



## **REQUEST FOR FEEDBACK**

### **7(b)(2) Methodology**

#### **I. Background**

Section 7(b)(2) of the Northwest Power Act (NWPAct) contains provisions for rate protection from certain elements of the NWPAct, principally the Residential Exchange Program (REP). The REP allows Pacific Northwest utilities to provide benefits to their qualifying residential and small farm loads by purchasing relatively inexpensive Federal power from BPA and selling an equal amount of power back to BPA at the utility's average system cost of resources.

On January 23, 1984, BPA published a notice of its proposed legal interpretation of section 7(b)(2) (49 Fed. Reg. 2811). Comments and reply comments were received from interested parties. Subsequently, on May 31, 1984, BPA released its legal interpretation (published on June 8, 1984, 49 Fed. Reg. 23998). The interpretation resolves the basic legal issues required to implement section 7(b)(2).

On February 29, 1984, BPA issued its "Section 7(b)(2) Proposed Rate Test Methodology." A notice of the "Proposed Section 7(b)(2) Implementation Methodology, Public Hearings, and Opportunities for Public Review and Comment" was published on March 25, 1984, in 49 Fed. Reg. 11235. That notice initiated a formal hearing under section 7(i) of the NWPAct. 16 U.S.C. 839e(i). Subsequently, on August 17, 1984, BPA published the Implementation Methodology and Record of Decision (b-2-84-F-02).

Beginning with the 1985 rate case, BPA has performed the rate test each time BPA has conducted section 7(i) rate proceedings that determined Priority Firm rates (exclusive of CRAC adjustments). In six of the nine rate proceedings, significant issues regarding the rate test have been considered. Prior to the 2002 rate proceeding, BPA sought to resolve disputes arising under the REP by offering REP settlement agreements to investor-owned utilities participating in the REP. Those settlement agreements were challenged before the U.S. Court of Appeals for the Ninth Circuit. On May 3, 2007, the court issued opinions that held that the settlement agreements were inconsistent with the NWPAct and that BPA's allocation of REP settlement costs was contrary to section 7 of the NWPAct.

In order to be prepared if the court's opinions are ultimately upheld after petitions for rehearing are resolved, BPA is preparing to reinstitute the REP by offering Residential Purchase and Sale Agreements (RPSAs) to investor-owned utilities. In addition to the RPSAs, BPA is conducting a consultation to reform the Average System Cost Methodology concurrent with this reconsideration of the section 7(b)(2) rate test.

The current Legal Interpretation and Implementation Methodology are posted on BPA's web site at [www.bpa.gov/corporate/pubs/RODS/1984/](http://www.bpa.gov/corporate/pubs/RODS/1984/)

The NWPAct provides that whenever a Pacific Northwest electric utility offers to sell electric power to BPA at its average system cost of resources, BPA shall purchase such power and, in return, shall offer to sell an equivalent amount of power to the utility for resale to that utility's qualifying residential and farm consumers. 16 U.S.C. 839c(c)(1). The NWPAct also requires BPA to conduct a rate test that potentially protects BPA's preference customers from some of the costs of the REP and can be an important element in determining the rate at which BPA sells power to the exchanging utilities.



Section 7(b)(2) of the NWPA, 16 U.S.C. 839e(b)(2), requires that after July 1, 1985, the rates charged by BPA for firm power sold to public body, cooperative and Federal agency customers (7(b)(2) customers) may not exceed, in total, as determined by the BPA Administrator, such customers' power costs for their general requirements, under five specified assumptions. In other words, the Administrator, before establishing rates to be charged the 7(b)(2) customers for wholesale firm power sold them after July 1, 1985, must compare two numbers: the average amount BPA would charge them over a five-year period pursuant to the general ratemaking guidelines found elsewhere in the NWPA (the Program Case rate)<sup>1</sup> and the average cost of power to them over the same five-year period pursuant to those guidelines and, in addition, pursuant to the five assumptions listed in section 7(b)(2) (the 7(b)(2) Case rate). If, upon comparison of the two numbers, the 7(b)(2) Case rate is smaller than the net Program Case rate, then the 7(b)(2) customers will be charged the sum representing the total Program Case rate less the difference between the net Program Case rate and the 7(b)(2) Case rate. The purpose of section 7(b)(2), then, is to afford BPA's preference customers rate protection in the event that other provisions of the NWPA (in particular, the REP with the investor-owned utilities) would otherwise increase the price of power sold them.

