MEMORANDUM

TO: Board of Commissioners

FROM: ***POWER CONTRACT NEGOTIATING TEAM***

RE: Proposed Term sheet with Alcoa
(Reference December 5, 2005, Memo regarding Puget Agreements and January 3, 2006, Memo regarding Template Aspects of Puget Agreements. Both memos are attached)

DATE: October 15, 2007

GUIDING PRINCIPLES

- Since at least 2001, the District Board of Commissioners has directed staff to negotiate with Alcoa for a new long-term contract. The jobs Alcoa provides has been noted as an important factor.
- The Puget PSA was to be used as a template (Resolution No. 06-12830)
- Operational flexibility and control remain with the District
- Financial flexibility and control remain with the District
- Reduction of District debt
- Payment of some capital improvements as we go
- Cost-based approach that captures all-encompassing definition of costs for generation and delivery and includes additional revenues to the District
- Maintain family wage jobs at Alcoa as a way to enhance the economy of Chelan County
- Ensure that Alcoa must use power at Wenatchee plant
- Protect the District's interests if Alcoa shuts down the plant
- Contracts with terms shorter than 20 years
- Provide benefits to the customer-owners of the District
- Retain sufficient power for Chelan County PUD's current and long-term needs

MAJOR POINTS OF PROPOSED TERM SHEET

1. **<u>25% or 26% of Output</u>** of Rocky Reach and Rock Island. A 26% share is the maximum agreed upon in this proposed term sheet. We are hopeful that the parties will be able to negotiate a capacity-energy exchange with a third party to decrease that percentage share to 25% or less. The parties have agreed to allow three years after the final agreement is signed to negotiate and execute a capacity/energy exchange. If that is not possible and a 26% share is sold to Alcoa, the District will keep for its own use and benefit the capacity not needed to

provide energy to Alcoa. Note that there is a provision for a different percentage to be sold from October 2011 (when the Rocky Reach contract expires) until July 2012 (when Rock Island power is available).

A 25%/26% share of Output in an average water year will provide energy to operate three pot lines compared to the current two. We had originally discussed a post-2011 agreement for a 20% share in the 2001 and 2004 Agreements. However, based upon plant economics, a 25%/26% share was negotiated. (See the CRU report, Item No. 13 in notebook.)

2. **17 years – expires October 31, 2028**. Definitive agreement if approved by both parties would become effective if Alcoa is not in default of the current 2004 Agreement and has continuously operated the plant for the 12 months prior to October 2011. If a shutdown has been caused by an Uncontrollable Circumstance as defined later in the term sheet in Section 5.8, there would be an "assumed operational level" as described in section 5.8 for those 12 months and agreement would be effective.

3. **Take and pay obligation**. Alcoa will pay the percentage of costs related to Output share (25%/26%) regardless of the actual amount of Output produced by the Projects or received by Alcoa at Wenatchee Works. The District has the right to interrupt service or curtail output for operational and reliability reasons. Same as Puget.

4. **Operational Control**. The District will make operational decisions in its sole discretion using prudent utility practices. The District has the obligation to use commercially reasonable efforts to operate and maintain the Projects in an efficient and workmanlike manner. Semi-annual meetings with Alcoa are required to provide information and consider any recommendations. There is no obligation by the District to follow or implement such recommendations. Same as Puget.

5. **No ownership**. This is a proposed contract for the sale of Output only. Alcoa is granted no rights to or interest in the Projects. Same as Puget.

6. **Cost-based contract**. This is "cost-based." Costs are defined to include concepts not included in current contracts (i.e. transmission; relicensing). There are additional amounts to be paid that are not tied to District costs. Same as Puget.

7. **Financial Control**. The District will make financial funding decisions without obtaining approval from Alcoa. Same as Puget.

8. **Upfront payment payable when definitive agreement is approved by FERC**

This is a payment for the right to reserve system capacity for 17 years starting in 2011. This payment is not tied to the District's costs of operation.

