

**EXHIBIT NO. ___(RG-33HC)
DOCKET NO. UE-072300/UG-072301
2007 PSE GENERAL RATE CASE
WITNESS: ROGER GARRATT**

**BEFORE THE
WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION**

**WASHINGTON UTILITIES AND
TRANSPORTATION COMMISSION,**

Complainant,

v.

PUGET SOUND ENERGY, INC.,

Respondent.

**Docket No. UE-072300
Docket No. UG-072301**

**THIRTY-SECOND EXHIBIT (HIGHLY CONFIDENTIAL) TO THE
PREFILED DIRECT TESTIMONY OF
ROGER GARRATT
ON BEHALF OF PUGET SOUND ENERGY, INC.**

**REDACTED
VERSION**

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**Energy Management Committee
March 15th 2007**

**Sumas – PPA Financial Concerns
Jim Elsea and Roger Garratt**

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Exhibit No. _____ (RG-33HC)
Page 1 of 21

Sumas PPA – Overview

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Term: April 1993 – April 2013

Capacity: 133 MW

Heat Rate: btu/kwh

Pricing:

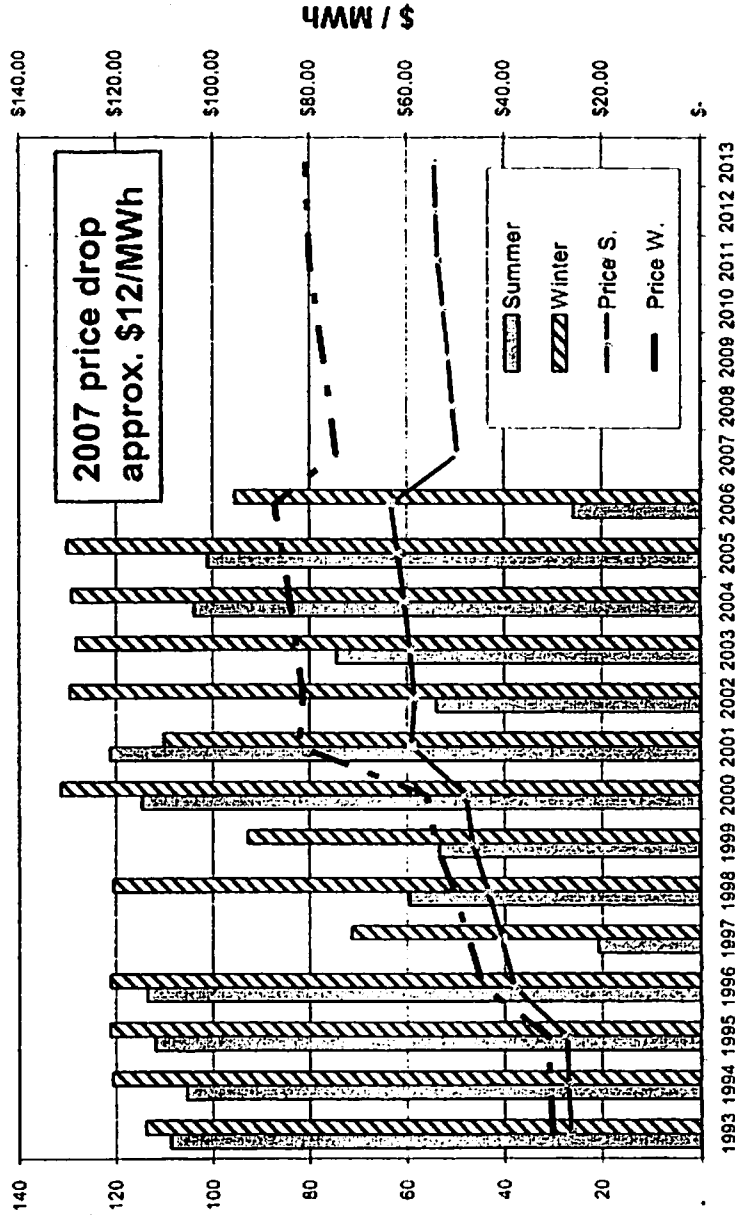
Winter = Sep. – Mar.

Summer = Apr. – Aug.

Displacement by mutual agreement

Bulge in pricing negotiated in original PPA

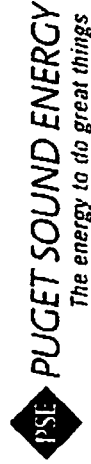
Sumas Power and PPA Price



Plant: Sumas 133 MW from a single CT (GE 7EA) with a smaller HRSG and STG in combined cycle.

