

MINUTE ITEM

This Calendar Item No. C62 was approved as Minute Item No. 62 by the California State Lands Commission by a vote of 2 to 0 at its 10-20-03 meeting.

**MINUTE ITEM
C62**

10/20/03
G10-08.10
C. FOSSUM
J. LUCCHESI

**SAN DIEGO UNIFIED PORT DISTRICT
(TRUSTEE)**

Regular Calendar Item 62: Commissioners listened to a staff presentation on the South Bay Power Plant. Commissioners also listened to comments from the public. The item was amended and approved by a 2-0 vote.

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G10-08.10

C. Fossum

J. Lucchesi

**CONSIDERATION OF A REPORT REVIEWING THE VARIOUS AGREEMENTS
BETWEEN THE SAN DIEGO UNIFIED PORT DISTRICT AND DUKE ENERGY
REGARDING THE SOUTH BAY POWER PLANT, CITY OF CHULA VISTA, SAN
DIEGO COUNTY**

TRUSTEE

San Diego Unified Port District
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BACKGROUND

The State Lands Commission directed staff to provide background information and legal advice on the Cooperation Agreement and Lease Agreement between the San Diego Unified Port District and Duke Energy South Bay, LLC regarding the South Bay Power Plant and to provide an update on the progress being made to select and develop a Replacement Generation Plant.

The two main documents governing the South Bay Power Plant (SBPP) are the Cooperation Agreement and the Lease Agreement (Lease). In December 1998, the San Diego Unified Port District (Port or Port District) and Duke Energy South Bay, LLC (Duke) entered into a Cooperation Agreement regarding the SBPP. As part of that agreement the Port District agreed to lease the SBPP to Duke for a period of approximately ten years. The Cooperation Agreement by its nature has limited enforceability. Either party may terminate the agreement on 30 days notice and the only remedy for breach or termination is the provision that the air quality credits transferred to Duke are to be re-conveyed to the Port District. (See following discussion under SDG&E Offsets). In January 1999, the California State Lands Commission (CSLC) approved the Port's acquisition of the SBPP site from San Diego Gas and Electric (SDG&E) pursuant to its limited authority under Section 30.5, Chapter 67, Statutes of 1962. Duke and Port District entered into the Lease on April 22, 1999.

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The 150-acre, 706-gross megawatt facility is located at 990 Bay Boulevard in Chula Vista, California, on the southeastern shore of San Diego Bay. The SBPP consists of four steam turbine generators and one smaller combustion turbine. Units 1-3 are under Reliability Must Run (RMR) contracts with the California Independent System Operator (ISO), making the SBPP essential to the supply of adequate power to the region. On January 2, 2003, Unit 4 was taken off of RMR status because its capacity was not required to meet reliability needs for 2003. Unit 4 was used as a "peaker facility" this summer and will return to RMR status on January 1, 2004.

Pursuant to the Cooperation Agreement, as long as the ISO continues to designate the SBPP as a RMR facility (removal of the RMR status and demolition of the facility must be preceded by the availability of replacement capacity within an appropriate area of the grid), Duke agreed to use commercially reasonable efforts to site and develop a Replacement Generation Plant (RGP) prior to the termination of the Lease, and, at the Port District's request upon termination of the Lease, to close and decommission the SBPP in accordance with the provisions of the Lease.

SPECIFIC PROVISIONS OF THE COOPERATION AGREEMENT

Pursuant to Article 7.1(a) of the Cooperation Agreement, "for so long as the SBPP is designated as a must-run facility by the ISO, Duke shall use commercially reasonable efforts to develop, finance, construct and place into commercial operation a new RGP replacing the SBPP which shall have a generating capacity at least sufficient to cause the ISO to terminate (or fail to renew) the must-run designation applicable to the SBPP on or before the termination of the Lease Term."

Pursuant to Article 7.1(b) of the Cooperation Agreement, "Duke shall commence feasibility studies and siting activities for the RGP and shall diligently pursue development of the RGP pursuant to a development plan and schedule intended to achieve commercial operation of the RGP, if feasible, as of the termination of the Lease Term. See the attached development schedule (Development Milestone Schedule). Duke shall provide regular progress reports to the Port District, no less frequently than every 6 months, concerning its development activities and shall advise the Port District in writing of any material events or circumstances which affect the implementation of the development plan or schedule." Relevant details from these progress reports are further discussed.

