

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

**Credit and Capital Issues Affecting the Electric Power Industry
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**PREPARED DIRECT TESTIMONY OF BRUCE LEVY
ON BEHALF OF
INTERNATIONAL POWER PLC**

SUMMARY OF TESTIMONY

In this timely and important technical conference, the Commission is seeking comments on the availability and cost of capital necessary to support long-term investments. This inquiry is, no doubt, driven by the Commission's understanding that at a time when this nation faces the most significant need for new investment in electric infrastructure, the cost and availability of capital (both equity and debt) for the construction of that infrastructure has been dramatically and negatively affected by the upheaval in the nation's financial markets. The impact of this lack of capital is even more significant given that it is taking place when the nation faces a long-delayed, multi-billion dollar need for new generation and transmission infrastructure.

Over the past two decades, after lengthy debate and analysis, the Commission and the Congress have repeatedly endorsed competition as the best model to meet the nation's infrastructure and reliability needs at the least risk and cost to consumers. This endorsement was based on the conclusion that competition not only led to the most appropriate investment decisions, but that it transferred risk from consumers to suppliers and from government to private investors. Accordingly, as we face the need for approximately \$600B of investment in new power generation facilities and a corresponding amount for transmission expansion and upgrades – amounts that are twice the level of all of the investment currently in operation in our industry – it is important to ensure that impediments to this needed investment are properly and promptly addressed.

International Power plc (International Power) is a global independent power generation company with more than 45 generating facilities totaling over 30,000 MW. These assets are diversified by geography (with 36% of our assets in Europe, 25% (or nearly 7,500 MW) in the US, 17% in Australia, 22% in the Middle East and Asia) and fuel type (with 57% of our plants using natural gas, 25% coal, 8% pumped storage, 6.5% wind, 3% oil, and 0.5% hydro). In addition, various commercial structures have been used to support the financing of these assets. About 45% have financing structures based on short-term contracts, 40% on long-term contracts and 15% without a set contract. Accordingly, International Power has a unique perspective on how to develop, finance, construct and operate electric power infrastructure. We have financed, developed and operated power plants all over the world, in every conceivable regulatory structure, and in a vast variety of economic climates; indeed, we regard our ability to finance power plants as a core expertise.

While the recent financial market collapse has made financing of such projects more difficult, the financing market remains available for properly structured projects. In fact, within the last few weeks, we closed financing on a new 420 MW combined-cycle natural gas facility we are building in Belgium. This financing was underpinned by a 15-year PPA for the facility's output - demonstrating that we can continue to meet the need for additional generation plant construction despite the weak financing markets if the correct commercial structure and regulatory policies are in place.

Before we discuss the current environment, we need to acknowledge that during the past few years, developers of new generation facilities have had unprecedented access to low cost capital needed to support new construction. We not only saw debt pricing at all time low levels,

but we also saw debt open to a broader range of technologies. This allowed for construction of significant new capacity additions in many markets, including fully merchant markets and a large wave of renewable generation (primarily wind) for the first time.

As those favorable conditions are replaced now with a new reality, all participants in our industry (developers, utilities, equipment suppliers and regulators) must adapt to these new conditions. FERC can play an important role in facilitating that adaptation by taking the necessary steps today to frame a regulatory environment that will support the development of new energy infrastructure projects in a credit constrained world.

THE IMPACT OF THE CREDIT CRISIS ON THE DEBT MARKETS

While the reduction in available credit has affected all sectors of the economy, it has had an even greater impact on the power sector. To understand the dynamics of that impact, it is necessary to recollect how these large, costly and technologically complex assets are actually financed and commercialized. Large scale power facilities are financed through a combination of debt and equity financing, both of which have been impacted by the current financial crisis. Specifically, the cost of financing has increased and the availability of such financing has simultaneously decreased, as the market views these investments as being more risky and having less cost recovery certainty.

Because these investments are viewed as more risky, the market and the credit rating agencies are assessing a premium above the risk free rate for financing. To determine the level of premium needed for financing of a power plant, the agencies evaluate the differential repayment risk between the borrower and risk free rates such as treasury bills or LIBOR. Currently, these agencies are viewing these investments as more risky for a number of reasons:

1. Since the recession has led to reduced energy demand growth, and is projected to continue to do so in the short term, lenders question whether new generation projects will be needed.
2. The combination of lower fuel prices and decreased demand for electricity will likely result in lower energy margins for electric generators; particularly those in organized markets, in the near-term since the payment in those markets are determined, in large part, by fuel cost and demand levels. These lower margins are substantially below the level needed to support investment in major new baseload power plants. This has raised concern by lenders that the market assumptions used when making existing loans in the sector (including the level of demand growth, energy and capacity pricing) may not be realized. As a result, we have seen the secondary market for existing debt in organized markets trade up to reflect credit spreads well above normal levels. Thus, by definition, any new financing for such projects would be priced at or above these levels.
3. The recent economic crisis and the resulting sharp reduction in capital in the financial system have decreased the number of lenders with capital available for investment in the energy sector, thereby significantly reducing the supply of debt capital available

at any price.

THE EFFECT OF THE FINANCIAL CRISIS ON EQUITY FINANCING

The credit crisis has had similarly harmful impacts on the availability of equity financing for new projects. This impact is substantial since, as the debt markets have tightened, the leverage available for future investments has decreased, which further increases the need for equity investment.

The market valuation of equity is based on the estimated value of cash flows that the equity investment can earn, including the expected growth of that cash flow over the life of an investment. In the case of a generation asset, there is a tradeoff between an investment with a defined cash flow where the upside case is limited versus an investment more closely tied to market prices. For example, the case where the facility's output is sold under a long-term PPA of 10 years or more versus the case where the asset has a shorter-term PPA or hedge or relies solely on market pricing. The more certain the cash flow, the lower the required equity return.

