UTILITY COMMITTEE

The Utility Committee Meeting was held on July 13, 2015 at 5:01 p.m. with Chairman Hutchison presiding. Members present were Mr. Neil, Mr. Blakeman, and Ms. Stewart. Mr. Cole was absent. Members of Council present were Mr. Anderson, Mr. Hare (arrived at 5:02 p.m.), and Mr. Slavin (arrived at 5:36 p.m.). Mayor Christiansen was also present.

AGENDA ADDITIONS/DELETIONS

Mr. Blakeman moved for approval of the agenda, seconded by Mr. Neil and unanimously carried.

North American Energy Services (NAES) Amended and Restated Operating Agreement

Mr. Scott Koenig, City Manager, introduced the City's Power Supply Attorney, Mr. Kirk Betts, Betts & Holt, LLP, who worked on the renegotiation of the North American Energy Services (NAES) agreement.

Mr. Betts reviewed his memorandum dated July 13, 2015 regarding Proposed Agreement for Plant Operating Services ***(Attachment #1)***. He advised that in 1996, the City entered into a contract with Duke Energy and its subsidiaries to operate the power plant on the City's behalf. He stated that the Duke contract was unique because Duke assumed all of the responsibility for everything, including fuels, and sold energy to the City. Mr. Betts stated that in 2006, Duke was no longer interested in that type of service and the City had to change the contract style.

Mr. Betts explained that the 2006 contact bifurcated the services. Dispatch, design, fuel purchasing, etc. were completed by PACE Global, while NAES operated the plant, integrated, and interfaced every day to determine what the dispatch should be. He stated that all of the plant employees, including former City employees who went to Duke and those that stayed with NAES, remained at the plant; however, over time NAES managed the level of employees in order to operate the plant.

Mr. Betts informed members that, under the NAES contract, NAES provides an annual budget for the operation of the plant, which City staff negotiates prior to budgeting any staffing or operating costs. He stated that fuel costs and services are managed by The Energy Authority (TEA), and TEA operates as a dispatching advisor to the plant. Mr. Betts explained that the current contract was a four (4) year contract which the City let renew annually under an evergreen provision. In order for the contract to be terminated, 18 months notice had to be given. He advised that one (1) of the reasons that the City had a shorter contract was because it had an escalation provision in it that went up according to a Bureau of Labor Statistics (BLS) standard for professional employees in this region. Mr. Betts stated that, on average, the cost had escalated approximately 21%, since 2006. He noted that the belief had been that the City would probably renew, renegotiate, or rebid that contract prior to this time.

Mr. Betts explained that, after evaluating the quality of the services and the market for companies that do this type of work, and given the age and the institutional knowledge that NAES has on operating the plant, he and staff agreed that there is an inherent value in trying to sole source negotiate the contract. He stated that he, Mr. Harry Maloney, Electric Director, who is an

experienced power plant supervisor, and NAES worked together to develop a slightly different contract that operates at a lower cost and has some new orientation on how the City wants the project to be operated.

Mr. Betts informed members that the proposed agreement would be for five (5) years (2015 - 2020). He explained that he, the City Manager, and the Controller/Treasurer agreed that five (5) years would be a good transitional period for the City because it is toward the end of the age of this plant and also a period of great transition for PJM. Mr. Betts stated that this proposal would allow the City to capture and hold onto the institutional knowledge that exists, and provide some opportunity for managing the longer term International Brotherhood of Electrical Workers (IBEW) labor contract. He noted that the IBEW contract had been extended for one (1) year; however, staff had been advised that the IBEW contract would now be finalized for a longer duration.

Mr. Betts explained that the proposed agreement provides for a fixed annual fee for management, and the amount of this fee would decrease from the current fee. He stated that this fee would include the management fee, home office support, which previously averaged at approximately $75,000 per year, and operating incentives, employee bonuses, and burdens.

Mr. Betts informed members that, in the past, there was an incentive fee provision which provided an annual bonus of several hundred thousand dollars if the plant achieved specific operational parameters. He explained that the proposed contract includes a maximum performance reduction, which would allow for a contract price reduction between $500,000 and $550,000 per year if they fail to meet certain standards, such as availability and dependable capacity. Mr. Betts stated that the City has to meet certain standards in order to get the full value out of the PJM Reliability Pricing Model (RPM) payments, and this provision aligns the mutual interests of both parties in the operations of the plant.

