Grays Harbor PUD

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October 31, 2006

Mr. Stephen J. Wright
Administrator
Bonneville Power Administration
P.O. Box 3621
Portland, OR 97208

Dear Steve:

We are pleased to provide you with the attached comments regarding the Bonneville Power Administration's *Long-Term Regional Dialogue Policy Proposal*, dated July 13, 2006. Our comments are divided into three parts: 1) the IOU Residential Exchange Program; 2) the Slice Product Post-2011; and 3) the Benefits for Direct Service Industrial Customers Post-2011.

Grays Harbor PUD (the District) is the sixth largest PUD in terms of retail revenues in the state of Washington with over 40,000 customers, $100 million in gross revenues, 1,735 miles of transmission and distribution lines and 38 substations. We are a preference customer of Bonneville presently receiving our power under slice-block contract, but are not a full-requirements customer.

Comments regarding the IOU Residential Exchange Program

The Northwest's Federal Power system, though originally funded by the Treasury, is paid for through the rates charged to BPA's preference power customers and not by taxpayers. One of the IOU's arguments is that the taxpayers in their service territories help pay for the federal power system, which is why they deserve a portion of the power. This argument is based upon false premises and should be rejected.

Due to the success of the IOUs in selling this inaccurate argument that their customers should receive benefits of a system "their taxes pay for" (which they don't), BPA and regional politicians determined to come up with a vehicle to get power or money to the residential and small farm customers of the IOUs.

The residential exchange program (REP) was created as a means to reduce the disparity in rates paid by customers of Consumer-owned utilities and those paid by customers of IOUs. It was originally proposed in 1977, three years before it passed. It was unacceptable to Consumer-owned utilities, the utilities with preference, because there was no protection to guarantee that these same Consumer-owned utilities would not see increased costs and then have their communities' dollars flow to the IOUs' customers.

The condition required by Consumer-owned utilities, before they finally agreed to the REP as included in the 1980 Northwest Power Act, is the "§7(b)(2) rate test." The purpose of this test was to guarantee that the REP did not cause costs paid by Consumer-owned utilities to be higher than they would have been without the Act.

For twenty years BPA adhered to the provisions in the 1980 Act and the REP worked as intended by Congress. However, as the disparity between BPA and IOU system costs diminished and the level of REP payments decreased, the IOUs became dissatisfied. The REP was successful from the perspective of the Consumer-owned utilities, but not from that of the IOUs who were trying to get more. Ultimately, it is not in the IOUs' best interests to have lower-cost and reliable Consumer-owned utilities as neighbors, because it might encourage their ratepayers to form their own utility.

BPA abandoned the explicit Congressional statutory language on how to apply and determine the REP in 2000-2001. This was done to settle the possibility of a lawsuit threatened by the IOUs that was never filed. By BPA's own calculation in 1999, under the REP the IOUs would have received amounts ranging from $25-63 million (average $45 million) between 2001 and 2006. This was an expected result, because BPA's costs were going up and the disparity was disappearing (remember that during the late 1990s BPA's costs were higher than the market and even preference customers were looking to get power elsewhere).

This average payment of $45 million did not meet the expectations of the IOUs. BPA abandoned the methodology based on comparison of IOU average system cost with BPA's PF rate and instead implemented a calculation that was originally projected to generate close to $145 million per year, comparable to REP amounts in the late 1980's and 1990s. Due to the ensuing Western Energy Crisis in 2000-01, this $145 million ballooned to over $325 million per year for the 2001-06-rate period. This money was distributed to IOUs in the region regardless of whether or not their average system costs were more or less than BPA's.

With the abandonment by BPA of the "§7(b)(2) rate test," there was no protection for the customers of Consumer-owned utilities, who ended up paying much more for power from BPA just to pay these REP benefits, resulting in subsidization of IOU rates that in many cases were lower than those of the utilities providing the subsidy. This was in addition to other cost increases. It is important to emphasize that these are not benefits from BPA, but cash taken from Consumer-owned utility ratepayers' pockets.

Several Consumer-owned utilities sued BPA to stop this unlawful giveaway to the IOUs. The ruling on this suit is still pending, so the bleeding continues. Had BPA followed the law under the Act and properly calculated the benefits to the IOUs, those benefits would be dramatically lower than current amounts, and potentially $0. BPA now proposes an initial benefit to the IOUs of $250 million that would potentially escalate annually.

It is our understanding that based on the Regional Dialogue Proposal analysis done by BPA, IOU benefits would be zero in 7 of 24 cases. The average benefit under all scenarios, using a "§7(b)(2) rate test" designed to materially increase the benefits BPA could pay the IOUs, was determined to be $162 million. Additionally, we understand

that in 40 settlements of its payment obligation under the statutory REP calculations using current methodologies and assumptions, the average annual benefit payment to the IOUs was approximately $33 million per year. BPA's proposed starting point of $250 million seems to have been pulled from thin air rather than based on a rational analysis of what would be intended under the law.

