allow cities, counties, and other qualifying governmental entities available within the service areas of investor-owned utilities (such as Pacific Gas and Electric Company) to purchase and/or generate electricity for their residents and businesses. It is not an investor-owned utility program. The investor-owned utilities continue to deliver the electricity through their transmission and distribution systems, and provide meter reading, billing, and maintenance services for community choice aggregator customers.
[2] East Bay Community Energy is rebranding as AVA Community Energy on October 24, 2023.

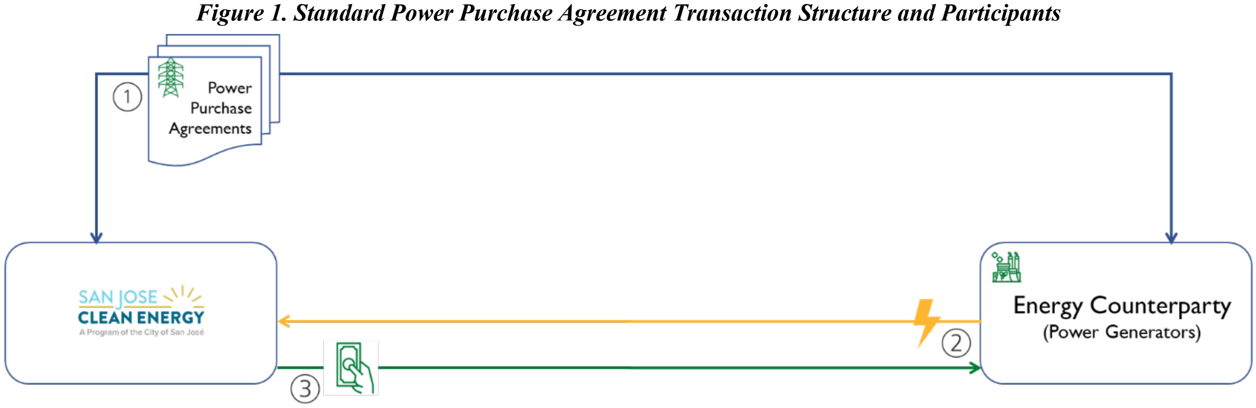
CCAs/Participant	Closed	Total ($ Million)
Clean Power Alliance	2/23/2023	998.78
Clean Power Alliance	6/15/2023	958.29
East Bay Clean Energy	8/16/2023	997.90
Central Coast Community Energy	10/26/2023	647.75
Total		**$ 7,672.41**

ANALYSIS

Staff identified a potential opportunity to reduce the costs of certain existing SJCE power purchase agreements, as well as the costs of qualifying future SJCE power purchase agreements, by prepaying the respective energy costs for those agreements with tax-exempt debt issued by the CCCFA, a conduit issuer of tax-exempt bonds, on the City's behalf. This aligns with the City's overall priority to always look for opportunities to be cost-effective in all aspects of our service delivery system.

SJCE enters into power purchase agreements (PPA) for the purchase and sale of energy products. Standard SJCE PPA transactions generally are structured as in Figure 1:

Figure 1. Standard Power Purchase Agreement Transaction Structure and Participants

