

Jim Lazar responds to questions on the Thurston Public Power Initiative

WIP News Service

Jim Lazar is an economist with more than thirty years of experience examining electric utility planning and financing, and has been a consultant to both the Office of the Attorney General and to the Washington Utilities and Transportation Commission (WUTC) in evaluating utility rate filings. He was an advisor in three previous public power activations in Oregon and Hawaii.

Q: What is the process for activation and electrification of the PUD?

Lazar: The process is relatively straightforward. First, to sell electricity to the general public, the voters must grant the Public Utility District (PUD) authority. That's what the initiative is about. Then, if the voters grant authority, the PUD must decide whether or not to proceed. It must do that in an open public process.

If it decides to go ahead, it must either acquire or build a distribution system. Concurrently, it must hire the staff to operate the electric utility, obtain a supply of electricity, and attract customers. If it acquires the PSE system (or part of it), then the customers now served by PSE would be transferred along with the sale. If it decides to build a parallel system, then customers could choose between the PUD and PSE.

Q: Are other communities doing this?

Lazar: In Washington, only Jefferson County PUD is moving ahead with electrification, but several new public power utilities have been formed in Oregon during my career, including Emerald PUD, Columbia PUD, the Oregon Trail Electric Cooperative, and the city of Hermiston.

Q: Does the PUD have to acquire PSE's system?

Lazar: Most public power activations occur when a public utility acquires the distribution system of a private utility, either by negotiation or by a court-supervised purchase under an exercise of eminent domain. Thurston PUD could instead decide to build its own system, connecting to the transmission system at the Bonneville Power Administration substation in Tumwater, or connecting to PSE's transmission system. Unless it would adversely affect reliability, PSE is required under federal regulations to provide wholesale transmission service to the PUD.

Q: How much would it have to pay if it did acquire the PSE system?

A. Washington state law requires the PUD to pay "fair market value" if it acquires the PSE facilities through an exercise of eminent domain. That fair market value would be decided by a court process or by negotiation. When cities, counties, and the state buy property this way (for parks, for highways, and for other purposes), they typically pay a premium over the assessed value on the tax rolls.

Washington law also requires the PSE's facilities be assessed, for property tax purposes, at "fair market value." PSE's facilities are currently valued at \$131 million for state property

tax assessment. In theory, this "fair market value" should be about equal to the price the PUD would have to pay (if it's really worth more than that, then PSE is paying too little in property taxes, and the rest of us are paying more than our share). Generally, courts find that the value is somewhat greater than the assessed valuation, in which case the price goes up above \$131 million. In negotiated acquisitions, public utilities typically pay 130% to 170% of the depreciated book value of the acquired assets.

Jefferson PUD has agreed to pay a higher premium, and most of us who have worked on previous transitions are shaking our heads in disbelief. Because Jefferson is a rural county, was able to get very low cost financing guaranteed by the Rural Utility Service, and because it has access to Bonneville Power Administration (BPA) for 100% of their power needs, they could afford to pay a high price for the poles and wires.

Assuming the typical premiums over assessed value and book value that we see

in public power takeovers, then the PUD would likely pay \$170 to \$220 million for PSE's entire distribution system and other properties in the County. Talk by PSE of a \$500 million to \$1 billion price is mostly political posturing; if it cost that much, the PUD would probably not proceed with a takeover, as it would probably be cheaper to build a new system from scratch in many parts of the County.

Q: What would happen to the premium, if the PUD paid more than the book value to PSE?

Lazar: That would be a decision for the WUTC, and there's not a lot of consistency on this. In Oregon, Pacific Power was recently required to return 95% of the premium they received when the city of Hermiston formed a municipal utility. The WUTC could let PSE keep the premium, could make them return it to the remaining PSE electric consumers, or could make them return it to Thurston County consumers. My guess is that the majority of the gain would be returned to ratepayers, but whether it's 60% or 95% would be pure speculation.

Q: How could the PUD finance a takeover?

Lazar: The PUD could issue "revenue bonds" backed by its future electric revenues to acquire or build a distribution system. There is a limit set by state law that would hold the PUD to no more than about \$200 million of indebtedness. This limit would make it difficult for the Thurston PUD to acquire the entire PSE system and pay start-up expenses. It could, however, easily purchase a major portion of the PSE system and have sufficient debt capacity to pay for start-up.

WIP: Do public utilities have lower rates?

