Department of Energy

Bonneville Power Administration
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EXECUTIVE OFFICE

March 26, 2003

In reply refer to: P-6

Dear Customers and Other Interested Parties:

The Bonneville Power Administration (BPA) held three public meetings over the past month where we discussed the causes of our current financial condition and alternative solutions. At the last meeting, BPA suggested a way forward that we believe has real promise to meet the needs expressed by customers and others who attended these meetings. It particularly addresses the importance of minimizing any rate increase in the face of our weakened regional economy. Unfortunately, the fact that we said “no” to the recommendation that we halt the Safety Net Cost Recovery Adjustment Clause (SN CRAC) process seems to have overshadowed the fact that we also suggested an alternative way forward. While our approach would be the subject of the SN CRAC process, I want to describe this alternative more fully so it can be better understood.

But first, I want to summarize some of the major messages we heard at these meetings. We heard that utilities, industries and individual ratepayers are reeling from rate increases and can’t handle more. We were told that the economic situation is so bad that BPA should not count on getting more total revenue if it raises rates, because of the ultimate rate effects on retail loads. We heard that BPA should stop the current SN CRAC process and focus on reducing costs.

We heard that any SN CRAC should be year-by-year, not multi-year. We heard strong opposition to a rate increase in 2004 that is driven by BPA’s concerns about possible financial results in 2005 and 2006. We were advised that the region cannot afford to have BPA seek to fully meet historical financial standards in these extraordinary times. We heard that a significant problem with the SN CRAC proposal is the belief that it takes the pressure off BPA to reduce costs, because BPA gets an automatic source of revenue to cover higher costs. We heard that BPA must focus heavily on further cost reductions, including its own internal costs as well as all the other costs reflected in power rates.

We also heard from environmental advocates and tribal representatives that expenditures for necessary fish and wildlife mitigation measures should not be cut but instead should be stabilized, and that BPA should comply with the Fish Funding Principles. We heard concerns that BPA should continue to pay Treasury so that we preserve the long-term benefits of the system for the Pacific Northwest.

The problems with a further rate increase have been made clear to us. It is also clear that capturing as much as reasonably possible of the $754 million in cost reductions and revenue improvements described by customers would help to minimize the need for rate increases. We have been working for months to achieve these cuts and revenue improvements, and we promise to continue to work diligently – both internally and with all other parties – to pursue them. We are getting closer on some reductions, but they are not "in the bag" yet.

We clearly heard the request to halt the SN CRAC process now, in order to focus exclusively on achieving cost reductions. However, as we said at these meetings, we remain concerned that postponement of the SN CRAC process is financially perilous for BPA in FY2004 because of the current lack of certainty about several key opportunities for cost reductions, most of which are not in BPA's sole control. Consequently, if these cost reductions or revenue enhancements do not materialize, BPA and the region would be confronting a substantially higher rate increase proposal next year than the one we are proposing now. Even with a much higher rate increase, we could still face a significant risk of missing next year's Treasury payment. These concerns are detailed in Attachment #2.

For this and other reasons, we suggested at the last meeting that there is another way of assuring that cost reductions could result in a substantially reduced effective rate increase, or possibly no effective rate increase in 2004 if we have good luck on water conditions and market prices. We remain open to this and other proposals on the rate case, but I want to clarify the four-point approach we suggested at the March 14 meeting:

1. A variable and contingent rate mechanism could achieve the most important goal of the customer proposal: a significant reduction in any rate increase in October if major cost reductions can be achieved, and possibly no rate increase if cost reductions are coupled with the actual realization of good water conditions and favorable market prices.

2. We could use a TPP standard that is lower than we have historically used, as incorporated in the initial SN CRAC proposal. The determination of the final TPP standard will be part of the SN CRAC process.

3. We could use a rate mechanism that would keep pressure on BPA costs by precluding BPA from recovering any excess controllable internal operating costs in the SN CRAC, if those costs exceed further reduced limits for 2003-2006.

4. Most importantly, we would redouble our efforts to capture prudent cost reductions, both in those internal costs that we control and in working with our generation partners, regional utilities, and others to bring down the costs we don't directly control. As a part of this, we will create an opportunity for customers and other stakeholders to review and comment on the trade-offs of borrowing, deferring expenses, and additional cost reductions in a manner than can impact final rate levels.