Capacity Reservation Charge (CRC)
$21,000,000 if 26% (2006 Dollars)
$17,500,000 if 25% (2006 Dollars)

This provision differs from the Puget PSA due to the jobs and economic value of the Alcoa plant to the local economy. The difference between this dollar figure and $89,000,000 paid by Puget is deferred. If Alcoa remains in operation, there is no further payment of the deferred CRC. However, if Alcoa does shut down, Alcoa will pay the deferred CRC as described below.

The deferred amount increases between signing of the definitive agreement and 2012 based upon an assumed interest rate of 6% to recognize foregone interest. Then, the balance declines over the 17 years. See table below taken from Appendix C to the proposed term sheet.[1]

If Alcoa shuts down for 90 days (initial shutdown), Alcoa would pay an "Initial Shutdown Amount" defined as a fraction (numerator is the months from the start of the shutdown to when a startup has occurred and the denominator is twelve) of $8,615,526. If that initial shutdown continues for 18 months or there is a second shutdown of 90 days' duration, whichever occurs first, Alcoa would owe the entire balance of the deferred CRC. The amounts to be paid and the decreasing balance of the deferred capacity reservation charge are set forth on Appendix C and the table below. There is an exception for the payment if a "shutdown" is the result of an Uncontrollable Circumstance and for this situation only, an Uncontrollable Circumstance could include a strike and lockout situation as defined in Section 11(a)(v). This clause is only effective if certain criteria are met.

Proposed Term Sheet
Exhibit C

Column	A Initial Shutdown Amount	B Shutdown Settlement Amount
2012	8,615,526	87,067,603
2013	8,615,526	83,676,133
2014	8,615,526	80,081,175
2015	8,615,526	76,270,520
2016	8,615,526	72,231,225
2017	8,615,526	67,949,573
2018	8,615,526	63,411,021
2019	8,615,526	58,600,156
2020	8,615,526	53,500,640

[1] The deferred CRC does not become payable until after effective date of the approved definitive agreement. If Alcoa shuts down between now and 2012, the current 2004 Agreement controls and the new agreement may not go into effect (See Section 2 above).

2021	8,615,526	48,095,152
2022	8,615,526	42,365,335
2023	8,615,526	36,291,729
2024	8,615,526	29,853,707
2025	8,615,526	23,029,404
2026	8,615,526	15,795,642
2027	8,615,526	8,127,855
2028	8,615,526	8,127,855

See Section 12 of this memorandum (and Section 5 of the proposed term sheet) for other economic consequences of less-than-full operation by Alcoa.

9. **Payments – lump sum payments – payable 2011/2012**

a. Prepayment to be used as collateral/Collateralization of obligations. A prepayment is not included in the proposed Alcoa term sheet as it was in the Puget PSA. Rather, a requirement to fully collateralize payment obligations is included (Section 28 of term sheet). This provision was discussed as an option in January 3, 2006, memo. Puget chose to "prepay" in lieu of posting collateral if their credit rating dropped. Alcoa chose not to prepay and will post collateral if their credit rating drops to below investment grade. See Section 12f of this memo.

b. Working capital. Upon the respective effective dates of the contract for each Project, Alcoa will pay $2,500,000 (if 25% and $2,600,000 if 26%) per Project as working capital. The funds may be used for operating costs while waiting for monthly payments or otherwise. This is an upfront payment but will be adjusted annually per the Consumer Price Index (inflation). The District may increase the working capital fund as necessary to meet prudent utility practices. The initial amount is roughly equivalent to Alcoa's share of an estimated three (3) months of the District's anticipated operating expenses for the Projects. At the end of the contract, the District retains the funds. The funds retained can be used for any purpose by the District. Same as Puget.