A. Yes. All of the PUDs in Washington have lower rates for residential, commercial, and industrial customers than the rates charged by PSE. There are several reasons for this:

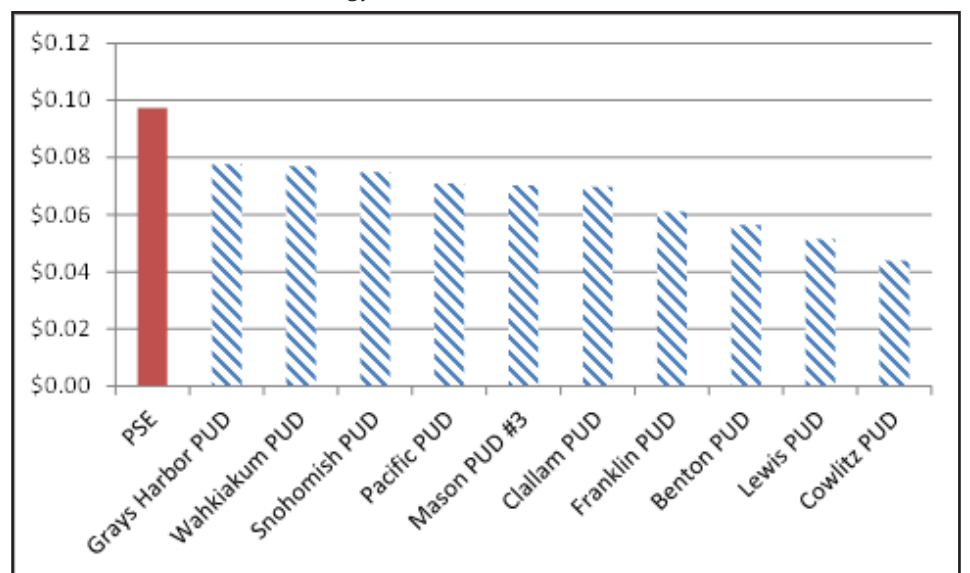
1. The PUDs have access to low-cost power from the Bonneville Power Administration, mostly from federal dams. PSE does not have access to this power on the same terms as a PUD.
2. Bond interest is a part of rates for either a PUD or for PSE. PUDs can borrow at much lower interest rates than a private utility, because bondholders are required to pay federal income tax on PSE bonds, but not on PUD (or other local government) bonds. The lower interest rate on PUD bonds translates into a cost savings for electricity consumers.
3. PUDs are non-profit, owned by the voters. They therefore pay no shareholder dividends or federal income tax. PSE incurs federal income tax and pays dividends to its single shareholder, a privately-held Australian conglomerate.

These explain most of the difference in rates. The labor and other operating costs are about the same for public and private utilities; PUDs usually pay their professional and technical employees a little more than PSE, but they pay their top executives a lot less than private utilities—it works out about even.

The graphic below compares PSE's average rates to those of several nearby PUDs. Many of these PUDs have counties that are more rural than Thurston County, and therefore have higher distribution costs than would Thurston PUD.

Example Average Rates of Sample Washington Utilities, 2010

(US Energy Information Administration Data)



Q: Does this mean that the Thurston PUD would have lower rates than PSE immediately?

Lazar: Not necessarily. First and foremost, the PUD could not take over immediately. Even if the voters approved the initiative, and the PUD went to work immediately on activation, it would probably take 5 years or more before the PUD could provide electric service.

The PUD might not be able to get all of its power at the same low power costs that other PUDs have immediately. Plus, when they first start up, PUDs have significant one-time costs to acquire offices, hire staff, acquire equipment, train their people, and set up computer and billing systems. This is expensive. Over time, it should cost no more than we

now pay PSE for these functions, though at first, it's a big set of costs to deal with all at once.

When Emerald PUD started up in the Eugene area, they were able to achieve about a 5% savings over Pacific Power rates. The same is expected for Jefferson PUD, expected to start operation in 2013 with slightly lower rates than PSE. Oregon Trail Electric Cooperative and Columbia PUD both were able to offer lower rates than the private utilities they replaced. Hermiston, Oregon took over Pacific Power's system in that city, and has been able to hold rates significantly below the level charged by Pacific. All of those utilities were able to acquire all of the power they needed from BPA, and that's uncertain for Thurston PUD, as explained below.

If the PUD built its own distribution system, it would avoid costly and time-consuming negotiations with PSE, but a new system would certainly cost more than a used one. It would be more reliable (underground, not overhead). The higher initial costs would be partly offset by lower maintenance costs for a new system.

Only a detailed analysis can answer this question. Such a study is likely to be undertaken if the voters grant electric authority to the Thurston PUD. The preliminary feasibility study being done for the PUD in 2012 will provide general guidance, not detailed results.

