<u>Reducing BPA's Wholesale Power Rate Increases</u>

Managing through a short-term crisis to ensure long-term benefits

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Last January, I sent out a letter to Northwest citizens that caused some shock waves. That was my intent. I believe it is important to warn of bad news while there is still time to take actions that can lessen the impact. At the time, I said that, if certain conditions persisted, BPA's customers--Pacific Northwest utilities and direct-service industries--could face a significant rate increase for the wholesale power they buy from the Bonneville Power Administration. The figures I cited then were for an average rate increase of 60 percent over the five-year rate period that starts this coming October. I cautioned that the increase could be as high as 90 percent in the first year.

Unfortunately, the situation has worsened. It now appears possible that, without the kinds of action that I am about to call for today, the first-year increase could be 250 percent or more. If that were to occur, it likely would translate into doubling the retail rates in many utility service areas.

An increase of this magnitude would have widespread economic consequences. Already, we are seeing some businesses curtail operations or even close as a result of high energy prices. With such an increase, we'd surely see more businesses close and more job losses, with people with lower incomes suffering disproportionately. In addition, a weak economy frequently translates into less public support for environmental protection.

I don't believe these consequences are acceptable. More importantly, I don't believe they are inevitable. That's why I am here today to call for some very specific actions and to call on all stakeholders in the Pacific Northwest to own part of the process that will help us avert an economic blow to our region. I believe we can get the rate increase down to a manageable level, but we need to make some tough decisions, and we have little more than 60 days to do this. BPA's rates, which will go into effect in October, should be submitted to the Federal Energy Regulatory Commission in June.

First, let me review what has led us to this point. Some of it you already know. We are experiencing the second worst water year in 72 years of record-keeping. According to a report released by the Northwest Power Planning Council, if the drought persists, the hydropower generating capability in the Northwest from March through August will be 4,700 megawatts below normal over those months--the equivalent power consumed by four Seattles. The implications are ominous since the Northwest relies on hydropower for nearly three-quarters of its electricity.

But the summer drought is only the immediate crisis. We are becoming increasingly concerned about power supply for the coming winter. Canadian reservoirs, which store half the system's water, are extremely low this year, which means we could start next year with less than a full tank. If that were to happen, and especially if we have a second dry year in a row, electricity reliability wouldn't be the only thing at risk. Low reservoir levels also raise concerns for salmon and steelhead next year.

Low water combined with a tight wholesale power market and skyrocketing power prices is a devastating combination. The fiasco in California has helped drive wholesale electricity prices to unprecedented levels. When we completed our new Subscription power contracts last fall, BPA's contractual obligations added up to approximately 11,000 megawatts--about 3,000 megawatts more than our current generating resources can provide on a firm basis. The only way we can meet our obligations is to buy the vast majority of the additional power in a wholesale power market where supplies are tight and prices are sky high. This is what is driving rates up.

This year, due to the high power prices, BPA has not been able to purchase sufficient power to ensure system reliability. Consequently, we have periodically declared power system emergencies. These emergency declarations have allowed us to increase power generation from the river and reduce operations that offer benefits to migrating juvenile fish. The increased generation has reduced the amount of water that is normally stored at this time of year so that it can be used to augment spring and summer river flows. While there may be some impact on fish, by far the major impact on fish is the drought itself, not the emergency power operations. We are continuing to implement all other aspects of the federal measures for fish recovery.

Currently, we are operating the river on an emergency basis, and we can continue some fish spill or flow augmentation only as long as water volume does not dip much below current estimates. The record low runoff is a water volume of 53 million-acre feet. As of last week, the volume forecasts had dropped to 56 million-acre feet, which is 53 percent of the normal runoff. This severely limits our flexibility to do much more than meet power needs.

Beyond the current drought, high power prices are expected to continue until significant new generation and additional conservation measures are put in place. This will take a couple of years at best. And, we can’t expect much help from Canada, which also is suffering drought, nor any help from California, which is in the throes of an electricity restructuring crisis.

We must focus instead on what we can control if we expect to minimize the size of the coming wholesale rate increase. The most immediate and direct way to decrease the size of next year's rate increase is quite simply to decrease the amount of power BPA has to buy in the market.