Mr. Betts reminded members that two and one-half years ago, the City decided to allow for the retirement of Units 1 and 2. He stated that these units are 50 year old, 17 MW steam units which are difficult to find parts for, and they are not as reliable as they need to be. Mr. Betts advised that the decision to retire these units would change the operations of the plant and, as a result, the City would realize a several hundred thousand dollar reduction in operating costs in the proposed contract.

Mr. Betts informed members that, between the changes in the way the management fee is structured, the way the incentive fee and performance penalty pieces are constructed, and with the change in how the plant will operate, he anticipates that the City will realize an annual cost reduction in excess of $300,000 within a year and a half and will not reach the current contract price of $6M per year within the next five (5) years. He explained that, overall, the objectives were to save the institutional knowledge, preserve the operation of the plant, and reincentivize the plant in order to earn money as opposed to keep costs down. Goals would be to operate more efficiently, dispatch more frequently, reduce the number of outage days, change the scheduled outage, and raise performance so the plant is not offline for as long as it has been in the past, and ultimately earn more money for

the City by having this unit online. Mr. Betts stated that the proposed contract would provide the City with a reduction in cost and provide the performance that the City needs to maintain a competitive posture in the marketplace.

Responding to Mr. Hutchison, Mr. Betts stated that Units 1 and 2 would be retired on May 31, 2017.

Mr. Anderson stated that he had concerns regarding the contract, whether or not it should have been put out for bid, the amount that the City is spending, and whether or not the City is getting the most for its money. He questioned what the City's five (5) year plan was and whether the City should lock in a manager prior to deciding what to do with the City's plants. Mr. Anderson stated that he liked the inclusion of the six (6) month provision.

Mr. Anderson requested further explanation of the negotiated cost savings. Responding, Mr. Betts stated that the biggest savings would be realized in the management fee costs and staff savings. He reiterated that the fixed management fee, the amount held for performance, and bonuses that are part of their compensation package would be lower. Additionally, he explained that there was an expectation that there will be a change in how the plant is managed staff-wise, which would add several hundreds of thousands of dollars in benefits. Mr. Betts noted that some of the City's risk associated with using back office personnel would also be mitigated by fixing that as part of the base contract. He explained that the City would receive all of the services that are now prescribed, without the risk of having hourly rates based upon how the City uses those services. Mr. Betts reminded members that the proposed contract also included a maximum performance reduction. For example, he explained that if the City is penalized through PJM for too many forced outages, NAES would be penalized as well. Mr. Betts stated that this provision would help compensate the City in the event that NAES fails to perform on those important criteria for availability, dependability, unit capacity dependability, etc.

Mr. Betts stated that Mr. Anderson's concerns regarding whether or not this agreement should have gone out to bid were important. He explained that it would be difficult to find people in the marketplace who have the skill sets to deal with a 40 to 50-year-old plant. Additionally, the people who run a unit develop a sensitivity about the equipment, they know how an engine is supposed to work, when the steam is supposed to be going through, and what it sounds like before you synchronize, and Mr. Betts and staff believed that these skills could help negotiate the price down, because they have mitigated some of the risk of not knowing how this plant functioned. Mr. Betts explained that a new supplier may not want to guarantee the plant's availability because of the unknown factors; therefore, it was his recommendation to try to negotiate a fairer price to operate the plant with the same entity, based on the City's criteria, rather than going out to the marketplace and bringing in an entity that would add to the risk premium for operating a plant like the City's. He believed it was wiser to stay with the same entity and the people who know how to operate the plant rather than taking that risk at this point in the plant's history.

Mr. Hare asked if NAES could provide an estimate of the maintenance costs for the next three (3) or four (4) years. In response, Mr. Betts stated that NAES knows how the City's plant functions, noting that they have approximately six (6) steam plants of similar vintage within their system and they have monthly manager meetings to discuss equipment. He explained that there are two (2) types of maintenance, major maintenance and annual scheduled maintenance, and the annual

scheduled maintenance is estimated for five (5) years. Mr. Betts expressed his opinion that, with the experience of TEA and Mr. Maloney, there would be more than just an annual projection of plant costs and types of maintenance.