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Pursuant to Article 7.4(a) of the Cooperation Agreement, "Duke shall use commercially reasonable efforts to develop and locate the RGP as an off-site plant. In the event such a site is not reasonably available, Duke shall have no further development obligations under Article 7 unless the Port District approves the development and construction of a RGP on the South Bay Site or on other property owned or leased by the Port District, which approval may be withheld in the Port District's sole and absolute discretion." In addition, "the parties shall mutually agree upon the location of any RGP to be located at the South Bay site or on other property owned or leased by the Port District." "If the Port District approves the siting of the RGP on the South Bay site or on other Port District property, then the parties agree to negotiate in good faith for Duke's acquisition of a ground leasehold interest in the land necessary for the RGP, which ground lease shall be at fair market rent, and for the license or transfer to Duke of water rights and other rights and interests necessary for the RGP." Furthermore, "in the event the RGP is located at the South Bay site or on other Port District property, the parties agree to negotiate in good faith to provide an arrangement whereby the Port District may acquire an economic participation in the RGP based upon its contribution to the development, financing or operation of the RGP."

Pursuant to Article 13.1 of the Cooperation Agreement, "no change, amendment or modification of the Agreement shall be valid or binding upon the parties unless such change, amendment or modification is in writing and duly executed by both parties."

SPECIFIC PROVISIONS OF THE LEASE AGREEMENT

The Lease incorporates none of the above-stated provisions contained in the Cooperation Agreement, but does provide:

Pursuant to Article 2.1 of the Lease Agreement, the lease term "ends on the date falling 3 months after the latest to occur of

- (a) the date of payment in full and retirement of the Bonds" (the final maturity of the bonds / amortization term is approximately 10 years and six months from the April 22, 1999 commencement date of the lease). The bonds are to be paid in full on November 1, 2009; hence the lease would terminate February 1, 2010.
- (b) "the termination by the ISO of those must-run obligations imposed by the ISO", and
- (c) "the last day of the Primary Lease Term" (10 years, beginning April 1999 plus 3 months). This means the primary lease term would

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end July 22, 2009). However, since the amortization of the bond payoff in (a) above is scheduled for November 1, 2009 and the must-run MRM status (b) above is currently unknown, the actual lease termination date will in all likelihood occur after the primary lease term.

Assuming that the bonds are not retired early, the earliest date that the lease could expire and by which the Cooperative Agreement contemplates the construction of an RGP, would be as provided by (a), which would be February 1, 2010. However, based upon the Cooperative Agreement milestones and calculations of anticipated timeframes for development, an RGP might not be constructed before mid 2010. It should be noted that nothing prevents the Port District from entering into a new lease with Duke or another entity following the end of the Lease term.

DEVELOPMENT MILESTONE SCHEDULE DEADLINES

As stated above, pursuant to Article 7.1(b) of the Cooperation Agreement, Duke shall diligently pursue the development of the RGP pursuant to a development plan. The specific milestones are discussed below.

Notice of Intent

Pursuant to the Cooperation Agreement Development Milestone Schedule, Duke is required to file a Notice of Intent (NOI) or an NOI Exemption with the California Energy Commission (CEC) by no later than June 30, 2003. Based on the language of Section 25540.6 of the Warren-Alquist State Energy Resources Conservation and Development Act, which expressly states that no notice of intention is required for a thermal power plant that will employ natural gas-fired technology, Duke believes that neither an NOI nor an NOI Exemption is required in connection with the development of the Replacement Plant. Similarly, according to the Port, the NOI or NOI Exemption requirement is basically obsolete. Originally any proposal to build a new power plant was required to file an NOI, which helped to streamline air emission permits. This was specific to diesel and coal powered power plants. However, because the RGP will be a natural gas-fired plant, the Port agrees with Duke that an NOI or NOI Exemption is not required. Therefore, Duke does not intend to, nor is required to, make a filing with the CEC relative to a NOI or a NOI Exemption. The CEC has verified that Duke is not required to make a filing with the CEC relative to an NOI or an NOI Exemption.

