EXHIBIT NO. KRK-1CT
DOCKET NO. UE-10____
WITNESS: KARL R. KARZMAR

BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Petition of **PUGET SOUND ENERGY, INC.** **For a Declaratory Order Regarding the Transfer of Assets to Jefferson County Public Utility District.**	**Docket No. UE-10____**

PREFILED DIRECT TESTIMONY (CONFIDENTIAL) OF KARL R. KARZMAR ON BEHALF OF PUGET SOUND ENERGY, INC.

REDACTED VERSION

JULY 15, 2010

PUGET SOUND ENERGY, INC.

PREFILED DIRECT TESTIMONY (CONFIDENTIAL) OF KARL R. KARZMAR

Q. Please state your name, business address, and present position with Puget Sound Energy, Inc.

A. My name is Karl R. Karzmar. I am the Director of Regulatory Relations at Puget Sound Energy, Inc. ("PSE"). My business address is 10885 N.E. Fourth Street, Bellevue, Washington, 98009.

Q. Would you please provide a brief description of your educational and business experience?

A. Please see Exhibit No. KRK-2.

Q. What is the purpose of your testimony?

A. My testimony will describe the steps taken by PSE to reach a proposed settlement of threatened litigation with Public Utility District #1 of Jefferson County ("JPUD"). These steps were taken in response to JPUD's threat to condemn PSE's transmission and distribution facilities in Jefferson County. My testimony will also discuss the alternative of rejecting the proposed settlement and the corresponding risks associated with defending PSE's interests in condemnation proceedings. Finally, my testimony will explain the terms and conditions of the proposed settlement as set forth in the Asset Purchase Agreement ("APA") entered into by and between the parties on June 11, 2010, which is provided as Exhibit No. KRK-3.

Q. Please describe the course of events that led PSE to enter into the proposed settlement with JPUD.

A. In the summer of 2008, a sufficient number of signatures were gathered in Jefferson County, Washington, to submit "Proposition No. 1" to the voters for consideration in the November general election. Proposition No. 1 authorized JPUD to "construct or acquire electric facilities for the generation, transmission or distribution of electric power." Proponents of Proposition No. 1 advanced this proposal as a means to authorize JPUD to take over PSE's service area in east Jefferson County (the "Service Territory").

Proposition No. 1 was a controversial ballot measure. There was open and vigorous public debate on the relative merits of "going public" as opposed to maintaining PSE as the preferred service provider. In the course of these public discussions, both PSE and JPUD also retained outside experts to undertake independent preliminary feasibility analyses of the potential costs and risks that JPUD was likely to face if it proceeded to acquire PSE's assets and go into the business of providing retail electric service to our customers. JPUD's consultant, D. Hittle & Associates, prepared a "Preliminary Feasibility Study" and concluded that the cost to JPUD to acquire PSE's service area would be approximately $47.2 million, plus another $9 million would be needed for start up and separation costs in order to commence service. The D. Hittle & Associates study if provided as Exhibit No. KRK-4. PSE retained Utilipoint International, Inc. ("Utilipoint") to prepare a preliminary feasibility analysis, which is provided as Exhibit No. KRK-5. Utilipoint concluded that the cost to JPUD to acquire PSE's distribution facilities in the service area and commence service would be approximately $77 million.

Proposition No. 1 was approved at the November election by a small margin (53% of the vote in favor; 47% against). See Exhibit No. KRK-6 for a copy of the official returns of the general election in Jefferson County. Although PSE accepted the results of the election, PSE advised JPUD that it was an "unwilling seller" in the context of a potential takeover and that PSE believed that it was best suited to be the electric service provider in the Service Territory. However, PSE was also cognizant of state law, RCW 54.16.020, that authorized JPUD to acquire PSE's assets by eminent domain.

Over the course of the next several months, JPUD began to execute its plans to take over the Service Territory and acquire PSE's transmission and distribution assets. In June of 2009, JPUD retained outside counsel to assist JPUD in the acquisition of PSE's transmission and distribution assets, by purchase or by condemnation. At this time, JPUD approached PSE's top management to explore the possibility of entering into settlement negotiations. PSE indicated that it would undertake such negotiations as an "unwilling seller." PSE further stated its expectation that it would agree to sell only if JPUD was prepared to offer a price that fully and fairly compensated PSE for its investments in Jefferson County. A further condition of entering into these negotiations was that, until such time as JPUD took ownership of the system and assumed full responsibility to serve our customers, PSE was to have absolute and unfettered discretion to continue to serve its customers at substantially the same quality and level of service that PSE provides to its other customers, and to do so in accordance with the rules and regulations of the Washington Utilities and Transportation Commission ("WUTC").

