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**IN THE MATTER OF AN ARBITRATION UNDER CHAPTER ELEVEN OF
THE NORTH AMERICAN FREE TRADE AGREEMENT
AND THE ICSID ARBITRATION (ADDITIONAL FACILITY) RULES**

BETWEEN:

MERCER INTERNATIONAL INC.

Claimant

AND:

GOVERNMENT OF CANADA

Respondent

WITNESS STATEMENT OF PIERRE LAMARCHE

CONTENTS

A.	The Howe Sound Pulp and Paper Mill Facility	3
B.	Howe Sound's 1989 Generation Agreement with BC Hydro.....	4
C.	BCUC Order G-38-01 and Howe Sound's 2001 Purchase Transaction Enabling Agreement.....	8
D.	Howe Sound's Use of Incremental Generation to Displace BC Hydro Purchases	13
E.	The Joint Industry Electricity Steering Committee's Concerns About Arbitrage	14
F.	Conclusion.....	16

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I, Pierre Lamarche, declare as follows:

1. I was born on [REDACTED]. I currently reside at [REDACTED].
2. In January 1989, I assumed the position of Production Manager – Pulp at the Howe Sound Pulp and Paper Ltd. mill in Port Mellon, BC (“Howe Sound” or “the Mill”). As Production Manager – Pulp, I was responsible for personnel and any operational issues relating to all process areas in the fibre line, the liquor recovery cycle as well as the areas relating to power generation.
3. In 1995, I was promoted to Mill Manager – Kraft, and my responsibilities expanded to include oversight over maintenance, engineering, technical services, quality control and customer service.
4. In September 2004, I took on the role of Manager – Energy for Howe Sound, where my primary responsibility was to work on matters relating to electricity and natural gas. In this role, I dealt with all issues relating to BC Hydro directly and/or through the British Columbia Utilities Commission (“BCUC”).
5. Outside of my employ at Howe Sound, I was Chairman of the Joint Industry Electricity Steering Committee (“JIESC”) from 2005 to 2009. JIESC is a non-profit organization comprised of large industrial consumers in British Columbia that represents its members’ interests before BC Hydro, the BCUC, and the provincial government on matters relating to electricity. My role as Chairman included working closely with the Executive Director to ensure that JIESC would address all issues of interest to its members. I was a primary spokesperson for JIESC at meetings with the provincial government and BC Hydro.
6. I retired from Howe Sound and as Chairman of JIESC in January of 2009. I attach my resume as Appendix A to this witness statement.
7. In this witness statement, I will explain the following: (a) the facilities at Howe Sound; (b) the terms of Howe Sound’s 1989 Generation Agreement with BC Hydro and Howe Sound’s inability to meet those terms; (c) Howe Sound’s agreement to sell

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electricity to Powerex on an hourly non-firm basis; (d) Howe Sound's use of incremental generation to displace purchases of electricity from BC Hydro; and (e) the role and position of JIESC in the proceedings leading to BCUC Order G-48-09.

8. All of the statements are based on my personal knowledge of the matters described in this witness statement, except where based on specific information and belief, in which case I indicate the source of the information and my belief that it is true.

9. I have reviewed the documents cited in my witness statement for the purposes of preparing this witness statement. I am a fact witness in this NAFTA arbitration.

A. The Howe Sound Pulp and Paper Mill Facility

10. The Howe Sound facility has two production lines: one that produces Northern Bleached Softwood Kraft ("NBSK") through a chemical pulping process and one that produces newsprint using fibre primarily from its own Thermo Mechanical Pulping ("TMP") process.

11. The steam and electricity generation equipment at Howe Sound is comprised of two boilers and two turbo generators. The largest boiler is the recovery boiler, which combusts "black liquor" (concentrated spent liquors from the digestion and washing stages of the chemical pulping process) to generate steam. The recovery boiler was put into service in late 1990 when the new and upgraded kraft line began operation. Steam from the recovery boiler is passed through Howe Sound's two turbo-generators to produce electricity.

12. The second boiler is the power boiler whose primary source of fuel is hog fuel (*e.g.* bark and wood waste material from sawmills). While the power boiler can also generate steam by burning natural gas, that was never its intended purpose and it was only ever done when economically justifiable. The power boiler was put into service in 1992 and its steam is fed through Howe Sound's two turbo-generators to produce electricity.

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13. Howe Sound's first turbo generator ("TG 1") is a back pressure extraction turbine that was installed along with the new kraft line in late 1990. TG 1 has a nameplate capacity of [REDACTED] megawatts ("MW") of electricity.