The five assumptions are:

1. The public body and cooperative customers' general requirements had included during such 5-year period the DSI loads which are: (1) served by the Administrator; and, (2) located within or adjacent to the geographic service boundaries of such public bodies and cooperatives;
2. Public body, cooperative, and Federal agency customers were served, during such 5-year period, with FBS resources not obligated to other entities under contracts existing as of the effective date of the NWPA (during the remaining term of such contracts) excluding obligations to DSI loads included in this paragraph;
3. No purchases or sales by the Administrator as provided in Section 5(c) were made during such 5-year period;
4. All resources that would have been required, during such 5-year period, to meet remaining general requirements of the public body, cooperative, and Federal agency customers (other than requirements met by the available FBS resources determined under this paragraph) were: (1) purchased from such customers by the Administrator pursuant to Section 6; or (2) not committed to load pursuant to Section 5(b), and were the least expensive resources owned or purchased by public bodies or cooperatives; and any additional resources were obtained at the average cost of all other new resources acquired by the Administrator; and,
5. The quantifiable monetary savings, during such 5-year period, to public body, cooperative and Federal agency customers resulting from: (1) reduced public body and cooperative financing

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<sup>1</sup> Section 7(b)(2) also requires that the program case rate be reduced by certain 7(g) costs before it (net program case rate) is compared with the second number. See BPA Legal Interpretation, 49 Fed. Reg. 23998, 24002 (June 8, 1984).



costs as applied to the total amount of resources, other than FBS resources, identified under this paragraph; and, (2) reserve benefits as a result of the Administrator's actions under the NWPAs were not achieved.

As noted above, BPA developed a Section 7(b)(2) Legal Interpretation and Section 7(b)(2) Implementation Methodology in 1984. The Interpretation and Methodology guide BPA in performing the rate test. In addition, many issues have been considered and decided in subsequent rate proceedings. The combined record of the Methodology and subsequent rate case records of decision have been the subject of continuing dispute in succeeding rate proceedings.

## **II. The Reconsideration Process**

BPA is currently requesting informal feedback on the Section 7(b)(2) Legal Interpretation and Implementation Methodology. The Administrator will formally reconsider the Section 7(b)(2) Legal Interpretation and Implementation Methodology in BPA's upcoming power rate proceeding. In a concurrent process, the Administrator is conducting a consultation process on the Average System Cost Methodology. Both of these methodologies are key components in determining the level of benefits that will be paid to utilities participating in the REP.

## **III. Issues:**

BPA is seeking feedback on the following issues. This list is not exclusive and feedback on any additional issues is welcome.

### **1. Should the portion of the output Mid-Columbia hydro resources sold to PNW investor-owned utilities be included in the 7(b)(2)(D) resource stack as available to the BPA to serve 7(b)(2) customer loads?**

The Legal Interpretation determined that Type 2 resources "are those resources owned or purchased by the 7(b)(2) customers, and not dedicated to their own loads." Certain publicly-owned utilities have sold shares of their hydro resources to investor-owned utilities, and therefore these shares are "not dedicated to their own loads." Therefore, under the current Legal Interpretation, these resources are considered to be Type 2 resources and are included in the 7(b)(2)(D) resource stack. Since these resources tend to be cheaper than alternative resources, the result is lower 7(b)(2) Case rates resulting in an increased rate test trigger. However, section 7(b)(2)(D) uses a different phrase: "not committed to load pursuant to Section 5(b)." The investor-owned utilities are eligible 5(b) customers, and have committed these Mid-Columbia purchases to their load. Therefore, an issue has been raised whether these resources should no longer be treated as Type 2 resources.