Mr. Betts reminded members that one (1) of the reasons the City decided to proceed with closing the two (2) oldest units, aside from their inefficiency, was the high cost of performing the next level of maintenance. He stated that the approximate cost was $500,000 and would have included opening up the units, working on the turbines, and attempting to provide some life extension.

Mr. Betts stated that by looking at the five (5) year projection, the City can determine what expenses are appropriate, given where it is in its life cycle. He expressed his opinion that NAES has very sophisticated people and Mrs. Donna Mitchell, Controller/Treasurer, has done a great job of assuring that the City receives a budget with accurate estimates.

Mr. Betts informed members that a major part of the discussions regarding the proposed contract focused on ensuring that the City receives accurate estimates for the budget to ensure staff does not have to request additional funds from Council and because it affects the customer's rates.

Mr. Hare asked whether the City could provide a six (6) month notice and get these credits cheaper elsewhere if PJM were to stop giving the City capacity credits. Responding, Mr. Betts explained that there are a lot of strategies that the City would want to review prior to making that decision. He advised that some municipal clients were looking at going behind the meter, explaining that the City can take that capacity inside and plan against peaks to achieve similar results, so that the City is not getting hit with the PJM charges. Mr. Betts stated that, with the proposed contract, the City would have an option to terminate the agreement; however, the City would want to thoroughly study and line up alternatives prior to providing a six (6) month notice.

Mayor Christiansen stated his appreciation for the work Mr. Betts had done and asked what he projected may happen over the next five (5) years, particularly with the PJM grid requirements. Noting that this is one (1) of the City's major sources of revenue, Mayor Christiansen also questioned if the City should be looking at the possibility of moving out of the utility business or looking for another deal to keep the City as a competitive player in the business.

In response to Mayor Christiansen, Mr. Betts stated that Mr. Maloney has been proactive in looking to the future and trying to determine different alternatives. He stated that technological advancements are changing the market. Mr. Betts thought that some of the questions members should ask are what the future would look like in terms of how the City will use and produce energy and how its customers will use it. He explained that the City needs to understand how customers will use energy in the future to ensure that whatever the City does matches the market and to ensure that the City does not end up overbuilding and overcharging for services based on year 2000 ideas that the City is trying to implement in 2020.

Mr. Betts informed members that he had recently read an article about a municipal utility in the Midwest that is building a 40MW battery station instead of a power plant. He explained that it takes in energy during the day, feeds it out at the night, and deals with solar and wind factors. Mr. Betts noted that this balances the frequency problems that PJM and all the utilities are having today because of the variety of sources coming in.

Mr. Betts stated that Mr. Maloney has proposed reviewing everything comprehensively to determine what would make sense for the future. He stated that this would include a review of fixing McKee as a power plant, generation options, where to get the best deal on a unit, consideration of recent gas issues on the peninsula, PJM requirements for two (2) forms of fuel, solar which is being incentivized, renewable portfolio standards, etc. Mr. Betts noted that this was an exciting time to be on the Utility Committee because there is so much going on, with many variables and ways to look at how to solve customer needs.

Mr. Betts stated that there is a difference in thinking today from 20 or 30 years ago. He reminded members that Kraft wanted to build a coal-fired plant 20 or 30 years ago and 10 years later it was not a good idea; however, they kept it going and ultimately sold it to a third-party to operate. Comparatively, he stated that P&G is currently considering building two (2) MW solar on some of their properties. Mr. Betts stated that some of these decisions are driven by tax credits or the desire to have a green energy facility. He explained that, in contrast, the City is trying to figure out how to balance those interests and still provide the revenue that supports the City. Mr. Betts advised that he would not encourage the City to get out of the business, if for no other reason than that the City owns the distribution rights and can control all the electricity that goes out to the customers. He stated that, even if the City got out of generation, it would still have a resource for revenue through the distribution system. Mr. Betts expressed his opinion that the City has resources in place, a great 69kV loop, a good distribution system, and is in a really good spot, as an entity, to be in the utility business.

