October 15, 2002

Mr. Stephen Wright, Administrator
Bonneville Power Administration
Routing A-1
P.O. Box 3621
Portland, Oregon 97208

Mr. Frank Cassidy, Jr., Chairman
Northwest Power Planning Council
851 S.W. 6th Avenue, Suite 1100
Portland, Oregon 97204-1248

SUBJECT: The Future Role of the Bonneville Power Administration:
A Regional Dialogue on Options for Service After 2006

Dear Administrator Wright and Chairman Cassidy:

My client, the Canby Utility Board ("Canby"), submits the following response to the invitation from BPA and the Northwest Power Planning Council (the "Council") to comment on the future role of BPA and options for post-2006 service.

We address our comments to the Joint Utility Customer Proposal (sometimes called "the settlement proposal"), which calls for BPA to offer new 20-year power sales contracts to its customers.

At the outset, we note that the invitation, published in June by BPA and the Council, requested that interested parties *not* offer proposals requiring changes in federal statute. Those directions precluded parties, such as Canby, from submitting proposals to restructure BPA, and foreclosed a debate on broad reforms to the Pacific Northwest power system.

The last time the region engaged in such a process was more than 20 years ago, when Congress considered the Northwest Power Act. In the intervening years, the electric utility industry has changed dramatically. We believe it would have been productive for BPA and the Council to encourage and then evaluate proposals involving significant changes to BPA's statutes.

Canby would have welcomed an opportunity, for example, to work with others in developing a proposal for a customer-owned cooperative or other entity to lease the turbine-generators at federal dams for 20 or more years (and bypass BPA's Power Business Line).

We are aware that in the last decade, different parties in the region have discussed purchasing the federal dams outright. But that option has proven too expensive and complicated. A long-term lease, to our way of thinking, offered a more pragmatic alternative for transferring control to the region. Perhaps that option, too, would have met insurmountable obstacles, but at least the customers could have participated in a public process to consider fundamental changes to the way that the federal power system is operated in the Pacific Northwest.

Instead of considering innovative alternatives, BPA and the Council opted for a more restrictive dialogue. As a result, the choices for post-2006 service are limited. Only one comprehensive proposal is now on the table: the Joint Utility Customer Proposal, submitted by a group of public power and investor-owned utilities ("IOUs").

The overall goals of the Joint Utility Customer Proposal are ones that Canby endorses: providing some semblance of stability for utilities, and settling outstanding litigation. The proposal contemplates that BPA will continue to offer "requirements" service for small utilities, like Canby, which have no generation of their own. BPA would also offer a "Slice" product, by which utilities can purchase a share of the output of the federal power system (and pay a share of its costs).

The proposal, however, contains several defective provisions, as explained in more detail below. We therefore request that BPA treat the proposal only as a starting place from which to develop long-term contracts, and not as the "end game."

The Proposal's Goals

The proposal, according to proponents, is important for two reasons:

First, "we all learned during the electricity crisis of 2000-2001 how expensive it is when BPA is forced to buy power on the wholesale market during an energy shortage. The proponents therefore believe BPA should allocate a portion of the federal power system to the utilities "undiluted" by the high costs of BPA's market purchases.

“With a portion of the federal output as a solid, affordable foundation, utilities could then decide how best to meet the remainder of their customers’ loads, now and into the future.” Page 2 of Proposal Executive Summary.

Second, “this is an opportunity to set aside decades of strife between preference utilities and investor-owned utilities.” Page 2 of Proposal Executive Summary.

To achieve their goals, the utilities propose to settle litigation regarding contracts signed pursuant to BPA’s Power Subscription Strategy. The litigation is pending before the U.S. Court of Appeals for the Ninth Circuit. At issue is BPA’s Supplemental Record of Decision (2000), as well as agreements BPA signed with the IOUs to "settle" (terminate) the Residential Exchange Program until 2011. Under the settlement, BPA gave the IOUs a combination of power and money as a replacement.