### **2. Should the Program Case load forecast for preference customer load be increased for conservation that BPA has purchased since December 5, 1980, the enactment date of the NWPAs?**

Section 7(b)(2)(D) specifies that resources "purchased from [preference] customers by the Administrator pursuant to Section 6" are to be included in the 7(b)(2)(D) resource stack. BPA purchases conservation resources pursuant to Section 6. In order to place these resources in the stack to be used to serve 7(b)(2)



customer loads, as needed, the Implementation Methodology specifies that this conservation be removed from the preference customer load forecast. This results in 7(b)(2) Case loads being greater than Program Case loads. Section 7(b)(2)(D) says “all resources that would have been required, during such five-year period...” An issue has been raised whether preference customer loads should be increased for purchased conservation, or whether only conservation that was or is acquired in the particular rate case period plus the ensuing 4 years be included in the 7(b)(2) resource stack. A related issue would then be what are the “applicable” 7(g) cost of conservation that are to be subtracted before performing the rate test?

A separate issue is, should the loads continue to be adjusted for past conservation, whether conservation that is beyond its useful lifespan should be excluded from the load adjustment.

Another issue arises from the annual amounts of conservation investments within the 7(b)(2) resource stack being expensed to a significant degree. Should the conservation be 100 percent capitalized and financed through bonds issued by the Joint Operating Agency (JOA). The rationale for this proposed change is that in the first year of the rate test, a large amount of conservation resources can be chosen to meet 7(b)(2) case loads. The current implementation practice is to expense a substantial portion of each year’s conservation investment. Proponents of the 100 percent capitalization and debt financed change argue that the JOA would not expense this level of conservation expenditures in a single year (multiple years of investments) due to the resultant “rate shock.”

**3. Should section 7(b)(2)(E) reserve benefits be limited to reserves provided by Direct Service Industry (DSI) loads?**

At the time of the enactment of the NWPA, contracts with DSIs provided a number of reserve benefits to BPA, including plant delay reserves, capacity reserves, and interruptible energy reserves. Since 1996, the contracts with DSIs have no longer provided many of those reserve benefits. An issue has been raised whether BPA should expand its recognition of reserve benefits to include other sources, such as surplus sales.

**4. What DSI loads should BPA consider in application of section 7(b)(2)(A)?**

Section 7(b)(2)(A) refers to “the public body and cooperative customers’ general requirements had included during such five-year period the direct service industrial customer loads which are served by the Administrator...” BPA has interpreted “are served” as the DSI loads forecast to be served during the rate test period. BPA requests comments on whether the distinction in tense between “had included” and “are served” might alternatively mean the DSI loads that “are served” at the time of the enactment of section 7(b)(2).

**5. Should BPA consider natural consequences in the rate test? Should additional or expanded natural consequences be considered? Are the current natural consequences implemented appropriately?**

The current Implementation Methodology identifies three natural consequences in performing the rate test: demand elasticities, amount of surplus firm power available, and size of non-firm energy markets. The implementation of demand elasticities has been limited to potential increased production at operating aluminum



smelters if a lower 7(b)(2) rates should warrant. An issue has been raised whether demand elasticities should consider potential DSI load at plants not operating or being served by non-Federal power.

**6. Over what period should the rate test be considered?**

Section 7(b)(2) specifies that the rate test should consider "...any year after July 1, 1985, plus the ensuing four years..." BPA has implemented this as applicable to the rate period plus the ensuing 4 years. An issue has been raised whether the rate test should be limited to the first year of the rate period plus the ensuing 4 years without respect to the length of the rate period.

**7. Should BPA reconsider the 7(g) costs that reduce the Program Case rate?**

The rate test uses the Program Case rate exclusive of amounts charged those customers for costs specified in section 7(g) of the NWPA. Those specified costs are conservation, resource and conservation credits (billing credits), experimental resources, and uncontrollable events. Arguments concerning the scope of "uncontrollable events" have been argued in several rate cases since 1984. An issue has been raised whether the scope of "uncontrollable events" should be modified. Further, it has been asked whether it is appropriate to remove any costs from the Program Case rate if those same costs remain in the 7(b)(2) Case rates.



**8. Should the individual annual Program Case and 7(b)(2) Case rates be converted to constant dollars before averaging for comparison?**

The rate test Methodology discounts each year's rates in both the Program Case and the 7(b)(2) Case by the nominal interest forecast before computing the simple average. An issue has been raised whether BPA should convert the rates to constant dollars prior to discounting and averaging.