c. Coverage fund. In 2011/2012 respectively for each Project, Alcoa will pay into a fund its 25%/26% share of the Coverage Amount. The Coverage Amount is equal to 15% of the highest annual payment necessary to cover the debt service (principal and interest) on outstanding debt obligations of the Projects. As new debt obligations are issued that increase the overall debt service, Alcoa will pay an additional 15% on the incremental portion. The District retains the interest in this fund. At the end of the term, the District retains the money in the fund. The funds retained can be used for any purpose by the District. Same as Puget

10. **<u>Payments - monthly – payable after 2011/2012</u>**

a. Monthly operating and maintenance costs. Alcoa will pay 25%/26% of all costs and expenses of every kind, direct and indirect, incurred by the District regarding the operation and maintenance of both Projects. Specifically, certain relicensing costs (Rock Island license expires in 2028 and the relicensing process will probably begin by 2020) are included as ongoing operating costs. Same as Puget.

b. Financing costs. Alcoa will pay 25%/26% of financing costs on outstanding and future debt obligations. Alcoa will pay a set amount as defined. If debt is refinanced or remarketed, the District will retain all benefit or costs of such activity which would not change Alcoa's payment obligations. Other details beneficial to the District include changing the definition of average service life for new capital improvements to provide that service life of assets will not exceed 25 years. Further, Alcoa will pay an "assumed index rate" on debt obligations which is 110% of a taxable rate based on an amortization of 25 years or less. Same as Puget.

c. Capital Recovery Charge. Alcoa will pay a "Capital Recovery Charge" on a monthly basis. This will be a percentage, designated annually (notice given one year in advance) by the District, which falls between 0% and 50% of the "Charge Base." The Charge Base is $25,000,000 (2004 dollars – will escalate per the Consumer Price Index). This Charge Base is computed upon an estimate of the District's annual capital improvements for the next 30 years. The Charge Base may be modified by the District if necessary. Example: A 30% charge would result in a total capital recovery amount of $7,500,000. Alcoa's pro rata share would be $1,875,000 per year (based on an assumed 25% share). Interest accumulates in this fund. Money may be used to fund capital improvements when needed (pay for some capital as we go) or may be used to defease or redeem debt obligations associated with the Projects. Same as Puget.

d. Debt Reduction Charge. Alcoa will pay a "Debt Reduction Charge" on a monthly basis. This will be a percentage, designated annually by the District (notice given one year in advance) which falls between 0% and 3% of the total debt obligations outstanding at the beginning of each year associated with the Projects. Example: A 2% charge on $800,000,000 would be $16,000,000. Alcoa's pro rata share would be $4,000,000 per year (based on an assumed 25% share). Interest accumulates in the fund. Money can be used to redeem or defease debt obligations or fund capital improvements for the Projects. Same as Puget.

e. Limit on Capital Recovery and Debt Reduction Charges. There will be a limit on the total amount that can be accumulated in the combined Capital Recovery and Debt Reduction funds by an amount equal to five times the

escalated charge base of $25,000,000 (2004 dollars). The limit on the District's ability to raise the amounts of these charges only applies in the last two years of the contract. In the Puget contract, the limit applied in the last five years. Reason for difference is due to shorter length of the Alcoa proposed term sheet.

f. Credit Rating Premium. Puget chose to pay a fixed Debt Administration Fee of 1% over the life of the contract plus some cash upfront. Alcoa chose the other option discussed in the January 3, 2006, memo which is a charge that "floats" with the difference between Alcoa's credit rating and the District's. A situation where Alcoa's credit rating is low and our rating is high will result in a larger premium being paid to the District. In no event will Alcoa receive a credit if its rating is higher than the District's. This charge may be used for any purpose by the District.

g. Transmission Charges. The District currently has substations, switchyards, and high voltage lines that serve to integrate the Projects and deliver energy to our purchasers. These facilities (which have been previously hydro assets) will be moved to Distribution System. The District will then charge transmission fees for the delivery of the output from the point of generation to Alcoa's point of interconnection to our system. This income will go directly to the Distribution System and may be used for any purpose. This is a change from our current contract to reflect the true costs of delivering the output to Alcoa. There will be a separate Transmission Agreement. Same as Puget.

h. Interconnection Agreement. The parties will also need to negotiate an interconnection agreement. One currently exists that was signed in 1967. This agreement will address the interconnection points and costs of improving the McKenzie Substation, the Rocky Reach Columbia No. 2 tap line and working with BPA regarding the Valhalla Substation. The interconnection agreement will be different than the one executed with Puget.

i. Taxes. Alcoa will pay its own state and federal taxes associated with the purchase of output.

