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Puget Sound Energy, Inc.
P.O. Box 97034
Bellevue, WA 98009-9734

August 20, 2008

Honorable Maralyn Chase
Washington State House of Representatives
18560 1st Avenue NE
Suite E-750
Shoreline, WA 98155

Re: Your memo titled, "PSE Transfer of Owners"

Dear Representative Chase:

Thank you for the opportunity to review and respond to the analysis and questions you posed in your recent memo concerning PSE's proposed merger transaction. In order to fully address these issues, Puget Sound Energy (PSE) retained the services of Mr. Allan Abravanel to review your memo and research the questions raised. His analysis is attached, but there are some key points I would like to highlight for you.

PSE is pursuing the merger to give us committed access to capital to carry out our business plan to meet the growing customer needs of the region. We will remain locally managed and operated.

As a general statement, the Puget Energy merger agreements, existing regulations, and recent case law all support the proposition that the transaction will not adversely affect consumer prices, the sanctity of commitments given to regulators regarding capital structure and debt service, or the broader regulatory authority of the Washington Utilities and Transportation Commission (WUTC) or other local, state, and federal agencies that have jurisdiction over PSE and its operations.

More specifically, nothing in the investment chapters or other chapters of relevant "free trade agreements" (NAFTA and the Australia-United States FTA) would override, or prevent the enforcement of, legal commitments that have been willingly made by the investors here concerning indebtedness and debt service; nothing in those agreements would bolster the ability of the new investors, in comparison with PSE's existing owners or any other owners, to press regulators to approve higher rates or take other desired regulatory actions; nothing in those agreements would prevent the use of eminent domain in the context of forming a Public Utility District; and nothing in those agreements would exempt PSE in any way from the rigors of new policies adopted at the municipal, State or Federal level with regard to carbon control or other similar matters. Trade agreement protections against explicit nationality-based discrimination, and against uncompensated expropriations, do not interfere with the regulatory role entrusted to the WUTC by the Washington legislature.

Similarly, commitments scheduled by the United States under the GATS preserve the ability of regulators (e.g., the WUTC) to regulate in the public interest; they do not offer a means of escaping commitments voluntarily made in connection with a license transfer, and they do not put foreign owners or their U.S. investment targets in any sort of privileged position in the other areas discussed above.

The 2005 decision in the Methanex case goes a long way toward dispelling questions about a foreign investor's ability to leverage the investment provisions in trade agreements to overturn a state's ability to regulate in the public interest. While a summary of this case is provided in the attachment, PSE would be very happy to provide you a copy of the entire decision (it is not attached because the written opinion is over 300 pages).

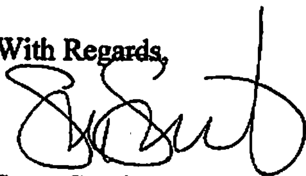
The debate over making sure that trade commitments undertaken by the United States are sensitive to federalism, and to State regulatory flexibility, is an important one. But we believe it has no implications for the transaction at issue here, which involves a cross-border (incoming) flow of capital rather than of goods or services.

Representative Chase, you have raised a series of questions concerning the implications of the proposed merger transaction that we have carefully reviewed, analyzed, and now submit to you. Thank you for the opportunity for this dialogue and I trust that the information provided by PSE responds to your questions. The merger agreements filed at the WUTC provide important safeguards for consumer and State interests; those agreements are, and will remain, fully enforceable.

I can't stress enough that we are pursuing the merger to give us committed access to capital to carry out our business plan to meet the growing customer needs of the region. We will remain locally managed and operated.

If you have any additional questions, I would be pleased to answer them for you.

With Regards,



Steve Secrist
Puget Sound Energy
Deputy General Counsel

Cc. Ken Johnson
Mark Quehrn

rb:SS

Perkins Coie

August 20, 2008

TO: Ken Johnson
Director, State Policy and Government Affairs
Puget Sound Energy

FROM: Allan R. Abravanel

RE: **International Trade Agreement Issues**

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Washington Representative Maralyn Chase recently submitted a letter to the members of the Washington Utilities and Transportation Commission ("WUTC"), containing questions regarding the sale of Puget Sound Energy, Inc. ("Puget"). A copy of the letter is attached to this memorandum at Tab A. This memorandum contains responses to the questions raised by Representative Chase.

Representative Chase has divided her questions into two principal categories:

a. **Debt Service**. The first series of questions relate to the possible impact of trade agreements, including the North American Free Trade Agreement ("NAFTA") and the General Agreement on Trade in Services ("GATS"), on the *servicing of debt* incurred by the target company.

b. **Regulatory Authority**. The second series of questions relate to the possible impact of NAFTA and GATS on the *regulatory authority* of the WUTC (referred to in the letter as "PUC").