The Direct Service Industries (“DSIs”) also filed a petition challenging the IOU contracts. They have not formally endorsed the Joint Utility Customer Proposal, which allocates 650 aMW to them.

The proposal now before BPA is a revised version. In response to an earlier draft, BPA raised a number of legal issues. See, letter dated July 2, 2002, from BPA senior vice president Paul Norman to Portland General Electric vice president Ron Johnson.

The utilities then deleted or changed some elements to accommodate BPA’s legal concerns, and they describe the revised proposal as "consistent with existing statutes." Proposal at II.8, page 1. Nonetheless, Canby believes that significant, legal issues remain unresolved.

Summary of Canby's Concerns
Canby believes the proposal has three, fundamental defects:

First, we believe the proposal violates BPA’s statutory obligations under the Northwest Power Act. 16 U.S.C. § 839 et seq. Specifically, we do not believe BPA can disregard the Residential Exchange methodology under the Act and approve a formula for cash payments to the IOUs that is based on a new set of variables, not contemplated by Congress.

In addition, the settlement assumes that BPA can approve those payments without ever triggering the "rate test" under section 7(b)(2) of the Act. We believe the decision whether or not to trigger the rate test must be made within a rate case and cannot be pre-determined in contracts, as the settlement contemplates.

Second, we believe the cost of the settlement is far too high. We fear that the formula, which is tied to the index price of natural gas and other variables, will prove expensive, so expensive that the settlement will *increase* the retail rates of public power utilities above the comparable rates of IOUs. Only a handful of public power utilities currently face this dilemma. However, if the rate differential, which is now mostly favorable to public power, disappears, then so will customer support for public power. That development will not likely occur at once. Our concern is with a steady, irreversible, deterioration of public power rates.

Third, we believe it is difficult, if not impossible, for small public power customers of BPA to manage or assess the risks associated with 20-year contracts offered as part of this proposal.

One possible solution is for BPA to create a "firewall" between those utilities that want to sign 20-year contracts and those utilities, such as Canby, which want to be shielded from paying the excessive costs of the proposed IOU settlement. We discuss this option later in our comments. If BPA can create such a firewall, then Canby would likely become neutral on the proposal.

Another possibility: let public power utilities, such as Canby, receive the same benefits as the IOUs. Under this approach, Canby would agree for 20 years not to buy BPA power for its residential and small-farm loads. In exchange, BPA would pay Canby a revenue stream calculated under the settlement formula.

In sum, if BPA were to adopt the Joint Utility Customer Proposal as the *only* contract option available for post-2006 service, Canby would likely oppose the settlement in any forum available. We therefore request that BPA examine a broad range of alternatives.

Legal Issues

The settlement proposal would send a stream of revenue to the IOUs and would terminate the Residential Exchange Program for 20 years. That provision is probably the single, most-important part of the proposal.

Begun in 1980 under the Northwest Power Act, the Residential Exchange Program was an attempt to bring "equity" to residential and small farm rates in the Pacific Northwest. 16 U.S.C. § 839c(c).

The program is a paper transaction. BPA "buys" power from the IOUs at their average system cost and "sells" back an identical quantity of power at a cost-based "exchange rate." The BPA rate reflects the lower costs of generating electricity from the federal power system. The benefits to the IOUs are passed on directly to their residential and small farm customers. The cost of the BPA program is then paid by public power utilities and the DSIs in their rates.

But the amount of money in the Residential Exchange Program is subject to a "rate ceiling" called the "rate test." Contained in section 7(b)(2) of the Act, it requires BPA to evaluate the effects of the Residential Exchange Program against a hypothetical scenario in which the Northwest Power Act was never passed.

The purpose of this test is to protect public power utilities. If the rate test "triggers," then BPA reduces the IOU financial benefits. The rate test, admittedly cumbersome and obscure, limited the scope of the Residential Exchange Program in the 1980s and 1990s.