Concern: For BPA to distort the REP valuation to this degree represents a wholesale disregard of its preference customers, its mission and the intent of Congress as outlined in the 1980 Act.

Conclusion: BPA should devise an IOU payment that is comparable to what would result from the operation and intent of the REP and §7(b)(2) rate test. For BPA to do anything less makes its motives suspect and invites another legal challenge.

Grays Harbor PUD is one of the Consumer-owned Preference Utilities that has suffered financially over the past several years from BPA's abandonment of the REP methodology specified in the 1980 Act. We applaud BPA's efforts to manage costs and lower its rates for 2007-09. Unfortunately, we are perplexed by BPA's continued efforts to afford benefits to the IOUs to which they are not entitled.

Comments regarding the Slice Product Post-2011

For BPA, Slice contracts executed in October 2001 provided a timely and convenient way to reduce the financial and volumetric risks inherent in the unpredictable water cycles that affect the hydro system from year to year. Coincidentally, Slice implementation occurred about the same time as the Western energy crisis, when BPA found itself in financial trouble. Predictable, monthly Slice payments help BPA make on-time payments to the Treasury each year, which is one of BPA's highest obligations.

Grays Harbor PUD was among 25 utilities that chose to purchase the Slice product under a 10-year contract. For the District, Slice offered a way to integrate replacement power after the sale of the Centralia coal-fired steam plant in 2000, when the District had no choice but to sell its minority interest in the plant. Slice offered the District a sensible and fair product, based on the principle of receiving a pro rata share of the federal system output for a pro rata share of costs.

Slice has forced the District to become quite sophisticated in its scheduling and management of generating resources. The District works closely with its scheduling agent, The Energy Authority (formerly Power Resource Managers, owned by Grays Harbor, Franklin and Benton PUDs), and has developed sound risk management policies and practices related to its use of the Slice product.

Under Regional Dialogue, BPA is proposing to limit the "flexibility" of the Slice product post-2011. The term "flexibility" is not well defined, however. Customers have already agreed to give up dynamic scheduling (i.e., essentially real-time, automatic signals) of their slice output, which would have provided ultimate flexibility of scheduling

generation to loads. Other attributes of Slice that could fall within the category of "flexibility" include operating reserves, energy imbalance, and hour-ahead scheduling.

It is imperative that BPA understand how the District and other Slice purchasers utilize the so-called "flexibility" of Slice to follow their loads. Utilities can forecast loads within a range of accuracy, but must respond moment to moment as customers unpredictably turn their electricity on and off. This type of load following "flexibility" is what the District needs from the Slice product. Hour-ahead scheduling, operating reserves and energy imbalance all provide necessary tools for managing load variability. Without these abilities, the Slice product becomes far less useful to the District and other utilities that need to follow load and integrate other resources.

Renewable portfolio standards (RPS) are likely to be imposed on the District in the near future. Without the Slice product, the District will have difficulty integrating intermittent renewable resources such as wind power into its portfolio. Slice provides the "flexibility" needed to deal with those times when intermittent resources are not generating. Without Slice, any intermittent renewable resources purchased by the District will have to be firmed with gas-fired generation, a paradox for achieving the environmental gains envisioned by renewable resource advocates.

Under Regional Dialogue, BPA is contemplating ways to allocate the federal based system output under Tier 1 rates, and to supplement shortages of energy with Tier 2 resources. There is much concern in the region that federal generation resources will be inadequate for future needs. Again, Slice and its "flexibility" provides a solution by allowing some customers to develop non-federal resources that will take pressure off BPA as it serves full-requirements customers' needs. Slice is good for all customers of BPA, because it provides diversity of load service strategies in the region.

The District heard from Steve Oliver at a WPUDA conference presentation in May 2006 that specific staff at BPA is not supportive of the Slice product. The District is of the opinion that, over the past five years, Slice customers have developed very productive, professional working relations with BPA operations staff in managing Slice operations. Slice customers have made staff and monetary contributions toward improving the operation of the FBS. Earlier challenges have been overcome through working together collaboratively with BPA.

It is not in the best interest of the region to allow specific staff at BPA to determine the fate of a product as versatile and successful as Slice in meeting the needs of preference customers who choose to utilize its "flexibility." This is especially true when considering how valuable the Slice contracts have been to BPA in the aftermath of the energy crisis.

Concern: We are very concerned that the proposed changes to the Slice product post-2011 will render it practically useless to the District in managing our risks, our rates, our loads and our resources in the foreseeable future. The District would like to continue managing its resources using the current "flexibility" of Slice, as it provides our ratepayers more local control over resources and rates.

Conclusion: The Slice product has been operated successfully by preference customers large and small for the last six years, and it is no longer an "*experimental*" product. Increased regional knowledge of FCRPS operations benefits the region as well as BPA, as Slice customers work closely with BPA to manage their respective shares of the system output. A product that is currently working successfully, such as the Slice product, should not be singled out for unwarranted modifications, especially when Slice has the best likelihood of enabling more non-federal resource integration in the region post-2011.