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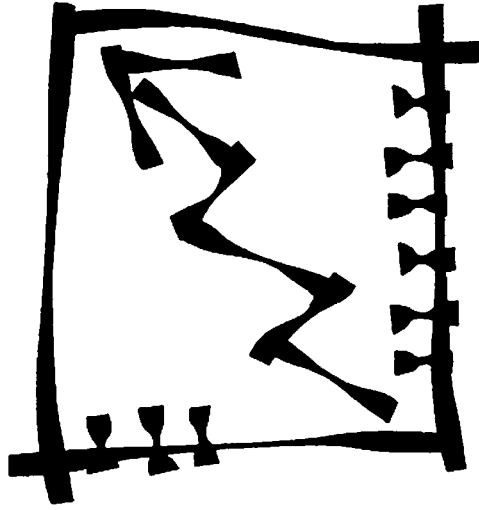
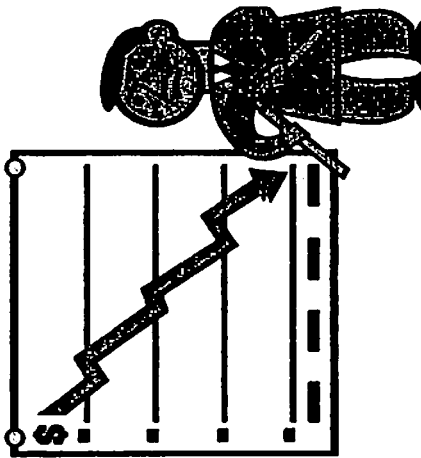


Financial Distress Revealed

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April 2006

Sumas initiates restructure talks indicating they are getting squeezed by rising fuel prices and royalty payments.



January 2007

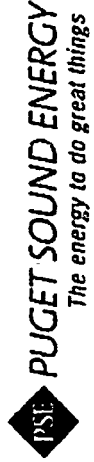
- NESCO shares details of financial concern.
- Negative [redacted] cash flow to owners through 2013
- Owners have deferred a portion of Federal Estate Tax; [redacted] million owed

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March 2007

- Balance sheet 2006 shows [redacted] restricted cash
- NESCO preparing GAPP format financial forecast
- PSE considering independent audit
- 2006 Income before Fed Income Tax about [redacted]
- 2006 cash flow before Fed Income Tax about [redacted]



Plant Purchase Option

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Key Steps:

- (i) Sumas discloses to PSE proof of financial condition,
- (ii) PSE agrees to purchase Sumas plant for [] million,
- (iii) Parties agree to cancel PPA upon closing of plant sale,
- (iv) PPA amended to allow gas reserves sale prior to closing of plant sale,
- (v) Sumas places [] million in escrow in favor of PSE in event of failure of closing of plant sale,
- (vi) Plant sale closing occurs between July and Oct. 2007,
- (iv) PSE purchases replacement power contract in attempt to protect customers from market price uncertainty

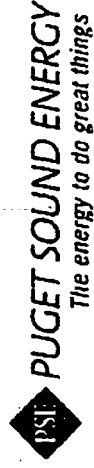
Costs / Benefits:

- Pre-tax earnings drag of []mm (regulatory lag 7/1/07 to 12/31/08)
- Replacement Power about break-even with existing contract
- Plant adds portfolio benefit, but not as good as Goldendale
- Risks: Regulatory

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No Deal Option

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Likely Scenario - Breach:

- (i) Sumas provides notice of intent to breach PPA (breach 7/1/2007),
- (ii) PSE balances open position (near term Mills, long term replacement PPA) and files claim
- (iii) Sumas sells gas reserves, retires debt and owns plant free and clear,
- (iv) Sumas auctions plant (price > million) or retains,

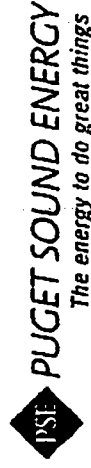
Pros and Cons:

- Avoid regulatory risk
- Avoid earning drag
- Legal claims and costs
- QF status would allow "put" of power to PSE at Avoided Cost
- If purchase plant, likely higher capital cost

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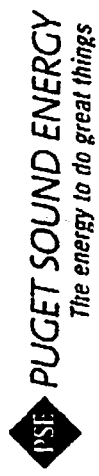
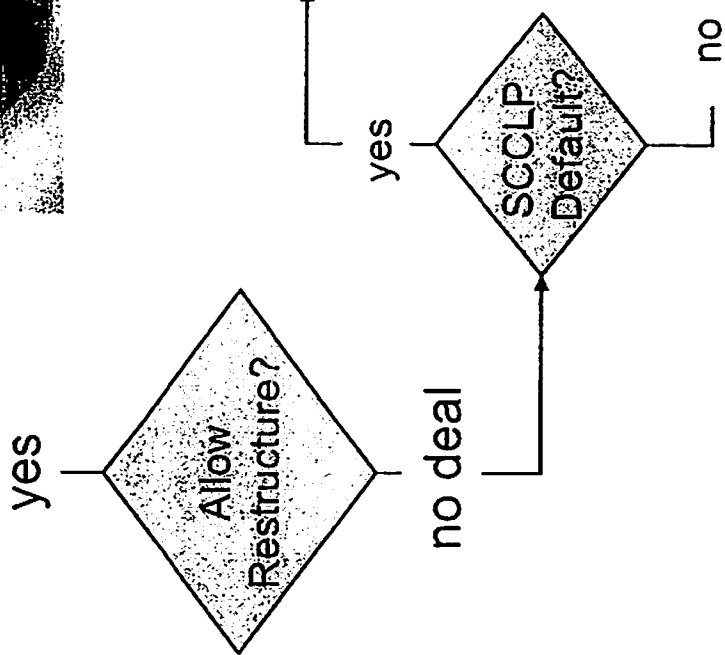
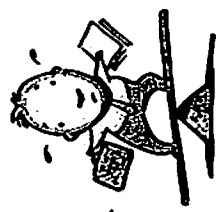
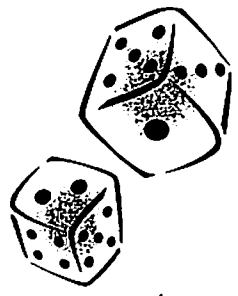
Summary Decision Tree