In 2000, however, the IOUs and BPA agreed to terminate the program for the 2002-2011 period. The settlement, part of BPA's Subscription Strategy, called for BPA to replace the program by giving the IOUs money and power in the five years (2002-2006). For the second five years (2007-2011), BPA would offer a yet-to-be-determined combination of money and power.

The money for the IOUs in the current, five-year rate period was not subject to the 7(b)(2) rate test. The reason: BPA said it was settling the Residential Exchange Program pursuant to its broad administrative authority under section 2(f) of the Bonneville Project Act and reaffirmed under section 9(a) of the Northwest Power Act. Thus, the cost of the settlement was an expense, like any other at BPA, and was not subject to the 7(b)(2) rate test trigger.

Ironically, many of the public power groups that now support the settlement on the table in this process opposed the last settlement to the Residential Exchange Program -- and BPA's reasoning -- precisely because it removed the IOU revenue stream from the 7(b)(2) rate test. See, for example, the briefs filed by the Western Public Agencies Group ("WPAG") in the 2002 rate case. WPAG unsuccessfully argued that BPA could not develop its own formula for sending money to the IOUs and then remove that money from the computation of the rate test. BPA's approach, WPAG said, would render the rate test provisions of the Northwest Power Act meaningless. See, WP-02-R-WA-01 at 7. See, also, the Administrator's Record of Decision, WP-02-A-02 at 12-28 and 12-29.

The Joint Utility Customer Proposal, now on the table in this process, institutionalizes the very conduct that WPAG complained about. It calls for BPA to pay money to the IOUs to terminate the Residential Exchange Program for another 20 years. In the proposal, there is no contract "re-opener" to adjust the payments pursuant to the section 7(b)(2) rate test. The formula for IOU payments is locked in concrete.

Making matters worse, the revenue stream is not based on the difference between the average system cost and BPA's cost-of-service rate. It is based instead on the cost of a proxy power plant, fired by natural gas.

The formula is calculated by multiplying 3,300 average megawatts (aMW) of IOU residential and small farm load by a number that represents the difference between the cost of a gas turbine and the "Slice" rate. Put another way: the turbine cost, minus the Slice rate, equals the number that is multiplied against IOU loads to calculate the annual BPA payments. We note that the 3,300-aMW figure is 50 percent greater than the amount used to calculate IOU benefits in the current rate period (2002-2006).

In the formula, the construction and capacity costs of the turbine (a combined-cycle plant) are fixed. The fuel costs, however, go up and down according to a moving, 10-year, historic average. The higher that natural gas prices go in the future, the more money the IOUs receive. The lower the Slice rate, the more money the IOUs receive. The reverse is true. A decrease in gas prices and an increase in the Slice rate will reduce IOU benefits.

Whatever one wants to think of this formula, it is not spelled out in the Northwest Power Act. The utilities themselves make little pretense that the proposal is somehow rooted in the statute. The IOU contracts, the proposal states, are "designed to provide benefits similar to the value of a slice contract to the residential and small farm customers of the investor-owned utility." Page 3 of Proposal Executive Summary.

But a Slice contract is not what Congress had in mind when it adopted the Residential Exchange Program. Congress could, of course, change the provisions of the Act and mandate that BPA offer a "virtual Slice" contract to IOU residential and small-farm customers. Our point is simply that it has not done so, and the approach taken by the Joint Utility Customer proposal conflicts with the statutory rate directives of the Northwest Power Act.

Furthermore, the proposal improperly limits the BPA Administrator's discretion and precludes BPA from ever triggering the 7(b)(2) rate test as a result of the IOU settlement costs. The proposal assumes that BPA will *permanently* classify the settlement costs as an ordinary expense (not subject to the trigger), as opposed to a proxy for the Residential Exchange (which is subject to the trigger). In other words, it assumes BPA will treat the IOU costs under the proposed settlement as it did in the 2002 rate case.