Q: Can the PUD obtain a power supply to serve Thurston County?

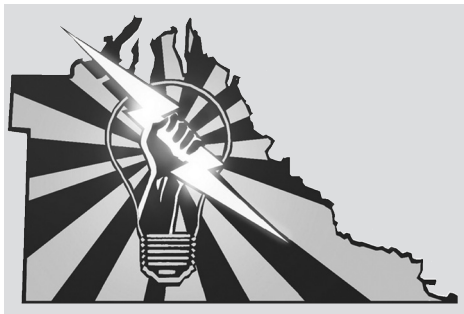
Lazar: Unquestionably, yes.

First, federal law requires BPA to sell power to any utility in the region "whenever requested" BUT, that does not mean that BPA would sell Thurston PUD all of the power it needs at the same price that Lewis, Mason, or Grays Harbor PUD

pay. Those utilities are grandfathered into low-cost resources, and Thurston would have to gradually earn the right to the low-cost "tier 1" pool, called "priority firm" power. Initially, if the PUD served the entire county, it would take a period of years to phase into getting a majority of their power at BPA's "priority firm" rate. The balance would be at a market-based price, which might be higher or lower than the BPA rate. Because PSE is a private utility, it does not have access to priority firm power from BPA; that is set aside for utilities that are "public bodies and cooperatives."

The PUD would not be limited to buying from BPA. There is an active wholesale power market, and currently prices are very low, even lower than BPA's prices. But those prices change every year, and the PUD would have to find a seller willing to offer a multi-year price in order to offer predictable prices to Thur-

► JIM LAZAR, continued on page 7



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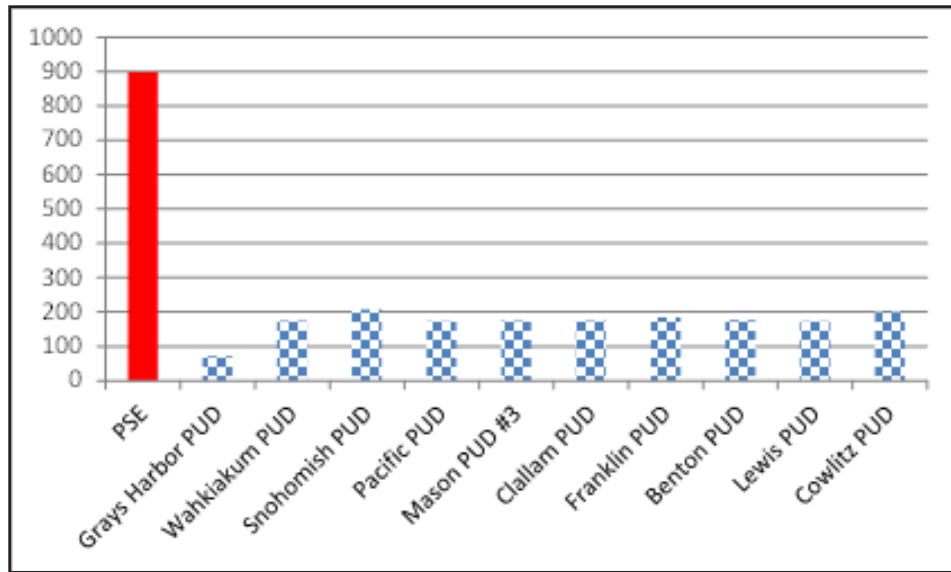
► **Jim Lazar**, cont. from page 6
 eston County consumers. So, as of today, the PUD's blended rate for wholesale power would likely be much cheaper than the average cost of power to PSE, but activation is a minimum of several years away, and the low-cost power available in the wholesale market today may not be available then.

Q: *Would the PUD's power supply be cleaner or dirtier than PSE's power supply?*

Lazar: Most likely it would be cleaner. PSE's power supply, as reported most recently to the State Department of Commerce, is 36% coal, most from a power plant complex in Montana, while the state's power supply as a whole is only about 18% coal. Most Washington PUDs get less than 10% of their power from coal. If the Thurston PUD bought only first tier power from BPA, that power is about 90% hydro, and 10% nuclear. While big dams and nuclear plants have significant environmental impacts, they do not directly emit carbon dioxide from combustion.