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Savings Not Compelling
 Risk adjusted replacement PPA (\$9.0 million)
 Discounted plant price similar to short-listed RFP offers, but not winner
 Regulatory risk
 Earnings drag [] mm pre-tax (7/1/07-12/31/08)

Future Uncertainty
 Regulatory – need open dialogue
 Legal claims / costs
 Cost of replacement PPA depends upon timing of default
 QF risk: “put” at avoided cost
 Sumas assets up for bid: plant, gas reserves, gas transportation.

Status Quo PPA
 Mark-to-Market needed?



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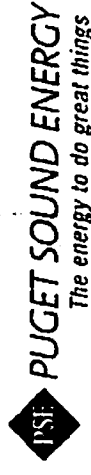
Exhibit No. ___ (RG-33HC)
Page 6 of 21

Recommendations

Energy Resources Group Staff recommends the following actions be approved by the EMC:

In the absence of compelling power cost savings for customers, PSE will withdraw from current negotiations with Sumas. Given the possibility that the existing PPA with Sumas might not be sustainable, ERG Staff will undertake follow-up discussions with WUTC Staff regarding this EMC decision and possible need for a replacement PPA to hedge price risk for customers. ERG Staff will monitor replacement PPA pricing and be ready to execute if necessary. ERG Staff is advised to be open to offers from Sumas that provide more compelling power cost savings for PSE customers.

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Appendix

Note: The first two slides in the appendix were included in the main presentation when discussed with WUTC Staff on March 14, 2007

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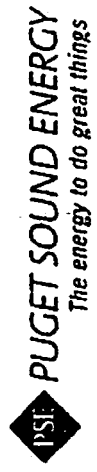
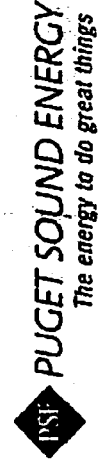


Exhibit No. ____ (RG-33HC)
Page 8 of 21

PPA History – abbreviated

1978	Public Utility Regulatory Policies Act (PURPA)
2/24/1989	PPA signed
April 1993	Commercial Operation
1991 1994	Amendments: 1994 provided for displacement
1999	PSE initiated unsuccessful restructure discussions similar to negotiations with Encogen and Tenaska
2001	Owner, Darrell Jones, dies in boating accident
2004	Sumas sought PSE approval to refinance. Sumas initiated restructure alternatives from simple sharing of refinance savings to purchase of reserves. No deal. Sumas refinanced at another level of their organization.
2003 RFP Bids	NESCO submits several bids in 2003 RFP. Each includes offer to restructure Sumas PPA
2006 Apr – Dec	NESCO initiates restructure. Talks develop into shared savings approach. PSE concern with regulatory risk.
2007 Jan – Feb	NESCO shares details of financial concern. PPA status quo not sustainable. PSE discusses options including simplified deal to acquire plant at discount.

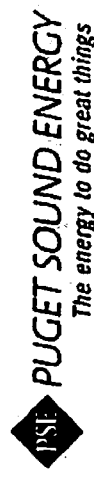


Sumas – PPA Financial Concerns

- Sumas Cogeneration Company, L.P. (SCCLP) is under increasing financial pressures:
 - ◆ Increasing cost of royalties on natural gas produced from ENCO reserves (royalty is a function of market price not production cost)
 - ◆ Increasing cost of market gas for supplemental market purchases not supplied by ENCO reserves
 - ◆ Increasing Federal tax payments –
 - ◆ Reversing of deferred taxes due to accelerated depreciation on plant
 - ◆ Estate taxes arising from death in 2001 of owner and developer Darrell Jones.
- Owners of SCCLP much better off with PPA restructure. PSE told status quo operations cannot be sustained*.

* Based on meetings with Chuck Martin and Daren Anderson of NESCO, who are business managers of SCCLP

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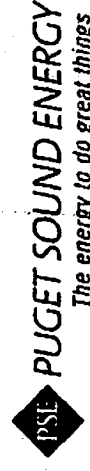
QF – Qualifying Facilities Risk