BPA, in our opinion, is obligated to make this determination in a rate case, not in a contract. During the course of the rate case, BPA must decide on the record how to classify the settlement costs. The effect of the customer proposal is to remove BPA's choice for 20 years and to preclude utilities, such as Canby, from raising this issue within a rate case hearing and before the U.S. Court of Appeals for the Ninth Circuit. Canby believes this portion of the proposal clearly violates section 7(i) of the Northwest Power Act, which gives interested parties the right, among other things, to cross examine witnesses. 16 U.S.C. § 839e(i).

Policy Issues

Another troubling aspect of the settlement is the amount of money BPA must pay the IOUs. The amount is estimated at $285 million in the first year (2007). As part of the settlement, BPA would sell power to only one IOU: Portland General Electric. That sale, for roughly 140 aMW, would last for five years. When the sale expires in 2011, all IOUs in the region, including PGE, would receive only cash ("financial benefits").

The $285-million figure, even in BPA's assessment, is an inflated number. It is based on what the IOUs currently receive from BPA under anomalous circumstances. The number reflects energy prices during the tumultuous period when West Coast prices skyrocketed. It was during those months that BPA "bought down" the IOUs' right to purchase BPA power and sent an even larger stream of revenue to the companies. BPA itself has acknowledged the unusually large amount of money currently paid to the IOUs in the current rate period. See, the Administrator's letter to IOU executives, October 10, 2002. In an earlier letter, BPA said the proposed amount of cash payments to the IOUs in 2007 would likely translate into a significant increase in BPA's power rates. See, page 6 of the BPA letter to PGE, July 2, 2002.

But there are more financial risks to public power. The reason is that the IOU payments will escalate or decline during the 20-year term according to the price of natural gas and the "Slice" rate.

Unfortunately, gas forecasts strongly suggest that the market price for natural gas will rise steadily and sharply. If that should happen, the IOU settlement becomes even more lucrative to the companies.

If the settlement were implemented today, the price of natural gas would be pegged at $2.10 per mmbtu (the 10-year, rolling average between 1992-2001). The Northwest Power Planning Council, however, estimates that the price of gas in the next two decades will significantly exceed the historic, 10-year average. According to the Council's Draft Fuel Price Forecast, the medium, 20-year forecast between 2005-2025 is $3.13 per mmbtu. That's a 50-percent increase from the historic average used to compute the starting IOU benefits.

To be sure, the use of a 10-year, historic average will insulate BPA from a sudden jump in IOU benefits. Furthermore, the settlement places a 5-year cap on IOU cash benefits (ending in 2011). See Attachment D of the proposal. After the cap expires, however, the Council Forecast suggests that BPA will have to pay the IOUs more and more money -- a revenue stream reflecting a steady, significant increase in natural gas prices.

But there are other problems, as well. If the Slice rate goes down, the benefits to the IOUs go up, too. As BPA pays off the nuclear power plant debt of Energy Northwest (formerly the Washington Public Power Supply System), its costs may stabilize or even decrease.

The combination of a low Slice rate *and* rising natural gas prices could force BPA to pay unprecedented sums to the IOUs, perhaps as much as $500 or $600 million per year, twice the initial payment in 2007.

Yet another problem is that the settlement attempts to "freeze" the technology used to calculate the cost of the proxy natural gas turbine. The gas turbine is based on current, available technology, with a heat rate of 7,100 btu per kWh for a combined-cycle plant. Proposal at VI.4 and VI.7, pages 14-15. Improvements in technology are not reflected in the formula. The settlement therefore precludes any adjustment for more efficient plants. Ironically, those changes would likely be reflected in the average system cost of the IOUs under the conventional calculation of the Residential Exchange Program (assuming the IOUs invested in new generation).