Here's how the approach could work if it were pursued.

First, in the formal SN CRAC process, parties could work on a rate design that would produce a rate that depends on actual financial results in 2003, as already included in the initial staff proposal. We could also look forward and adjust the 2004 rate to capture those additional cost reductions for 2004-2006 that are secured by this August. We believe that this variable and contingent rate design approach could allow for the lowest possible rate while still ensuring a sufficiently high probability of payment to Treasury. The variable approach to the SN CRAC also appears to respond to the strong customer objection to a rate increase in 2004 that is driven by forecasts of financial performance in 2005 and 2006.

The forward-looking contingent aspect of this approach could make the proposed 2004 rates lower if, for example, the investor-owned utilities agree to restructure the BPA financial benefits for their residential and small farm consumers. If water conditions and prices we receive for our secondary sales substantially improve between now and August 1, the variable aspect of the rate structure would incorporate that improvement through a lower SN CRAC increase.

Depending on what cost reductions are achieved, and other changes that occur in BPA's financial picture between now and August, this approach could lead to a substantially reduced effective rate increase in 2004. Cost reductions, coupled with good water conditions and favorable market prices, could result in no rate increase. See Attachment #1 for specific actions that may affect either variable or contingent rates.

Second, with respect to the customer concern that the extraordinary economic times call for a departure from historical financial standards, our initial proposal for the SN CRAC already takes more risk with respect to making our annual Treasury payment than we have taken historically. Our proposal brings TPP up to just 50 percent over the next three years – far lower than historical standards. This low TPP is justified by the multi-year and variable nature of the proposal, which allows us to demonstrate that we have an 80 percent chance of making all Treasury payments, including any "misses," by the end of 2006. We are calling this new measure the Treasury Recovery Probability (or TRP). The issue of whether this is the right standard to use and the level of risk we should take will be a part of the SN CRAC process.

Third, to address the customer concern about reducing pressure on BPA internal costs, we are open to a mechanism that could preclude BPA from recovering any excess controllable internal operating costs in the SN CRAC, if those costs exceed the further reduced limits for 2003-2006.

We would also be willing to institute monthly reporting on costs, at least quarterly meetings to discuss progress on cost reductions and BPA workshops each August that would bring regional focus and attention to BPA, the Corps of Engineers, Bureau of Reclamation, Energy Northwest, fish and wildlife mitigation programs, and other operating and program expenses before the level of any SN CRAC is finalized.

Finally, and most importantly, we will respond to the customer appeal that BPA focus heavily on further cost reductions and on potentially deferring costs in an effort to capture maximum cost reductions by August 1, inside and outside BPA. As a part of this, we will create forums for customers and other stakeholders to discuss costs and the use of ENW refinancing. These forums will explore the trade-offs and risks associated with further cost reductions, cost deferrals and borrowing. Due to the formula rate design described above, results from this process could be incorporated in any final rate levels for FY2004 and for the remainder of the rate period. Attachment #1 includes the opportunities for actions to lower costs or increase revenues. We will conclude these forums with decisions that will be included in the October rates.

As we proceed with our efforts to minimize the proposed SN CRAC increase, we must not lose sight of potential near and long-term impacts. Further reductions in operations and maintenance costs of our generating partners can reduce rates in the near term, but at the expense of long-term reliability, safety and generation capability. Similarly, use of borrowing to hold down rates now increases rates in the long term while passing costs along to future ratepayers and potentially affecting BPA's future rate levels. We also want to minimize the risk of including overly optimistic cost or revenue assumptions. In seeking to find a way out of our current problems, we want to limit the risk of sowing the seeds for the next financial crisis.

With the joint efforts of BPA and the region to further reduce costs, we believe the alternative approach described above has the potential to substantially reduce the need for a 2004 rate increase. Our approach would keep pressure on BPA's costs and would not give BPA an "easy out" for cost increases. In addition to other proposals, BPA's rates staff are submitting testimony in the rate case that opens the door to formal consideration of such an approach in the rate case. We hope it will receive positive consideration by the parties during the rate proceeding. In the meantime, please join us as we continue to work toward maximum prudent cost reductions.

Sincerely,

Stephen J. Wright

Stephen J. Wright
Administrator and Chief Executive Officer

2 Attachments