Mr. Betts stated that he was very encouraged and excited by all of the changes in the industry, noting that there are new ideas every day that are changing the way people use energy and the way energy can be produced and delivered more efficiently. It was his opinion that the City is almost in a perfect spot by having a facility that can be given up to switch to something that would allow the City to leap ahead from where it would otherwise have been (5) years ago.

Mr. Neil questioned how long the bid process would take and what effect it would have on the City if the proposed contract were not accepted and the City put this out to bid. Responding, Mr. Betts estimated that it would take a minimum of six (6) to eight (8) months. He reminded members that the City would remain under the old contract, which has an 18-month notice period; therefore, the City would probably want to give notice right away and take the risk of completing that process in time. Mr. Betts stated that he did not have the same confidence that he had 10 years ago when he suggested that there were a lot of people out in the marketplace that are providing these types of services and are willing to take the type of risks that the City would ask them to assume. He noted that he is an advocate of RFPs; however, the current market is narrow, which creates a greater risk. Mr. Betts reiterated that it was his recommendation to try to negotiate a sole-source deal, due to where the City is with the cycle of this plant and the knowledge of the type of plant it is.

Mr. Hutchison reminded members that the City had been working on this for a while and the playing field will be changing in 2017. He stated his support for Mr. Betts' recommendation and the proposed contract. Although he recognized members' concerns, Mr. Hutchison expressed his opinion that dealing with a known partner was critical.

Mr. Betts advised that one (1) of the challenges that the City has faced since transitioning out of operating the plant relates to employees. He explained that, in the past, the City has negotiated a responsible transition for those individuals to have the first opportunity for positions; however, he was not certain how that would work in today's market. Mr. Betts stated that there is a value to those people and it is potentially disruptive to put this out to bid. He reminded members that over a year ago when the City discussed whether or not to continue in the utility business or sell to Delaware Electric Cooperative, it had an effect on the morale of the people who work in the utility part of the City, which always affects how a system functions. Mr. Betts stated that settling this issue had provided real value to the City. He stated that the uncertainty of the bid process has a potential impact on the City's capacity to operate as efficiently as it does now and also on what happens to those employees.

Mr. Hare expressed his opinion that the City's value is not in the plants but the network, noting that if the City has to shut the plants down, it will still be in the business of supply through the network.

Mr. Betts stated that he had previously discussed the net benefit of the utility with Council. He advised members that half of the cost of the NAES contract is for labor and the management fee, while the other half is the traditional costs for operation and maintenance. He stated that there is an approximate cost of $6M with PJM; therefore the City makes approximately $3M by having the plant, whether or not it is working, and the City makes money because of the capacity value, as long as it functions. Mr. Betts explained that the City needs to ensure that the plant is ready to operate, because if the City has a forced outage at a really bad time, the City gets penalized. He reiterated that the proposed contract is meant to ensure that the plant is always ready to operate over the next five (5) years, with the inclusion of the maximum performance penalty. Mr. Betts stated that there are now weekly meetings between Mr. Maloney, as the owner's representative, and the plant manager. He noted that there is not a separate entity operating with TEA telling them when to run, the City is in the middle of the process now to ensure the plant is ready, able, and capable of producing, so that the City gets the optimum value for the plant. Mr. Betts informed members that the City is also in a good position because the City is connected to a gas line and has oil. He stated that in the new capacity product that PJM is requiring, you have to have alternative fuel if you are on gas. Mr. Betts explained that the City has the potential to get the optimal value in PJM for the plant, at least until the City decides to shut it down, based on the differential between the operating costs and what the City can get in terms of capacity payments from PJM.

Mr. Neil explained that he did not doubt that this was a good contract and that his question pertaining to an RFP was intended to ensure that the City had looked at the alternatives and this was the best alternative. He noted that if the City were going to do an RFP, it should have been done eight (8) months ago, not now. Mr. Neil expressed his support for the contract, noting that it is the alternative that serves the citizens well.

Mr. Neil moved to recommend approval of the contract, seconded by Mr. Blakeman and unanimously carried.