- **What is a QF?** To address the energy shortages of the 1970s, the Public Utility Regulatory Policies Act was enacted to empower qualifying cogenerators or small power producers (from renewables) — qualifying facilities or QFs — to “put” their electric generation to an interconnected electric utility and charge the utility an avoided-cost rate.
- **Sumas QF will retain right to “Put” power to PSE at Avoided Cost.** In the Energy Policy Act of 2005, Congress agreed and directed FERC to end prospectively the “put” for post-October 8, 2005, power sales by QFs that are found to enjoy nondiscriminatory market access. The larger QFs can rebut the presumption of nondiscriminatory access by showing that characteristics of how they operate — for example erratic cogeneration available for sale or non-dispatchability, or where they operate — for examples in proximity to a binding transmission constraint — preclude market access.
- **How Avoided Cost Pricing might play out:**
 - ◆ Cogeneration Coalition of WA states.... If a QF participates in the RFP but does not have the winning bid, the utility has not satisfied its obligation under PURPA with regard to that QF. The results of an RFP can be used to determine the avoided cost for a purchase from a QF. But that would be true only if the RFP sought the same type of resource as the QF is providing.
 - ◆ PSE might say... avoided cost is determined by the lowest RFP bids
- **QF Risk needs further exploration**

Source: Bracewell & Giuliani LLP, Energy Legal Blog
<http://energylegalblog.com/archive/category/1017.aspx>

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INCREMENTAL COSTS AND RISKS TO PSE OF Sumas Default on PPA

- **Power Costs.** If SCCLP files for bankruptcy protection, Court would probably agree to reject PPA. PSE is exposed to a rejected contract in a higher priced market, thus increasing power costs. PSE would also face higher power cost in market if SCCLP defaults, but would incur legal costs in making claim and challenges.
- **Earnings Volatility.** PSE does not control the timing of default and thus control the timing of a replacement contract or generation plant. Timing or resource additions (whether it be contract or ownership) and the resulting regulatory lag can have a big impact on earnings. Earnings volatility could raise capital costs, thus impacting customers.
- **Legal Costs.** There will be legal costs associated with following a bankruptcy or filing claims in the event of default to be sure that the impact to PSE interests is minimized.
- **Plant Purchase Leverage.** PSE would have less negotiation leverage to acquire the plant at a discount. In fact, PSE could be bidding against other potential buyers similar to the situation at Goldendale.
- **Transmission Support.** The Sumas plant is helpful in supporting south to north flows on the Northern Intertie into BC. This helps BPA meet its Columbia River Treaty obligations and reduces PSE's probability of having its transmission rights on BPA curtailed.
- **QF Status.** New plant owner could use QF status to put power to PSE at avoided cost.

Is this compelling?

Replacement PPA Compared to Sumas PPA

million savings (including displacement)
lost option value of existing PPA
net cost – NPV July 2007 – April 2013

Purchase of Sumas plant for mm

Portfolio Benefit = \$32 million (20 year NPV)

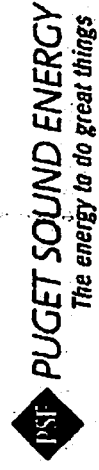
Levelized Cost = / MWh

Goldendale = \$104 million benefit; / MWh (Aug. Update)

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Exhibit No. (RG-33HC)
Page 13 of 21

Replaced PPA is a Risk Adjusted Cost

PV Power Cost \$000, July 2007 – April 2013

Replacement PPA JP Morgan Bid Date 3-5-2007


 PV PPA Replacement Contract (125 MW Q1, Q3 & Q4; 75 MW Q2) Balance is market

Existing Sumas PPA (Sustainable?)

 PV Sumas Contract Payments

PSE Share of Displacement Benefits (forward prices Kiodex 3-9-07)
Subtotal PV Status Quo

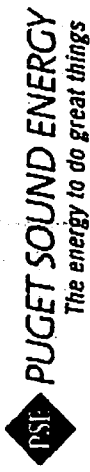
Power Cost Savings

 Net Before Volatility Uncertainty
Risk Adjustment for option value of existing PPA*
Net Power Cost Changes to PSE Customers

* Elsea approach to look at KW price variability for CY 2008 and assume similar variability in all years through 2013. KWI pricing 1-11-07

