

May 10, 2017

Andy Wappler
Vice President, Customer Operations & Communications
Puget Sound Energy, Inc.
10885 NE 4th Street
Bellevue WA 98004

Dear Andy,

Concentric Energy Advisors Inc. (“Concentric”) has performed this preliminary independent assessment of the costs and implications of the City of Bainbridge Island (“City”) acquiring Puget Sound Energy’s (“PSE”) existing utility assets and assuming responsibility for providing electric service to PSE’s Bainbridge Island customers.¹

Our report presents facts and industry insights that will inform the primary stakeholder constituencies regarding a choice between the establishment of a new municipal electric utility by the City or the continuation of service from PSE. This includes information that pertains to the rates that may be charged either by PSE or the City, as well as the services that are currently provided by PSE or may be provided by the City. It is appropriate to jointly consider the rates and services to be provided by PSE or the City to provide an apples-to-apples comparison between the two alternatives.

The key determinants of the rates that customers can expect to pay under the two alternatives are: (1) the City’s cost of acquiring PSE’s utility assets and other initial actions necessary to prepare to serve as the electric utility, (2) the City’s annual costs of providing electric service including operating and maintaining, continuing to invest in utility assets, and acquiring power supplies and having them delivered to the Island, (3) a forecast of the City’s rates based on the initial investment and ongoing operating costs, and (4) a forecast of PSE’s rates to serve as a benchmark by which to compare the municipal utility alternative.

There are several other financial and non-financial factors that should also be considered when making an informed decision. The City will have more control over decisions that uniquely affect its electric utility, the services that it provides, and the rates that customers pay. For example, the City could decide to provide customer incentives to install solar panels on their rooftops or develop a community solar project or increase spending on energy efficiency programs. A City-owned utility could also decide to underground more of its distribution network. Of course, the ability to make these decisions comes with the knowledge that Bainbridge Island customers will pay for all of the costs.

¹ It will be appropriate to update this assessment and any subsequent formal valuation studies to reflect new information becomes available that will have a meaningful impact on the results.



Customers will continue to care about the quality of service that they receive and their interactions with the utility when requesting a new service, asking questions, or registering concerns. PSE is organized to provide this function in a centralized manner with staffing, processes and systems that are sized to serve the needs of its 1.1 million customers. The City may be able to replicate this function with local personnel or may decide to rely on a combination of outside vendors and City functions. In either case, the City will be challenged to achieve the economies of scale that are possible at a large utility. On the other hand, the claim is often made that local personnel may be more responsive to customer concerns. There is also a difference in governance between the two alternatives as it relates to oversight of customer service, pricing, key decisions, and other matters. PSE is regulated by the Washington Utilities and Transmission Commission (“WUTC”) with its staff of attorneys, economists, accountants and engineers. The City will need to establish a governance organization to approve key decisions and oversee the quality of service provided by the municipal utility.

The estimate of electricity rates under the City utility option begins with an estimate of the costs of forming the utility, comprised of acquisition costs that are established by the condemnation process as well as certain transaction and start-up costs. As shown in Figure -1, Concentric estimates the cost of forming a utility at \$146.8 million, assuming a 2021 acquisition.²

Figure -1: Preliminary Estimate of Acquisition Costs

Cost Category	2021 (\$Million)
Acquisition Costs	\$109.1
Transaction Costs	\$8.7
Start-Up Costs	\$29.0
Total	\$146.8

Acquisition costs include the cost of acquiring PSE’s transmission and distribution assets in service as of the transaction date, land and easements, and compensation that is due to PSE for modifying facilities to “separate” the Bainbridge Island utility system and establish a new Point of Delivery for the City to receive its supply of electricity. Transaction costs include legal fees and underwriting costs necessary to issue debt to finance the acquisition costs and fund the start-up efforts that prepare the municipal utility to exercise its responsibilities. These start-up costs include new systems, inventory, facilities and machinery that will be necessary to operate and maintain the

² This is a preliminary estimate that can only be refined after a complete system inventory is conducted. It should also be noted that a transaction close date in 2020 is optimistic. An additional scenario has been included in Section 6 assuming a transaction close date of 2024, which may be more reasonable.



transmission and distribution system, manage customer relationships, provide detailed billing of the electric service and provide financial reporting.