I was designated by the Company to lead the negotiating team for PSE. Although every meeting with JPUD's representatives was professional and cordial, from the inception, these negotiations were pursued by JPUD under threat of condemnation. On September 2, 2009, JPUD's governing body directed its General Manager to prepare to exercise its authority to condemn. See Exhibit No. KRK-7.

To facilitate settlement negotiations, the parties entered into a Production and Confidentiality Agreement, dated September 3, 2009, which is provided as Exhibit No. KRK-8C. This agreement provided for the exchange of information concerning the characteristics of the facilities to be acquired and their value. The Production and Confidentiality Agreement afforded this information the protection of Rule of Evidence 408. Twenty-seven "data requests" were received by PSE pursuant to this agreement; PSE provided a full response to each such request.

Information provided to JPUD pursuant to the Production and Confidentiality Agreement led to movement on JPUD's part towards a fair and sufficient purchase price. However, in February of 2010, JPUD advised PSE that it needed to bring closure to the negotiations, and if it was unable to do so, then JPUD would initiate condemnation proceedings. JPUD pointed to growing public pressure to bring this matter to a close as one factor prompting this decision. *See* Exhibit No. KRK-9. JPUD also stated that its ability to obtain power from the Bonneville Power Administration ("BPA") at desired rates by 2013 required it to either initiate condemnation proceedings or effect a settlement by June of 2010.

On February 18, 2010, JPUD made its best and final offer to purchase PSE's assets and facilities in the Service Territory for $103 million. This offer met PSE's condition that, during the transition period, PSE would continue to serve its customers at substantially the same quality and level of service that PSE provides to its other customers in accordance with the rules and regulations of the WUTC. The terms of JPUD's final offer were memorialized in a Letter of Intent dated April 30, 2010 ("LOI"), which is provided as Exhibit No. KRK-10. The parties subsequently negotiated the APA to address the details of the proposed settlement. If consummated, the APA will constitute a settlement of threatened litigation and a disposal of property to a special purpose district pursuant to RCW 80.12.020(2).

Q. Please describe how you determined which assets were to be sold.

A. PSE is only selling its transmission and distribution facilities that are needed by JPUD to serve our existing customers within the Service Territory**.** These assets are limited to what PSE believes that JPUD would be able to acquire, under Washington law, by application of the standard of "public use and necessity" in a condemnation case. The assets in question are all located within the Service Territory. There are no assets being sold that are located outside of Jefferson County. None of the assets being sold are used to provide service outside of Jefferson County.

Unique characteristics of the configuration of PSE's system in Jefferson County provide for a "clean break" from the remainder of our system. Jefferson County is served by a radial transmission and distribution system, originating primarily from the BPA Fairmount substation. There are no generation assets involved in or affected by this transaction. The assets in question serve no function or purpose outside of the Service Territory. No electrical facilities of any significance are stranded or rendered uneconomic by reason of this acquisition. There are no severance damages (or stranded assets) to be accounted for in this transaction. This would not be the case in any other city or county currently served by PSE. If there were severance damages to be accounted for (e.g., assets within or outside of the Service Territory impaired or rendered uneconomic by reason of the acquisition) PSE would be entitled to recover these damages in a condemnation proceeding and would have required JPUD to pay for these costs in the context of a settlement.

During the course of settlement negotiations, PSE compiled a detailed inventory of its assets at risk of being condemned. The bulk of this work was done in response to a JPUD "data request"; therefore, in accordance with the Production and Confidentiality Agreement, PSE was able to bill JPUD for much of this work ($28,078.40). In order to compile this inventory, I asked Jennifer Tada, Director of PSE's System Planning, to oversee the preparation of an itemized list of all of PSE's transmission and distribution facilities in the Service Territory. This included facilities such as substations, transmission lines, distribution lines, transformers, meters and related equipment. I also asked Roger McNulty, Director of PSE's Corporate Facilities, to oversee the preparation of an itemized list of all of PSE's real estate assets in the Service Territory, primarily PSE's fee owned properties and easements. It took over 350 hours to compile these inventories, and approximately two dozen individuals were involved in completing this work. Specific attention was given to the question of whether there were any assets outside of Jefferson County that would be affected, or whether PSE needed to retain any assets in Jefferson County needed to serve our customers in other locations. For example, PSE has communications facilities in the Service Territory to support system wide needs. These facilities are not being sold to JPUD.