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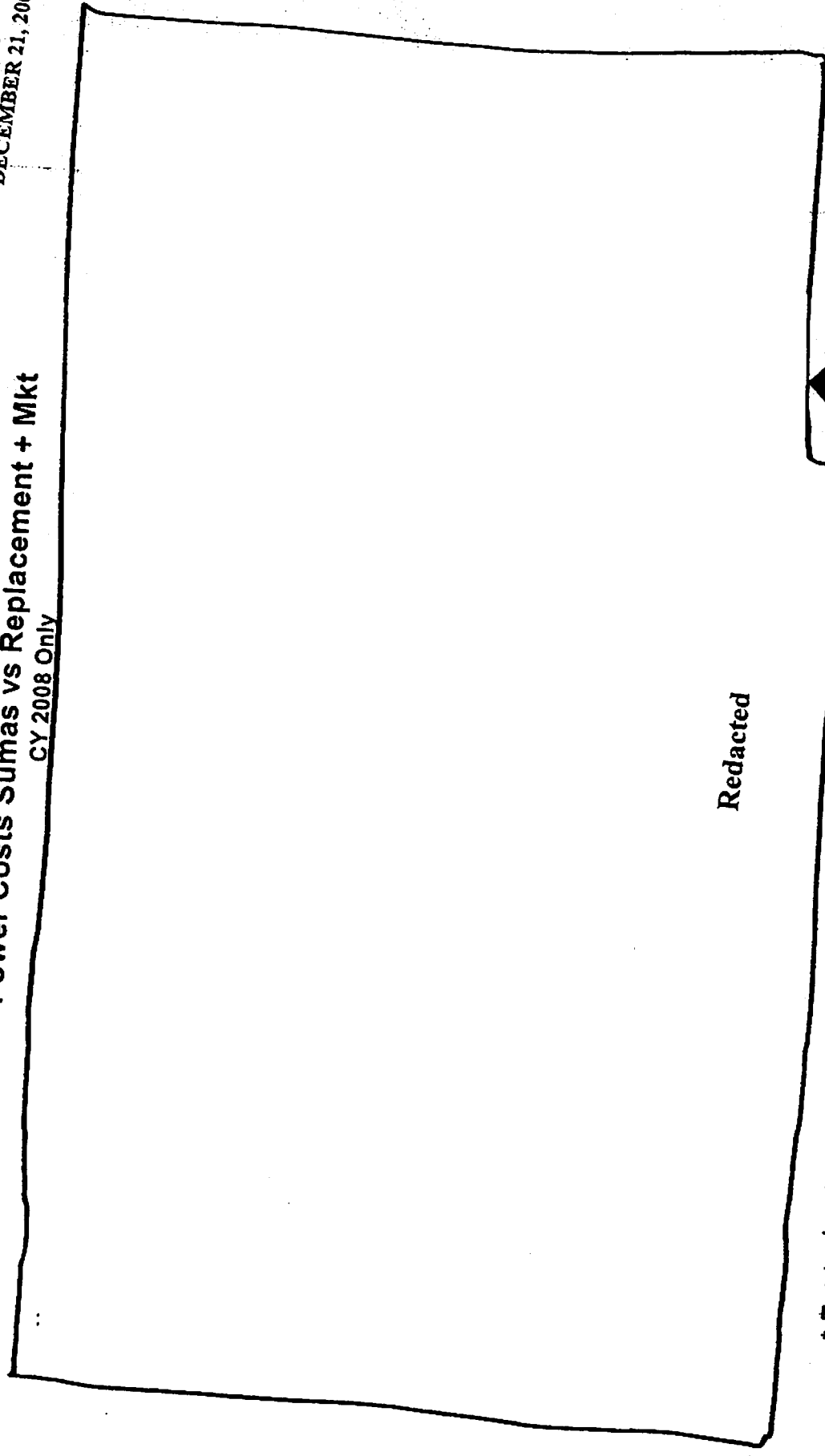


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Existing Sumas PPA has Extrinsic* Option Value

Power Costs Sumas vs Replacement + Mkt
CY 2008 Only

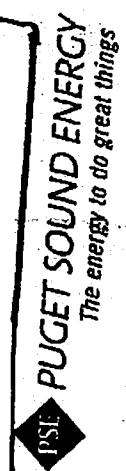
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* Extrinsic, due to power and gas price volatility.

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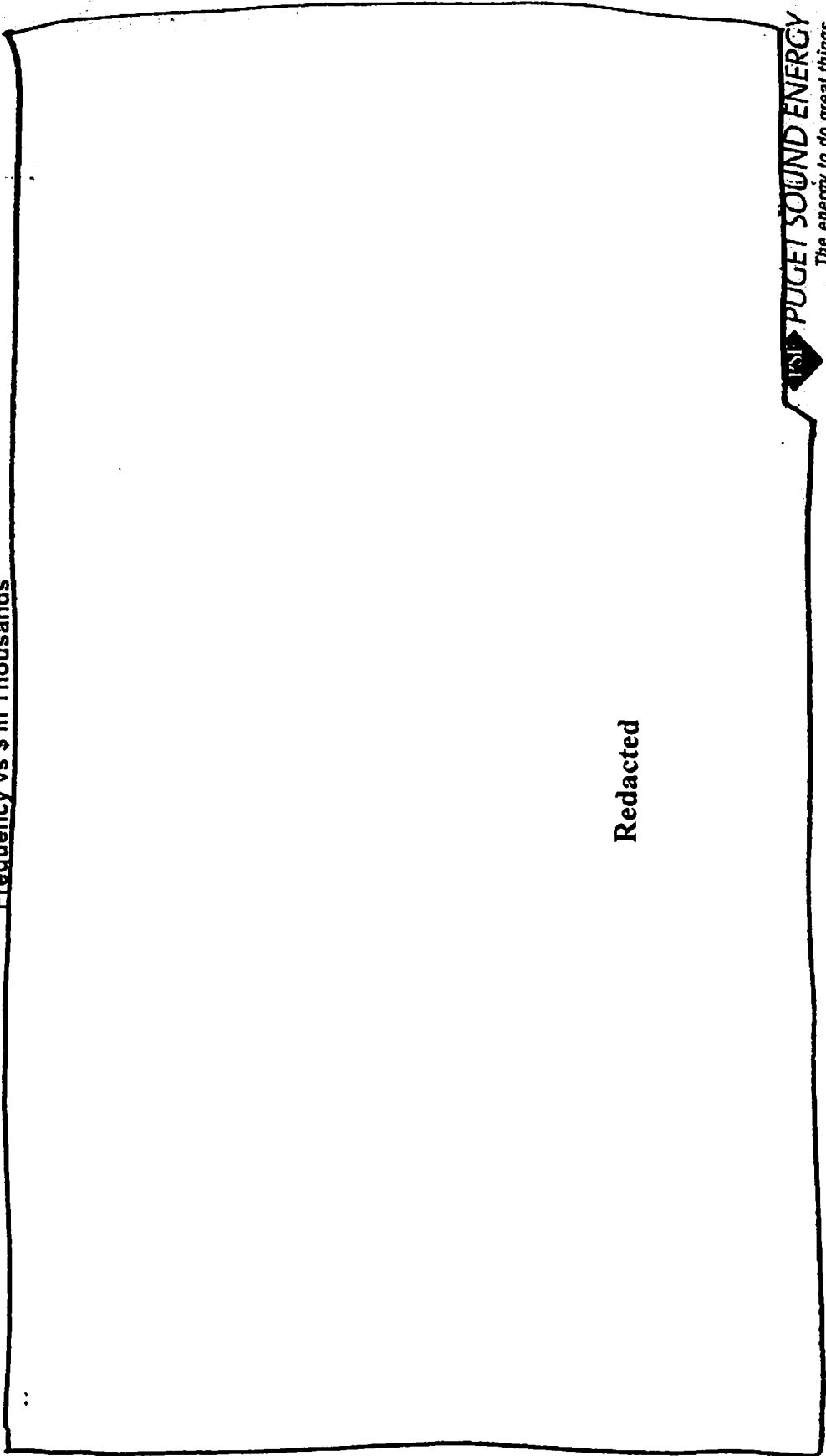
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Exhibit No. (RG-33HC)
Page 15 of 21