Finally, we note that comparing the Joint Utility Customer Proposal with alternatives is extremely difficult. A utility wishing to perform due diligence would face unusual obstacles. It would have to assess natural gas prices and the Slice rate in order to arrive at a projected cost of the IOU settlement. Then, it would have to assess the impact of the settlement costs on BPA's public power rates. Then, it would have to compare that rate with alternatives. The due diligence process is difficult enough when dealing with BPA, given the political pressures it faces. But a formula, based on variables not subject to control by BPA or the utility, makes that process even more uncertain.

Due diligence is not an academic exercise. Under the proposal, utilities must decide -- possibly by next year -- whether to turn in their existing contracts for new ones. Some contracts, like the one held by Canby, expire in 2006. Most public power contracts expire in 2011. What happens to those utilities who decide not to sign new 20-year contracts? What benefits, if any, will they forego by hanging on to their existing agreements? What tangible advantages will the new contracts provide? Utilities need answers to those questions before they can make intelligent decisions.

The Firewall and Other Options

One possible solution is for BPA to create a firewall between the Joint Utility Customer Proposal and other post-2006 contract options, thus allowing utilities who are not satisfied with the settlement to select different terms and conditions.

Under this approach, BPA could let public power utilities sign up, if they wished, for the Joint Utility Customer option. Those utilities would waive their statutory rights to litigate section 7(b)(2) issues and would agree to pay the IOUs a revenue stream based on the calculations in the settlement formula.

For those utilities, like Canby, which find those terms unacceptable, BPA would conduct a conventional rate analysis and would employ the 7(b)(2) rate trigger under the circumstances spelled out in the Northwest Power Act.

The IOUs would therefore receive two streams of revenue. The first would come from public power utilities that endorse the settlement proposal and sign the contracts. The second stream would come from customers that want to receive the protections they are entitled to receive under the Act.

Another possibility: let public power utilities, such as Canby, receive the same benefits as the IOUs. Under this approach, Canby would agree not to buy power from BPA for its residential and small-farm loads. In exchange, BPA would pay Canby a revenue stream calculated under the settlement formula.

The point of suggesting those alternatives is to provide public power utilities with more choices. If, for instance, they support the proposal as written, they can waive their rights and buy power from BPA for 20 years under the terms and conditions of the settlement. On the other hand, if they want to receive money, they can sign up for the proposal and receive annual cash payments, as if they were an IOU. And if they don't like the settlement and don't want to receive cash, they can buy power from BPA under traditional service.

There may be other avenues as well that reach the same result. We propose such an approach here to stimulate discussion within BPA and within the utility community about viable alternatives to the settlement.

Conclusion

The Joint Utility Customer proposal contains some positive characteristics: it attempts to end allocation disputes between public power and IOUs; and it provides stability for those public power customers who greatly value their historic relationship with BPA.

But the proposal contains fatal flaws. It precludes BPA from triggering the 7(b)(2) rate test, and thus prevents BPA from reducing IOU payments. It ties the IOU revenue stream to a proxy gas turbine that may look as inefficient 10 or 15 years from now as a simple-cycle thermal plant looks today.

Under the Northwest Power Act, public power utilities have an opportunity to participate in a section 7(i) rate case. Under the proposal, however, they are precluded from raising certain issues. They trade their statutory rights for the putative benefits of new 20-year contracts. The new contracts limit BPA's authority to adjust the revenue stream to the IOUs, and force BPA to pay money based on natural gas prices, which move up or down according to weather, consumer demand and other forces beyond its control.

We do not see that such an approach brings certainty or predictability to public power customers. Once a utility signs the contract, it has committed itself and its retail customers to a course of action from which there is no exit, no adjustment.

Canby therefore requests that BPA examine a broad range of alternatives to the proposal. We believe there must be a better way of achieving regional consensus than the adoption of a proposal that settles litigation in a way that jeopardizes the future of public power.

Sincerely,

Dan Seligman
Attorney at Law

cc: Mr. Dirk Borges, general manager, Canby Utility Board