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File Application with CEC

Pursuant to the Development Milestone Schedule, Duke is required to file an Application for Certification (AFC) with the CEC within 1 year after receipt of approval of an NOI, or if neither an NOI nor an NOI Exemption is required, by no later than June 30, 2006. Because Duke does not intend to make a filing with the CEC relative to an NOI or an NOI Exemption, Duke is required to file an AFC with the CEC by June 30, 2006. A final site selection for the RGP is required in order for Duke to file an AFC.

Other Milestones

Pursuant to the Development Milestone Schedule, Duke is required to use reasonable efforts to secure all equipment and rights required to obtain funding for the construction of the RGP, within 1 year after receipt of certification of the project from the CEC. Within 6 months of securing all rights required to obtain funding for the construction of the project, Duke must commence construction. And within 24 months after commencement of construction, the RGP must be in commercial operation.

Timing

According to the CEC, the re-powering process (building a new base load power plant) generally consists of the following steps:

- 1) Alternative Site Analysis – as stated above Duke is currently in the process of site analysis and selection;
- 2) Prefiling Process– this is the informal portion of the siting process and is the period before an applicant files an AFC. This period includes meetings between the applicant, CEC staff, and agencies to discuss the project, siting process, filing requirements, and specific issues. Workshops, site visits, public meetings and an optional preliminary review of the applicant's filing document may also take place. Although all prefiling activities are optional, CEC staff strongly encourages early prefiling consultation. During this step the proponent also identifies a site, acquires site control, and retains consultants to prepare a preliminary facility design and numerous other documents for filing with the CEC. This process takes approximately 12-18 months;
- 3) Formal Application Filing and Data Adequacy Review – this occurs when the applicant delivers 125 copies of the application to the CEC, the CEC staff reviews the filing to determine its completeness. Responsible agencies affected by the project, such as the State Water Quality Control Board, Department of Fish and Game, local AQMD, and others participate in the review. Staff must determine completeness within 30 days and the

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CEC must act within 45 days. However, typically additional information is requested and thus this phase normally takes about four months to complete. When the application is deemed complete the next phase begins;

- 4) Licensing – a formal process during which critical issues requiring substantial review are identified and a proceedings schedule is developed. This phase includes CEQA functional equivalent analysis of the development proposal. Public workshops on technical and procedural matters and issues, and informational hearings for the public are held during this phase. CEC staff conducts an independent analysis focusing on environmental impacts, mitigation measures and the development of a compliance plan and staff report. Public hearings are held before the CEC. At the end of the licensing process (which is no longer than 12 months by statute), the CEC will vote on the proposed power plant;
- 5) Complete Design Engineering – this process can take anywhere from 6-9 months;
- 6) Construction – upon CEC approval and issuance of the license, construction can begin and typically takes 24 months to build.

Once site selection is completed, this schedule means that 58-67 months would be needed to complete construction on the RGP. Demolition and remediation of the existing SBPP will take an additional two to three years. If Duke is able to meet the fastest, 12 month, schedule for pre-filing activities, it would need to complete site selection by January 1, 2005, to complete construction by February 1, 2010, the earliest anticipated end of the lease term. However, given the public attention already paid to this project, which could prolong the process, it may be more reasonable to assume this stage will take the longer estimate for completion – 18 months. In that case, Duke should complete site selection and begin the pre-filing stage by July 1, 2004. Note that the activity schedule outlined above indicates Duke, if it is going to have the RGP constructed by February 1, 2010, may need to file an AFC with the CEC by February 1, 2006 – nearly 5 months earlier than provided by the Cooperative Agreement's Development Milestone Schedule.

REGULAR PROGRESS REPORTS

Pursuant to Article 7.1(b) of the Cooperation Agreement, Duke has provided the Port District with updates of Duke's efforts to develop an RGP. According to the documents submitted by the Port District, these updates occurred by written correspondence on December 4, 2000; June 4, 2001; September 12, 2001;

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January 14, 2002; June 11, 2002; February 18, 2003; and August 12, 2003.
These updates tend to focus on the location and development status of the RGP.

UPDATE ON SITE SELECTION FOR THE REPLACEMENT GENERATION PLANT

Information obtained by staff indicates that by June 2002 Duke had narrowed down the site selection to two prospective off-site alternatives of the more than thirty sites investigated by Duke. By February 2003, Duke had performed further site analysis, and is currently focusing its efforts on just one of these off-site alternatives, which is in close proximity to the existing SBPP. Duke hopes to have the land under option by the time of the next update. Due to the fact that Duke is currently in real estate negotiations regarding this specific off-site location, the Port District does not know the exact location of this off-site alternative. According to Duke's February 28, 2003 update report, the desirability of this specific site includes the ability to use reclaimed wastewater for cooling, as well as, the availability of sufficient acreage to serve as the site for an RGP.