Prior to the recent change in economic outlook, most investors expected market prices to continue to rise, based on the well-known need for new generation capacity in all markets, both organized and fully regulated. Particularly within organized capacity markets, this need for new capacity additions suggested that market prices would be driven to levels needed to support new investment.

However, the recession, with its corresponding drop in demand for energy and energy prices, has altered those forecasts and increased the uncertainty surrounding future capacity needs. This uncertainty has been further driven by reports from many power pools and ISOs that capacity additions currently proposed are sufficient to delay the need for new capacity by 5-10 years. Even though much of this proposed new capacity is now at risk of not being built, in no small part due to the credit crisis, most published forecasts by power pools and financial analysts have substantially reduced the expected growth in energy market and capacity prices that would justify the investment in construction of new capacity based on short term market signals alone. As a result, equity financing for new investment depending solely on market energy rates for revenue and margins has become considerably more difficult and costly to obtain. This condition will likely persist until stability is restored to the financial and energy commodity markets.

IMPACTS ON FINANCING MODELS FOR NEW POWER PLANT CONSTRUCTION

Generally speaking, there are three models that can support financing for a new generating facility: (1) projected annual revenues from the organized capacity markets, such as those found in PJM, ISO-New England, and the New York ISO, which is supplemented with forecasted energy income; (2) revenues from a long-term PPA (typically 10 years or longer); or (3) traditional cost-based rates.

The first model, capacity markets, is the newest and, in my opinion, most promising in the long-term of these options, but it is also the approach most imperiled by the credit crisis. Many of the organized wholesale electricity markets have sought to spur development of new

baseload generation through the development of capacity markets, such as the Forward Capacity Market (FCM) in ISO New England, Inc., and the Reliability Pricing Model (RPM) in PJM. International Power has direct experience with and continues to support and be active in the development of these new regimes.

These regimes, if allowed to continue to develop in the organized markets, show great promise to foster the development of new power plants at the lowest ultimate cost to consumers. The fact that these evolving regimes have not yet resulted in the development of new baseload plants is due to both the relative newness of the forward capacity markets and the extraordinary events in the financial markets that I previously discussed. Some have concluded that the evolving nature of these markets is a sign that they will never work and have often urged a return to traditional regulatory models. This conclusion is not justified by the facts, and is belied by the long-term promise of these new regimes. These markets have already provided very valuable market signals regarding the value and need of new capacity (whether it be from new generation, demand response or energy efficiency) and will continue to do so as the track record and reliability of these pricing models mature.

In the interim, in order to encourage the development of the needed long-term investments in new power plants, support in the form of competitive medium term PPAs will be needed. The term of such PPAs will depend on the nature and amount of the underlying investment; but the fact remains that current terms available in the organized markets, such as 5-year PPAs, are simply inadequate to attract the substantial debt and equity necessary to put steel in the ground today. International Power's agreements, as exemplified by the financing we secured just last month, suggests that PPAs of 15 years or more will be necessary to support the financing and construction of new baseload construction until the financial markets settle and the organized capacity markets develop further.

The third method of financing power plant construction is traditional cost-based rates for assets owned by vertically integrated utilities. Cost-based rates are, among other things, a financing mechanism, but they have proven to be an extraordinarily expensive way to build a power plant, providing little ability or incentive to manage risk or cost. We have seen many recent examples in traditionally regulated markets where state commissions are considering decisions that will expose end use customers to considerable cost and supply risk. We do not think that the financial crisis, no matter how bad it ultimately gets, could possibly justify a return to this funding approach in all markets, and urge this Commission and state regulators to resist this route.

CONCLUSION

As the nation begins its painful recovery from the current economic crisis, the Commission can affirm its commitment to building a robust, reliable electric system by taking steps to encourage the development of needed new resources in the competitive environment that it has worked so hard to support. The development of new, clean generation is overdue and will become more critical as time passes. Not only will the next wave of new generation provide the reliable electricity to fuel our nation's recovery through capital investment and job creation, it is a core requirement of America's approach to greenhouse gas reduction. International Power and the other competitive power companies that comprise 40% of the nation's operating generators

urge the Commission to take all necessary steps to ensure that these resources are developed through competitive means. That means continuing to implement policies that further promote the evolving capacity regimes in the wholesale markets, acknowledging the necessity during the ongoing financial crisis for competitively based PPAs of sufficient duration to support capital investments in new power plants, and approving traditional cost-based rates as a financing method for these assets only when no market alternative exists.

WHAT SHOULD THE COMMISSION DO?

First, the Commission should ensure that whatever solution we devise today does not undo the work that has been done in the past to configure markets to send appropriate signals for investment. Those policies have resulted in most of the efficiencies and environmental investment that have been made during the past two decades. In fact, the transparency, consistency and sustainability of these markets have been primary drivers to developing new technologies, attracting additional market participants and promoting renewable progress.

Second, the Commission should further policies that recognize that long-term capital investments in major new power plant construction will require term support (i.e. long-term power purchase agreements) in order to attract the substantial capital necessary to proceed with these investments until the problems facing the financial markets correct themselves.

Finally, the Commission can recognize that a key to maintaining momentum in these troubled economic times is regulators who acknowledge, understand, and adjust to the realities in the financial markets by facilitating or even mandating the types of financial structures and incentives that will promote the development of these investments. The financial markets will recover, and the emerging capacity markets will continue to progress, but FERC and the state commissions cannot afford to sit back and wait for the markets to heal, given the sheer size of the nation's infrastructure needs today.

I appreciate the opportunity to share my views on these important matters and look forward to any questions you may have.