These inventories are attached at Exhibit No. KRK-11C. These inventories were used to create Exhibit A to the APA, which is the list of assets being sold. I will hereinafter refer to the assets listed on Exhibit A to the APA as the "Assets."

Q. Please describe how you determined the value of the Assets.

A As I mentioned, in advance of the 2008 election, both PSE and JPUD retained outside experts to prepare independent preliminary feasibility analyses of a potential take-over. JPUD's consultant concluded that the cost to acquire PSE's facilities and commence service would be approximately $56.2 million; PSE's consultant, Utilipoint, concluded that the cost to JPUD to acquire PSE's facilities and commence service would be approximately $77 million. These preliminary assessments provided some useful information, but were prepared without the benefit of a detailed inventory of Assets. PSE retained Utilipoint as an advisor throughout the course of the negotiations, as well as retaining the services of the appraisal firms Allen Brackett Shedd and RE*SOLVE.

When negotiating under threat of condemnation, there is no market to determine a fair price. The transaction is, in all respects, a forced sale. Under the Washington law, a property owner is entitled to full and just compensation as a result of a taking for public use. However, Washington courts have not specifically endorsed any one method of valuation. Working with my negotiating team and with the assistance of outside experts, PSE considered a number of methodologies for valuing the Assets (all of which are admissible in condemnation proceedings). To summarize this work and our conclusions:

- **Assessed Value (tax purposes)**: RCW 54.16.020 states in part that in a condemnation proceeding, the court shall submit to the jury "the values placed upon the property by the taxing authority for taxation purposes." The assessed value of the subject Assets is [redacted] (2010). PSE considered this value but concluded that [redacted] did not constitute full and just compensation for the Assets.

- **PSE Net Book Value**: The net book value of the Assets as of April 30, 2010 was [redacted]. PSE considered this value but concluded that [redacted] did not constitute full and just compensation for the Assets.

- **Income Approach:** This method considers the present value of the future benefits of the property being acquired. JPUD used this methodology to support and present an Asset value of between [redacted]. In reply, using JPUD's pre-election "financial assumptions" (as reflected in the D. Hittle feasibility assessment), PSE presented a fair market value analysis based upon the income approach that showed a value of [redacted].

[redacted]

[redacted].

- **Comparable Sales:** JPUD used this methodology to support and present an Asset value of between [redacted]

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- **Market Sales:** JPUD also presented a "market sales" analysis in support of an Asset value of between [redacted]. As presented by the JPUD, PSE understood this to be a determination of Asset value derived from the premium paid for PSE stock in the recent merger. [redacted]

[redacted].

- **Reproduction Cost Less Depreciation (RCLD):** RCLD takes the Original equipment Cost Less Depreciation (OCLD), or book value, and applies an inflation factor (the Handy Whitman Index) to estimate the cost to reproduce the distribution system at today's prices. This is a methodology that is easily understood and difficult to refute with regard to the constructed infrastructure assets. [redacted]

[redacted]

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- **Replacement Cost New Less Depreciation (RCNLD):** Replacement cost "new" is the cost of construction at current prices using modern materials and construction methods (as distinct from reproduction cost, which is the cost at current prices of building a replica, using material and methods unique to the structure being appraised). Replacement and reproduction cost valuations are methods for valuation accepted by the courts when there is no active market for the subject property. RCLD and RCNLD were recognized by the experts assisting PSE and JPUD as credible methodologies for determining asset values. PSE was also advised that Washington courts accepted the replacement cost and reproduction cost methods as a proper approach to determining fair market value in this jurisdiction, although RCNLD is criticized by some courts as it tends to inflate the value of the assets being acquired. During the course of the negotiations, JPUD presented RCNLD analyses that ranged from a [redacted]. For purposes of negotiation, PSE represented that an RCLD/RCNLD range was from [redacted], inclusive of real estate assets. Notwithstanding these differences, [redacted].