Federal law prohibits the use of tax-exempt debt to finance the acquisition of utility property from an investor-owned utility. Concentric assumed that the acquisition costs would be financed with 30-year taxable revenue bonds. All other costs are assumed to be financed with 30-year tax-exempt debt. Debt service costs are a major element of the cost of providing service as shown in the following figure.

Figure -2: Preliminary Estimate of Cost of Providing Service

	2021	2024	2029	2034	2039
	-----(\$000)-----				
Debt Service (Principal & Interest)	\$ 10,849	\$ 12,087	\$ 13,120	\$ 14,561	\$ 16,170
Power Supply & Delivery					
Purchased Power	\$ 8,611	\$ 9,074	\$ 10,366	\$ 11,446	\$ 13,083
BPA Transmission Expense	\$ 1,216	\$ 1,290	\$ 1,538	\$ 1,731	\$ 2,065
O&M Expenses					
Operations and Maintenance Expense	\$ 3,072	\$ 3,378	\$ 3,958	\$ 4,636	\$ 5,432
Customer Accounting	\$ 1,096	\$ 1,206	\$ 1,412	\$ 1,655	\$ 1,939
Administrative & General	\$ 3,847	\$ 4,230	\$ 4,956	\$ 5,806	\$ 6,802
Energy Assistance Program	\$ 32	\$ 35	\$ 39	\$ 44	\$ 50
Washington State Utility Tax	\$ 981	\$ 1,060	\$ 1,159	\$ 1,306	\$ 1,429
Energy Efficiency	\$ 759	\$ 817	\$ 924	\$ 1,046	\$ 1,183
Total BI Municipal Electric Utility Cost of Service	\$ 30,462	\$ 33,175	\$ 37,473	\$ 42,231	\$ 48,152
Replacement Property Taxes	\$ 158	\$ 171	\$ 194	\$ 220	\$ 249
Total Bainbridge Island Cost	\$ 30,620	\$ 33,346	\$ 37,667	\$ 42,451	\$ 48,401

Excluding the debt service, power supply and delivery costs, which include the cost of acquiring supply and the transmission charges to transport power to Bainbridge Island is the largest cost of providing service. Concentric has assumed that the City municipal utility will be able to secure power from the Bonneville Power Administration (“BPA”). In addition, Concentric has assumed that the transmission costs will be limited to the BPA transmission rates, and that the City municipal utility will not be required to compensate the BPA for any new investments in transmission capacity required to meet its load.

For comparison purposes, Concentric has assumed that PSE’s rates increase by approximately 3.2 percent in 2018 based on PSE’s current rate case request and 3.0 percent every other year beginning in 2020. The Base Case analysis yields a 10-year net present value cost **increase** resulting from municipal ownership and operation of the electric utility on Bainbridge Island of \$36.6 million.



However, given various uncertainties, Concentric prepared alternative “Lower Bound” and “Higher Bound” scenarios to reflect the fact that costs may be higher or lower than expected and the timing of the municipal acquisition of the system. These scenarios are based on an internally consistent set of assumptions developed around transaction dates that are either aggressive (2020 for the Lower Bound scenario) or reflect an extended condemnation process (2024 for the Upper Bound scenario). In addition, these scenarios reflect the range of potential operating and acquisition costs. In fact, the acquisition of Jefferson PUD has resulted in rates that are significantly higher than initially forecast during the feasibility study phase due to a number of factors including unrealistically low estimates of acquisition costs and transaction costs.³ Residents and businesses of Bainbridge Island will want to consider the expected costs of the two alternative scenarios, and the potential that the costs of either alternative will end up being significantly higher than expected. The results of the Base Case and the two alternative scenarios are presented in Figure 3.

