



October 16, 2006

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RE: Alaska Intertie Agreement

Gentlemen:

This letter provides notice of termination under Section 2.2.2 of the Alaska Intertie Agreement dated December 23, 1985 ("Agreement"). The Agreement will terminate 48 months from today's date.

The Alaska Intertie ("Intertie") is a 170-mile, 345kV transmission line between Willow and Healy owned by the Alaska Energy Authority ("AEA"). The Intertie was built in the mid-80's with state of Alaska appropriations totaling \$124 million and allows Golden Valley Electric Association ("GVEA") in Fairbanks to purchase electricity from Chugach Electric Association ("CEA"), Anchorage Municipal Light & Power ("ML&P") and the Bradley Lake Hydroelectric Project.

The Intertie is governed by the Agreement by and between the Alaska Power Authority (now the Alaska Energy Authority), ML&P, CEA, GVEA and Alaska Electric Generation & Transmission Cooperative ["AEG&T" comprised of Matanuska Electric Association ("MEA") and Homer Electric Association]. The Intertie's operation and maintenance are overseen by the Intertie Operating Committee (IOC) that includes representatives of all signatories to the Agreement. The utility signatories are defined in the Agreement as "Utility Participants." Intertie operating and maintenance costs are the sole responsibility of the Utility Participants, not AEA. Neither the state of Alaska nor AEA receives any rent or user fees from the utilities that use the Intertie.

The current AEA Board held its first Board meeting on January 30, 2003. At the next AEA Board meeting (June 30, 2003), AEA staff presented the Directors a report on the Intertie that pointed out problems with the Agreement. Of particular interest to the Board was mention of the fact that the Agreement has no mechanism to fund capital improvements and that a number of needed repairs identified by the IOC in October 2002 in their "Alaska Intertie Upgrade Report" were not being addressed. These problems included needed repairs to Static Var Compensators ("SVC"), repairs to tower foundations and Intertie snow loading concerns. AEA staff also advised the Board that under Section 2.2.2 of the Agreement, AEA may terminate the Agreement, "by giving at least 48 months advance written notice when (AEA) determines such action to be required to improve Power systems serving Alaska Railbelt Utilities." At the June 30, 2003 meeting, the Board directed staff to review the Agreement and report to the Board.

On December 29, 2003 the General Managers of CEA, GVEA and ML&P, and Ron Saxton (attorney for GVEA) met with AEA staff and Assistant Attorney General Brian Bjorkquist at AIDEA to discuss methods of financing needed repairs to the Intertie. At the end of that meeting, the utility representatives committed to seeking financing for the repairs through AEA-issued bonds with the utilities as the borrowers/guarantors.

AEA staff continued working through the IOC to address the repairs and problems with the Agreement throughout 2004 and the first half of 2005. Progress was made addressing concerns with snow-load issues but no mechanism was developed to finance work on the tower foundations or SVC's.

On June 24, 2005 the Utility Participants were advised in writing by AEA staff that the AEA Board would meet on July 25, 2005 and discuss, among other issues, the following problems with the Agreement:

1. No R&R fund (repair & replacement fund) or other capital fund to finance major maintenance or upgrades;
2. Deferral of needed repairs;
3. Lack of compliance with the Agreement's terms and conditions.

The June 24, 2005 letter also notes that the AEA Board:

"...has concerns regarding continuing operations of the Alaska Intertie under the current Agreement. The inability of the Intertie Operating Committee to timely address tower foundation repairs, SVC upgrades and other necessary deferred maintenance evidences fundamental deficiencies in the Agreement. Even if those specific problems were soon addressed, the Agreement would still lack adequate provisions to maintain the Intertie and prevent future serious degradation of the line's ability to transmit power.

These fundamental deficiencies in the Agreement must be rectified. We understand that the conventional wisdom of the Utilities in the past has been that the Agreement cannot be amended to cure these deficiencies. However, if no other realistic solution is forthcoming, the AEA Board may be compelled to exercise its option to terminate the Agreement..."

The response to this letter by some of the utilities letter was to lobby the Governor's Office to convince the AEA Board and staff to remove this item from the July 25, 2005 meeting agenda

and to meet informally with the utilities instead. As a compromise, the Board agenda was kept as originally proposed and a work session was held on July 22, 2005 with two AEA Board members, AEA staff and utility representatives to discuss the issues raised in the letter.

At the July 22, 2005 work session, the representatives of CEA, GVEA and ML&P committed to working together to fix problems with the Agreement and to finance needed Intertie repairs. AEA staff was asked to prepare revenue bond and loan financing scenarios for \$3 million, \$5 million and \$7 million over, 7-year, 15-year and 20-year terms. At the end of the work session, AEA Chairman Mike Barry advised the utilities, "We're trying to look at a constructive way to make the Intertie work better for everybody. But when we look at financing for example, it's difficult for us in good faith to sponsor financing when we're being told by the IOC that the agreements (sic) don't work. As a Board, the only way we can force the agreements (sic) to work is to terminate them and start over again. If you guys collectively come to an agreement to change it that's the best solution for everybody, but I think it needs to be addressed before somebody talks about financing or we can limit the financing term (to) less than four years."