Q. How did you arrive at $103 million as a settlement amount?

A As noted above, this was JPUD's best and final offer. PSE chose to accept this offer, in part, because we determined that for settlement purposes $103 million fully and fairly compensates PSE for its investments in Jefferson County. My reasons for drawing this conclusion are summarized as follows:

- **RCNLD/RCLD (all facilities, exclusive of real estate):** Using the facility inventories discussed above, I asked our transmission and distribution planners to provide me with present day replacements costs for all of the Assets. In some cases (due to the age or unique characteristics of the facilities) we used reproduction cost instead of replacements cost. We determined that it would cost JPUD [redacted] today to rebuild the existing system, and its depreciated value after taking into consideration its age and condition would be [redacted]. We also calculated an RCLD adjusted number, using book values and the Handy - Whitman Index of Public Utility Construction Costs and other adjustments to account for the unique characteristics of this system. We arrived at a final number of [redacted], without taking into consideration real estate values. *See* Exhibit No. KRK-12C. Over the course of our negotiations, we were allowed to meet directly with JPUD's consultant, Brown & Kysar, Inc, ("Brown & Kysar "). Brown & Kysar was asked to undertake an RCNLD analysis for JPUD. Brown & Kysar determined an RCNLD [redacted], inclusive of real estate values. *See* Exhibit No. KRK-13C. In reviewing the Brown & Kysar analysis, [redacted] However, we agreed, by and large, on the overall approach for determining the value of the Assets.

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- **Real Estate:** JPUD's desire to wrap up negotiations in May made it impossible to secure real estate appraisals prior to settlement. [redacted]. In view of the uncertainty regarding real estate values, PSE included a contingency in the APA that afforded PSE the opportunity to obtain the opinion of a third-party appraiser in order to verify real-estate values. This contingency was set to expire on July 1, 2010. On June 29th, PSE was advised by its appraisers:

  > Based on our independent review and analysis of the subject properties, as identified by PSE, a range in value from [redacted] for PSE's Jefferson County real estate holdings, as of April 30, 2010, is indicated. At the present time, a point estimate of value would lie toward the center of this range.

  With this information in hand, PSE determined that the contingency to confirm real estate values had been satisfied and so informed JPUD on June 30, 2010.

If you use the real estate value suggested by the appraisers [redacted] and PSE's RCLD determination of value of the facilities [redacted], PSE's "all in" number for the fair market value of the Assets is [redacted]. This compares favorably to the settlement purchase price of $103 million.

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Q. How does PSE propose to account for the proceeds of the sale?

A. PSE plans to file a petition for an accounting order with its proposed accounting treatment if and when the transaction is ultimately completed.

Q. Is PSE also entitled to recover "going concern" damages in the context of condemnation?

A Yes. PSE considered the merits of its potential claim for "going concern" damages in this case. Going concern damages may be claimed in a condemnation proceeding involving the take-over of a utility's service territory. Going concern damages may be recovered, if proven, to compensate the utility for lost revenue potential. [redacted]

[redacted].

In the context of our negotiations, PSE and JPUD agreed to disagree on the existence and measure of going concern damages. However, if you take the high [redacted] by agreeing to a purchase price of $103 million.

Q. How does the proposed settlement compare to the alternative of litigation?

A As I explained above, in a condemnation case, PSE would be entitled to "full and just" compensation and may, depending upon the amount by which the award exceeds the condemning authority's highest and best offer, recover its costs and attorneys' fees. In most cases, the amount of the award is determined by a jury.

Based upon the valuation analyses discussed above, we assumed that JPUD's low [redacted] established the range of litigation risk. [redacted]

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[redacted]

Similarly, while JPUD's numbers are low, it is certainly possible that a jury could be persuaded to move towards the Brown & Kysar RCNLD range of [redacted]. In light of this risk, we concluded that a $103 million settlement is reasonable and prudent from the standpoint of avoiding litigation risk.

Q. Please summarize the key terms and conditions of the APA.

A. Some of the key terms and conditions of the APA are summarized as follows:

- **Assets**. The Assets to be sold are listed in Exhibit A of the APA and are generally defined as an asset, facility or property that "constitutes a real property interest located in the Service Territory or an improvement or fixture located thereon that is used by and useful to PSE to provide retail electric service to customers located in the Service Territory. . . ." The list of Assets in Exhibit A is fixed as of the effective date of the APA; however, the APA provides for due diligence activities (i.e., confirmation that the asset list is complete and accurate) and for improvements to the existing transmission and distribution system that are likely to occur during the 18 to 36 month transition period. Title to the Assets will pass to JPUD at closing.

- **Transition of Service**: The APA requires that closing occur no earlier than 18 months and no later than 36 months from the date of execution. During this transition period, PSE will construct, operate and maintain the Assets, and provide electric service to its customers in the Service Territory in accordance with the rules and regulations of the WUTC (including, but not limited to, PSE rates and tariffs on file therewith). The APA creates a Transition Advisory Committee ("TAC") comprised of three (3) members appointed by PSE and two (2) members appointed by JPUD, whose purpose is to facilitate the cooperative efforts of the parties to transfer the assets to JPUD in accordance with the terms and conditions of the APA. The APA also provides a structure pursuant to which the parties will facilitate transition with agreed upon measures for transition of customer data, maps and any materials related to the location and configuration of the Assets, arrangements regarding requests for transmission interconnections and transmission services, billing records, electric service cut-over planning and procedures, and security and communication protocols.

