Testimony of Herbert M. Allison on the Independent Consultant's Review with Respect to the Department of Energy Loan and Loan Guarantee Portfolio

before the Senate Committee on Energy and Natural Resources

March 13, 2012

Thank you, Chairman Bingaman, Ranking Member Murkowski and members of the Committee for asking me to testify today.

Last November the Chief of Staff of the White House, then William Daley, appointed me to conduct an independent study of the Department of Energy's ("DOE") portfolio of loans and guarantees to clean energy projects (hereinafter, "the Portfolio").

I was assigned three tasks:

1. evaluate the current status of the Portfolio;

2. recommend ways to strengthen management and oversight of the DOE's program for granting loans and guarantees to clean energy projects (hereinafter, "the Program"); and

3. propose an early warning system for spotting potential problems that could affect the value of the Portfolio.

I was asked to focus on the present and future of the Program, not to conduct an investigation into past decisions and actions. Several independent investigations were already underway.

The Chief of Staff requested that I complete the assignments within 60 days after retaining advisors. I selected Arnold & Porter LLP as legal advisor, Greenhill LLC as financial advisor, and David M. Johnson, an experienced financial executive, as project advisor.

Given the tight timeline for the project, my team and I had to rely on readily available information. DOE rapidly provided documents and arranged interviews with current and former DOE officials that we requested. We also interviewed selected officials of the Office of Management and Budget and the Department of the Treasury. We evaluated 30 individual transactions with aggregate loan and guarantee commitments of $23.77 billion.

We conducted our review and developed our recommendations independently of the White House and DOE. I decided on the methods of valuation and the conclusions about the current status of the Portfolio, the recommendations for strengthening management and oversight of the Program, and the proposed early warning system. We did not include the Solyndra and Beacon loans in our review, as those loans are no longer in the Portfolio.

We used two quantitative methods to assess the loans in the Portfolio.

The first is the method that the DOE must use to comply with the Federal Credit Reform Act of 1990 ("FCRA"). It calculates the "Credit Subsidy Cost" that is the amount needed to cover expected shortfalls in payments from each loan. The Credit Subsidy Cost reflects DOE's assessment of that loan's credit quality.

The FCRA method is appropriate for budgeting the government's wide range of loan programs because errors in estimating losses in the various programs tend to offset each other over time.

We also evaluated the Portfolio by the Fair Market Value method, or "FMV." It is used in the capital markets to estimate the discount from a loan's face value that investors would demand so they could receive an acceptable return if they were to purchase the loan.

The FCRA and FMV methods have fundamentally different purposes, so their outputs are not directly comparable.

> -- FCRA estimates the government's expected loss on the loans.

-- FMV estimates the discount that investors would require to purchase the loans.

The FMV discount reflects not only credit risks but also market risks and transactions costs that will not affect the government if it holds the Portfolio until the loans are paid off.

We used the FMV method in addition to the FCRA method because FMV provides additional insight into the future marketability of these loans and guarantees, into the financial incentives that sponsors and other parties have to invest in these projects, and into ways that DOE should manage the Programs to protect and enhance value to taxpayers over time.

Using the FCRA method, we estimated that the expected credit loss on the Portfolio will be $2.7 billion, about seven percent less than DOE's own recent re-estimate, which is $2.9 billion.

Using the FMV method, we estimated that investors would demand a discount of $5.0 billion to $6.8 billion from the face value of the loans if they were to purchase the Portfolio. All estimates of expected credit losses and discounts presented in my testimony are as of January 31, 2012, the date of my Report.

To facilitate our analyses, we grouped the loans and guarantees into three categories, each with distinctive credit characteristics. The categories are:

1. "Utility-Linked Loans" to projects where an investment-grade public utility has agreed to purchase the output of the project for most or all of its useful life. These 20 commitments total $14.4 billion. Because the loans will be supported by power-purchase agreements once the projects are operational, we consider their risk to be moderate.

2. “Non-Utility-Linked Loans” to cellulosic ethanol projects, solar manufacturing companies, and small, start-up automotive manufacturing companies. These commitments to eight projects total $2.01 billion and exclude Solyndra and Beacon Power. On average, these loans are smaller than the Utility-Linked Loans and entail greater risk because the projects do not have guaranteed outlets for their production.