At the July 25, 2005 meeting, the AEA Board was briefed on the July 22, 2005 work session. AEA Chairman Mike Barry noted that deferred maintenance items identified by the IOC in October 2002 still had not been addressed. He further advised the Board that staff would report on the status of the utilities' efforts to amend the Agreement and finance the repairs at every Board meeting until there is a resolution.

On August 17, 2005, financial analyses by AEA staff were provided to the Participating Utilities based on the scenarios discussed above. No responses from the utilities to these analyses were ever received.

At its December 5, 2005 meeting the AEA Board was briefed on IOC actions since the July 25th Board meeting. There had been discussions regarding possible amendments to the Agreement and possible ways to finance deferred maintenance. AEA's Chairman stated that the utilities needed to address Intertie issues raised since June 2003 and that meant, "these issues get resolved and not just talked about."

Subsequent to the December 5, 2005 AEA Board meeting, the utilities admitted that the Agreement could not be amended, since amendments require unanimous consent and the utilities could not unanimously agree to any amendments. Some utilities proposed "side agreements" to address problem areas in the Agreement. Also, some utilities contended the Agreement was not a problem since the utilities simply chose to ignore problem areas and would work by consensus regarding desired actions regardless of the provisions of the Agreement.

On March 17, 2006, the General Managers of the Participating Utilities were sent a letter by AEA staff reiterating AEA's concerns regarding defects in the Agreement. The letter imposed a June 15, 2006 deadline for the parties to craft cures to those defects and for AEA to give notice of termination of the Agreement. The letter also invited the utilities to meet and continue working with AEA staff.

On April 21, 2006, AEA and the utilities' General Managers met. The June 15, 2006 deadline and notice of termination was modified to require the utilities to demonstrate real progress in curing defects in the Agreement

In May 2006, AEA and utility attorneys met to discuss possible resolutions to the problems with the Agreement. At the June 21, 2006 AEA Board meeting, the CEA, GVEA and ML&P reported that they were making progress on addressing the problems the AEA Board had been pointing out since 2003. The AEA Board expressed frustration that there was still not concrete evidence of any progress in solving the Intertie problems and urged the utilities to redouble their efforts in this regard.

On July 10, 2006 the AEA Board met and, after hearing from AEA staff and utility representatives discussed the fact that no real progress had been made in curing defects with the Agreement or financing the deferred maintenance. The Board passed Resolution No. 2006-04 with attachments finding that giving 48 months advance written notice of terminating the Agreement is required to improve Power systems serving the Alaska Railbelt Utilities. The Resolution also noted that the utilities appeared to be making progress toward developing amendments and "side agreements" to the Agreement, and concluded that the utilities should be given additional time to finalize the amendments and side agreements and that notice of termination should not be given until September 1, 2006. The Resolution directed AEA's Executive Director to give the written notice of termination if the utilities failed by September 1, 2006 to negotiate and execute final amendments to the Agreement and any side agreements needed.

The IOC met on August 8, 2006 and passed a resolution supporting tower foundation repairs and SVC upgrades, proposing the Utility Participants share in the costs of these repairs and recommending the utilities' General Managers meet with AEA to develop a financing plan for the repairs. On August 9th utility representatives and attorneys met with AEA staff and proposed that a finance subcommittee of the IOC be created to address financing deferred maintenance. On August 15, 2006 utility General Managers and their attorneys met with AEA staff and assistant attorney general. The utilities approved the concept of an *ad hoc* finance subcommittee since AEG&T did not agree to create a standing finance subcommittee. At the August 15th meeting, the utilities were advised to submit to AEA by the close of business on September 1, 2006 executed final amendments to the Agreement and any executed side agreements.

On August 31, 2006 AEA received an email from legal counsel on behalf of CEA, GVEA and ML&P advising of work subsequent to the August 15th meeting and forwarding an unsigned proposed Amendment 2 to the Agreement. On September 1, 2006 AEA received a letter from MEA on behalf of AEG&T disagreeing with the proposed Amendment 2.

The proposed Amendment 2 provided some amendments to the budget process, but was not comprehensive and did not address other defects in the Agreement, and, as pointed out above, is unsigned. The Board's direction in Resolution No. 2006-04 was that the utilities had to submit "executed" amendments by September 1, 2006.

If AEA gives notice of termination, there should be no significant, immediate impact. Under the Agreement, notice of termination could not result in actual contract termination for 48 months. The status quo would continue – meaning, in part, that the existing contract language, including all of its defects, would remain in place – however, only for an additional 48 months rather than indefinitely.