The graphic below compares the CO2 emissions for PSE compared with the PUDs in the state per 1,000 kilowatt-hours of power sold:

Carbon Dioxide Emissions for Sample Washington Utilities
 (Washington Department of Commerce Fuel Mix Data, 2010
 Calculation based on 2,000 lb/MWh for coal, 800 lb/MWh for natural gas)



PSE is currently acquiring renewable energy from wind, solar, and other sources to meet its obligations under Initiative 937, and if the Thurston PUD served over 25,000 consumers, it would also be subject to this same regulation. There are more than 100,000 homes and businesses in Thurston County.

Q: *Would the PUD have conservation and renewable energy programs?*

Lazar: All of the PUDs in Washington have conservation programs. Under Initiative 937, all utilities serving over 25,000 customers must acquire "all cost-effective conservation." While PSE's conservation programs have been award-winning in the past, I-937 requires that all large utilities in the state have essentially equal conservation programs.

Most PUDs offer a "green power" product, roughly equivalent to PSE's offering. However, fewer customers subscribe, in part because their general power supply is so much cleaner. Most PUDs offer incentives for customers to

install solar and other renewable energy systems. Decisions on these issues would be made by the three PUD commissioners.

Q: *Would the PUD be as accountable as PSE?*

Lazar: PSE is subject to regulation by the Washington Utilities and Transportation Commission (WUTC), appointed by the Governor, and confirmed by the Senate. The WUTC uses a very formal court-like process to evaluate rate applications and are constrained by laws that require them to allow the utility a reasonable opportunity to earn a fair rate of return, assuming prudent management. Much of the data they rely upon is marked "confidential" by PSE, and cannot be obtained by the public even under the state public records act.

The PUD is self-regulated by an elected board of three Commissioners. They hold public hearings and are required to make data on the system available to anyone who requests it, allowing

All of the PUDs in Washington have lower rates for residential, commercial, and industrial customers than the rates charged by PSE.

system repair expenses disallowed by the WUTC. There's no simple answer here.

Q: *I also get natural gas service from PSE. Will that switch to the PUD also?*

Lazar: No. The PUD does not have legal authority to offer natural gas service, so that will remain with PSE. This is similar to the situation in Seattle, Tacoma, and in Snohomish County, where PSE offers gas service, but not electric service. However, it would make sense for the PUD and PSE to cooperate on meter reading and billing service, since PSE already has the computer systems in place, and can spread the costs of billing over both services, saving money for both gas and electric consumers.

Q: *Who would be the "winners" and "losers" if the PUD were to provide electricity service?*

Lazar: The biggest winners would probably be the commercial and industrial electric customers, who would get access to low-cost electricity from BPA, and would get the benefit of a non-profit utility providing the distribution service. These customers currently have no access to BPA power. This group includes the State of Washington, the cities, the LOTT sewage treatment plant, and all of the school districts. Next would be the residential customers, who currently get a small credit on their bills reflecting a benefit of BPA power, but it only makes up about one-fourth of the difference in wholesale power cost.

A surprising winner would be the remaining PSE electricity customers. Since the PUD would not take over any of PSE's power plants (none are located in the County), those facilities would be available to serve other loads, for example, in King County. PSE would not need to buy any expensive new power for several years, meaning its rates for remaining customers would go up more slowly.

The "losers" would be the customers of other PUDs around the state, and public power customers throughout the Northwest. They would have to share the limited amount of low-cost BPA power with the new PUD, but that phase in would be very gradual. The impact would be very small, since Thurston County is only a few percent of the total load already being served.

WIP: *What about tax revenue to the state and the cities? What would change?*

Lazar: Very little would change. PUDs must pay the same "public utility excise

tax" to the state that PSE pays. PUDs must collect city utility taxes, just as PSE does. Both of these are calculated on a percentage of revenue basis, and if the PUD rates were a little lower, the tax collections would be a little lower. The PUD would pay a "privilege tax" of 2.14% of revenues, which is in lieu of property taxes. In fact, RCW 54.28.120 provides that privilege taxes paid by a PUD on acquired Investor Owned Utilities (IOU) property will not be less than was paid prior to the IOU properties acquisition.

Q: *If the voters gave the go-ahead, how long would it take before the PUD actually provides electric service?*

Lazar: The public vote is only one step of the process. The next step is a decision by the PUD Commissioners on whether or not to move ahead, and it can take several years to complete the studies needed to guide that decision. Finally, the actual process of either acquiring the PSE system or building a separate system takes several years. I'd guess it would be a minimum of five years, assuming that the initiative gets the required signatures and that the voters approve it.

Q: *Do you have a position on the Initiative?*

Lazar: No. I've had discussions with supporters and opponents, but I have not volunteered for or donated financially to either campaign.

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