Comments regarding the Benefits for Direct Service Industrial Customers Post-2011

Under the Regional Power Act of 1980, the "Direct Service Industrial" (DSI) customers of BPA were granted purchase rights to power from the FBS for twenty years. This was to end with contract termination on September 30, 2001. There was also an apparent understanding related to the Act, which encouraged the DSIs to develop their own resources in order to replace power from the FBS post-2001.

The DSIs went from interruptible contracts to receiving a firm power allotment from BPA, which seemed reasonable at the time. Unfortunately, the DSIs did not develop alternative resources to BPA, and instead came back with more demands for power for the 2001-06 rate period. Rather than inform the DSIs that they were no longer eligible for any power as stipulated in the Act, BPA offered the DSIs 1500 aMWs of power for the period from 2001-06.

In spite of this allotment of power to the DSIs, which was resold by these DSIs into the market at outrageous mark-ups during the Western energy crisis, all but two aluminum companies and the Port Townsend pulp mill closed anyway. BPA, through its decision to provide the DSIs power when they weren't entitled to it, caused additional financial hardship to Consumer-owned utilities, exacerbating the negative effects of the Western energy crisis, and did not guarantee the production of one ingot of aluminum.

BPA had no obligation to sell power to the DSIs after September 30, 2001 and the DSIs had no right to buy power from BPA after that time. BPA, in spite of strenuous objection by its preference customers, again offered power or subsidies for the 2007-09 rate period when it had no obligation to do so. When the Consumer-owned preference utilities begrudgingly agreed to $40 million in subsidies, BPA unilaterally raised this to $59 million.

We believe that BPA's rates charged to its preference and priority customers during the FY 2007-09 rate period are again improperly inflated because of costs incurred unlawfully and allocated unlawfully to those rates. This is a consequence of BPA's decision to again provide "service benefits" to a small number of DSI entities. These benefits do not come from BPA, but from the pockets of the ratepayers of Consumer-owned utilities. There are no guarantees that any of these DSIs will survive even with the subsidies, as they can only cover a small portion of the required energy costs of these DSIs.

Other industries continue to struggle and go out of business due to high operating or high power costs, but they are not eligible for subsidies from BPA. As a matter of record, Grays Harbor has seen the demise of another large log Weyerhaeuser sawmill, a large Boise siding plant and a Weyerhaeuser Pulp Mill. These closures have resulted in over 500 direct family wage job losses and huge community impacts. For BPA to continue to single out one customer group for subsidies, based upon historical relationships that have no bearing today, is absurd.

Concern: We are very concerned that, unless the remaining DSI subsidized power sales go away by 2009, BPA will again agree to subsidize these entities for 2010, 2011 and beyond. These subsidies make no sense under the present economic circumstances in which the Northwest finds itself. No other industries have access to these subsidies.

There are more appropriate venues for subsidies than taking money from the pockets of the Consumer-owned utility ratepayers. We understand that the Washington state legislature passed a bill providing tax breaks to Alcoa. We believe that is a legitimate, if perhaps unwise, political action for the Washington legislature to take. Likewise, the Congress could legitimately, if unwisely, pass an act that would allocate a portion of the federal government's tax revenues to subsidize DSIs.

Without such legislation, BPA is engaging in discrimination in favor of large, wealthy, politically powerful companies. BPA is, in effect, imposing a tax on the retail ratepayers, including businesses, that we purchase BPA power to serve. There are far more of these businesses, providing far more jobs, in our service territory, not to mention those of other preference customers, than there are DSIs and DSI employees.

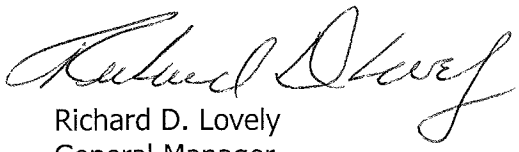
BPA is engaging in wealth transfers without any statutory authority to do so. We believe this is unfair and inexcusable. We urge the Administrator to abandon these practices once and for all.

Conclusion: Grays Harbor PUD implores the Administrator to resist the political pressure the DSIs bring to bear for price reductions and subsidies. It would be fundamentally unfair, and legally dubious as well, to provide power post-2011 to the DSIs in an allocated system under a tiered rate construct. It is time for BPA to acknowledge that while many of the DSIs have been longstanding customers of BPA, preference customers can no longer afford to provide the subsidy necessary to provide them with a power supply at a price lower than market. It is time for the DSIs to make their way, as so many other Northwest industries have been forced to do, without a subsidy extracted by BPA from the pockets of its preference customers.

Thank you for this opportunity to comment on BPA's *Long-Term Regional Dialogue Policy Proposal*. We appreciate the manner in which BPA has actively engaged its

customers in this important process, and hope our comments will be useful as BPA considers the impacts of its decisions on its customers. If you have questions or seek clarification on any of these comments, please feel free to contact me.

Sincerely,



Richard D. Lovely
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