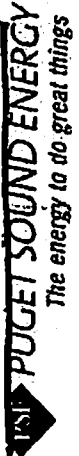
Decreasing Q2 Replacement PPA MWS Increases Savings but Increases Risk

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Compare CY 2008 Power Costs Sumas vs Replacement + Mkt
Frequency vs \$ in Thousands



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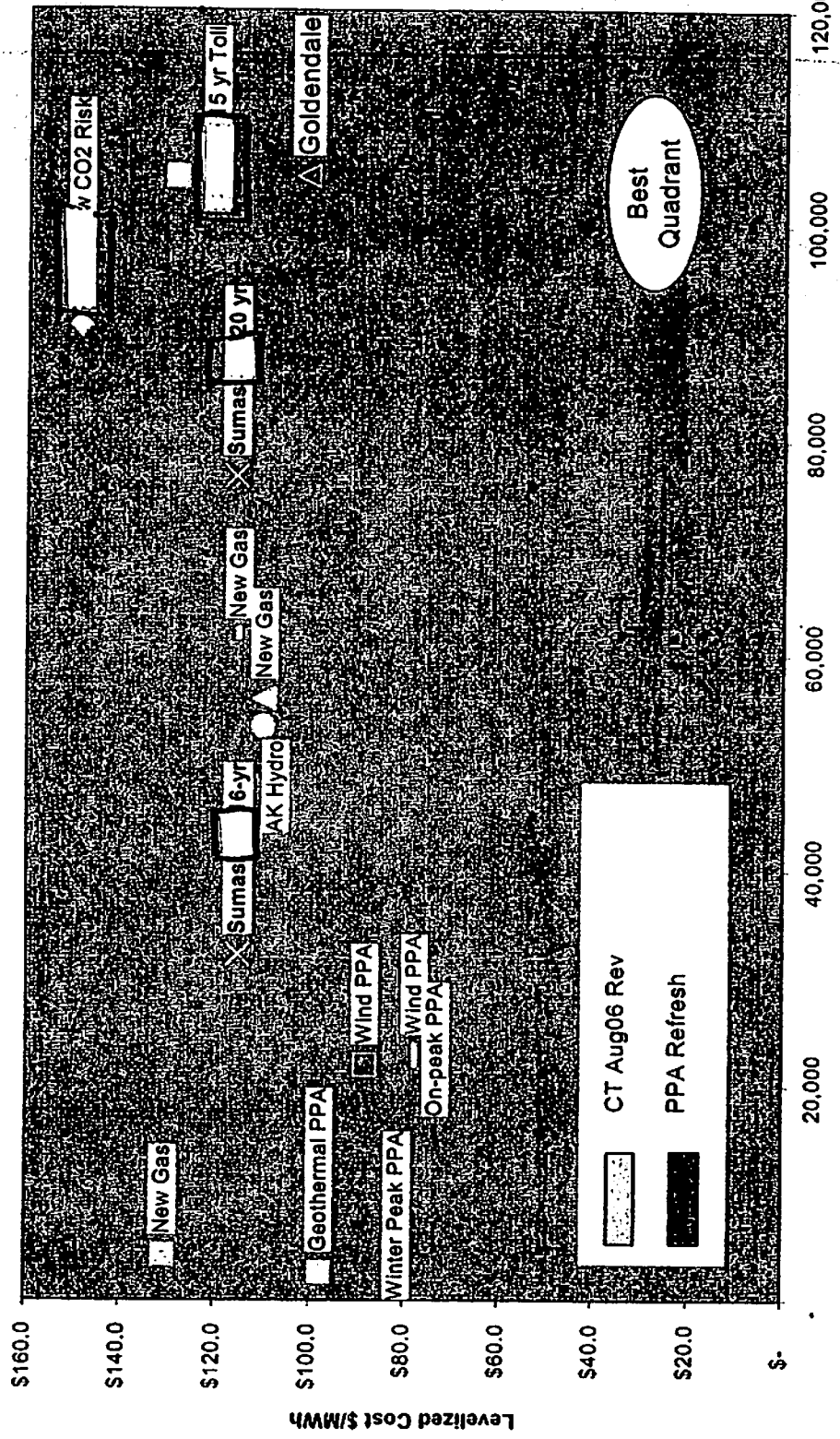
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Exhibit No. (RG-33HC)
Page 16 of 21