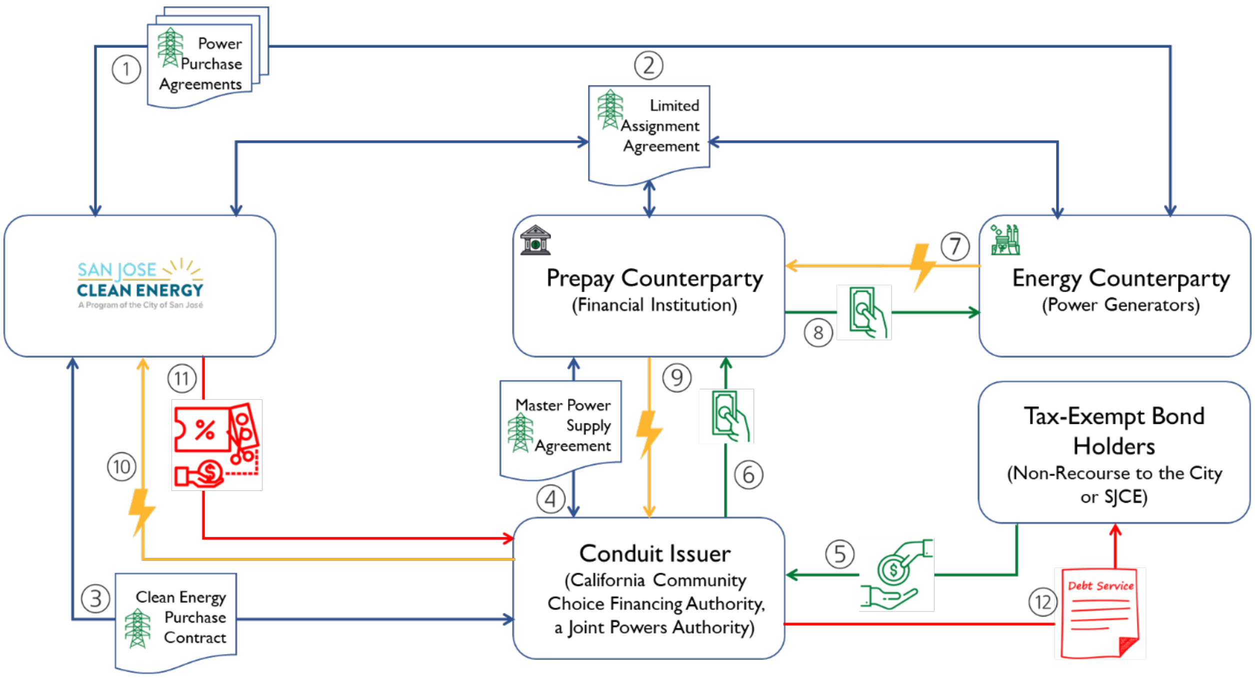


(1) SJCE enters into a PPA with an Energy Counterparty to procure power;
(2) Energy Counterparty provides power per the PPA;
(3) SJCE pays the Energy Counterparty for the power provided per the PPA.

A potential energy prepayment transaction for the City would involve a collection of agreements among the City/SJCE, the Energy Counterparty who are the power generators, the financial institution acting as the Prepay Counterparty, and the Conduit Issuer, currently contemplated to be the CCCFA. The CCCFA is a Joint Power Authority founded by a community choice aggregation consortium including Central Coast Community Energy, East Bay Community Energy, Marin Clean Energy, Silicon Valley Clean Energy, and Clean Power Alliance.

A graphic demonstrating the structure of and participants in an energy prepayment transaction is shown in Figure 2.

Figure 2. Energy Prepayment Transaction Structure and Participants



(1) SJCE enters into PPA(s) which include language allowing SJCE to assign either all or a portion of the power being purchased to a Prepay Counterparty.
(2) SJCE, the Prepay Counterparty, and the Energy Counterparty enter into a limited assignment agreement, which assigns rights for the Prepay Counterparty to receive all, or a portion of, the power that would otherwise be delivered to SJCE under the PPA, and details other terms and conditions of the assignment.
(3) SJCE enters into a clean energy purchase contract with the Conduit Issuer detailing delivery obligations, PPA(s) assignment provisions, and minimum percentage discount.
(4) The Conduit Issuer enters into a master power supply contract with the Prepay Counterparty, which details performance requirements and termination provisions.
(5) The Conduit Issuer issues non-recourse to the City/SJCE, tax-exempt "green" bonds for the amount of the clean energy purchase contract and receives bond proceeds from the bondholders.
(6) The Conduit Issuer prepays the Prepay Counterparty for a 30-year power supply.
(7) The Energy Counterparty delivers power to the Prepay Counterparty monthly.
(8) The Prepay Counterparty pays the Energy Counterparty monthly, in arrears.
(9) The Prepay Counterparty delivers power to the Conduit Issuer monthly.
(10) The Conduit Issuer delivers power to SJCE monthly.

(11) SJCE pays the Conduit Issuer the original PPA price less discount (savings) monthly, in arrears.
(12) The Conduit Issuer makes debt service payments to the bondholders as scheduled.

While the tax-exempt bonds issued by a conduit issuer will have a nominal (stated) 30-year term, the energy prepayment transaction will have an initial pricing period of 5-10 years (tenor), given current market conditions. The actual discount to the PPA contract, which represent savings SJCE will realize under the energy prepayment transaction, is contingent on the spread between taxable and tax-exempt rates at the time the energy prepayment transaction is executed. The City would need to reevaluate after the initial pricing period whether the spread will yield the desired minimum discount. The City will not pursue an energy prepayment transaction unless the transaction can realize financial savings with a minimum of 8% during the initial pricing period.

At the end of the initial tenor, the energy prepayment transaction will be re-priced, and the discount (savings) reset through a new agreement with the conduit issuer, subject to a minimum discount (savings) threshold. This minimum discount (savings) threshold for future resets is contemplated to be between 4% and 5%, depending on the market conditions at the time of the repricing transaction.

It is important to note that neither the City nor SJCE will be obligated for payment on the bonds; that burden lies and will remain with the conduit issuer. As such, the bonds issued as part of this transaction will not be on the City or SJCE balance sheets, nor will these bonds affect SJCE's future credit ratings or debt capacity.

Initial Consideration of Energy Prepayment Transaction Risks

Staff has already considered certain risks in the energy prepayment transaction, which are briefly described below, along with potential mitigations. As staff completes its evaluation of the feasibility of an energy prepayment transaction, it will fully study these as well as any other risks identified during its evaluation. Should staff present an energy prepayment transaction for City Council review and approval in the future, any identified risks as well as corresponding mitigations will be brought forward for City Council consideration concurrent with the proposed transaction.