The utility General Managers at the April 21, 2006 meeting suggested that notice of termination would create "chaos." The apparent concern was that the Agreement is both an interconnection agreement and a management, maintenance and operations agreement for interconnected

utilities. These terms and conditions for interconnection were apparently very difficult to negotiate originally, and likely would be very difficult to re-negotiate.

At the June 21, 2006 Board meeting, in reaction to questions from the Chairman, utility representatives suggested that the problem with AEA giving notice of termination is that it would require parties to abandon the entirety of the existing Agreement and renegotiate every term and condition, even though they believe relatively few sections actually require modification to cure the defects in the Agreement.

I have carefully considered these utility concerns. It appears that these two expressions are each premised on an assumption that AEA giving notice of termination would result in the complete abandonment of the existing contract. That assumption does not appear valid.

The utilities appear to fear suffering from self-inflicted wounds during the renegotiation process. AEA has consistently attempted to narrowly focus upon curing specific, limited defects in the existing Agreement. The utilities, however, individually appear to have a broader range of concerns with the Agreement. It appears that the only reason that "chaos" might result from completely abandoning the existing Agreement is if the utilities insist upon that outcome.

Giving notice of termination may lessen, not exacerbate, the utilities' fears. Making even limited changes to the Agreement has not occurred because utilities could not agree unanimously on amendments. At least one utility has objected to any proposed amendment until other concerns the utility has with the Agreement are addressed. The AEA-sponsored cures to agreement defects are thus held hostage by disagreement among participants – a circumstance that will likely continue as long as the existing Agreement remains in place.

After notice of termination, AEA can freely negotiate modifications to the Agreement with less than all the IOC Utilities. Nothing would preclude AEA from executing an amendment to incorporate the modifications as part of what would become the subsequent Agreement, regardless of whether those modifications may take effect immediately or only after the 48 month notice period. Providing notice of termination will signal that the Authority will no longer be an enabler for any one or more utilities to indefinitely thwart cures to Agreement. Rather than creating "chaos," arguably the Authority is more likely to help instill order by giving notice of termination.

AEA's position is that certain modifications to the Agreement are necessary to insure the continued safe, reliable and efficient operation of the Alaska Intertie. The failure to implement these modifications could disrupt Intertie operations, and direct harm to the IOC Utilities that rely on the Intertie for energy transfers to serve Railbelt ratepayers¹. Ensuring that these necessary modifications be made to the Agreement is an effort "required to improve Power systems serving the Alaska Railbelt Utilities" as that phrase is used in Section 2.2.2 of the Agreement related to Authority termination of the Agreement, in a reasonable and timely manner.

¹ Failure to adequately address the deferred maintenance on the Intertie could place all Railbelt ratepayers in peril. The wide-spread electrical outage in the Railbelt in June of this year points to the how susceptible to service interruptions the Railbelt power grid is. While the cause is still under investigation by the IOC reliability committee, initial indications are that an insulator failed just north of Anchorage for unknown cause. Other operational issues made the outage more widespread, and of longer duration.

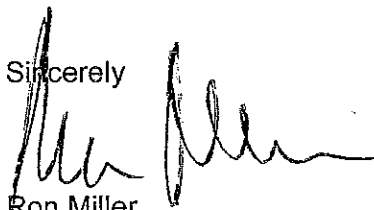
We therefore conclude it is necessary to terminate the agreement. to effect necessary modifications to the Agreement. We base this decision in part on the following points.

- Amending the Agreement requires unanimous consent, and at least one Participating Utility has refused to agree to necessary modifications.
- There is no factual basis upon which to conclude that unanimous consent is likely to occur at any time in the near future.
- Absent unanimity between utilities, no modification to the Agreement could be implemented without AEA providing notice of termination.
- While AEA could postpone giving notice of termination until after one or more replacement or side agreement(s) are negotiated, that course would delay the time at which cures to the defects in the Agreement become effective.
- There is no factual basis upon which to conclude that one or more replacement or side agreement(s) can be timely negotiated. Further, one utility has suggested it would legally challenge that approach if implemented.
- Giving notice of termination is the only mechanism that would ensure that necessary modifications will in fact be implemented in the most expeditious manner.

We do not take this action lightly. Over the past 3 years AEA has pursued cures for agreement defects with the Participant Utilities at several levels, to no avail. Since June 2003 AEA's Board has discussed the terminating the Agreement. They advised the Participating Utilities on several occasions that action was required to address deferred maintenance and needed amendments to the Agreement. Some of the utilities have stated their intent, since late 2003, to finance the needed repairs but no concrete action has taken place.

By providing this notice of intent to terminate the Alaska Intertie Agreement 48 months from today's date AEA is taking a major step to improving the power systems along that grid. AEA staff is ready to work with the utilities to resolve defects in the Agreement before the end of this notice period.

Sincerely



Ron Miller
Executive Director
Alaska Energy Authority

cc: AEA Board of Directors
Governor Frank Murkowski