

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: Comparison of current power sales agreement to proposed agreement (2011-2031) with Puget Sound Energy (PSE)

DATE: December 5, 2005

Issue	“Old”¹	“New/Proposed”
System “Output”	<p>Purchaser receives a percentage of the output of each project, including all ancillary services, pond and transmission.</p> <p>Separate contracts for Rocky Reach and Rock Island.</p>	<p>Purchaser to receive percentage (PSE 25%) of the energy and capacity output of Rocky Reach and Rock Island.</p> <p>The projects to be operated as a “system.” One contract for both projects.</p> <p>Purchaser to receive its percentage share of 90% of the pond, not 100%. This gives District extra capacity flexibility.</p> <p>Purchasers will pay a separate additional amount for transmission within District’s system.</p> <p>Some ancillary services (e.g. load following) are included; others (e.g. black start) will be available at an extra cost.</p>
Percentage	PSE receives 43% of output of	PSE to receive 25% of output.

¹ Power Sales Agreement and various Financing Agreements

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Amount of Output	<p>both projects and the District receives 27%. These numbers assume PSE and the District share equally in Rock Island output starting in Nov. 2006. (The District’s share of 27% does not include Alcoa’s share of Rocky Reach.)</p> <p>The Rock Island contract allowed the District to “withdraw” up to 50% of System 2 output if necessary for the District’s load. As of November 2006, the District will have withdrawn the maximum.</p>	<p>The retention of output for future use by the District provides greater flexibility than “withdrawal” rights.</p>
“Take and/or Pay”	<p>Purchaser must pay its percentage of costs and debt service regardless of actual output generated.</p>	<p>Purchaser must pay its percentage of costs and debt service regardless of actual output generated.</p> <p>District has the ability to curtail or interrupt generation and delivery of output for reliability and safety concerns.</p> <p>District may decide in its sole discretion to decommission up to 20% of system and Purchaser would still be required to pay its share of all costs.</p>
Term	<p>Rocky Reach: 50 years Rock Island: 38 years (Rock Island second powerhouse). There were earlier agreements with PSE regarding Rock Island dating back to the mid-1950s.</p>	<p>The contract for both projects expires Oct. 2031.</p> <p>This shorter term ensures greater flexibility to provide for future growth in Chelan County.</p>
No Ownership No Joint Venture	<p>Purchaser receives defined output only. No ownership rights to projects.</p>	<p>Purchaser receives defined output only. No ownership rights to projects.</p>
Upfront Payment	<p>None.</p>	<p>\$89,000,000 to be paid upon Approval Date</p>
Operating Costs	<p>Purchasers pay all ongoing operation and maintenance expenses monthly.</p>	<p>Purchasers pay all ongoing operation and maintenance expenses monthly.</p>

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	There have been disputes as to categorizing some costs as operating or capital.	Certain relicensing, decommissioning, litigation and loss prevention costs are clearly categorized as operation and maintenance costs.
Working Capital	<p>Working capital fund originally established to pay operating expenses when necessary. Total working capital for Rocky Reach: \$2,000,000 Total Working capital for Rock Island: \$1,400,000</p> <p>No mechanism to increase due to inflation or any other reason. Inadequate now.</p> <p>Rocky Reach contract requires that working capital balance be returned to Purchaser at end of contract.</p> <p>Rock Island contract is silent as to the return of working capital balances.</p>	<p>Working capital fund established to pay operating expenses as necessary prior to Purchaser payments being made. Total working capital for Rocky Reach: \$10,000,000 in 2004 dollars (PSE 25%; \$2,500,000). Total working capital for Rock Island: \$10,000,000 in 2004 dollars (PSE 25%; \$2,500,000).</p> <p>Amount increases every year based upon CPI (inflation). Also, the District may increase if additional working capital is needed and supported by prudent utility practices.</p> <p>The balance of the working capital fund will remain with the District at the end of the contract.</p>
Operational Control	<p>Monthly Purchaser meetings.</p> <p>Purchasers can make recommendations which the District must consider.</p> <p>Purchaser able to force issue into arbitration if District does not follow recommendations as to operation, maintenance, capital items and all matters materially affecting the cost of power.</p>	<p>Semi-annual meetings.</p> <p>Purchasers may make recommendations. No obligation by the District to consider or implement them. District to share budgets, plans and other information. District makes all operational decisions in its sole discretion using commercially reasonable efforts.</p> <p>No arbitration right if Purchaser disagrees with District decision.</p>