Annual Engineering Consultant's Report on the Operation and Maintenance (O & M) of the Electric System - Fiscal Year 2014

Mrs. Donna Mitchell, Controller/Treasurer, reviewed the conclusions of the Annual Engineering Consultant's Report on the Operation and Maintenance (O & M) of the Electric System - Fiscal Year 2014, prepared by Burns & McDonnell Engineering Company, Inc. She reminded members that the Annual Engineering Consultant's Report was required by the 1985 Bond Resolution for the electric utility.

Mr. Blakeman noted that the Engineering Consultant had endorsed the fact that the electric system has been well run and well maintained. He advised that Page 1-3 of the Report stated that "specifically, the generation facilities have demonstrated a high level of availability despite the dispatching of the units primarily for peak demand." Additionally, in regard to the transmission and distribution (T&D) system, the Report stated that "In recent years, the City has made appropriate upgrades and improvements which the Engineering Consultant has observed while conducting the reviews and assessments to complete the annual reports."

Mrs. Mitchell informed members that the City's debt calculation requirement was 1.5%. Referring to Page 4-6 of the Report, she noted that in FY14 the City had a net loss of $2.3M. She explained that although the City met the debt calculation, the loss was a result of the polar vortex which caused the City to increase the transfer from the Rate Stabilization Reserve from the budgeted amount of $4M to $7M. Mrs. Mitchell stated that the City's sales were $2M under the estimated amount and that created the net loss. She advised that she was in current conversation with Moody's and they have some concerns with the transfer because there is a clause in the City's resolution that indicates if the transfer will cause the City to miss the covenant, the City is to hold that transfer. Mrs. Mitchell explained that the City has the Rate Stabilization Reserve for that purpose, noting that if the power supply spikes, the City covers it. She stated that she had another call with Moody's scheduled for Tuesday, July 14, 2015 and would keep members apprised.

Mayor Christiansen asked if it would be convenient for the Chairman of the Utility Committee, himself and, perhaps, the Council President to sit in on that call as well. In response, Mrs. Mitchell stated that this was not typical; however, they could sit in on the call if they wished. She explained that she simply wanted to make members aware of the discussion, noting that staff had already had two (2) discussions with Moody's. Mrs. Mitchell advised that she had also sent Moody's several pieces of information, one (1) of which was the balance in the Rate Stabilization Reserve as of June 2013, which was 35% of revenue. She explained to Moody's that the policy is 10% and the City was more than well enough funded, had set aside those funds to cover volatile issues such as this, and was following financial procedures.

Mayor Christiansen questioned how it would affect the City's bond rating if Moody's does not understand the reason why the City increased the transfer. Responding, Mrs. Mitchell stated that, based on her previous conversations with Moody's, she did not think that they would downgrade the City; however, rather than putting the City on a positive outlook, they may put the City on a stable or a watch, or possibly a negative.

Mayor Christiansen asked if the City of Dover was the only utility that they deal with that had to take such action because of the change in the weather. In response, Mrs. Mitchell stated that she could not answer that question; however, she stated that Moody's would be reviewing the credit of many other entities at a meeting scheduled with a utility review committee, not just the City of Dover's credit. *[City Clerk's Office Note: Subsequent to the meeting, members were informed that Moody's had affirmed the Aa2 rating of the City of Dover's electric bonds.]*

Responding to Mayor Christiansen, Mrs. Mitchell stated that on a scale of one (1) to 10, the City's concern regarding this matter should be around three (3).

In response to Mr. Hutchison's question regarding the additional $6M or $7M expense last winter related to peaking time, Mrs. Mitchell explained that the City was required to run the plant and could not because there was no oil available. In addition, she stated that the City had to purchase off the open market, through PJM, and the price escalated because of the cold weather. As a result of these factors, the City had to transfer an additional $3M from the reserve to the operating fund.

Responding to Mr. Hutchison, Mrs. Mitchell advised that everyone under PJM, including the City, has the same reliability standards and must be able to run when they are called on or be penalized. She explained that there was not a problem with the operation of the plant or the people who operate it; the plant was unable to run when called on because there was a problem with oil deliveries across the peninsula.

Mr. Blakeman noted that this was not the first time that the City had to take units offline because of fuel unavailability.