14. The second turbo generator ("TG 2") is a double extraction condensing turbine with a capacity of [REDACTED] MW of electricity and was constructed along with the power boiler in 1992.

B. Howe Sound's 1989 Generation Agreement with BC Hydro

15. When I joined Howe Sound in 1989, the Mill was owned equally by Canadian Forest Products Ltd. and Oji Paper Co. of Japan. At that time, Howe Sound was upgrading and expanding its kraft production facilities and was constructing the newsprint machine and its accompanying TMP line.

16. The addition of these new assets was going to increase Howe Sound's load; and the consumption and generation of electricity was therefore given serious consideration during the design of the new Howe Sound facility. It is my understanding based on discussions with Oji Paper Co. executives that electricity costs in Japan were extremely high compared to those in North America and that Oji Paper Co. was concerned about future electricity costs at the Mill. Howe Sound thus approached BC Hydro for a loan under its newly launched Power Smart Program, which was developed by BC Hydro to incentivize consumers of electricity to reduce their consumption in order to eliminate BC Hydro's need to invest in new and more expensive generation assets.

17. Howe Sound concluded a loan agreement with BC Hydro on October 1, 1989 (the "1989 Generation Agreement").¹ Pursuant to that agreement, BC Hydro provided Howe Sound with a [REDACTED] loan towards the purchase and construction of a new power boiler and two turbo generators (*i.e.* TG 1 and TG 2).² In exchange, Howe Sound was required to repay the loan and offset part of the increased load the

¹ Generation Agreement between BC Hydro and Howe Sound Pulp and Paper Limited, 1 October 1989 ("1989 Generation Agreement"), **R-64**.

² [REDACTED]. see A.F.E. – H.S.P.P. 88-17, Co-Generation-Revision 1, December 1990, at bates 021443, **R-74**.

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newly configured Mill would place on BC Hydro's system by generating at least [REDACTED]
[REDACTED] for [REDACTED] years. [REDACTED]
[REDACTED].

18. While Howe Sound fully repaid the [REDACTED] loan in [REDACTED]
[REDACTED]
[REDACTED].³
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED].

19. First, the characteristics of coastal hog fuel changed dramatically in the early 1990s. Sawmill operations began removing all "white wood" (*e.g.* sawdust, shavings, etc.) from the hog fuel supplies as there was a new market for that material in the pulping industry. White wood possesses more heat value than bark and its removal from the fuel resulted in heat values that were considerably lower. [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED].

20. [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]

³ Howe Sound generation/penalty data under 1989 Generation Agreement, R-75.

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[REDACTED]
[REDACTED].

21. [REDACTED]
[REDACTED]. “Salty hog” occurs when logs are floated on sea water resulting in the absorption of sea salt in the wood and bark (*i.e.* the hog). Sea transportation is the only practical method of log transportation and log storage on the coast of British Columbia and is used almost exclusively by all coastal logging companies. [REDACTED]

[REDACTED]⁴,
[REDACTED]
[REDACTED]
[REDACTED].

22. Finally, [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED].

23. [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]. Natural gas prices during the mid-1990s were low [REDACTED]
[REDACTED]. Natural gas prices were, however, rising and reached a point in mid-2000 where [REDACTED]
[REDACTED].

⁴ [REDACTED]
[REDACTED]: BC Hydro Generation Shortfall Briefing, Re-Discussion with Larry Bell, **R-76**.

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24. [REDACTED] While natural gas prices peaked in mid-2000, [REDACTED]

[REDACTED].⁵

Month	Generation (MWh)
[REDACTED]	

25. In the period between October 2000 and February 2001,⁶ [REDACTED]
[REDACTED]

⁵ [REDACTED]

⁶ In March 2001, we signed an interim agreement that permitted us to ramp-up our power generation assets and sell the incremental output to Powerex: Letter from Shawn Thomas to Russ Fulton, Re: British Columbia Hydro and Power Authority (“BC Hydro”), 16 March 2001, **R-77**. [REDACTED]

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[REDACTED]⁷ [REDACTED]
[REDACTED]
[REDACTED], Howe Sound was required to [REDACTED]
[REDACTED].⁸

26. It became clear that it would soon be [REDACTED]
[REDACTED]. Since the price of natural gas was forecast to escalate into the future, [REDACTED]
[REDACTED]. The economic evaluations we carried out took into account [REDACTED]
[REDACTED].

