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
Administrator and Chief Executive Officer

2 Attachments

Attachment #1
Potential Cost Reductions or Revenue Increases for FY2004-2006

In the SN CRAC process, staff are proposing a rate design that could vary based on actual financial results from the year before the rate goes into effect as well as reflect cost reductions we are reasonably certain of in future years. It's proposed that these variables would be pinned down by the time the actual SN level is set in August of the prior year. Below is an example list of impacts that, under a variable/contingent rate approach, could lead to a substantially reduced rate increase in 2004, or no rate increase if cost reductions are achieved and secondary revenues improve due to favorable hydro and market conditions.

Potential Reductions in Cost or Increases in Revenue, with BPA action plans for each (dollars in millions)	Impact on FY2004 Rate Calculation	Impact over the entire FY2004-2006 period
1. Improved hydro conditions and/or improved prices we receive for secondary sales in FY2003. ◆ This improvement is not in our current forecast, but is within the range of possibility given good water conditions and favorable market prices.	$75M ($75M for FY03)	$75M ($75M for FY03)
2. Improved hydro conditions and/or improved prices we receive for secondary sales for FY2004-2005. ◆ This improvement is not our current forecast, but is within the range of possibility given good water conditions and favorable market prices.	$0M	$200M ($100M for FY04-05 Each)
3. Further reductions in BPA internal operating costs charged to power rates. ◆ The additional reductions shown here bring BPA internal costs to 2001 actuals, net of revenue offsets. We will commit to managing to these reduced levels. ◆ We will define the effects of additional 5% and 10% reductions in internal operating costs to further inform regional discussions.	$10 M	$20 M
4. Further reductions in Corps, Reclamation and/or ENW operations and maintenance costs. ◆ We are asking ENW, Corps and Reclamation to define the effects of additional 5% and 10% O&M cost reductions, to inform further regional discussion of costs. ◆ Benchmarking information indicates that Corps and Reclamation costs are already below industry norms. Benchmarking is less clear for CGS.	$?	$?
5. IOUs restructure benefits for their residential and small farm consumers such that benefits are not paid during this rate period. ◆ BPA is participating in active discussions with other parties in an attempt to achieve these reductions.	$110M	$220M
6. Publics and IOUs settle litigation over IOU subscription contracts. ◆ Affects LB CRAC. ◆ BPA is participating in active discussions with other parties in an attempt to achieve these reductions.	$67M	$200M
7. BPA successfully renegotiates certain augmentation contracts. ◆ Active negotiations are underway. Results should be clear by the end of April.	$10M	$30M
8. Reductions in fish and wildlife direct costs and hydro operational costs through more cost-effective achievement of biological goals. ◆ Continue work with NW Power Planning Council on potential reductions in direct program costs for FY2004-2006. ◆ Use Council conclusions from mainstem rulemaking to engage NOAA Fisheries about which measures are appropriate to include in financial projections. ◆ Seek additional efficiencies in river operations consistent with biological opinion.	$?	$?
9. Debt management activities such as freeing up reserve accounts and accounting for foregone interest on such accounts, reflecting refinancing savings and swap transactions, and other potential actions.	$65M	$81M
10. ENW paying agent settlement and financing of spent fuel storage facility.	$19M	$14M
Total	**$356** M	**$840** M
Resulting rate increase over FY2003 effective average rates. If all the possible improvements above occur, an SN CRAC may still be necessary to maintain rates at the 2003 level.	**About 0%**	**Between 0%-5%**

Attachment #2
Effects of Deferring the SN CRAC Process:
High Financial Risks

- **Additional cost reductions and revenue increases have not been achieved yet.** All of the $754 million of cost cuts and revenue increases in the customer alternative should be pursued, but none of it can be counted on as assured now, except for $20 million of BPA internal power-related cost reductions in addition to the $140 million already done. Virtually all the $754 million requires the agreement of other institutions that has so far not happened (or requires cooperation of the weather and markets). BPA has been pursuing all of these reductions for months. Virtually none is unilaterally achievable by BPA.

- **Relying on uncertain financial improvements, and then not getting them, could mean financial disaster or a much higher rate increase.** If we defer the SN CRAC process and get none of the $754 million of financial improvements except $20 million more in internal cost reductions:

  TPP in FY04 with no SN CRAC: 15%
  SN CRAC in April 2004 to bring FY04 TPP back to 50%:
  59% increase in base rates
  37% above FY03 rates

- **Extraordinary cash tools will be needed, even with an SN CRAC.** Extraordinary cash tools, such as use of ENW refinancing proceeds or the Treasury note, are BPA's last line of financial defense. Even with an SN CRAC in FY04, there is high probability that BPA will need these last-defense tools to meet obligations both in the fall of 2003 and the fall of 2004. Using $100 million of ENW refinancing proceeds to avoid an SN CRAC means that the last line of defense is that much smaller. The SN CRAC is important to replenishing this tool. Without it, BPA's risk of illiquidity and failure to pay Treasury or other creditors could be substantially increased.

- **BPA already has lowered financial standards to mitigate rate impacts.** The rate case standard for TPP is 80% to 88% for five years, translating to over 90% for individual years. The TPP target for individual years in the SN CRAC proposal is 50% in combination with a three-year 'Treasury Recovery Probability' (not TPP) of 80%. Also, in the SN CRAC proposal the power business line can use transmission reserves to achieve a higher TPP, departing from the prior standard of a power-only TPP. Returning to the rate case standard for TPP would require a far higher SN CRAC. We are proposing a lower TPP standard to recognize the severe impacts of a rate increase while still achieving our traditional level of TPP by the end of FY06. See Table 1.