3. Loans to Ford and Nissan, which we view as investment-grade credits. These loans total $7.355 billion, are secured, and have terms typical of corporate loans.

The credit ratings we assigned to the Utility-Linked Loans were modestly lower than those assigned by DOE. Therefore, our estimate of the Credit Subsidy Costs for Utility-Linked Loans using the FCRA method is nine percent higher than DOE’s re-estimate as of December 11, 2011 ($1.696 billion vs. $1.551 billion).

Using the fair market value method to evaluate the Utility-Linked Loans, we estimate that investors would require an aggregate discount of $3.5 billion to $5.0 billion to the face value of those loans if they were to purchase them.

In evaluating the Non-Utility-Linked Loans, we assigned lower average credit ratings than did DOE. We estimate the Credit Subsidy Cost for these loans to be $820 million, 28 percent higher than DOE’s FCRA re-estimate of $640 million.

Our fair market value analysis yielded an estimated discount of $707 million to $858 million from the face value of the Non-Utility-Linked loans.

The Ford and Nissan loans represent a commitment of $7.4 billion. We assigned a credit rating to the Ford loans that is four notches higher than DOE’s rating at re-estimation, but we agreed with DOE’s re-estimate of the Nissan rating.

Our estimate of the Credit Subsidy Cost of the Ford and Nissan loans totals $166 million, 78 percent less than DOE's FCRA re-estimate of credit loss, which is $753 million as of December 11, 2011.

We calculated the fair market value discount from the face value of the Ford and Nissan loans to be $716 million to $1.021 billion.

It is important to emphasize that neither FCRA nor FMV nor any other financial model can reliably predict the amount of eventual loss on the DOE Portfolio.

The actual loss will depend upon the outcomes of many factors:

-- First, the Program's loans have long maturities—up to 30 years, well beyond the limits of forecasting.

-- Second, most projects are in early development and some are deploying unproven technologies, so their future performance is hard to predict.

-- Third, once some projects are completed, their prospects will be clearer, so their risks and estimated losses will diminish in some instances. In other instances, possible changes in factors such as regulations and markets could increase expected losses.

-- Fourth, the FCRA and FMV methods assume that all of the projects will be fully funded and the DOE will be a passive bystander unable to influence the Portfolio's risk over time. However, DOE has funded only about a third of its total commitments. Some of the riskier projects have not received any DOE funding and others have been funded only partially.

DOE has negotiated protections in the loan agreements that enable it to cut off further funding and to demand more credit protection if projects do not meet targets. If DOE denies further funding to such projects, the risks and expected losses will decline.

For all of those reasons, focusing on forecasts of losses is far less productive than is assuring that DOE will effectively manage the Portfolio going forward.

DOE must be an active manager, continuously monitoring the projects, spotting risks, exercising its rights in the loan agreements, and limiting taxpayers' exposure to loss.

The Report contains numerous recommendations for strengthening management and oversight of the Program and providing early warning of potential problems.

Our recommendations regarding management of the Program include:

Assuring adequate funding and staffing for management and oversight of the Portfolio for the long-term. That funding will be small compared to the risk of higher losses if the Portfolio is not actively managed.

Clarifying the authority and accountability of managers along the chain of command.

Establishing clear goals for the Program, to include defining the vague financial goal in the enabling law for all of the loans except the automobile loans, which is to assure a "reasonable prospect of repayment."

Engaging in long-range strategic planning for the Program, including determining whether to hold or sell loans over time, and whether to outsource management of the Program;

Protecting taxpayers by strengthening DOE’s position as a creditor wherever possible and having well-defined policies for cutting off funds if projects are not meeting targets.

The laws establishing the Program contain few requirements for oversight and reporting. While the DOE has developed policies and activities in those areas, we recommend several improvements:

Strengthen internal oversight of the Program by forming a Risk Management department separate from the office administering the Program and by consolidating various risk committees in the DOE that oversee the Program;

Establish an interagency Advisory Board composed of senior officials from other agencies and experts from the private sector to review the Program’s governance and advise the Secretary of Energy on policy matters concerning the Program;

Create a comprehensive early warning system covering market conditions affecting the Program, regulatory changes, performance of every project, loan, and involved party, and internal operation of the Program; and, lastly,

Improve public reporting about the Program by enhancing its content and increasing its frequency.

Thank you. I will be pleased to answer your questions.