The following discussion sets forth our comments on these series of questions, with reference to the relevant provisions of NAFTA and GATS. To assist with this analysis, a brief discussion of NAFTA and GATS is attached at Tab B.

Although the letter from Representative Chase does not specifically refer to the Australia-United States Free Trade Agreement, which entered into force on January 1, 2005, we have also included under Tab 2 a brief discussion of the terms of that Agreement; the investment provisions of the Australia-United States Free Trade Agreement are substantially identical to the provisions of NAFTA Chapter 11, with a few exceptions noted in Tab 2.

## I. Trade Agreements and the Servicing of Debt.

Representative Chase asked the following questions in connection with the debt to be incurred by the corporation or other business entity to be formed to acquire the business of Puget Sound Energy.

Question I.A: *For example, NAFTA doesn't say the investor can withdraw equity, but the investor can make payments under a loan agreement.*

*Does that [NAFTA Article 1109] mean a foreign investor has a NAFTA right to load up on debt, which would be held by (and with payments to) a corporate affiliate of the investor?*

NAFTA Article 1109 provides that a NAFTA Party must permit an investor of another NAFTA Party to make transfers of funds related to its investments (such as profits, dividends, interest and royalty payments) freely and without delay. Article 1109 also prohibits forced repatriation of funds (i.e., by the home government). Certain exceptions are permitted to enforce laws of general application related to, for example, bankruptcy and trading in securities. NAFTA Article 1109 relates to the free flow of funds, therefore, and not to assuring the availability of those funds.

There is no provision in NAFTA Article 1109 that mandates that an investor has the right under NAFTA to receive debt payments under investments, even if the debtor is not financially able to make those payments. NAFTA was never intended to remove business risk from NAFTA investments; its principal goal was to assure that investors in each of the NAFTA Parties would be treated on a non-discriminatory basis.

The proposed new investors in Puget have agreed, as part of the pending proceeding, to be bound by stipulated commitments specific to the proposed acquisition. These stipulated commitments are designed to protect Puget's customers from any risks that might arise from business activities upstream from the regulated utility. The investors have contractually agreed to these commitments, and the commitments will not be subject to attack by any provision of NAFTA, GATS or the Australia-United States Free Trade Agreement. None of those trade agreements would enable an investor to seek to undo covenants and conditions voluntarily agreed to in negotiations.

Question I.B: *If the foreign investors incorporate in the United States, in New York or Delaware, for example, are they a domestic subsidiary of foreign investors or simply an independent domestic corporation?*

Under the definition of NAFTA Article 1139, the corporate entity itself would not be an "investment," but the equity securities of the entity and the loans to the entity would be considered "investments" for the purposes of NAFTA Chapter 11. A substantially identical set of definitions is set forth in Article 11.17 of the Australia-United States Free Trade Agreement.

*If a registered subsidiary, owned by foreign investors (such as Macquarie Infrastructure Partners (New York), The Canada Pension Plan Investment Board (Toronto), The British Columbia Investment Management Corporation (Victoria), Alberta Investment Management (Edmonton), Macquarie-FSS Infrastructure Trust (Australia) Macquarie Capital Group Limited,) loads up on debt to the foreign corporate affiliate investor, or requests increases in rates for debt service and ROI to the foreign investor holding the debt, does the foreign corporate affiliate holding the debt have NAFTA or GATS rights?*

The use of the term "registered subsidiary" is somewhat unclear, since it is not a term used in NAFTA or GATS. The thrust of this question appears to be, however, whether NAFTA (in the case of the Canadian entities) or GATS (in the case of the Canadian and Australian entities) would give any rights to the Canadian and Australian investors to demand the fixing of a rate and ROI sufficient to service the debt payments due to them under the relevant loan agreements.

As noted below under Tab B, the thrust of NAFTA is to provide national treatment, and certain minimum standards of treatment, to a foreign investor, and not to assure that payments under debt instruments and equity investments will be protected from all business risks and regulatory requirements. The same analysis applies to the Australia-United States Free Trade Agreement. As a result, there is no "protected debt service" nor any "protected equity return" under NAFTA, the Australia-United States Free Trade Agreement, or GATS.

**II. Trade Agreements and the Nature of Domestic Regulation.**

While conceding that the WUTC may not be in a position to deny a merger because of foreign ownership, Representative Chase asks in the second part of her letter if there are mechanisms that could be considered by the WUTC (a) as conditions to mitigate or (b) waivers of certain legal risks down the road.

