B O N N E V I L L E   P O W E R   A D M I N I S T R A T I O N

issuealert

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Highlights of BPA's FY 2007-2009 power rate case

The Bonneville Power Administration has begun the process to set wholesale power rates for the three-year period beginning with fiscal year 2007 and running through fiscal year 2009. All current power rate schedules expire with the close of fiscal year 2006.

This Issue Alert provides a broad overview of major issues to be addressed before final rates are determined. (A separate Backgrounder, "The fiscal year 2007-2009 rate case process," provides information about the process and schedule of hearings and comment.)

The role of adjustable rates

Prior to 2000, it was relatively easy to conclude a rate case with an average rate that represented what customers would actually pay in the rate period. That is not the case today because the level of risk and unpredictability is so much greater. Because of that unpredictability, BPA moved from a fixed rate to an adjustable rate in 2002 with the addition of cost recovery adjustment clauses known as CRACs.

An adjustable rate allows BPA to set base rates lower because adjustments can be triggered if necessary to cover contingencies for which costs can vary widely – such as extreme water conditions, market price fluctuations, generation going off line and litigation. Such adjustments would be invoked only when these contingencies occur. The alternative would be for BPA to set rates higher to build up reserves to cover these potential contingencies.

While the down side of this system is that there is no guarantee of rate stability, many BPA customers have said they prefer adjustable rates to higher stable rates.

A more unpredictable world

Not only are there more risks today, but they are of greater magnitude. Where variations in market price were once in thousands of dollars, they are now in the tens of thousands. And, where once the market was relatively steady, it has proven hugely volatile and difficult to predict.

Market volatility combined with the unpredictability of water supply creates major uncertainty over what BPA can earn from surplus power. Much of the system's surplus is sold outside the region. Revenues from these sales are used to keep (non-Slice) preference rates in the Northwest down. Today, how much these revenues will contribute is far less certain.

Another major new risk is litigation over the 2004 Federal Columbia River Power System Biological Opinion issued by NOAA Fisheries. The biological opinion governs federal hydro operations on behalf of fish listed as threatened or endangered. Court-ordered changes to hydro operations in 2006 and beyond could prove costly.

Approaches to managing risk

BPA is proposing three methods to account for risks. One is a cost recovery adjustment clause, similar to those in the current rate period, to ensure that costs can be recovered if net accumulated power revenues fall below a certain level for reasons such as low water or poor market prices for surplus power.

The adjustment clause would have a cap of $300 million annually.

Second, BPA is accounting for the risk of potentially costly court-ordered fish operations by proposing a mechanism that would increase the annual $300 million cost recovery cap to allow for recovery of increased costs or reduced revenues resulting from a specific set of events related to the litigation over the biological opinion. The adjustment in the cap would not exceed the mount of the net impacts of these changes.

The initial rate proposal also contains a dividend distribution mechanism to return money to customers if accumulated net power revenues exceed an amount roughly equivalent to a BPA reserve level of $800 million during the rate period.

The role of the initial proposal

Under the initial proposal, BPA is proposing wholesale power rates across the 2007-2009 period averaging about $30 a megawatt-hour for priority firm power. This figure will change. It is important to remember the word "*initial*." The proposal is a starting point and subject to a formal legal process. The input from this process will inform the BPA administrator when he makes a final rate decision.

The initial proposal carries the expectation that the first year of the rate period will have the highest rate due to the relatively low reserve levels BPA is forecasting at the beginning of the rate period.

BPA has been diligent in holding power-related internal costs down, but other costs have risen as BPA has provided additional benefits to the region. Also, some costs were pushed out into the future as a means to help the regional economy during a serious recession. These costs are now coming due.

Since the 1997-2001 rate period, there have been huge increases in fish costs, in benefits going to residential and small-farm consumers of investor-owned utilities, higher conservation and renewable costs and larger public utility loads, creating less surplus power. Operations and maintenance costs for the generating system have also been going up at about the rate of inflation.

Throughout the rate-setting process, BPA's goal and effort will be focused on keeping rates as low as possible for the benefit of the regional economy while still delivering on its mission. Northwest retail rates remain among the lowest in the nation and are expected to compare even more favorably as the rest of the nation faces large increases due to the dependence on finite supplies of gas and oil.

The role liquidity can play

The final rate can change based on several factors, and some are within the region's control. Customers and others can play a key role in keeping rates down. Securing tools and agreements that increase BPA's access to cash may be the single largest opportunity to bring rates down. If BPA can achieve $300 million in fully flexible liquidity, power rate levels potentially could drop by 5 to 10 percent per megawatt-hour next year, all other things being equal. In addition, this could narrow the range of year-to-year fluctuations in rates by reducing the size of the cost recovery adjustment.

The issue is one of cash flow. BPA faces cash flow challenges in part because of the way it pays the bills for Energy Northwest, which owns the operating and terminated nuclear plants. Starting in July – when the Energy Northwest fiscal year starts – all BPA revenues from power bills for customers who are participants in the net-billed nuclear plants go directly to Energy Northwest until that net-billing obligation is met. The timing of the obligation varies by customer, but for most concludes between September and December. As a result, after BPA makes its Treasury payment at the end of the fiscal year, it has an extremely low cash level until the net-billing impact dissipates by January. The low cash reserve presents a challenge for BPA since other bills must be paid during that time.

The goal is to find liquidity tools that would increase the amount of cash BPA has during those low-cash months. The alternative to these tools is for BPA to increase its rates so it can accumulate sufficient cash reserves to carry the agency through the lean first quarter of each fiscal year. The initial rate proposal reflects the fact that BPA does not yet have the liquidity tools.

Liquidity tools include the possibility of changing the way BPA pays the costs of Energy Northwest, holding debt optimization refinancing cash prepayments of federal debt through December or obtaining a line of credit with the U.S. Treasury. Other tools would require customer participation, such as agreements to prepay power bills or agreements by investor-owned utilities to reshape benefit payments.

Cost management continues

Starting last January and continuing for six months, BPA held a Power Function Review to engage the region in examining and determining BPA's power-related program costs during the coming rate period. As a result of the review, BPA reduced projected annual costs for fiscal years 2007-2009 by about $100 million from the start of the review and committed to continue to look for ways to get costs down.

As a result, BPA will conduct another public review of costs in the spring of 2006. This work now goes beyond finding efficiencies and is likely to involve trade-offs that could affect customers or constituencies. This review of program costs is not part of the rate case but a parallel process that will inform the final rate decision. Examples of areas BPA is pursuing range from further efficiency costs to consideration of extending Columbia Generating Station (nuclear) debt to potential removal of geothermal costs in FY 2009.

Slice customers

A group of customers has chosen to purchase a Slice product from BPA that is characterized as a "slice" of the generation output of the federal system. By purchasing this product, the customers pay their appropriate percentage of BPA's actual costs. In return, they manage their proportionate share of the risks associated with variable water volume and price for surplus power rather than paying BPA a risk premium to manage those risks on their behalf. Therefore, the "average" rate discussed generically does not apply to them.

For more information

For information on the initial wholesale power rates proposal, call Diane Cherry at (503) 230-5648 or Elizabeth Evans at (503) 230-4284.