**9. Should residual costs of additions from the 7(b)(2)(D) resource stack from prior rate cases be recognized in subsequent rate tests?**

When conducting the rate test, BPA does not recognize any effects of adding resources from the resource stack in prior rate cases. BPA treats each rate case's rate test as a stand-alone event with no recognition of costs from prior rate cases. An issue has been raised whether some recognition of costs of added resources from prior rate tests should be recognized in subsequent years' rate tests.

**10. If BPA continues to provide financial payments to DSI customers in lieu of power, should those payments be subtracted from the 7(b)(2) Case revenue requirement?**

In the 7(b)(2) Case, the DSI loads are served by their local utility. Therefore, BPA subtracts payments to the DSIs from the 7(b)(2) Case revenue requirement because in the 7(b)(2) Case, BPA does not have a contractual relationship with the DSIs. An issue has been raised whether this is the proper treatment of these costs.

**11. If a DSI is served through a surplus sale to an adjacent preference customer, should the load be treated as a surplus load or a DSI load?**

Currently, BPA sells surplus power to Clallam PUD for transfer to Port Townsend Paper, a DSI. The rate test does not currently recognize this load as a DSI load since the sale to Port Townsend is not made under the IP rate schedule. An issue has been raised whether this loads should be recognized as a DSI load in the 7(b)(2) Case.

**12. The rate test considers Federal Base System power used for Program Case firm surplus sales as available to serve 7(b)(2) customer loads. How should the rate test treat requirements sales to preference customer load if that sale is made at a 7(f) rate?**

At times, BPA sells requirements power to preference customers under the FPS rate schedule. Examples of such sales are the pre-Subscription contracts. The rate test recognized this surplus power as an available FBS resource to serve 7(b)(2) customer loads and would use this power before utilizing the 7(b)(2)(D) resource stack. An issue has been raised whether the power used to serve these requirements loads should be available to serve 7(b)(2) customer loads, as well as whether pre-Subscription customers should be included as 7(b)(2) customers.



### **13. Should the treatment of Type 1 and Type 2 resources be modified?**

The current methodology brings Type 1 and Type 2 resources on as discrete “lumps.” Any extra energy recognized due to the discrete lump is sold at market prices. Under current conditions, market prices are often higher than the cost of the added resources, creating a cost benefit for the 7(b)(2) Case. When adopted in 1984, BPA sold surplus power under an established standard rate or spill rate, usually much less than the cost of the added resources. This treatment mitigated the cost of the added resource, but did not provide a cost benefit to the 7(b)(2) Case. An issue has been raised whether this treatment continues to be appropriate given the differences in market conditions.

### **14. Should the 7(b)(3) allocation of the rate protection amount be modified to include an allocation to surplus sales?**

Although this is not an Implementation Methodology issue, it deals with the results of the rate test and may have an impact on the PF Exchange rate under which the 5(c) sales are made to exchanging utilities. Section 7(b)(3) states that “[a]ny amounts not charged to public body, cooperative, and Federal agency customers by reason of paragraph (2) of this subsection shall be recovered through supplemental rate charges for all other power sold by the Administrator to all customers.” While surplus sales are encompassed by “all other power sold,” BPA has not allocated any 7(b)(3) rate protection amounts to surplus sales for two reasons. First, these sales are made at negotiated market rates that would not be receptive to “supplemental rate charges.” Second, since “supplemental rate charges” cannot be added to market-priced sales, any allocation of costs to these sales would reduce the revenue credits to preference customers. Such an allocation would result in the preference customers bearing some of costs of their own rate protection. An issue has been raised whether rate protection dollars should be allocated to surplus sales.

### **15. Should the implementation methodology deal with how REP settlements are treated in the rate test?**

BPA has to set rates at least every 5 years. An interpretation of the court’s ruling is that as long as BPA settles issues in accordance with 5(c) and 7(b) then there should not be a problem with the court in receiving approval of such settlements. In addition, BPA has often settled REP claims with public utilities. An issue has been raised that the methodology should address procedures for the treatment of these settlements in the rate test.