We already have taken a number of extraordinary steps in this direction. We have promoted conservation aggressively and sought voluntary curtailments in power use. We have begun to purchase curtailments from our direct service industrial customers and from irrigators who are served by our utility customers. We have offered innovative incentives for development of conservation and renewables, and we have engaged in beneficial 2-for-1 power exchanges with California. We also are continuing to collaborate with the Corps of Engineers and Bureau of Reclamation to increase the productive capability of the federal power system.

But even these extraordinary measures haven't been enough in the face of the triple whammy of historic low water conditions, an extremely tight power market and enormous volatility in power prices. We now need to up the ante if we are to get the rate increase for the next year down to a manageable level.

We literally are at a crossroads, and the region has essentially two options. Path A is to wait and see where market prices settle in June. Under this scenario, we'd rely on cost recovery mechanisms to kick up rates if prices remain high. We would take no special actions and we wouldn't push or negotiate with our customer groups to secure load reductions. The risk is that, if market prices stay the same, we could expect to see a first year rate increase in the 200 to 300 percent range, and possibly greater.

Then there's Path B, which calls for aggressive and immediate steps to reduce the size of the rate increase by reducing the amount of electricity demand put on BPA. Under this scenario, BPA would not have to buy as large an amount of power in a very expensive wholesale power market. It's a strategy that calls on our customers and other stakeholders to share a sacrifice by reducing their demands for power. It requires significant, and I mean **significant**, contributions from all customer groups. It could keep the first-year rate increase below 100 percent. I believe Path B is the course we must choose, so let me lay out some of the actions that will move us along this path.

As I discuss this path, let me outline the principles I believe are key to reducing rates. First, rates must be set to cover costs if we are to avoid creating a credit problem, which could lead to refusals to sell to us in the future. We must also cover our costs to ensure we preserve the benefits of the federal hydropower system over the long term, which is essentially the bottom line.

Second, the situation is urgent. We must act quickly because rates must be in effect this coming October 1. As I said earlier, our rate proposal is due in to the Federal Energy Regulatory Commission in June.

Third, our problem is caused by a significant exposure to a volatile market in the first one-to-two years of the rate period. If we are to manage a reduction in the rate increase, we must reduce our exposure to that market by reducing demand for energy, increasing our supply and minimizing the short and long-term damage to the region's economy.

Fourth, contributions to the solution are needed from all customers. We can't play a game a chicken where each party waits for the other to step forward. If that happens, no one will step forward. Each group must contribute if we are to preserve an equitable distribution of the benefits of our hydropower resource.

Actions needed

Given those principles, let me outline the actions we as a region need to take. We need a three-pronged approach that includes curtailment of power use, conservation--or more efficient use of power--and power buybacks. This needs to happen across all four states, across public and private power, and across all sectors of energy use--industrial, commercial, agricultural and residential. It will take all of us working together if we are to avoid severe economic hardships for the region. Let me be clear; what I am about to suggest requires a great deal of sacrifice, but the alternative is to suffer far more serious consequences. We are beginning negotiations now with our customers. If people don't come to the table with reductions in their demand for electricity, a very large and very damaging rate increase is inevitable.

First, we are calling on our public utility customers to make a contribution to the solution. We need every utility customer to reduce its Subscription purchases from BPA by 5 to 10 percent. BPA's rate increases will spur some of this reduction, but more focused efforts are needed if we are going to achieve significant savings. We are willing to make modest incentive payments to help achieve this, but the incentive payments cannot be large or they will defeat the intended effect.

We are running several demand-side management initiatives including a conservation and renewables discount, a conservation augmentation program and a demand exchange program. In addition, we now are discussing the potential for new programs to provide incentives to our public utility customers to adopt innovative retail rate structures that encourage their consumers to conserve energy.

Second, we are calling on investor-owned utilities to make a contribution. When our new rates go into effect this October, investor-owned utilities--or IOUs--will receive sizable benefits from BPA for their residential and small farm customers as a result of a the residential exchange. Under this program, as it is set out in the Subscription period, 1,900 average megawatts of financial and power benefits are scheduled to go to the IOUs. But, because of dramatic changes in market prices, the estimated value of these benefits has increased enormously since they were negotiated a year ago. By 2002, the value will be 10 times higher than the negotiations intended to capture. As a result, IOUs are in a position to reduce their Subscription demand significantly and still enjoy benefits in excess of anything they have experienced in the 20-year history of the residential exchange.