11. **Miscellaneous Provisions**.

a. Step up. If another purchaser with a similar contract defaults, Alcoa agrees to "step up" and take its pro rata share of the defaulting party's share of output upon the same terms and conditions as described herein. (Note: energy taken as a result of the step up can be sold by Alcoa on the market). Same as Puget.

b. Insurance. Insurance is required of Alcoa and the District. The District's self-insurance program is approved as being adequate and prudent. Same as Puget.

c. Assignment. Alcoa has no right or ability to assign the proposed contract to any other entity without written consent of the District. This provision is different than the Puget PSA. The Puget PSA allowed assignment under limited situations (i.e. merger).

d. Audit. Alcoa has the right to annually audit expenses charged to it. However, the District's determination of charges is final. Same as Puget.

e. Events of default. The events of default are well defined. The District reserves a variety of remedies in the event of Alcoa's default. Same as Puget. However, the remedies for default by Alcoa include payment of the deferred capacity reservation charge as appropriate in the year of any default.

f. Limitation of liability. Neither party is liable for damages caused to the other party's system or lost revenues. There is no personal liability of Board members or employees of either party. Same as Puget.

g. Lawsuit. If there is a lawsuit, it will take place (venue) in Chelan County Superior Court. Same as Puget.

h. Pondage and ancillary services. The District has maintained flexibility in the pondage by committing that Alcoa (and other purchasers) will only have access to their pro rata share of 90% of the total pondage. Some ancillary services are included in the definition of output (i.e. load following) and others (i.e. black start) are not (and may be sold under separate agreements). Same as Puget.

i. Environmental Attributes. See Section 12g of this memo regarding environmental attributes associated with the Output sold to Alcoa. Different than Puget.

j. RTO. The Agreement contemplates the potential of a Regional Transmission Organization (RTO) but does not (and cannot) resolve all possible issues associated with a potential RTO. Same as Puget.

12. **Use of energy in Wenatchee and protection of District's interests distinct to Alcoa**. Provisions unique to the proposed Alcoa term sheet.

a. Energy can only be used by Alcoa at Wenatchee Works (Section 5.2).

b. Alcoa will do its own forecasting of water and weather to determine an operating level it can maintain with energy from RR/RI and market purchases (Section 5.3).

c. Different operating levels have different economic consequences based upon the power available (Section 5). The concept is to incent Alcoa to run at a high level (more jobs) when the energy is available.

A three potline operation would employ about 460 to 490 employees. A two potline operation employs about 390 employees.

The level of operation set forth as megawatts translates as follows into number of pot lines:

Level 1 – 250 aMW plus - approximately 3 or more pot lines
Level 2 – 215 to less than 250 aMW - approximately 2½ -3 pot lines
Level 3 – 175 to less than 215 aMW - approximately 2 – 2½ pot lines
Level 4 – less than 175 aMW but not shutdown - approximately less than 2 pot lines
Shutdown – 60 aMW or less (ingot production only)

The aMW numbers allow for some flexibility in having a few pots out of service.

The negotiating team determined that measuring aMW used was an objective criterion that the District could independently verify and measure. Unlike the 2001 Agreement with Alcoa, a guarantee of a particular number of jobs was not included. District staff have good knowledge of the Alcoa plant operation and will know what energy is available and what is being used. The negotiating team thought this was a more practical and verifiable measurement but also provided Alcoa with some means to be efficient and continue operations.