In addition, while Duke's primary focus with respect to an RGP has been on an off-site alternative to the existing SBPP site, according to the February 2003 update report, based on various meetings with the Port, Duke appreciates that there may be growing local support for further investigation by Duke of an on-site RGP option. Specifically, the city of Chula Vista has been increasingly interested in locating the RGP on tidelands within the city of Chula Vista primarily because of the tax benefits associated with locating the RGP in Chula Vista. In fact, at its November 13, 2001, City Council meeting, the city of Chula Vista unanimously voted (with City Councilwoman Salas abstaining) to support the re-siting of a new power plant near the existing SBPP on tidelands. Duke has met with Port District staff, Chula Vista representatives, and other local stakeholders, such as the Environmental Health Coalition, Utility Consumers Action Network (UCAN), and Baykeeper, in order to develop a plan for determining the commercial reasonableness of a RGP and planning the development activities needed to support an AFC.

REGIONAL WATER QUALITY CONTROL BOARD

The renewal of the National Pollution Discharge Elimination System Permit (NPDES or discharge permit) for the SBPP was brought to the RWQCB in December 2001. The Board gave instructions for staff to incorporate additional information into the staff report and instructed Duke to do additional studies. These studies include reviewing the effects of the discharge into San Diego Bay and conducting an updated study on the intake process. Board staff expects that these studies will be completed by the end of 2003. Although the NPDES permit

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is theoretically expired, because the Board did not approve or deny the renewal, but rather instructed staff and Duke to gather more information, the NPDES permit allows Duke to continue with its operation until the updated staff report is presented to the Board and the Board has the opportunity to approve or deny the permit. Therefore, the RWQCB position is that Duke is legally in compliance with the NPDES permit. An updated staff report, including the results of the additional studies, is tentatively set to be presented to the RWQCB in June 2004.

\$15 MILLION APPROPRIATION

Pursuant to Chapter 324, Statutes of 1998 (AB 1656 – Ducheny) \$15 million was appropriated to facilitate the acquisition, decommissioning, demolition and remediation of the SBPP by the Port District. The \$15 million was placed in an interest bearing account. As of July 9, 2003, approximately \$1.5 million in interest has been spent on the demolition and remediation of the North Tank Farm, leaving an available balance of approximately \$17.2 million.

SDG&E OFFSETS

SDG&E Offsets (Offsets) are an air pollution control allowance transferred by SDG&E to the Port pursuant to the Asset Sale Agreement, and subsequently transferred by the Port to Duke for operation of the SBPP. As part of the development of an RGP, the applicant negotiates with the local air pollution control district (APCD) to convert a portion of the offsets to obtain air pollution control credits. These credits are based upon the elimination of pollutants from the old plant. These credits are required to operate a new power plant, with the goal to offset air emissions created during the operation of the new plant. Air credits are a scarce resource in San Diego County and thus can be quite costly to obtain. The Cooperation Agreement and the various other agreements transferred all of the Offsets to Duke as plant operator. It is the Port District and Duke's understanding that the Offsets remain with the SBPP but are Duke's to utilize in the repowering process of a new RGP either off-site or on-site. If Duke does not build an RGP as provided for in the Cooperation Agreement, Offsets remain with the plant and are conveyed back to the Port District.

Staff believes that there may be some internal inconsistencies within the relevant documents relating to the way the Offsets are treated if there is a default by Duke or if there is a termination of the Lease Agreement. For example, pursuant to Article 9.3, "upon any termination of the Cooperation Agreement by the Port District pursuant to Section 9.2(g) because of a breach by Duke in the performance of its obligations under Article 7 regarding the development of a RGP, Duke shall be obligated, within ten days following such termination, to