Question II.A: *In general terms what are the legal risks to PUC authority?*

1. *Are there foreseeable circumstances where NAFTA investor rights (ch. 11), energy rules (ch. 6) or service rules (ch. 12), new GATS disciplines on domestic regulation or existing GATS commitments on services incidental to distribution of energy govern? For example:*

   *A. Major policy changes in the future that could affect profit margin: e.g., carbon pricing in a cap-and-trade system, including anti-"leakage" measures that would apply to cross-border trade in gas or electricity. Sensitive electricity imports might be from Alberta (thermal generators fired by tar sands); sensitive gas imports might be LNG from the Pacific Rim.*

   *B. Major infrastructure permits that involve complex and expensive procedures: e.g., LNG terminals or major transmission lines.*

Some commentators feared that early NAFTA tribunal decisions might be used as precedents to support NAFTA Chapter 11 investment claims by investors for damages allegedly caused by environmental or utility regulation. These fears have been substantially eliminated by the 2005 decision in *Methanex Corp. v United States of America*, an investor-state case under NAFTA Chapter 11 and by ministerial-agreed interpretations of certain key substantive provisions of NAFTA Chapter 11.

Methanex is a major Canadian-based producer of methanol, a component of MTBE (methyl tertiary butyl ether), a gasoline additive. The State of California banned the use of MTBE, because the State claimed it was contaminating the drinking water, and therefore posed a significant risk to human health and safety, and the environment. Methanex commenced an action under NAFTA Chapter 11 against the United States, arguing that the California ban was the equivalent of an expropriation of the company's investment in violation of NAFTA Article 1110; that the ban was enacted in breach of the national treatment obligation in NAFTA Article 1102; and that the ban was in breach of the minimum international standards of treatment obligation in NAFTA Article 1105.

The tribunal in the dispute resolution proceeding rejected all of Methanex's arguments in the tribunal's final award, creating precedents in a number of areas:

- *NAFTA Article 1102*. The tribunal totally rejected the argument that the MTBE ban contravened the national treatment requirement under NAFTA Article 1102 by favoring domestic U.S. investors over foreign investors. The tribunal said that the ban applied equally to *all* methanol producers, whether U.S. or foreign, and had "precisely the same effect on American investors and investments as it had on the Canadian investor, Methanex."

- *NAFTA Article 1105*. The tribunal rejected arguments that the ban contravened NAFTA Article 1105, which mandates "treatment in accordance with international law, including fair and equitable treatment and full protection and security." It found no justification for a claim that this standard had been infringed, saying that nothing in either the NAFTA or customary international law precludes some forms of *differential* treatment of nationals and aliens – providing, of course, that differential treatment is not for an improper purpose.

- *NAFTA Article 1110*. In Part IV, Chapter D, paragraph 7 of the Final Award, the tribunal rejected all of Methanex's arguments that the ban was an expropriation or a measure "tantamount to" an expropriation under Article 1110 of the NAFTA. In a key statement, the tribunal said:

  > . . . as a matter of general international law, a non-discriminatory regulation for a public purpose, which is enacted in accordance with due process and which affects, *inter alios*, a foreign investor or investment is not deemed expropriatory and compensable . . . .

In Part IV, Chapter D, paragraph 15 of the Final Award the tribunal added the following conclusion:

> From the standpoint of international law, the California ban was a lawful regulation and not an expropriation.

The tribunal's decision provides significant comfort to those who may have been concerned that investment provisions in U.S. trade agreements encroach on the legitimate right of governments to regulate in the public interest. There is no pending case before a NAFTA tribunal of which we are aware that appears to be following a position that would reduce the comfort provided by the *Methanex* holding. The Australia-United States Free Trade Agreement provides similar assurances in the Annexes to that Agreement's Chapter 11 ("Investment"), as described below under Tab 2.

The interpretations of NAFTA Chapter 11 adopted by the NAFTA Free Trade Commission also provide comfort regarding the scope of NAFTA Chapter 11. The NAFTA Free Trade Commission, as established under NAFTA Article 2001, is composed of cabinet-level trade representatives of the United States, Canada and Mexico. The Commission meets yearly to supervise the implementation of NAFTA, oversee its further elaboration, resolve disputes about the interpretation of NAFTA, supervise the work of the NAFTA committees and working groups, and consider any other matters that may affect the operation of NAFTA.

For the purposes of NAFTA Chapter 11, the NAFTA Free Trade Commission is important because it can issue binding "interpretations" of NAFTA provisions, pursuant to NAFTA Article 1131(2), which sets out the governing law for a Chapter 11 arbitration.