Figure 3: Base Case and Scenario Results⁴

	2020	2021	2024	2029	2034	2039
	-----(\$000)-----					
Base Case						
Total Cost						
Bainbridge Island	\$ -	\$ 30,620	\$ 33,346	\$ 37,667	\$ 42,451	\$ 48,401
PSE	\$ -	\$ 25,360	\$ 27,398	\$ 29,959	\$ 33,753	\$ 36,925
Net Savings/(Costs)	\$ -	\$ (5,260)	\$ (5,948)	\$ (7,708)	\$ (8,698)	\$ (11,476)
10-Year Net Present Value		\$ (36,648)				
20-Year Net Present Value		\$ (74,476)				
Lower Bound Scenario						
Total Cost						
Bainbridge Island	\$ 26,796	\$ 26,956	\$ 29,242	\$ 33,037	\$ 37,030	\$ 43,855
PSE	\$ 25,451	\$ 25,607	\$ 28,204	\$ 31,442	\$ 36,465	\$ 40,671
Net Savings/(Costs)	\$ (1,345)	\$ (1,350)	\$ (1,038)	\$ (1,595)	\$ (564)	\$ (3,184)
10-Year Net Present Value	\$ (8,670)					
20-Year Net Present Value	\$ (15,322)					
Upper Bound Scenario						
Total Cost						
Bainbridge Island	\$ -	\$ -	\$ 40,185	\$ 45,514	\$ 51,369	\$ 61,183
PSE	\$ -	\$ -	\$ 26,240	\$ 27,667	\$ 29,853	\$ 32,217
Net Savings/(Costs)	\$ -	\$ -	\$ (13,946)	\$ (17,847)	\$ (21,516)	\$ (28,966)
10-Year Net Present Value			\$ (87,620)			
20-Year Net Present Value			\$ (251,229)			

³ The initial feasibility study for the formation of the Jefferson County PUD estimated an acquisition cost of \$47 million when the final acquisition cost was more than twice that at \$103 million plus start-up expenses. In that case, just compensation and other contractual issues were resolved through negotiation.

⁴ Total costs for Bainbridge Island are slightly higher than in Figure -2 because they include foregone property tax revenues that will no longer be paid by PSE to the City.



As shown in Figure 3, the Lower Bound scenario assumes that the municipal acquisition and operation of the electric utility begins in 2020. This scenario results in lower acquisition costs that reflect less incremental capital investment between the valuation date of 2017 and the operation date of the new electric utility. In addition, because this scenario assumes that the acquisition occurs earlier, the transaction costs are estimated to be lower than the Base Case. In the Lower Bound scenario, with this aggressive timing assumption, the costs of municipalization are \$15.3 million higher than continuation of PSE service over a 20-year period.

The Upper Bound scenario assumes that the acquisition and municipal operation occur in 2024. The acquisition costs include capital investment and replacement that is projected to occur in each year from 2017 through 2023. In addition, the transaction costs reflect a more prolonged process for acquiring the assets, including higher legal and consulting fees. In addition, the Upper Bound scenario considers the high end of the range of potential costs for other key assumptions. A list of the assumptions that differ from the Base Case is presented in Figure 21. Based on the assumptions in the Upper Bound scenario, the cost of service for a municipal electric utility is \$251.2 million higher than continuation of PSE service over a 20-year period.

Finally, and as important as the cost of electric service, Bainbridge Island voters will want to make a realistic assessment of the ability of a City-owned utility to execute on its obligations to provide safe and reliable electric service at levels of customer service that approximate or exceed the level of service provided by PSE. This is referred to as “operating risk” and often receives short shrift in municipalization assessments where the municipality is entering a new business that is critically important to the health and safety of its citizens. A realistic view with respect to future system investments is part of this analysis.

I look forward to discussing our report in more detail with you.

Very truly yours,

CONCENTRIC ENERGY ADVISORS, INC.

A handwritten signature in blue ink that reads "Ann E. Bulkley".

Ann E. Bulkley
Senior Vice President