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transfer and convey back to the Port District the SDG&E Offsets transferred to Duke at the closing pursuant to Section 2.4(c).” Pursuant to Section 5 (a) of the Contract and Permit Rights Assignment and Assumption Agreement (an ancillary agreement to the Cooperation Agreement), if the Port District terminates the Lease because of Duke’s default, Duke’s rights in the Offsets shall terminate. However, according to Section 5 (b), in the event that some or all of the SDGE Offsets are not necessary for the continued operation of the SBPP or if the SBPP will not be operated after the termination of the Lease, the Offsets shall remain Duke’s property. It is therefore staff’s interpretation that it is unclear what result might happen if a situation occurs that causes two of the provisions to conflict. For example, if Duke violates the Cooperation Agreement resulting in termination of the Agreement, the SDG&E Offsets are conveyed back to the Port District. Also, if the Lease terminates because of Duke’s default, Duke’s right to the Offsets will also terminate because of Duke’s default, Duke’s right to the Offsets are also to terminate unless some or all of the Offsets are not necessary for the continued operation of the SBPP. In that case, the Offsets will remain with Duke.

The Port District does not disagree that there may be some internal inconsistencies or ambiguities with the way the Offsets are treated in various “what if” scenarios.

ANALYSIS

The Port District’s authority to ensure that Duke is following the terms of the Cooperation Agreement is limited. It is only a “cooperation agreement.” Pursuant to Article 9.3, “upon any termination of the Cooperation Agreement by the Port District pursuant to Section 9.2(g) because of a breach by Duke in the performance of its obligations under Article 7 regarding the development of a RGP, Duke shall be obligated, within ten days following such termination, to transfer and convey back to the Port District the SDG&E Offsets (air pollution control credits transferred by SDG&E to the Port pursuant to the Asset Sale Agreement, and subsequently transferred by the Port to Duke) transferred to Duke at the closing pursuant to Section 2.4(c).” Otherwise, pursuant to Article 9.3, “in the case of a defaulting party, termination of the Cooperation Agreement is the sole and exclusive remedy with respect to any matter and neither party shall be liable to the other party for additional losses or damages suffered by the other party as a result thereof.”

These limitations on the Port’s ability to require Duke to perform under the Cooperative Agreement affect both the schedule for completion of an RGP and

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meeting the "commercially reasonable efforts" standard for deciding whether to build an RGP at all.

The Lease between Duke and the Port District does not contain any terms regarding construction of the RGP. However, if Duke defaults on any of the lease terms, the Port District, at its sole discretion, may exercise one or more of the following remedies including: termination of the lease; surrender by Duke of the leased property; sale (the Lease provides that the Port District may sell in any commercially reasonable manner all or any portion of the leased property, however, the terms of the trust statutes and CSLC findings approving the acquisition in January 2000 would prohibit a sale of the land); releasing (the Port District may take possession and control of the leased property and hold or lease to others all or a portion of the facility, the facility site, the contract and permit rights, etc.); liquidated damages (these include the amount equal to the excess of aggregate stipulated loss value for the leased property or an amount equal to the excess of such aggregate stipulated loss value over the fair market sale value of the leased property); and other remedies available under law or in equity.

CSLC remedies, with respect to default by Duke or by the Port District, are likewise limited. The CSLC review and approval on January 29, 1999 consisted solely of the approval of proposed expenditures of public trust funds by the Port District for the acquisition of the SBPP property. These funds are to be repaid to the Port from proceeds of the Lease during the 10+ year Lease Term. The specific findings made by the Commission consisted of:

- (1) the acquisition was in accordance with the terms of the legislative trust grant;
- (2) any proceeds of the transaction to be deposited in an appropriate fund expendable only for public trust purposes of statewide benefit;
- (3) acquisition was in the best interest of the State;
- (4) lands acquired by the Port were to be accepted as public trust lands, held by the Port as public trust lands subject to the legislative trust grant.

The Commission did not approve either the Lease or the Cooperation Agreement, only the acquisition of the property. The transcript shows that Port District representatives stated at the Commission meeting that the RGP might not be built or that it might be built on the site of the present power plant rather than at a different location. There is no independent remedy provided by the Commission's approval of the acquisition for violation of the Cooperation Agreement or Lease. In addition, the Commission's approval was not

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conditioned upon any specific aspect of the Cooperation Agreement, the Lease Agreement, or any of the other ancillary agreements.