Also see how Uncontrollable Circumstances impact this calculation as allowing for an assumed level of operation under certain circumstances.

If Alcoa receives sufficient energy to operate at a higher level but chooses to operate at a lower level, the excess energy will be sold on the market. Depending on operating levels and energy available, the District will share in proceeds from excess energy sales if Alcoa is operating at less than Level 1. For example, if Alcoa operates at Level 2 but has available to it from its share more energy than used, then the excess energy will be sold. Alcoa will pay all operating costs associated with the entire share. No proceeds will be used to pay operating costs. The District will be paid an administrative fee of 1.5%[2]. Then, of the surplus monies generated from

[2] The 1.5% fee applies to all sales by the District.

the sales, Alcoa will be credited 50% of the proceeds and the District will retain for its own uses 50%. The pro rata split of proceeds varies based on the operation levels. See 5.6 of proposed term sheet.

Any and all proceeds credited to Alcoa will be retained by the District to be used for market purchases necessary for Alcoa's plant operations. If the credits are not fully utilized, the District will retain the balance at the end of the contract. The District is not obligated to separately manage the proceeds and no interest shall accrue or be deemed to accrue on the credit that is accumulated. See Section 5.7 of the proposed term sheet.

d. Protection for the District from a sustained shutdown is defined in Sections 5.10 and 11(a) of the proposed term sheet. One of these protections (payment of the deferred CRC) is discussed in Section 8 of this memorandum. In addition to payment of the deferred CRC, if the plant is shut down as defined, energy will be sold. The proceeds will first be applied to the costs, and then the District will retain for its own purposes 100% of the excess proceeds. These net proceeds can be used by the District in any manner and for any purpose.

e. District has the option to terminate the final definitive agreement if Alcoa operates at less than 175 aMW for 18 months or longer or announces a shutdown (See Section 25). This provision will allow the District to sell the power to another purchaser as it sees fit. It is an <u>option</u> by the District only. If the District decides not to terminate the Agreement, Alcoa remains liable to pay all continued payments. The optionality of this right is important to the District given the uncertainties of costs and operations until 2028.

f. There are also collateralization requirements. Alcoa will be required to post a letter of credit or other collateral satisfactory to the District if Alcoa's credit rating drops to below investment grade (Section 28). The collateral to be posted must cover three months of operating expenses <u>plus</u> the amount of the shutdown payment that would be due if the plant were to shut down. The posting of collateral is due to the credit rating, not based upon whether a shutdown occurs or not. If collateral satisfactory to the District is not posted, that would be a default under the contract and result in the District having remedies under the default provisions (including termination of the contract). If collateral is not posted, the District may declare the contract in default and, if the default is not cured, the District may exercise its remedies, including termination of the contract and collect damages.

g. There are provisions similar to those in the 2004 Agreement protecting the District from counterparty risks (delivery and payment).

h. RPS and environmental attributes issues are addressed in Section 30 of the proposed term sheet. Alcoa is a wholesale purchaser and should not be considered part of the District's retail load for purposes of the state's RPS requirements (Initiative 937). Protection has been built in so that if our interpretation is challenged, Alcoa will be responsible for all additional resources or costs associated with compliance with the RPS.

Further, the District has retained for its own use and benefit all environmental attributes of the power generated as output subject to the term sheet.

i. The current Industrial Power Contract (first entered into in 1992 and restated in 1996 and 2004) provides Alcoa the ability to use up to 42 aMW at the average industrial rate (Section 31). Alcoa uses approximately 17 aMW in an average year to operate two pot lines. The District currently sells for its benefit the remaining 25 aMW. If Alcoa increases its usage for more than two pot lines between now and 2011, Alcoa will pay the average industrial rate plus $7.00 per MWH for that extra energy. This is a modification to a current agreement. This current agreement expires October 2011, and there is no extension of that industrial power contract.