Third, we are asking our direct service industries--or DSIs--to agree not to take power from us for up to the first two years of the rate period in return for certain limited compensation to the companies and their workers. It is our expectation that the companies would not be able to operate given a potential tripling of our rates anyway. Coming to an agreement now that the plants will not operate would allow BPA to avoid making power purchases, thereby decreasing our rates for all remaining customers.

It is not our intention to drive the aluminum industry out of the region, but we are continuing to encourage the industry to move off of BPA power supplies after the 2006 rate period because we do not have a statutory obligation to continue to serve them. The customers we are obligated to serve--the region's retail electric utilities--need more than our current generation resources can produce. We will work with these companies to help them find a means to operate profitably in the long run without relying on BPA.

Almost all of the DSIs are already shut down until this fall, and their power is being remarketed to support Northwest needs during the current drought. These buydowns played a key role in keeping the lights on this winter and in maintaining reservoir levels higher than they otherwise would have been.

Fourth, I am urging all citizens of the Northwest to heed the call of our governors to reduce electricity consumption by 10 percent through eliminating waste and using electricity more efficiently. There are a number of common sense measures we can all take, and one good place to start right now is to go out and replace conventional light bulbs with compact fluorescents, which consume about 20 percent of the electricity used by regular bulbs for the same amount of light.

These four sets of actions that I have described are urgently needed between now and June if we are to avert grave near-term economic consequences. These are difficult actions. But, with hindsight, we can learn from the problems California experienced and seek to avoid them. We need to do everything we can to avoid power purchases in this incredibly expensive market. We also need to make sure we set rates high enough so we can cover our costs to assure generators get paid when they deliver power on a contractual basis so we don't put our credit at risk.

We also are looking to longer-term solutions that will help lead to lowering the incredible wholesale power supply prices we are currently experiencing. The fundamental problem is supply and demand being out of balance. Prompt infrastructure investments are needed in generating resources, especially gas-fired and wind-powered generation; gas pipeline capacity and storage; electric power transmission facilities; and energy conservation measures.

BPA’s rates will now be set on a six-month basis based on our actual costs. If wholesale power prices can be brought down quickly, through infrastructure investments and other actions, then our rates will come down in the future. The faster these actions can be taken, the quicker our rates can come down.

We already have begun plans to shore up the transmission infrastructure, and we are negotiating to purchase the output from combustion turbines and new renewable resources. We also are increasing our efforts to encourage and procure energy efficiency. We are working to implement these actions quickly, but at best, some actions, such as securing more generation, will take one-to-two years.

That's why I am calling for cooperation and sacrifices for the next two years from all parties BPA serves. If the region cannot or will not take the actions necessary to reduce the rate hike, we have no recourse but to set our rates to recover our costs. BPA does not receive subsidies from taxpayers. We must wholly cover our costs with revenues we receive from sales of power and transmission. We are obligated to repay, with interest, all capital investments that have been made by the federal government in the facilities that are part of the Northwest's federal power system. Already, we have drawn on our financial reserves heavily this winter, and more of the same still may be ahead of us.

Some have suggested that we can simply fail to pay one of our largest creditors--the U.S. Treasury--rather than declare power emergencies or raise rates sharply. While there is no absolute guarantee we will make our full Treasury payment this October, I believe we should use all management tools available to do so. Our ability to pay our debt in full and on time is the best protection the Northwest has to preserve the benefits of the Columbia River hydropower system for the region. There are interests outside the region that want to see the benefits of this system directed toward other purposes. They could take great political advantage of the opportunity that would be presented if BPA did not cover its costs. One consequence could be the loss of cost-based rates for power from the federal system. We have seen how exorbitant market rates can be. If that were to happen, the region would be looking at far higher rate increases than we are now facing.

So, in closing, let me underscore the message. We are on a trajectory that poses grave consequences for the Pacific Northwest, primarily due to extraordinary conditions beyond our control--extremely low water, an extremely tight power supply and extremely high wholesale power prices. We believe the only alternative to a huge rate hike is to reduce our exposure to the market in the first two years of the next five-year rate period by reducing the Subscription demand on BPA. It will take major contributions from all our customers if we are to prevent a triple digit rate increase. And, we will need to make these very difficult decisions very quickly.

Finally, we believe this proposal, while not an easy one to achieve, fairly balances the sacrifices the region needs and does not unfairly hit one customer group or one state over others. I know putting these proposals into place will be tough, but I believe the consequences of not taking this path will even be tougher.