Among the interpretations of NAFTA Chapter 11 adopted by the Commission are:

- An affirmation of the authority of investor-state tribunals to accept written submissions (*amicus curiae* briefs) by non-disputing parties, coupled with recommended procedures for tribunals on the handling of such submissions;

- An endorsement of the process of open hearings for NAFTA investment disputes; and

- A confirmation of certain interpretations under NAFTA Article 1105 ("Minimum Standards of Treatment"), including that (i) NAFTA Article 1105(1) prescribes the customary international law minimum standard of treatment of aliens as the minimum standard of treatment to be afforded to investments of investors of another Party, (ii) the concepts of "fair and equitable treatment" and "full protection and security" do not require treatment in addition to or beyond that which is required by the customary international law minimum standard of treatment of aliens, and (iii) a determination that there has been a breach of another provision of the NAFTA, or of a separate international agreement, does not establish that there has been a breach of NAFTA Article 1105(1).

As noted below under Tab 2, the negotiation of GATS has not produced the imposition of restrictions on regulations that were once feared; the goal of the USTR is to commit to the transparency of the process of utility regulation.

2. *Does experience with foreign investment in water utilities offer any guidance?*

   A. *Conditions imposed by the Kentucky PUC on acquisition of private water companies by Thames (UK), which was at the time owned by RWE (Germany) may offer suggestions.*

   B. *Is there the potential for incorporating disclosure and waiver provisions applying to utility concessions and/or the expectations of foreign investors as to litigation of contract terms into any merger agreement or PUC order?*

This question likely relates to the acquisition in 2002-2003 by Thames Water Aqua Holdings GmbH ("Thames") and its affiliate, Thames Water Aqua US Holdings, Inc. ("TWUS"), of Kentucky-American Water Company ("KAWC"). At the time, Thames was a wholly-owned subsidiary of RWE Aktiengesellschaft ("RWE"), a corporation formed under the laws of the Federal Republic of Germany, and TWUS was a wholly-owned subsidiary of Thames. The acquisition occurred pursuant to the merger of Apollo Acquisition Company, another wholly-owned subsidiary of Thames, with the corporate parent of KAWC. We assume that this proceeding is the Kentucky "acquisition of private water companies by Thames (UK)" referred to in the question.

The Kentucky Public Service Commission ("KPSC") approved the acquisition on May 30, 2002, and reaffirmed its decision on July 10, 2002, after the intervenors in the proceeding sought a rehearing. After the initial Commission approval was obtained, however, Thames and RWE modified the transaction by forming TWUS, and having it serve as an intermediate holding company. TWUS was also to hold the stock of Thames' other US holdings, thereby enabling TWUS to file a consolidated United States tax return for all of its US holdings. The transfer of the shares of KAWC to TWUS reopened the approval process; the KPSC docketed the application for the transfer of shares to TWUS as a new case.

In opening the new proceeding the KPSC indicated that the review of any proposed transfer had to include two considerations: (i) whether the party acquiring control had the requisite abilities to provide reasonable utility service and (ii) whether the proposed transfer was consistent with the "public interest."

During the original proceeding for the approval of the acquisition, the KPSC found that these considerations were met, but only after the compliance by the acquirors with certain conditions, to which the acquirors had stipulated their agreement. The Kentucky transaction was very fact specific, however, with many of the intervenors concerned about the quality of the acquirors, and their ability to manage the water systems. Many of the conditions, therefore, were specifically addressed to assure that the acquirors would act in a proper manner in the operation of the water systems.

At this new proceeding, however, the intervenors attempted to raise new issues that had not been raised in the prior proceeding in order to challenge the earlier finding by the KPSC that the acquisition was consistent with the "public interest." One of those new issues was the

proposed requirement that the acquirors waive any rights or claims under international law or treaties. The KPSC Commission summarized the assertion as follows:

> The Intervenors have expressed the concern that, upon the completion of the proposed transfer, the Commission's authority will be diluted or weakened by international law - treaties, foreign trade agreements, or other bi-national or multi-national compacts. They assert that the public interest requires that as a condition to approval of the proposed transfer of control, the Joint Applicants must waive all rights and defenses that they currently have or that they may possess in the future under international law or treaty.

The KPSC dismissed the argument of the intervenors, however, citing the lack of any evidence of their necessity, and found that "the imposition of such conditions [would be] unreasonable." The Attorney General of Kentucky attempted to raise the issue again in a Request for Rehearing, dated January 9, 2003, but the KPSC denied a rehearing on this issue in its Order dated January 29, 2003.

As noted above, the proposed new investors in Puget have agreed, as part of the pending proceeding, to be bound by stipulated commitments specific to the proposed acquisition. Those stipulated commitments, which will have been contractually agreed to by the investors, will not be subject to attack by any provision of NAFTA, GATS or the Australia-United states Free Trade Agreement. None of those trade agreements would enable an investor to seek to undo covenants and conditions voluntarily agreed to in negotiations.