27. These discussions continued until [REDACTED]
[REDACTED].

C. BCUC Order G-38-01 and Howe Sound’s 2001 Purchase Transaction Enabling Agreement

28. In the fall of 2000, the power demand in California and the southern United States was causing prices for electricity in that region to rise dramatically. It became apparent to Howe Sound that if it could sell incremental power at those market rates, it would be economically feasible to burn natural gas to supply steam to TG2’s condenser in order to generate the incremental power. Howe Sound approached BC Hydro and

⁷ [REDACTED]

⁸ [REDACTED]

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Powerex on the subject of selling idle power from TG 2 in February of 2001.⁹ BC Hydro indicated some interest but also expressed some concerns, and Howe Sound eventually approached the BCUC to seek permission to arrange for the sale of idle generation from TG 2 to Powerex.¹⁰

29. To my knowledge, this was the first time that an industrial self-generator in British Columbia was actively pursuing the possibility of selling incremental generation into market. The BCUC set up both a workshop and a hearing to address all concerns relating to Howe Sound's application. A workshop is a working session where BCUC staff (though not Commissioners) and all interested parties, including interveners,¹¹ discuss the proposal and the issues surrounding it in a less formal environment. The workshop was held on March 19, 2001,¹² and was followed by a formal hearing process, which involved written submissions made by interested parties to the BCUC, with BC Hydro being provided an opportunity to respond.

30. The fundamental issue that was raised at both the workshop and in the hearing submissions concerned the harmful arbitrage of BC Hydro's embedded cost power. BC Hydro was concerned that customers would increase purchases of embedded cost power in order to sell self-generation on the market. Howe Sound agreed with BC Hydro that such arbitrage could have a negative effect on BC Hydro ratepayers, but that self-generators should have the ability to sell incremental or idle self-generation.

31. In Order G-38-01, the BCUC agreed with Howe Sound that it would be beneficial for idle generation to have access to the market so long as BC Hydro's embedded cost

⁹ Chronology of Events for Howe Sound Idle Generation, **R-78**; Letter from Craig Folkestad to Jerry Peet, dated February 12, 2001, **R-79**.

¹⁰ Letter from Brian Wallace (Bull, Housser & Tupper) to Robert Pellatt (BCUC) Re: British Columbia Hydro and Power Authority ("BC Hydro") Sales to RS 1821 Customers with Self-Generating Capability, dated February 27, 2001, **R-80**; Note that this letter was in response to BC Hydro's letter dated February 23, 2001 to the BCUC, **R-81**. BC Hydro then responded with a letter dated February 28, 2001, **R-82**.

¹¹ Interested parties and interveners included BC Hydro, Howe Sound, the Ministry of Employment and Investment, the Consumers Association of Canada, JIESC, and a number of private individuals. *See* Meeting Notes, Workshop Monday 19 March 2001, BC Hydro Obligation to Serve Rate Schedule 1821 – Transmission Service customers with Self-Generation Capability, **R-83**.

¹² Meeting Notes, Workshop Monday 19 March 2001, BC Hydro Obligation to Serve Rate Schedule 1821 – Transmission Service customers with Self-Generation Capability, **R-83**.

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power is not arbitrated at the expense of ratepayers.¹³ The BCUC suggested the establishment of a customer baseline, based on either the historical energy consumption of the customer or the historical output of the generator, to identify how much generation could be considered idle or incremental and therefore available for sale into the market. In its Order, the BCUC encouraged both BC Hydro and customers to make every effort to agree on the proper base line.

32. A second issue that was raised by BC Hydro, but not dealt with directly by the BCUC, was Howe Sound's obligation under the 1989 Generation Agreement to generate [REDACTED] GWh/year in order to reduce its power purchases from BC Hydro. BC Hydro expressed the view that it could be "inappropriate for Howe Sound in particular to seek market opportunities for its idle generation when it is contractually obligated to be using that generation now to meet its own energy needs."¹⁴

33. The 1989 Generation Agreement did not, however, require Howe Sound to generate [REDACTED] GWh/year regardless of its economic impact on Howe Sound. The shortfall penalties were imposed on Howe Sound regardless of the reason for it falling short of the generation levels stipulated in the agreement. This was considered by Howe Sound, for example, when it reduced generation through the condensing portion of TG2 in 2000. In this situation, it was economical for Howe Sound to continue to incur monetary penalties under the 1989 Generation Agreement while at the same time selling electricity that would otherwise remain idle to Powerex on an hourly non-firm basis. BC Hydro eventually agreed with Howe Sound.