Financial Risk. Using a conduit issuer, such as CCCFA, minimizes the financial risk to the City and SJCE, as the energy prepayment transaction is non-recourse to the City and SJCE, given the bonds are not debt of the City or SJCE, but rather debt of the conduit issuer of the tax-exempt bonds. As such, the revenues of the City and SJCE are not pledged to debt service to bond investors.

Prepay Counterparty Risk. Prepay Counterparty risk exists should the Prepay Counterparty fail to meet its obligations. Bond rating agencies evaluate these energy prepayment transactions on the basis of the Prepay Counterparty rating, not the rating of the City or SJCE. The City will mitigate Prepay Counterparty risk by implementing a rigorous request for proposal process to select a seasoned Prepay Counterparty with demonstrated experience in the commodity business and energy prepay transactions. Should a termination event occur, terms and conditions in the relevant agreements will obligate the Prepay Counterparty to make a termination payment to be used to repay bondholders.

Volumetric Risk. Volumetric risk is the risk that an Energy Counterparty will not be able to deliver the required energy volumes to meet the requirements of the underlying PPA and sustain the transaction. While this same risk exists in all PPAs, a PPA in an energy prepayment transaction structure risks losing the anticipated savings from the transaction if mitigating actions available to the City/SJCE are not exercised. This volumetric risk may be moderated in three ways.

First, SJCE can choose to assign only a portion of the PPA contract volumes into the energy prepayment transaction, which will hedge against potential underperformance by the Energy Counterparty. Next, the energy prepayment transaction will be structured to allow SJCE to substitute or add additional PPAs to the transaction to sustain the SJCE-required volumes of delivered energy. Finally, the master power supply agreement between the CCCFA and the Energy Counterparty will provide a mechanism to back stop underperforming Energy Counterparties in the event of an outage or other unplanned market risk. Provisions included in the master power supply agreement will address termination events that may occur during the life of the energy prepayment transaction, such as a re-pricing failing to meet the target savings. Should there be a termination event, the energy prepayment transaction will unwind, and the energy contracts (PPAs) assigned to the CCCFA will revert to SJCE. In this case, SJCE will lose staff time and consulting resources spent on the project and any future savings expected to be generated by a successful energy prepayment transaction.

Regulatory Risk. Regulatory risk may materialize should the United States Treasury, through its Internal Revenue Service, change the guidance for the treatment of energy prepayment transactions. Since the Internal Revenue Service published rules approving the treatment of these transactions over 30 years ago, an estimated $60 billion of tax-exempt prepaid green bonds have been issued through December 2022. A final regulation was issued by the United States Treasury and the Internal Revenue Service in August 2003, and additional supportive regulations codified by Congress in the National Energy Policy Act of 2005, Section 1327. If regulations change, the City will assess the continuing viability of the energy prepayment transaction and, if necessary, unwind the transaction in an orderly manner. Under those exigent circumstances, SJCE would continue under the original terms of its PPAs with the downside being unmaterialized savings and any sunk transaction expense including the outlay of staff and consultant resources.

Climate Smart San José Analysis

The recommendation in this memorandum has no direct effect on Climate Smart San José energy, water, or mobility goals. However, the economics of implementing an energy prepayment transaction means the savings realized could be invested in new climate smart, low-carbon infrastructure to continue the City's planned growth under the Climate Smart San José Plan.

EVALUATION AND FOLLOW-UP

Staff will return to the City Council with a recommendation based on the results of its feasibility analysis of an energy prepayment transaction with the CCCFA and, should the staff recommendation be to carry out such a transaction, present the required agreements and ancillary documents for City Council review and approval.

COST SUMMARY/IMPLICATIONS

Professional services expenditures to support the evaluation of this energy prepayment transaction, including municipal advisor fees, bond counsel fees, and any membership fees the City would incur to join the CCCFA, if necessary, would be paid from already appropriated funds within the San José Clean Energy Fund and is expected to fall within City Manager spending authority.

COORDINATION

This memorandum has been coordinated with the City Attorney's Office, City Manager's Budget Office, and supporting consultants on the City Financing team, including municipal advisors.

PUBLIC OUTREACH

This memorandum will be posted on the City Council's Agenda website for the November 14, 2023 City Council meeting.

COMMISSION RECOMMENDATION AND INPUT

No commission recommendation or input is associated with this action.

CEQA

Not a Project, File No. PP17-004, Government Funding Mechanism, or Fiscal activity with no commitment to a specific project which may result in a potentially significant physical impact on the environment.

PUBLIC SUBSIDY REPORTING

This item does not include a public subsidy as defined in section 53083 or 53083.1 of the California Government Code or the City's Open Government Resolution.

/s/
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/s/
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For questions, please contact Luz Cofresí-Howe, Assistant Director of Finance, at luz.cofresi-howe@sanjoseca.gov or (408) 535-7041.