Question II.B: *Finally, what are the NAFTA/GATS implications of citizens forming a Public Utility District to assume responsibility for infrastructure and services held by a foreign investor or a domestic investor with NAFTA protected debt service to a foreign investor?*

*NAFTA*. With respect to "NAFTA protected debt service," see the discussion above regarding the protection of the ability to make payments under the debt service. This response is limited to a consideration, therefore, as to whether NAFTA or GATS would impact the process of formation of a Public Utility District to assume responsibility for infrastructure and services. For the purposes of this analysis, it is assumed that the acquisition of the infrastructure would be performed by eminent domain.

Nothing in NAFTA would prohibit the taking by eminent domain of the assets of Puget. NAFTA would, however, provide protections for the payment of adequate compensation.

NAFTA Chapter 11 contains protections against the expropriation of investments of an investor of another Party (in addition to those protections that may be provided by Washington law). As noted above, NAFTA Article 1110 provides that a NAFTA Party cannot directly or indirectly nationalize or expropriate an investment of an investor of another NAFTA Party, or take a measure tantamount to nationalization or expropriation of such an investment, except:

(i) for a public purpose;

(ii) on a non-discriminatory basis;

(iii) in accordance with due process of law; and

(iv) on payment of compensation equivalent to the fair market value of the expropriated investment immediately before the expropriation took place.

Compensation must be paid without delay and be fully realizable, and must be fully transferable in accordance with NAFTA Article 1109. NAFTA Article 1110 expressly provides that a non-discriminatory measure of general application shall not be considered a measure tantamount to an expropriation of a debt security or loan covered by NAFTA Chapter 11 solely on the ground that the measure imposes costs on the debtor that cause it to default on the debt.

If the investor believes that its rights under NAFTA Article 1110 have been violated, it may seek redress against the NAFTA Party allegedly causing the violation under the dispute resolution provisions of NAFTA Chapter 11.

*GATS.* There is no provision in GATS that specifically relates to the expropriation of an asset used for the provision of services.

TAB-A

Letter from Representative Maralyn Chase

to the Members of the Washington Utilities and Transportation Commission

**RE: PSE Transfer of Owners**

**Docket No. U-072375**

In 2003, the Washington State Legislature created the Joint Legislative Oversight Committee on Trade Policy to monitor the impact of trade agreements on Washington state laws, and to provide a mechanism for legislators and citizens to voice their opinions and concerns about the potential impacts of these trade agreements to state and federal government officials.

Citizens in our state have raised concerns regarding of the sale of Puget Sound Energy [PSE] to possible foreign investors. At the present time Puget Sound Energy holds a monopoly in an eleven county service area providing essential electrical and natural gas services to some 1.3 million electricity users and some 750,000 natural gas users. PSE, as a domestic, publicly-traded corporation, is regulated by the UTC, a branch of state government.

The citizens believe that UTC protects consumers from runaway monopoly power by ensuring that utility and transportation services are fairly priced, available, reliable and safe. They believe those protections may be lost by the diminishing of the UTC's oversight regulation of a privately held monopoly with substantial foreign investor ownership.

The citizens also are concerned that the proposed purchasers, led by foreign investors, may have greater rights under the various trade agreements than our own domestic investors regulated by the UTC. Those greater rights, of course, could be asserted in litigation of contract terms regarding pricing and the safe and reliable availability of the services directly challenging the UTC's regulatory mission. In the absence of a strong regulatory structure, the citizens fear increases in rates for debt service, infrastructure investment, increased rates for ROI and sporadic service by absentee owners should the proposed sale go through.

In light of the citizens' concerns, I request your consideration of the questions that come to mind in considering the relationship of the rights of foreign investors to domestic laws and regulations, especially in regard to monopoly control of essential public services and infrastructure, the absence of free competition and little state regulatory oversight.

## I . Is the citizens' concern about corporate debt (and potential impact on the rate base, I assume) a relevant concern under NAFTA's investment chapter.

The utility commission has authority to set capital contributions and returns on equity, but NAFTA Chapter 11 says that investors have a right to transfer a variety of returns and payments. [See excerpt below].

I'm not saying there is a problem, but it raises a question that might *not* come up with a domestic investor. The possibility of the expectations of foreign investors as to litigation of contract terms is challenging when viewed within the context of the various trade agreements possible conflicts with domestic regulations.

For example, NAFTA doesn't say the investor can withdraw equity, but the investor can make payments under a loan agreement.

Does that mean a foreign investor has a NAFTA right to load up on debt, which would be held by (and with payments to) a corporate affiliate of the investor?

If the foreign investors incorporate in the United States, in New York or Delaware, for example, are they a domestic subsidiary of foreign investors or simply an independent domestic corporation?

If a registered subsidiary, owned by foreign investors (such as Macquarie Infrastructure Partners (New York) , The Canada Pension Plan Investment Board (Toronto), The British Columbia Investment Management Corporation (Victoria), Alberta Investment Management (Edmonton), Macquarie-FSS Infrastructure Trust (Australia) Macquarie Capital Group Limited,) loads up on debt to the foreign corporate affiliate investor, or requests increases in rates for debt service and ROI to the foreign investor holding the debt, does the foreign corporate affiliate holding the debt have NAFTA or GATS rights?