PSM Results – Sumas Plant with 16 year life is reasonable compared with short list

Levelized Cost v Portfolio Benefit

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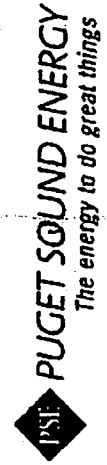


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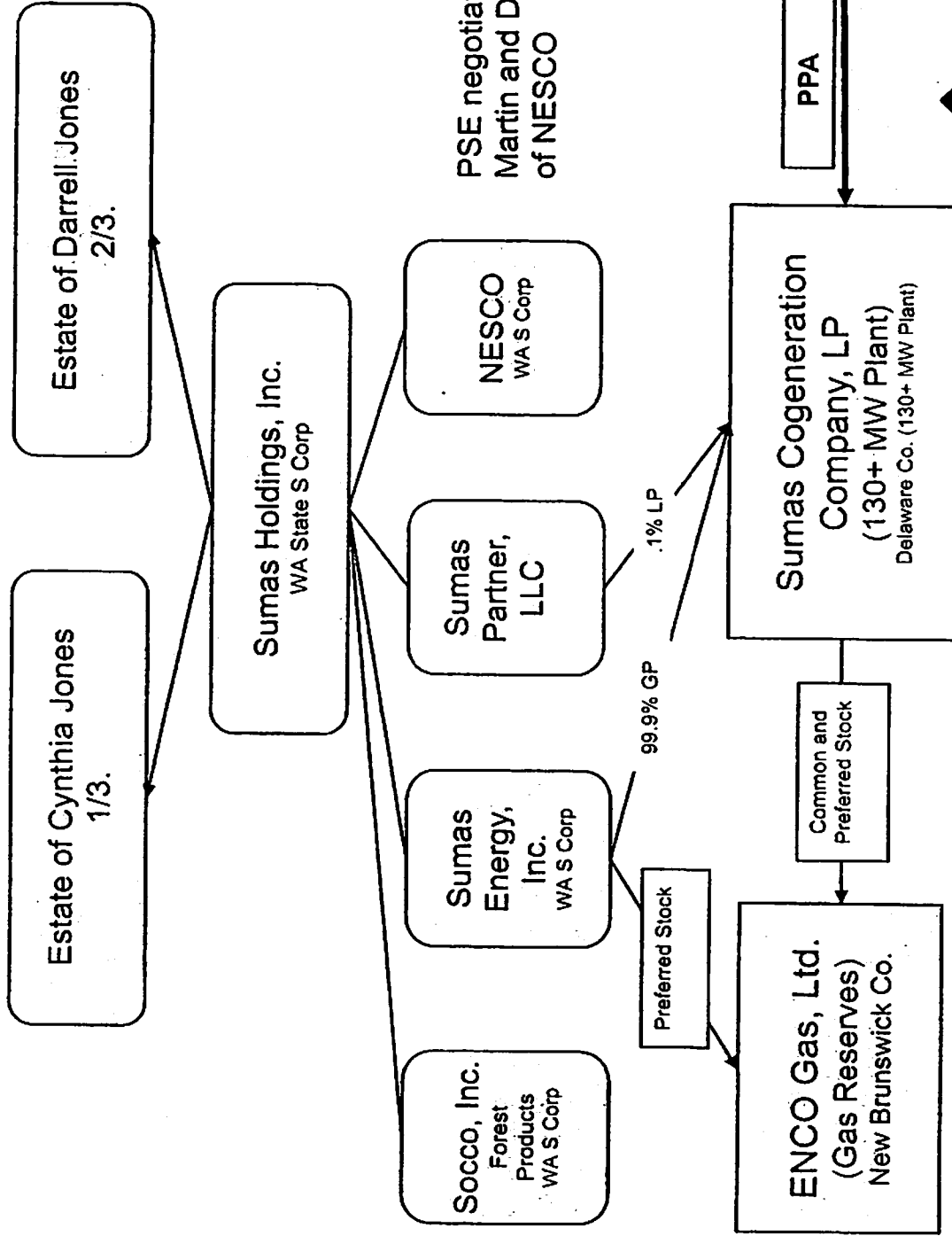
Portfolio (Cost) Benefit \$000



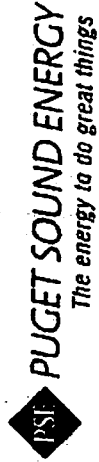
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Exhibit No. (RG-33HC)
Page 17 of 21

Organization Chart



PSE negotiating with Chuck Martin and Daren Anderson of NESCO



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Exhibit No. ___ (RG-33HC)
Page 18 of 21

Two Restructure Options Discussed

Shared Savings 50:50

(considered April 2006 – Dec 2006)

Three-part transaction:

- (i) the parties would share the net savings that would be produced from PSE's replacement of capacity and energy currently purchased under the PPA,
- (ii) the parties would share the net proceeds from sale of Sumas's gas reserves designated for the PPA fuel supply, and

Net of i and ii is [redacted] mm to PSE

- (iii) PSE would purchase the Sumas plant at a competitive price [redacted].