CONCLUSION

The goals ascribed to Duke, when the acquisition was approved by the Commission in 1999, were the demolition/rebuilding or relocation of the power plant. As noted above, it is unlikely that Duke can meet the goal in the Cooperative Agreement of operation of a new power plant by February 1 2010 if it waits until January 1, 2005 to complete site selection. Therefore, staff believes is Duke should file an AFC by February 2006 rather than the June 2006 deadline set forth in the milestones.

While there is no legally enforceable obligation to perform, the main purpose of the Cooperation Agreement is to find a location suitable for an RGP, decommission the existing plant and construct and commission a new RGP that will be more efficient and cleaner for the environment. Duke has agreed to use commercially reasonable efforts to achieve those goals within the framework provided by the Development Milestone Schedule.

As stated above, the Commission and staff have limited jurisdiction and remedies available. However, given the Commission and public interest in this project, staff is recommending that the Commission direct staff to continue to monitor Duke's compliance with the Cooperation Agreement and Lease and report back to the Commission. Staff also suggests that the Commission direct that a letter be sent by the Executive Officer on behalf of the Commission to Duke encouraging Duke to make a site selection in a timely manner. Staff would then report back to the Commission after July 1, 2004 on whether Duke had moved up its selection process in order to keep on schedule for the new RGP. The Commission and staff can also continue to monitor the situation to insure that the Port District is not in violation of its statutory trust grant or the Public Trust Doctrine. In order to determine whether any violations have occurred, the CSLC may decide that the CSLC staff should conduct an additional investigation and hearings and report those findings to the Commission. If it is determined by the CSLC that additional action is warranted, that action could include reporting to the Legislature any trust violations and seeking remedial legislation requesting the Attorney General's Office bring an action against the trustee-grantee to enforce the terms of the trust grant and the Public Trust Doctrine.

EXHIBIT:

- A. Development Milestone Schedule

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IT IS RECOMMENDED THAT COMMISSION DIRECT STAFF TO:

1. DIRECT THAT A LETTER BE SENT BY THE EXECUTIVE OFFICER ON BEHALF OF THE COMMISSION TO DUKE, ENCOURAGING DUKE TO MAKE A SITE SELECTION BY JULY 1, 2004 AND TO FILE AN AFC BY FEBRUARY 1, 2006; STAFF TO THEN REPORT BACK TO THE COMMISSION AFTER THESE RESPECTIVE DATES, ON WHETHER DUKE HAD MOVED UP ITS SELECTION PROCESS AND FILING IN ORDER TO KEEP ON SCHEDULE FOR THE NEW RGP.
2. CONTINUE TO INVESTIGATE AND MONITOR DUKE'S COMPLIANCE WITH THE COOPERATION AGREEMENT AND LEASE.
3. CONTINUE TO MONITOR DUKE'S COMPLIANCE WITH OTHER APPLICABLE LAWS, INCLUDING CALIFORNIA ENERGY COMMISSION AND REGIONAL WATER QUALITY CONTROL BOARD PERMIT REQUIREMENTS AND OTHER RELEVANT ENVIRONMENTAL LAWS.
4. CONTINUE TO WORK WITH THE SAN DIEGO UNIFIED PORT DISTRICT IN ENSURING ITS COMPLIANCE WITH THE GRANTING STATUTES AND THE PUBLIC TRUST DOCTRINE.

DEVELOPMENT MILESTONE SCHEDULE

Commence Site Selection Process	By no later than June 30, 2002
File Notice of Intent (NOI) or for an NOI Exemption with California Energy Commission (CEC)	By no later than June 30, 2003
File Application for Certification (AFC) with the CEC	Within 1 year after receipt of Approval of NOI, or if neither NOI or NOI Exemption is required, by no later than June 30, 2006
Use commercially reasonable efforts to secure all equipment and rights required to obtain funding for the construction of the project, including, without limitation (a) negotiate for contractual rights to the RGP project site and required easements, for a water supply and gas supply sufficient for the project, and interconnection rights, (b) apply for all other permits required in connection with the development, construction and operation of the project, (c) identify possible sources of construction funding and negotiate for commercially reasonable financing terms and conditions, and (d) when timely in conjunction with securing the following, order major equipment	Within 1 year after receipt of certification of the project from the CEC
Commence construction	Within 6 months after securing all rights required to obtain funding for the construction of the project
Commercial Operation of the RGP	Within 24 months after commencement of construction, subject to delays resulting from force majeure events

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