

MEMORANDUM

TO: Board of Commissioners

FROM: ***POWER CONTRACT NEGOTIATING TEAM***
Carol Wardell
Joe Jarvis
Debbie Litchfield
Kurt Carlson
Kelly Boyd
Randy Lowe
Steve Fisher
Janet Jaspers
Rick Coon

RE: Major points of proposed Puget Sound Energy (PSE) power sales contract (2011-2031)

DATE: December 5, 2005

The negotiating team is proud to present for the Chelan County PUD Commissioners' consideration a proposed power sales Agreement with PSE Sound Energy ("PSE") for the years 2011 to 2031.

This team has received a lot of input and help over the last several years from many advisors and experts beginning with the Board's strategic planning in 1997/98. Carol Wardell was assigned as the "lead negotiator and team leader" in 2001. Advisors have included: Board members; Charlie Hosken; Wayne Wright; our current assistant general managers; Bill Doyle (District bond counsel with the national law firm of Orrick Herrington & Sutcliffe); Rick Stephens (an attorney specializing in power sales contracts and financial transactions with the national law firm of Holland & Knight); and a number of other political and technical advisors.

BOARD DIRECTIONS AND DISCUSSIONS

The Board has discussed and developed some straightforward contract principles over the last several years:

- Retain sufficient power for Chelan PUD's current and long-term needs
- Maintain maximum flexibility for District operations and financing options.
- Comply with bond covenants and account for and consider future financing options.

- Maintain operating control.
- Redefine the costs of power to reflect all costs of the District's production and delivery of energy, capacity and other ancillary services/products.
- Ensure that the District can reduce debt and/or avoid future debt to a reasonable degree. Avoid contractual requirements that every dollar of capital improvements at the hydro projects must be financed. Include the ability to pay for some capital improvements as we go.
- Ensure adequate revenues for District operations and for providing utility infrastructure in Chelan County.
- Create a "template" that will be used for all long-term contracts for ease of administration and understanding.

These principles were recently communicated to reconfirm with the current Board.

NEGOTIATIONS

The District's team has been in negotiations with Puget Sound Energy ("PSE") for a new long-term power sales contract for output from Rocky Reach and Rock Island Projects ("Projects").¹ We have reached a proposed contract with PSE for the Board's consideration and approval. We strongly recommend approval of this contract.

PSE receives 43% of the output of these Projects under the current contracts.² This proposed agreement provides for the sale of 25% of the projects' output to PSE. PSE is the largest utility in the state of Washington and serves nearly one million electric customers located in nine counties (both rural and urban).

PRIOR POWER SALES CONTRACTS

The current long-term contracts served the District well over the last fifty (50) years. They contained provisions appropriate to the times and circumstances. However, those same contract terms are not in the District's best interest for the future. A separate memo describes those terms for comparison purposes.

We believe that the proposed Agreement will better serve the needs of our customer-owners into the future.

BASIC PRINCIPLES OF THIS PROPOSED AGREEMENT

The proposed Agreement provides for the following:

¹ Only output from Rocky Reach and Rock Island are included in the proposed long-term power contracts. Output from Lake Chelan will be reserved for the District's use and local needs. This combination of Rocky Reach and Rock Island into one contract made a lot of sense for operational efficiency.

² In November 2006, the District will receive an additional 5% of Rock Island project output. At that point, PSE and the District will each receive 50% of the output of Rock Island. The 43% figure is based upon PSE's share after November 2006 of Rocky Reach and Rock Island collectively.

- An ability to pay District debt or otherwise use an upfront payment of \$89,000,000.
- Financial certainty related to the hydro projects for the District through 2031.
- Substantial overall benefits to the customer-owners of the District.
- A cost-based approach with an all-encompassing definition of costs for generation and delivery of power.
- Operational flexibility and control for the District.
- Financial flexibility and control for the District.
- Reduction of District's debt.
- Payment of some capital improvements as we go, rather than having to issue debt for most capital expenditures.
- Benefits to the region in that PSE has nearly one million electric customers in nine counties in the state of Washington.

MAJOR POINTS OF THE PROPOSED POWER SALES AGREEMENT

The major points of the proposed Agreements are summarized below. The team is still negotiating specific language. There are still some issues in the Transmission Agreement that require resolution. The Interconnection Agreement may be done now or later. The team continues to work on that agreement. There will actually be three Agreements: (1) the Power Sales Agreement; (2) a Transmission Agreement; and (3) an Interconnection Agreement.

We look forward to discussing this proposed contract with the Board and our customer-owners. We look to the Board for guidance in how this discussion can best be accomplished.

1. **25% of the output**³ of Rocky Reach and Rock Island. The projects will be separately accounted for as to costs and expenses but will be operated as a system under this proposed Agreement for efficiency.
2. **20 years – expires October 31, 2031.** Effective start dates (“project availability” dates) are:
Rocky Reach: Nov. 1, 2011 (current contract expires Oct. 31, 2011)
Rock Island: July 1, 2012 (current contract expires June 7, 2012)
3. **Take and pay.** PSE will pay 25% of costs regardless of actual amount of output produced by the Projects. The District has the right to interrupt service or curtail output for operational and reliability reasons.
4. **Operational control.** The District will be able to make operational decisions in its sole discretion using prudent utility practices. The District does have the

³ Output includes energy and capacity and some related ancillary services. In an average water year, a 25% share would amount to approximately 250 aMW.

obligation to use commercially reasonable efforts to operate and maintain the Projects in an efficient and workmanlike manner. Semi-annual meetings with PSE are required to provide information and consider any recommendations. There is no obligation by the District to follow or implement such recommendations.