Financial Distress

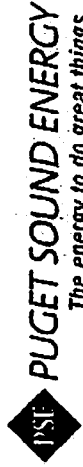
Plant Purchase

(considered Jan 2007 – Mar 2007)

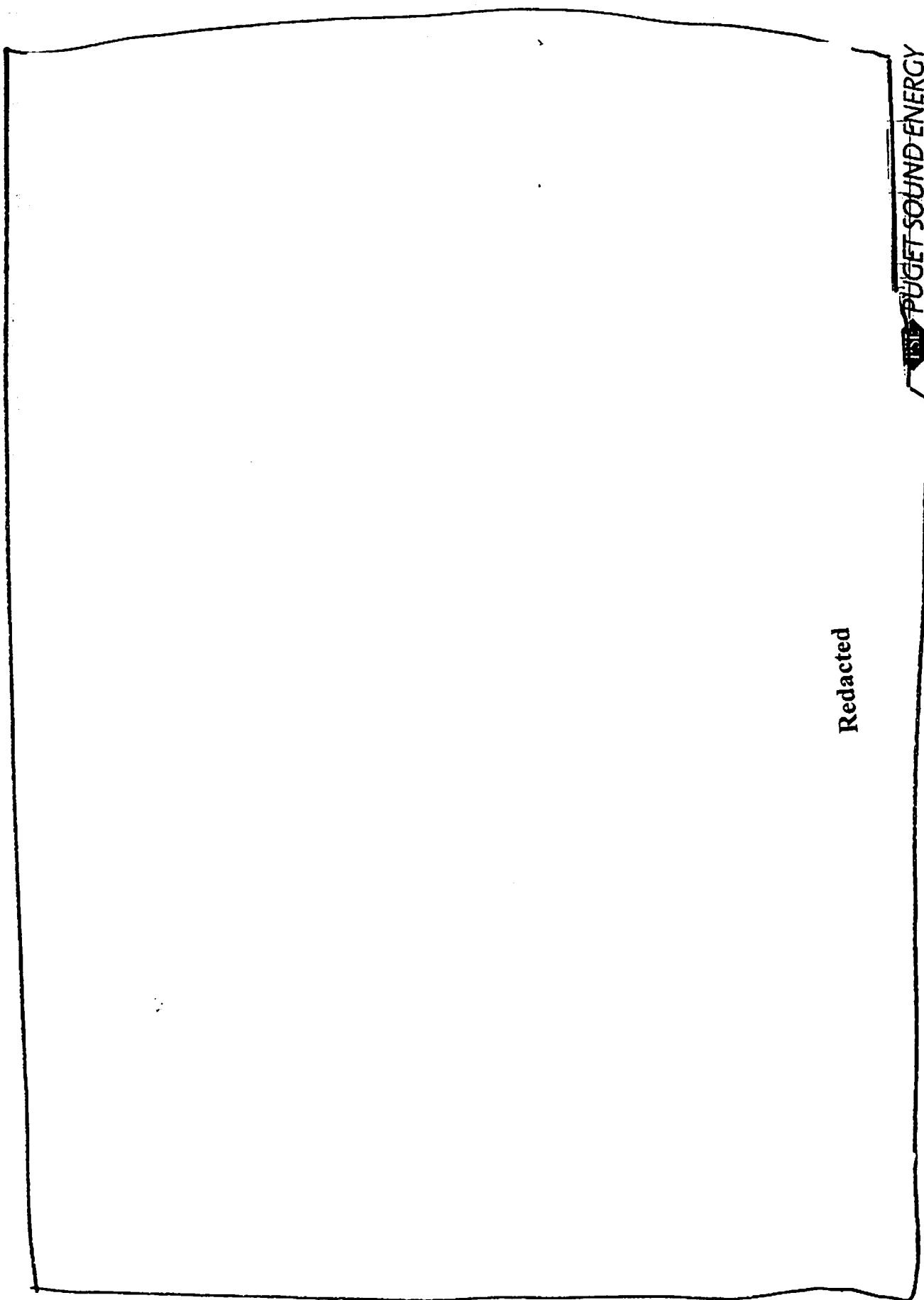
Steps:

- (i) Sumas provides evidence of financial distress from performing on the remainder of the contract,
- (ii) PPA amended, upon execution of plant acquisition agreement, allowing Sumas to sell gas reserves [redacted] mm held in escrow for PSE),
- (iii) The parties agree to cancel PPA and PSE purchases the Sumas plant at a [redacted] million.

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