Table 1
Impacts of TPP Standards on a One-Year SN CRAC

One-year TPP	Five-year TPP	One Year SN CRAC for FY04 above base rates	Rate increase for FY04 above FY03 rates
PBL – 95.6%	PBL – 88%	66%	42%
BPA – 95.6%	BPA – 88%	58%	37%

- **SN CRAC process deferral probably would mean further credit rating downgrades.** BPA's credit rating recently was downgraded by Fitch as well as placed on "negative outlook" by Standard and Poor's, even in view of the expectation that BPA will proceed with the SN CRAC process and shore up its TPP and liquidity positions. Putting off the SN CRAC process could result in additional downgrades, which would add costs and/or cause damage to BPA's debt optimization program, the source of funds that the customers would have us rely on. The S&P report states that a downgrade could be prompted by "the use of any debt restructuring savings to offset current operating expenses...," "failure to implement an adequate SN CRAC…," or "any restructuring of federal Treasury obligations."

Additional Notes Regarding Impacts of Different TPP Criteria on a Potential SN CRAC

- BPA's long-term TPP standard is 95% for a two-year period, equivalent to 88% for a five-year period. BPA relaxed this to 80% for a five-year period during the discussions of the Fish Funding Principles. BPA then applied this to PBL-only rates and cash in the 1996 rate case for FY97-01, and again in the 2002 rate case for FY02-06. This means that the cash reserves attributable to PBL plus the cash flow generated by PBL rates and revenues should have an 88% probability of being sufficient to cover the PBL portions of the Treasury payment for all five years.

- If we look at a one-year SN CRAC, we essentially have a one-year rate period. The one-year TPP that corresponds to an 88% five-year PBL TPP is 95.64%. An SN CRAC for FY04 alone is sufficient to produce a PBL one-year TPP of 95.64% is 66% (above base rates), or an increase in total non-Slice rates from FY03 to FY04 of 42%.

- BPA has proposed to relax this standard by proposing a whole-BPA TPP test for SN CRAC purposes. The 2004 SN CRAC needed to produce a one-year (FY04) TPP of 95.64% is 58% (above base rates), or an increase in total non-Slice rates from FY03 to FY04 of 37%.

- If BPA were to relax the TPP standard further than proposed, and aim for a BPA TPP of 80% for FY04, the needed SN CRAC would be 42% (above base rates), or an increase in total non-Slice rates from FY03 to FY04 of 26%.

- These all assume Initial Proposal data with the additional inclusion of $20 million in cost cuts BPA already has pledged as part of reducing costs to the level of 2001 actuals (net of offsetting revenues), assuming the $20 million is achieved in equal parts in FY03 and FY04.

Table 2
Factors in Support of a Multi-Year SN CRAC Proposal

	Five Year Equivalent TPP	TPP Criterion	SN CRAC (% over base rates)	Total rate increase above total FY03 (incl. all CRACs)
One Year SN CRAC for FY04	80%	One year at 95.6%	58% for FY04	37% for FY04
3 Year Fixed SN CRAC	80%	Three year at 87.5%	48% for FY04-06	30% for FY04-06
BPA Initial Proposal (variable SN CRAC)	n/a	TRP in FY06 of 80% and FY04-06 TPP of 50%	30% on average for FY04-06 *	15.6% on average for FY04-06 *

Note: The first two cases assume Initial Proposal data with the additional inclusion of $20 million in cost cuts BPA already has pledged as part of reducing costs to the level of 2001 actuals (net of offsetting revenues), assuming the $20 million is achieved in equal parts in FY03 and FY04. The initial proposal does not include these. However, if they are included, the impact is less than 1 percentage point (29%, 15.2%). TRP stands for Treasury Recovery Probability, which is the probability of making all Treasury payments by the end of FY06.

- **Is the three-year SN CRAC proposal aimed at rebuilding BPA reserves to original Rate Case levels of $600 million?** No. The BPA three-year proposal would aim to recover reserves to around $300 million by the end of FY06 – a level considered minimal.

- **Three-year Treasury Recovery Probability (TRP) allows a lower SN CRAC.** If a one-year SN CRAC is established at a sufficient level to provide an 80% probability that we pay Treasury in FY04 (still low by normal standards), it would have to be extremely high. The three-year approach allows BPA to make the case that we are on path to recovering TPP by FY06 (the 80% TRP standard in FY06).

- **A one-year SN CRAC also risks an extremely high SN CRAC in FY05 and FY06**. If the total financial shortfall is in the ballpark of current BPA estimates, compressing the period of recovery by deferring the SN CRAC process could mean creating a much bigger rate problem in FY05 and FY06. (Having no SN CRAC in FY04 could force the proposed FY05-06 SN CRAC rates to be 1.5 times the size of the proposed FY04-06 SN CRAC.)

- **BPA must set its rates to recover its costs**. We need to demonstrate to FERC that we are setting rates sufficient to cover our costs. Under current rates, assuming that we will have an FB CRAC, we have negative net revenues in each of the four years (FY03-06). (FY04 -$123M; FY05 -$117M; FY06 -$99M; on top of negative net revenues in FY02 and FY03)

- **Year-by-year SN CRAC increases the likelihood of cost deferral and makes clarification of long-term difficult:** Addressing the need for an SN CRAC each year could create a bow wave of losses that would be built up and pushed out past 2006. As long as this prospect exists, BPA's post-2006 cost structure remains more uncertain, making it harder to resolve post-2006 issues