5. **No ownership.** This is a contract for the sale of output only. PSE is granted no rights to or interest in the Projects.
6. **Cost-based contract.** This is a cost-based contract. Costs are defined to include concepts not included in current contracts (i.e. transmission; relicensing).
7. **Financial control.** The District will be able to make financial funding decisions without obtaining approval from the purchasers.
8. **Payments – upfront payments – payable when Agreements approved by FERC.**⁴
 - a. **Capacity Reservation Charge.** \$89,000,000 payable within thirty (30) days after the Agreement is approved by FERC. This money may be used by the District for any purpose.
9. **Payments – lump sum payments – payable in 2011/2012.**
 - a. **Prepayment to be used as collateral.** \$18,500,000 will be deposited by PSE in 2011. This fund will be used as collateral in the event of a missed payment. If it is used to make any payments, PSE must immediately replenish the fund. Any interest earned remains with the District. At the end of the contract, this fund will be used to make final payment(s) due by PSE.
 - b. **Working capital.** Upon the respective effective dates, PSE will pay \$2,500,000 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 can also increase the fund as necessary to meet prudent utility practices. The initial amount is roughly equivalent to PSE's share of an estimated three (3) months of the District's anticipated operating expenses for the projects. At end of the contract, the District retains the funds.

⁴ The Boards of both PSE and Chelan must first approve the Power Sales Agreement, Transmission Agreement and Interconnection Agreement. The Power Sales Agreement must then be approved by FERC. This approval is required by the Federal Power Act because the term of the Agreement extends beyond the terms of the Rocky Reach license (2006) and the Rock Island license (2028). This approval by FERC is a condition precedent to any payment being made. It is anticipated that FERC should have no issues with this Agreement and should approve it within 120-180 days after we submit it.

- c. Coverage fund. In 2011/2012 respectively for each Project, PSE will pay into a fund its 25% 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, PSE will pay an additional 15% on the incremental portion. The District retains the interest in this fund. At end of contract, the District retains the money in the fund.

10. **Payments – monthly – payable after 2011/2012.**

- a. Monthly operating and maintenance costs. PSE will pay 25% 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) are included as ongoing operating costs.
- b. Financing costs. PSE will pay 25% of financing costs on outstanding and future debt obligations. PSE will pay a set amount as defined in the contract. If debt is refinanced or remarketed, the District will retain all benefits or costs of such activity which would not change PSE'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, PSE 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.
- c. Capital Recovery Charge. PSE 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 next thirty (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. PSE's pro rata share would be \$1,875,000 per year. 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.
- d. Debt Reduction Charge. PSE 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. PSE's pro rata share would be \$4,000,000 per year. Interest accumulates in the fund. Money can be used to redeem or defease debt obligations or fund capital improvements for the Projects.

- 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). During the last five years of the contract, the maximum that can be maintained in the account will decline annually from five times to one time during the last year of the contract. If the defined cap is reached, additional charges will not be contracted. For example, in the year 2027, if we had accumulated five times the Charge Base (\$125,000,000 in 2004 dollars), no additional charges would be made during that month. In the last year of the contract, we could not charge additional amounts if we had accumulated one times the Charge Base (\$25,000,000 in 2004 dollars)
- f. Debt Administration Charge. PSE will pay a charge that recognizes the value of the District's high credit rating on Wall Street and our management of the debt associated with the Projects. The "Debt Administration Charge" will be a set amount: 1.0% of the total outstanding debt obligation at the beginning of each year multiplied by PSE's 25% pro rata share. This amount will be paid monthly. Example: 1.0% of \$200,000,000 (\$800,000,000 x 25%) would equate to an annual payment of \$2,000,000. This fund may be used by the District for any lawful purpose.
- 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 ownership. The District will then charge transmission fees for the delivery of the output from the point of generation to PSE'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 PSE. There will be separate Transmission and Interconnection Agreements.
- h. Taxes. PSE 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, PSE agrees to "step up" and take its pro-rata share (25%) of the defaulting party's share of output upon the same terms and conditions as described herein.

- b. Insurance. Insurance is required of PSE and the District. The District's self-insurance program is approved as being adequate and prudent.
- c. Assignment. PSE cannot assign the contract without the District's consent. However, PSE could transfer the contract to a "successor entity" so long as that entity serves PSE's retail and commercial customers and meets other requirements.
- d. Audit. PSE has the right to annually audit expenses charged to it. However, the District's determination of charges is final.
- e. Events of default. The events of default are well defined. The District reserves a variety of remedies in the event of PSE's 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.
- g. Lawsuit. If there is a lawsuit, it will take place (venue) in Chelan County Superior Court.
- h. Pondage and ancillary services. The District has maintained flexibility in the pondage by committing that PSE (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).
- i. RTO. The Agreement contemplates the potential of a Regional Transmission Organization but does not (and cannot) resolve all possible issues associated with an RTO.