Mr. Kirk Betts, Betts & Holt, LLP and the City's Power Supply Attorney, reviewed background information regarding some of the market forces involved in what happened during that polar vortex period. He stated that he has other clients who require gas and they have had more interruptions in the past two (2) years than in the past 15 years. In terms of their demand on the system, gas supplies on Delmarva have gone down and the pipes have not been able to supply it. He advised that many people are relying on oil during that time of year and the City should pay in advance or have a contract to ensure they have oil deliveries scheduled. Mr. Betts noted that this is a new way for them to exercise their market power to guarantee that they receive payment.

Additionally, Mr. Betts informed members that PJM has lifted the cap on pricing. He explained that, previously, there was always a market price based on dispatched prices; however, during the first polar vortex, it capped out at $1,000 and people complained that they could not get the gas or oil and pay for it, even at $1,000 per megawatt hour (MWh). Mr. Betts stated that $1,000/MWh equated to $1.00 per kilowatt hour (KWh), noting that the City normally pays $0.04 per KWh.

Mr. Betts advised that many companies were affected when PJM lifted the cap on pricing because they did not have contracts that allowed them to float through the extraordinary costs. He stated that it was done very quickly in order to get the market back in balance and many utilities could not recover that cost. Mr. Betts explained that some companies may have had a guaranteed price of

$0.09 per kilowatt hour in the wholesale market and had to take a loss on the other $0.91 because their contracts did not allow it. He stated that companies like Washington Gas Energy Services have gone out of the business because of that year and all of the changes that happened suddenly. Mr. Betts advised that one (1) of the things that Moody's and others are looking at is if the City is able to pass through and recover extraordinary costs, noting that if an entity's rate structure allows for that, the entity is in a better position.

Mr. Betts advised members that last year The Energy Authority (TEA) assumed that the City's plant was not going to dispatch and then it needed to dispatch. He stated that having Mr. Harry Maloney, Electric Director, onsite will add insight to the plant since he can probably predict when the plant is going to run. Mr. Betts noted that TEA's dispatching gas, the plant being ready, and onsite understanding regarding what to do next will really help the City in the future.

Mr. Blakeman questioned whether the cap had been reinstalled. Responding, Mr. Betts stated his understanding that the cap was now at $1,800, which is pretty high. He expressed his excitement about where the City is in terms of planning the next set of generation, noting that gas is one (1) of the factors in the mix but it is not the whole answer.

Mr. Blakeman moved to recommend acceptance of the report as presented, seconded by Mr. Neil and unanimously carried.

TEA/NAES Report (*May*)

The TEA/NAES Monthly Report for May 2015 was provided to members to enable them to monitor electric sales and revenues received, which will provide a better understanding of any fluctuations that occur and allow the opportunity to make improvements if deemed necessary.

Referring to the year-to-date summary on Page 12 of the TEA Report, Mr. Scott Koenig, City Manager, stated that the Variance indicated that the Actual YTD was approximately $1.3M more than the Budget YTD, noting that this was in part due to the City's load being up slightly. He advised that the variance had decreased fairly substantially over the last couple of months and he was hopeful that the variance would continue to close, as he expected that the numbers for June would be relatively strong because it was warm.

Mr. Koenig advised that the Final Cost of Service to City of Dover Ratepayers was budgeted at $63.42 per megawatt hour (MWh) and the Actual YTD was approximately $64.02 per MWh. Noting that there was only a slight variance, he stated that this was a good indication that things were tracking as expected throughout the year.

Referring to the Generation Summary on Page 4 of the TEA Report, Mr. Blakeman noted that the actual revenue had come in below budget for seven (7) out of the 11 months. He questioned if the City would be able to recover that revenue during the last month, or if it would even out since the actual revenue far exceeded the budgeted amount during a couple of the months. Responding, Mr. Koenig stated it would be very close.

Mr. Neil moved to recommend acceptance of the TEA/NAES Report for May 2015, seconded by Mr. Blakeman and unanimously carried.

Updates (Deferred during the meeting of June 22, 2015)
By unanimous consent, Item #4 - Updates was deferred.