**Article 1109: Transfers**

**1. Each Party shall permit all transfers relating to an investment of an investor of another Party in the territory of the Party to be made freely and without delay. Such transfers include:**

**(a) profits, dividends, interest, capital gains, royalty payments, management fees, technical**

assistance and other fees, returns in kind and other amounts derived from the investment;

(b) proceeds from the sale of all or any part of the investment or from the partial or complete liquidation of the investment;

(c) payments made under a contract entered into by the investor, or its investment, including payments made pursuant to a loan agreement;

(d) payments made pursuant to Article 1110; and

(e) payments arising under Section B.

2. Each Party shall permit transfers to be made in a freely usable currency at the market rate of exchange prevailing on the date of transfer with respect to spot transactions in the currency to be transferred.

3. No Party may require its investors to transfer, or penalize its investors that fail to transfer, the income, earnings, profits or other amounts derived from, or attributable to, investments in the territory of another Party.

4. Notwithstanding paragraphs 1 and 2, a Party may prevent a transfer through the equitable, non-discriminatory and good faith application of its laws relating to:

(a) bankruptcy, insolvency or the protection of the rights of creditors;

(b) issuing, trading or dealing in securities;

(c) criminal or penal offenses;

(d) reports of transfers of currency or other monetary instruments; or

(e) ensuring the satisfaction of judgments in adjudicatory proceedings.

5. Paragraph 3 shall not be construed to prevent a Party from imposing any measure through the equitable, non-discriminatory and good faith application of its laws relating to the matters set out in subparagraphs (a) through (e) of paragraph 4.

6. Notwithstanding paragraph 1, a Party may restrict transfers of returns in kind in circumstances where it could otherwise restrict such transfers under this Agreement, including as set out in paragraph 4.

## II. What are the investment and trade implications of Canadian and Australian ownership?

Once those are understood, if the PUC is not in a position to deny a merger because of foreign ownership, are there mechanisms to (a) consider conditions to mitigate or (2) seek waivers of certain legal risks down the road.

In general terms what are the legal risks to PUC authority?

1. Are there foreseeable circumstances where NAFTA investor rights (ch. 11), energy rules (ch. 6) or service rules (ch. 12), new GATS disciplines on domestic regulation or existing GATS commitments on services incidental to distribution of energy govern? For example:

   A. Major policy changes in the future that could affect profit margin: e.g., carbon pricing in a cap-and-trade system, including anti-"leakage" measures that would apply to cross-border trade in gas or electricity. Sensitive electricity imports might be from Alberta (thermal generators fired by tar sands); sensitive gas imports might be LNG from the Pacific Rim.

   B. Major infrastructure permits that involve complex and expensive procedures: e.g., LNG terminals or major transmission lines.

2. Does experience with foreign investment in water utilities offer any guidance?

   A. Conditions imposed by the Kentucky PUC on acquisition of private water companies by Thames (UK), which was at the time owned by RWE (Germany) may offer suggestions.

   B. Is there the potential for incorporating disclosure and waiver provisions applying to utility concessions and/or the expectations of foreign investors as to litigation of contract terms into any merger agreement or PUC order?

Finally, what are the NAFTA/GATS implications of citizens forming a Public Utility District to assume responsibility for infrastructure and services held by a foreign investor or a domestic investor with NAFTA protected debt service to a foreign investor?

The citizens are well aware that trade agreements do not regulate industry, they regulate government activity. In this case, the UTC and perhaps the PUD may be impacted along with millions of citizens.

Thank you for your consideration of these issues.

Sincerely,

Maralyn Chase

Chair, Joint Legislative Oversight on Trade Policy

Cc: Mark Sidran, Chairman

Patrick Oshie

Philip Jones

## TAB-B

**A Brief Description of NAFTA, GATS and the Australia-United States Free Trade Agreement**

a. *NAFTA*. The North American Free Trade Agreement, which came into force on January 1, 1994, governs commercial activity among Canada, Mexico and the United States of America; the three countries are each referred to as a "Party." NAFTA sets forth the rules for that trade, and establishes new institutions for their implementation, including dispute resolution mechanisms for investor-state disputes.

The principal purposes of NAFTA are set forth in Article 102 ("Objectives") of the Agreement:

- To eliminate barriers in the trade of goods and services among the member countries (who are referred to in the Agreement as the "Parties").
- To promote fair conditions of competition.
- To increase investment opportunities in the economies of the Parties.
- To protect intellectual property rights.
- To create effective procedures to implement and enforce the agreement.
- To establish a framework for further cooperation among the Parties on relevant issues.