34. Howe Sound negotiated a customer baseline threshold with BC Hydro that reflected the amount of electricity that Howe Sound was generating under normal operating conditions at the time. BC Hydro explained, and Howe Sound understood, that the intent of the threshold was to identify the level of electricity generated by Howe Sound in normal operations so that no "existing" generation would be sold to Powerex.

¹³ BCUC Order G-38-01, **R-19**.

¹⁴ Letter from Ray Aldeguer (BC Hydro) to Robert Pellatt (BCUC) re: BC Hydro Obligation to Serve Rate Schedule 1821 Customers with Self-Generating Capability, 28 February 2001, at bates 021967, **R-82**.

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35. Howe Sound was very conscious of the fact that this was the first time an industrial customer of BC Hydro was permitted to sell incremental electricity to Powerex and that concerns remained about the impact on BC Hydro ratepayers. Howe Sound thus proceeded cautiously in its negotiations with BC Hydro.

36. At the time of negotiating, power production was related mainly to kraft mill performance, which controls the recovery boiler's steam generation with the difference in required steam load being made up by the power boiler. [REDACTED]

37. The initial figure that we contemplated proposing to BC Hydro during the negotiations was [REDACTED] MW, but we decided that number was too low as it included poor kraft mill operating days. Ultimately we decided to propose a threshold of [REDACTED] MW as we believed that reflected [REDACTED]

38. BC Hydro agreed with Howe Sound's proposed baseline and, along with Powerex, entered into a Consent and Enabling Agreement with Howe Sound on April 12, 2001.¹⁵ Under the agreement, Powerex would purchase from Howe Sound any MWs of electricity produced on any given hour above [REDACTED]

¹⁵ Purchase Transaction Enabling Agreement between Powerex Corp and Howe Sound General Partner Ltd., **R-84**; Consent and Electricity Purchase and Sale Agreement between Howe Sound, Powerex and BC Hydro, 12 April 2001, **R-85**.

¹⁶ See Consent and Electricity Purchase and Sale Agreement, 12 April 2001, at bates 021825, s.7, **R-85**.

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39. Once the sales agreement was in place, [REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]
[REDACTED]

40. [REDACTED]
[REDACTED]
[REDACTED]

[REDACTED] Below is a table of the annual sales of electricity made by Howe Sound to Powerex:¹⁷

Year	Sales to Powerex (GWh/year) ¹⁸
2001	[REDACTED]
2002	[REDACTED]

[REDACTED] BC Hydro Generation Shortfall Briefing, Re-Discussion with Larry Bell, at bates 021624, **R-76**.

¹⁷ Data for 2003-2007 taken from Email from Wendy Guilbault to Lester Dyck Re: Howe Sound Generation Agreement, April 11, 2008, **R-86**. I calculated the sales to Powerex in 2001 and 2002 by subtracting the [REDACTED] from the gross generation numbers I received from Fred Fominoff [REDACTED]

¹⁸ Sales were made on an hourly basis when generation exceeded [REDACTED] MW. Averaging the numbers in this table to an hourly rate on the basis of 8,760 hours (365 days of operating at 24 hours a day), Howe Sound sold at an average hourly rate [REDACTED]

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2003	
2004	
2005	
2006	
2007	
2008	

D. Howe Sound’s Use of Incremental Generation to Displace BC Hydro Purchases

41. In April 2006, BC Hydro implemented a stepped rate program for its industrial customers.¹⁹ Under this two-tiered rate program, a specific annual customer baseline load (called a “CBL”) was determined for each BC Hydro customer to reflect the customer’s historical consumption of electricity. BC Hydro customers would then pay for energy at the lower Tier 1 rate for purchases up to 90% of their CBL and the higher Tier 2 rate for purchases above the 90% of their CBL. The Tier 2 rate was roughly double the Tier 1 rate. The program was thus intended to incentivize customers to try to reduce their overall consumption so as to avoid purchasing the higher cost Tier 2 power. Under the previous rate structure, all power was purchased at the same levelized price and there was therefore much less of an incentive to reduce consumption.

42. It became evident to Howe Sound during the implementation of stepped rates that, with the high proposed price for Tier 2 power, [REDACTED]

[REDACTED]

[REDACTED]

¹⁹ BC Hydro, Application to Amend Tariff Supplement No. 74 (TS No. 74) – Customer Baseline Load (CBL) Determination Guidelines for RS 1823 Customers with Self-Generation Facilities, 2 November 2012, online: http://www.bchydro.com/content/dam/hydro/medialib/internet/documents/planning_regulatory/other_regulatory/2012_11_02_TS74_amend_appl_ff.PDF at 4-5, **R-87**.