Mr. Neil moved for adjournment, seconded by Mr. Blakeman and unanimously carried.

Meeting adjourned at 5:55 p.m.

James Hutchison, Sr.
Chairman

JLH/TM/dd
S:\AGENDAS-MINUTES-PACKETS-PRESENTATIONS-ATT&EXH\Committee-Minutes\2015\07-13-2015 UTILITY.wpd

Attachments
Attachment #1 - Memorandum dated July 13, 2015 from Kirk Betts Regarding Proposed Agreement for Plant Operating Services

BETTS & HOLT LLP

COUNSELLORS AT LAW

1100 17th STREET • SUITE 901 • WASHINGTON, DC 20036
TELEPHONE 202.530.3380 • FAX 202.530.3389

July 13, 2015

To: Scott Koenig, City Manager; Donna Mitchell, Controller/Treasurer;

Harry Maloney, Electric Director

From: Kirk Howard Betts, Betts & Holt LLP

RE: Proposed Agreement for Plant Operating Services

Background

On May 4, 2006, the City of Dover entered into an Operations & Maintenance Agreement with North American Energy Services (NAES) to maintain and operate Dover's generation.[1] The contract had an initial four year term and it was extended four times automatically for one year terms.

Dover's generation consists of three steam units in the McKee Run plant and one combustion turbine at VanSant. NAES is responsible for operating and maintaining Dover's generation, staffing and collective bargaining, managing dispatch, environmental controls and complying with permits, guaranteeing capacity performance, maintaining records, preparing budgets, outage plans, and reports to governmental authorities.

The current contract provides for a management fee and reimbursement for all other costs, including staffing, relocation, insurances, training, permit fees, and advisors. All other plant operating costs (consumables, tools, spare parts, equipment, capital improvement projects, etc.) are paid directly by Dover. NAES management fee started at $175,000/year in 2006 and has escalated annually to almost $212,000 in 2015.

The contract also provides an incentive bonus (which started at $140,000 and is now approx. $173,000 for 2015-16) structure that rewards NAES and its personnel for achieving certain goals, such as commercial availability, dependable capacity, safety, and environmental performance. With the exception of 2014, NAES regularly achieved the full incentive bonus.

Both the management fee and the bonus escalated annually based on the Employment Cost Index for private industry works by industry and occupational group, published by the Bureau of Labor Statistics. The minimum was fixed at 1% per year. Since inception, escalation has increased the fixed fee and incentive fee components by 21.1%.

Negotiation Objectives

Discussions with Dover representatives produced the following objectives:

---

[1] The Agreement has been amended three times, June 1, 2006, July 1, 2007, and July 1, 2008.

- Update contract to address changes in operations, law, PJM, and decommissioning of McKee Units 1 and 2.
- Reduce the cost of NAES services.
- Address Dover financial concerns, including training, cost estimates for special services, cost of "home office services," qualifying suppliers and bidders, compliance with Dover procurement policies and practices.
- Address issues around performance incentives and accountability
- Incorporate market conditions affecting revenue and load growth
- Set new term and provide more flexibility for termination

Proposed Amended and Restated Operation and Maintenance Agreement

The proposed agreement addresses Dover's express objectives.

1. Lower the annual costs. The proposed agreement provides for a fixed annual management fee, paid monthly, that will have a starting cost $43,000 lower than the current agreement, but will be reduced further during the second and third years as staffing changes are implemented corresponding to the scheduled decommissioning of McKee Units 1 and 2. See Section 2.2 Management Fee. The fixed fee portion of the proposed agreement will be less than the current agreement costs in 2015-16 when it expires in 2020. Overall, fixed fee and reimbursable staffing expenses are estimated to reduce annual expenditures by more than $300,000/year compared to the current agreement, in addition to O&M costs avoided by closing Units 1 and 2. Some of these reductions start immediately, but the major reductions will be realized in 2017. The proposed effective date is July 1, 2015.