NAFTA Article 201 contains definitions of general applicability to NAFTA, including the following:

> **enterprise** means any entity constituted or organized under applicable law, whether or not for profit, and whether privately-owned or governmentally-owned, including any corporation, trust, partnership, sole proprietorship, joint venture or other association
>
> **enterprise of a Party** means an enterprise constituted or organized under the law of a Party
>
> **territory** means for a Party the territory of that Party as set out in Annex 201.1 [of NAFTA].

Since Puget, a Delaware corporation, is formed under the law of a Party (in this case, the United States of America), it is considered to be an enterprise of a Party operating within the territory of a Party. In the same way, the proposed investors that are based in Canada are considered enterprises of a Party.

All of the issues raised in the letter from Representative Chase relate to the provisions of NAFTA Chapter 11, which governs foreign investments in the territory of the Parties by "investors." NAFTA Chapter 11 is divided into three parts:

- Articles 1101 to 1114 contain the norms to be applied to foreign investments.
- Articles 1115 to 1138 provide the structure for investor-state dispute resolution.
- Article 1139 contains the definitions used in NAFTA Chapter 11.

"Investors" and "investments" are defined in NAFTA Article 1139. The term "investment" includes eight different categories:

(a) an enterprise (for the purposes of Chapter 11, "enterprise" means an enterprise as defined in NAFTA Article 201, and a branch of an enterprise);

(b) an equity security of an enterprise;

(c) a debt security of an enterprise where the enterprise is an affiliate of the investor, or where the original maturity of the debt security is at least three years, but does not include a debt security, regardless of original maturity, of a state enterprise;

(d) a loan to an enterprise, where the enterprise is an affiliate of the investor, or where the original maturity of the loan is at least three years, but does not include a loan, regardless of original maturity, to a state enterprise;

(e) an interest in an enterprise that entitles the owner to share in income or profits of the enterprise;

(f) an interest in an enterprise that entitles the owner to share in the assets of that enterprise on dissolution, other than a debt security or a loan excluded from subparagraph (c) or (d);

(g) real estate or other property, tangible or intangible, acquired in the expectation or used for the purpose of economic benefit or other business purposes; and

(h) interests arising from the commitment of capital or other resources in the territory of a Party to economic activity in such territory, such as under contracts involving the presence of an investor's property in the territory of the Party, including turnkey or construction contracts, or concessions, or contracts where remuneration depends substantially on the production, revenues or profits of an enterprise.

The equity securities of Puget to be owned by the Canadian investors, as well as the loans to be made to Puget by the Canadian investors, therefore, would be considered "investments" under NAFTA Chapter 11. Moreover, the Canadian investors would be deemed to be "investors

of a Party" under Article 1139, since they would be "a Party or state enterprise thereof, or a national or an enterprise of such Party, that seeks to make, is making or has made an investment," and their investments would be deemed to be "investments of investors of a Party."

The norms applied by NAFTA Chapter 11 to foreign investments include the following:

- National Treatment (Article 1102) – Each NAFTA Party will treat investors and investments from other NAFTA Parties no less favorably than it treats its own investors and investments, in like circumstances, with respect to such matters as the establishment, acquisition, operation and sale of investments.
- Most-Favored Nation Treatment (Article 1103) – A NAFTA Party may not treat an investor or investment from a non-NAFTA country more favorably than an investor or investment from a NAFTA country with respect to such matters as the establishment, acquisition, operation and sale of investments.
- Minimum Standard of Treatment (Article 1105) – This Article assures a minimum absolute standard of treatment of investments of the NAFTA investors based on long-standing principles of international law.
- Expropriation (Article 1110) – A NAFTA Party cannot directly or indirectly nationalize or expropriate an investment of an investor of another NAFTA Party except: (i) for a public purpose; (ii) on a non-discriminatory basis; (iii) in accordance with due process of law; and (iv) on payment of compensation equivalent to fair market value.
- Environmental Measures (Article 1114) – The NAFTA Parties have the right to adopt and enforce environmental measures consistent with the chapter. NAFTA Parties also recognize that it is inappropriate to encourage investment by relaxing domestic health, safety or environmental measures. Accordingly, Parties should not waive or derogate from such environmental measures to attract investment.

Investors aggrieved by a breach of these provisions may seek damages, through arbitration proceedings, directly against the offending NAFTA Party.

b. *GATS.* The General Agreement on Trade in Services ("GATS") establishes rules on trade and investment in services. Much like the World Trade Organization's ("WTO") goods agreement, GATS consists of a core set of disciplines, including most-favored-nation treatment, market access and national treatment.