- **Assumption of Service by JPUD**: After 18 months, the decision to take over the responsibility to serve customers within the Service Territory lies with JPUD. To exercise this discretion, JPUD must close the transaction and take title and physical control of the Assets. At such time, JPUD will have both the means and the responsibility under state law to serve these customers and PSE will be unable to serve and will have no responsibility to do so.

- **Purchase Price:** The Purchase Price of the Assets is $103 million. Any adjustments to the purchase price necessary to account for any facility additions or deletions made during the 18 to 36 month transition period will reflect the net book value of any Asset improvements (a price increase) and the net book value of any Asset removed from service (a price decrease). This mechanism also ensures that there is no financial disincentive during the 18 to 36 month transition period to make investments necessary to maintain safe and reliable service to PSE's customers. Within ten days of JPUD's receipt of its necessary long-term financing, JPUD must deposit $20 million in escrow. The balance is due at closing. JPUD will be responsible for all sales and transfer taxes payable by reason of the sale of the Assets.

- **Financing Obligation:** JPUD is obligated to obtain its long-term financing within 36 months of the date of signing the APA. JPUD will provide PSE with its plan for obtaining financing within six months of execution, together with all commitments for financing received by such date.

- **Title to the Assets:** The Assets will be sold by PSE and accepted by JPUD in their then current condition, and in all respects, "as is, where is, with all faults and defects, and without warranty or representation of any kind."

- **Due Diligence Review and Environmental Assessments**: Within 120 days of execution, the parties shall commence a due diligence review period, not to exceed 24 months, during which JPUD may inspect certain materials including title reports, real estate documents, maps, inventories, maintenance records, logs, and other items relating to the Assets' title and physical condition. PSE also shall make available for review all environmental documents relevant to the Assets or surrounding areas. JPUD may also conduct Phase I and Phase II environmental assessments of the Assets and is obligated to provide PSE with copies of any such assessments. JPUD will not be entitled to any reduction to the purchase price as a result of any environmental assessment.

- **Stores:** Certain PSE-owned stores, consumables, tools, furniture, and other personal property used in the Service Territory may, at JPUD's option, be purchased at no more than the actual cost of such items.

- **Liquidated Damages and Specific Performance**: In the event of the unexcused failure by either party to close the transaction, then the other party may either seek specific performance of the APA or may demand payment of liquidated damages in the amount of $2.5 million.

- **Regulatory Approvals:** PSE's obligation to close this transaction is conditioned, among other things, upon PSE's receipt of certain regulatory approvals from Federal Energy Regulatory Commission and upon the WUTC's confirmation that (a) the amount of the purchase price is sufficient to fully compensate PSE for the sale of the Assets; (b) the provisions of this APA pertaining to PSE’s transition of its responsibilities to provide electrical service to its customers are sufficient and consistent with PSE’s public service obligations; and (c) the asset transfer is authorized by RCW 80.12.020(2). JPUD has advised PSE that prompt resolution of these contingencies is a material factor affecting JPUD's plan of service and JPUD's ability to secure long-term financing on favorable terms.

- **Other Commercial Terms**: The APA provides that the parties will indemnify each other with respect to any third-party claims arising out of the transactions contemplated by the APA for which they are responsible. With respect to claims for environmental conditions, PSE is responsible for conditions that arose prior to closing (excepting conditions that are reasonably expected in the ordinary course of utility operations). JPUD is responsible for any environmental conditions arising after closing. The parties have agreed to seek resolution of any disputes under the APA first by referral to each party’s senior officers, then by means of mediation, then by resort to the federal or state courts in Thurston County, Washington. The APA shall terminate automatically if the closing has not occurred on or before the third anniversary of its execution.

Q. Was the decision to enter into the settlement reviewed and approved by the Company's top management and the Board of Directors?

A. Yes. I provided the Company's top management with frequent briefings throughout the course of the negotiations. Management was heavily involved in the process and provided direction throughout the course of the negotiations. The Board was frequently updated and took an active interest in the negotiations. The LOI provided that the APA was subject to the review and approval of the Board of Directors. The APA was approved by the Board on June 10, 2010.

Q. Does this conclude your testimony?

A. Yes, it does.