A major change in the proposed agreement is the shift to a fixed annual fee for management. The fee includes the management fee (which is decreased from the current fee), and home office support (previously billed hourly as a reimbursable expense), operating incentives, employee bonuses, and burdens (previously computed and reimbursed by Dover). In this agreement, if NAES needs more staff or if Dover require more home office support, the risk of higher costs reside with NAES. In other words, this agreement provides greater predictability. However, while also putting full responsibility on NAES to manage down the size of the staff while maintaining reliability, it also puts more of NAES' fee at risk, as described below.

2. Changed the focus from incentive bonus paid at year-end to performance based reduction where NAES pays Dover. The prior agreement had an incentive fee that had escalated to approximately $173,000 that would be awarded to NAES if it met certain criteria for availability, commercial unavailability, dependable capacity, safety performance, and environmental performance. Each performance standard had a dollar value. The proposed agreement contains objective performance standards that if not achieved penalize NAES. Under the proposed agreement, Dover negotiated a substantially higher amount of compensation at risk, defined as

the Maximum Performance Adjustment, if NAES does not the performance standards. See Section 2.2 Definition of Maximum Performance Adjustment and Appendix B. The performance adjustment puts more of NAES' fee at risk every year of the contract—over $500,000/year compared to $172,000 now. NAES's bottom line will "feel" the implications of a plant failure and share in the cost that would be imposed on Dover by PJM and aligns the performance interests of both parties more closely.

3. Clarifies scope of services included. The proposed agreement clarifies staffing and home office staff responsibilities that are included in the monthly fee. These services have been billed on an hourly basis and averaged about $75,000/year. They will be included in the Management Fee going forward. See Appendices A and F.

4. Procurement obligations. There is a positive tension on how costs are managed and contracts awarded. This tension also creates conflicting objectives between lowering costs and increasing plant operating revenue. The current draft seeks to focus on increasing revenue through more attention to reliability to maximize the generating resource and the City's investment in those resources. We have heard during these negotiations an appreciation for oversight and a concern about micro-management and mixed signals. The approach that is being recommended necessarily involves the terms of the contract and the collaboration of NAES and the City's finance office, particularly procurement, to make it work smoothly.[2]

The original and current agreement are based on having a third party operate and maintain Dover's generation. The agreement provides for an annual operating and capital budget and regular consultation concerning plant performance and costs. The plant operating and maintenance budget is provided as part of the Dover budget development cycle. A substantial part of the budget is for staffing, planned maintenance, and capital repairs and replacements (also planned). We are recommending a contingency in the budget for unplanned work. It is not intended to be a fund for cost overruns or discretionary projects, but it is intended to address the reality that generating plants, particularly of this vintage, experience equipment failures.

The procurement process follows the 2012 procurement procedures, Administrative Manual, AMP 501, latest edition, which was approved by the City. Although this appears to be a parallel procurement system, our recommendation is to continue using these procedures since the equipment and services are within NAES' particular expertise and it has the greatest knowledge of suppliers for the types of equipment and services needed. Moreover, planned maintenance and CIPs would all be reviewed as part of the budget process and also during periodic meetings with Dover's Representative, Electric Utility Director Harry Maloney. We believe his presence provides a day-to-day awareness of the utility, oversight, and qualified point of contact for NAES and the City who also is in regular consultation with the City Manager and Finance

[2] A recent inquiry involving cell phone service highlights the overlapping work and interests of the parties. It may expedite matters if the City and NAES clarify the scope of procurements, i.e., which are general services and which require specific plant expertise, to determine which services and types of procurements may be most efficiently managed by the City and by NAES.

Director. Mr. Maloney provides a level of technical capability regarding plants, PJM, and municipal procurement that has not been present in recent years.

Another consideration is that the agreement and PJM impose substantial penalties for failure to dispatch (availability). Consequently, both NAES and the City have an aligned interest in assuring the generating plants are ready to be dispatched and that unplanned outages, as well as planned outages, are as short as possible.

5. Duration of Agreement. The proposed agreement is for five years (2015-2020). Notice for termination or renewal has been shorted to six months for Dover, and twelve months if requested by NAES. The agreement expires in 2020.

6. Updated Agreement. The proposed agreement deletes all references to the transition period when NAES assumed responsibility for plant operations. It incorporates the changes anticipated by the scheduled withdrawal of McKee Units 1 and 2 from service in 2017. All the appendices have been updated.