Upon joining the WTO, each country decided whether and how to apply these core disciplines to services trade in its market. The agreed objective of the GATS negotiations (which, for the moment, have been indefinitely suspended) has been to extend that coverage. As part of the negotiations, each WTO member was charged with informing its trading partners of the improvements it sought in those countries' GATS commitments. As services take on a

larger role at the national level and in the global economy, continued liberalization will be vital for future growth and harmonious economic relations.

GATS covers four "modes of supply" of services, including the cross-border delivery of services from one market to another by electronic or other means ("cross-border supply"), the travel to foreign markets to use services in another market ("consumption abroad"), the establishment of a commercial presence in another market ("commercial presence"), and the travel by individuals to foreign markets to supply services ("presence of natural persons").

U.S. GATS commitments are carefully crafted in light of existing U.S. regulatory structures and the U.S. federal system of governance, and are designed to preserve the ability of regulators, including those at the state and local level, to regulate in the public interest and free of nationality-based discrimination. Nevertheless, opponents of trade liberalization have argued that U.S. GATS commitments (existing and proposed) may potentially undermine the prerogatives of local regulators, including utility regulatory authorities.

The Office of the United States Trade Representative (USTR), which is tasked with negotiating the commitments of the United States under GATS, has consistently argued that through its proposals under GATS, the U.S. is seeking transparency in the regulatory process among all WTO members, and not changes in the substantive rules of regulation. In that regard, the USTR has favored disciplines that adopt realistic and flexible standards of compliance, including the following basic transparency goals which, we are certain, the State of Washington has already adopted and seeks to follow in the operation of its system of utility regulation:

- The publication of regulations to make them available to interested persons.
- The operation of points of inquiry available to interested persons.
- The provision, on a best endeavor basis, for prior publication of new regulations and a reasonable opportunity for interested persons to comment.
- The expectation that substantive comments received from interested persons will be taken into consideration by the regulator.

Even assuming that an assertion might arise in the future that some state regulation is arguably inconsistent with the goals that the USTR is pursuing under the GATS negotiations, GATS has extensive measures in place to protect the validity of the challenged state regulation.

- The challenge to the regulation can only be made by a WTO member country, and not by an individual or private company; thus before any challenge can be initiated, a member country must be convinced that the challenge is merited.
- After the challenge is commenced, a WTO dispute resolution body must be convinced that the challenge is justified.

- Nothing in the decision of the dispute resolution body prevents the entity adopting the regulation from modifying or enforcing the regulation; instead, it is up to the U.S. Federal government to determine if it wishes to enforce the decision of the WTO dispute resolution body. While the U.S. Federal government may face the threat of trade sanctions if it determines not to enforce the WTO decision, it may refuse to take such action without undergoing any non-trade repercussions.

- Even if the U.S. Federal government determined to enforce the WTO decision, it may take such action only through a court proceeding in which the U.S. Federal government would have the burden of proof to demonstrate the inconsistency.

There is an ongoing discussion regarding which aspects of the electricity sector constitute the sale of a "good" (and would therefore be covered by the WTO goods agreement) and which constitute the provision of a "service" (and would therefore be covered by GATS). It is generally agreed that the sector has three components:

- Electric power generation,

- The transmission of electricity, which is the transportation of electricity from generation to distribution companies, and

- The distribution of electricity, which is the selling and delivery of electricity to end-users.

Some commentators will argue that within the WTO framework, the generation of electricity falls under the scope of the goods agreement, while the transmission, distribution and related services fall under the scope of GATS of the WTO Agreement; the characterization is not free from doubt, however.

c. *Australia- United States Free Trade Agreement.* Chapter 11 ("Investment") of the Australia-United States Free Trade Agreement is identical in many ways to NAFTA Chapter 11, except that the concept of expropriation described in Article 11.7 of the Australia-United States Free Trade Agreement is expressly governed by Annexes 11-A and 11-B to the Agreement, which echo the deliberations of *Methanex Corp. v United States of America*:

- Annex 11-A contains a clarification of the definition of "customary international law."

- Annex 11-B contains language defining direct and indirect expropriations. The Annex emphasizes that the finding of an indirect expropriation requires a case-by-case, fact-based inquiry that considers, among other factors, (i) the economic impact of the government action, although the fact that an action or series of actions by a Party has an adverse effect on the economic value of an investment, standing alone, does not establish that an indirect expropriation has occurred; (ii) the extent to which the government action interferes with distinct, reasonable investment-backed expectations; and (iii) the character of the government action. It concludes that except in rare circumstances,

nondiscriminatory regulatory actions by a Party that are designed and applied to achieve legitimate public welfare objectives, such as the protection of public health, safety, and the environment, do not constitute indirect expropriations.

Unlike NAFTA, the Australia-United States Free Trade Agreement does not include an investor-state mechanism for dispute resolution.