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<p>Funding Capital Improvements and Debt Reduction</p>	<p>Under the current contracts, there is a very limited ability to pay for capital items without bonding (creating debt).</p> <p>The Rocky Reach contract provides for a total annual charge (Reserve & Contingency or “R&C”) to all Purchasers of \$800,000 per year through 2011 and increasing to \$2,000,000 per year through the maturity date of the 1968 bonds (estimated to be 2015) that may be used to pay for capital items. The amounts were set in 1960s and there is no mechanism to increase. The Rock Island I R&C charge is \$400,000 per year. The Rock Island II R&C charge could be \$2,000,000 per year, but if the money is not actually utilized in the year, it must be returned to the Purchaser. Again, the contract provides no mechanism to increase the R&C funds.</p> <p>In the Rocky Reach contract, the District must first use the limited R&C funds to pay for capital. If insufficient, then the contracts require the District to issue bonds.</p> <p>In the Rock Island contract, Purchaser must approve any expenditures of more than \$25,000 per year for each powerhouse before R&C funds could be used. Issuance of bonds required for capital expenditures.</p>	<p>Purchasers to pay pro rata share of financing costs for outstanding and future debt obligations.</p> <p>No approval by Purchasers is necessary to add, defease or refinance debt.</p> <p>Purchasers pay on debt obligations outstanding as of signing based on a fixed payment amortization schedule. This schedule theoretically mirrors the payment obligations actually due under the current (old) contract.</p> <p>Purchaser pays an “assumed index rate” on the debt obligation after signing which is based on 110% of a taxable bond rate. The 10% of 110% is set to compensate the District for costs of debt issuance, reserves and related costs.</p> <p>The agreement provides for the establishment and maintenance of a Capital Recovery Charge (CRC) fund set by the District Commission from 0% to 50% of the average annual capital expenditures.</p> <p>The agreement provides for the establishment and maintenance of a Debt Reduction Charge (DRC) fund set by the District Commission from 0% to 3% of total outstanding project debt.</p> <p>Both the CRC and DRC funds can be used to pay for hydro project capital (avoid debt) or to reduce hydro project debt at the District’s discretion.</p>

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	<p>There are effectively no funds available for early retirement of the hydro debt.</p> <p>Capital items are amortized over the actual service life. The service life of an asset is a topic of discussion. Purchasers want a longer amortization.</p> <p>The balance of any Rocky Reach R&C funds available at the end of the contract are to be returned to Purchasers. The Rock Island contract is silent as to the disposition of these funds.</p>	<p>Capital items (incurred after the project availability dates) will be amortized over 25 years or the item’s service life, whichever is less. This benefits the District by ensuring certainty in amortization on larger capital items and efficiencies in structuring debt maturities. Removes opportunities for disagreement or argument as to the appropriate service life.</p> <p>District retains the balance in both CRC & DRC funds at the end of the contract.</p>
Financial Control and Flexibility	<p>All Consolidated System loans require Purchaser’s approval.</p> <p>Capital projects funded by such loans also require Purchaser approval.</p>	<p>No involvement by Purchaser in decisions to add, retire or structuring of debt.</p> <p>If a debt is refinanced or remarketed, the District retains all benefits/costs.</p> <p>Purchasers will pay a “synthetic debt service” payment as noted in the above section and the District will be responsible to pay the actual external debt service owed.</p>
Debt Coverage	<p>The current contracts require coverage on only Consolidated System loans assigned to the hydro projects, but the amount is limited to 15% of one year’s maximum interest (no principal included).</p>	<p>Purchasers to pay share of a debt obligation coverage fund as required (and anticipated) by future covenants.</p> <p>Coverage payment equals 15% of the highest annual principal and interest payment necessary to cover all hydro debt obligations. As added hydro debt obligations are incurred, additional coverage payments may be required.</p>

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	At the end of the contract, these monies are to be returned to the Purchasers.	District retains balance at end of contract.
District’s Credit Rating/Debt Administration Fee	<p>District issued debt utilizing its credit rating.</p> <p>No compensation for or recognition of debt administration by District or use of District’s higher credit rating.</p>	<p>PSE to pay its 25% share of a fee based on 1.0% of the total outstanding debt obligations</p> <p>As an example, fee payable by PSE would be \$2,000,000 per year based on current outstanding debt.</p> <p>This money may be used by the District for any purpose.</p>
Default/Payment Protection	<p>Rocky Reach: Purchaser must miss payment and fulfill another criteria (i.e. filing bankruptcy) before a default can be declared.</p> <p>Rock Island: Purchaser can fail to make payment for six months before District could terminate for default.</p> <p>Working capital inadequate to cover expenses while waiting for payment by the Purchaser.</p> <p>If any purchaser defaults, the Rocky Reach contract included a mandatory step up provision for remaining purchasers, including the District.</p>	<p>Default can be declared if payment is missed by three days and notice given.</p> <p>Purchaser is allowed to cure a payment default within limited time.</p> <p>Other defined events of default (i.e. filing for bankruptcy).</p> <p>Working capital sufficient to cover approximately 3 months of operating expenses.</p> <p>“Prepayment Amount” of \$18,500,000 paid by PSE in 2011 will be held by the District and used in the event of any missed payments. If money is used, the fund must be immediately replenished by the Purchaser. At the end of the contract, money held will be applied to final payments owed.</p> <p>The new proposed agreement also includes a mandatory step up and damage provisions to protect the District. The District will also be required to step up in accordance with its retained share.</p>