[REDACTED]

[REDACTED]²⁰ [REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]

[REDACTED]²¹

43. Given the natural gas and Mid-C electricity prices at the time, [REDACTED]

[REDACTED]

[REDACTED] Howe Sound sold power to Powerex only on rare occasions (see table above).²²

E. The Joint Industry Electricity Steering Committee’s Concerns About Arbitrage

44. On September 16, 2008, BC Hydro filed an application with the BCUC to amend its Power Purchase Agreement (“PPA”) with FortisBC, a privately owned utility in British Columbia. FortisBC had filed for acceptance agreements it had concluded with two of its self-generating customers, the City of Nelson and Zellstoff Celgar, that allowed them to sell self-generated power while they were purchasing electricity from FortisBC. FortisBC’s resource stack is supplied in part by BC Hydro under the PPA, and BC Hydro was concerned that FortisBC’s self-generating customers would be arbitraging BC Hydro’s power. A written public hearing process was ordered, and the proceedings eventually led to BCUC Order G-48-09.²³

45. As the representative of large industrial customers of BC Hydro, JIESC had an interest in the proceeding because this had the potential to impact all BC Hydro

²⁰ Letter from Pierre Lamarche to Lester Dyck Re: Surplus Electricity Volume – Impact on Future CBL, dated June 21, 2006, **R-88**.

²¹ See also letter from Lester Dyck to Pierre Lamarche re: HSLP Generation letter agreement, dated March 14, 2007, **R-89**.

²² Letter from Pierre Lamarche to Lester Dyck Re: Notice of Excess Power Sales for Period September 2006 to March 2007, dated August 28, 2006, at bates 021651, **R-90**.

²³ BCUC, Order G-48-09 and Decision, in the Matter of an Application by BC Hydro to Amend Section 2.1 of Rate Schedule 3808 Power Purchase Agreement, May 6, 2009, p. 3, **R-32**.

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customers. JIESC requested intervener status on October 28, 2008.²⁴ As Chairman of JIESC at that time, my role in the proceeding was to provide guidance to the JIESC legal counsel and Executive Director on behalf of the members and to ensure that the membership was kept informed of the proceeding and was involved in any decisions that might have a serious impact on any of the members.

46. JIESC submitted its final argument on January 21, 2009.²⁵ JIESC was of the view that the plans of the City of Nelson and Zellstoff Celgar to sell the output of their existing generators at market prices and then replacing that generation with purchases from FortisBC would ultimately lead BC Hydro to incur increased costs by supplying increased electricity to FortisBC, which BC Hydro would then seek to recover from its customers. JIESC therefore supported BC Hydro's position, arguing that BC Hydro's low cost electricity "should be used to serve the needs of the residential, commercial and industrial consumers of electricity in the province, and not to facilitate arbitrage activity that earns profits for certain customers at the expense of increased costs to other customers."²⁶

²⁴ Letter from Daniel Potts to Erica Hamilton Re: British Columbia Hydro and Power Authority, Application to Amend RS#38089, Project Number 3698531, dated October 28, 2008, **R-91**.

²⁵ Final Argument, Application to Amend Section 2.1 of Rate Schedule 3808 PPA, Project Number 3698531, **R-92**.

²⁶ Final Argument, Application to Amend Section 2.1 of Rate Schedule 3808 PPA, Project Number 3698531, **R-92**.

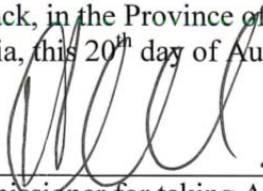
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F. Conclusion

47. In my various roles at Howe Sound from 1989 to 2009, I had extensive and consistent dealings with BC Hydro. At all times, I have known BC Hydro to operate in a fair, objective and transparent manner. Although we did not always agree on issues, BC Hydro was always forthcoming with the reasons for their positions and was always open to considering our point of view.

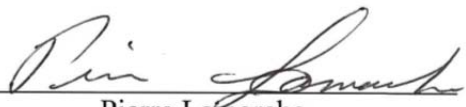
48. I affirm that the information provided above is true and correct.

SWORN BEFORE ME at the City of)
Chilliwack, in the Province of British)
Columbia, this 20th day of August, 2014.)



A Commissioner for taking Affidavits for)
British Columbia.)

HEATHER E. WAAL
Notary Public
9086 Young Road
Chilliwack, BC V2P 4R5
604-795-0070
PERMANENT COMMISSION



Pierre Lamarche