Bonneville Power Administration
Financial Issues Follow-up Workshop

March 7, 2003

BPA Rates Hearing Room, Portland, Oregon

As we told you last week, BPA "is staring down the barrel of a very serious financial situation," which prompted us to make the Safety Net Cost Recovery Adjustment Clause (SN CRAC) proposal, **Paul Norman (BPA)** said in opening the meeting. Customers responded by telling us a rate increase would further damage an already fragile economy and that there is an alternative approach through which we could avoid an SN CRAC, he said. We're here to talk seriously about alternatives, Norman stated. BPA is keeping its SN CRAC process moving, he acknowledged. As Steve Wright said, we have to keep it going "unless and until" there is a viable alternative, he said.

Linc Wolverton (ICNU) said the workshop should not be designated "a policy-level meeting." The two-day notice precluded policy-level people from attending, he stated.

<u>Customer Presentation</u>

John Saven (NRU) outlined a proposal he described as having strong support among public and private utilities, and industrial and direct service customers. Due to time constraints, it has not been reviewed or approved by boards, governing bodies, or managers of customers or customer groups, he noted. The elements in the paper offer BPA an opportunity to move into a position that would assure its Treasury payment in FY 2003 and 2004, as well as provide a reasonable probability in 2005 and 2006, without the SN CRAC, according to Saven.

Saven's paper proposes no SN CRAC rate increase be imposed on October 1, 2003 and suggests a new schedule for the proceeding that could be followed if an SN CRAC increase becomes necessary. An SN CRAC could potentially begin April 1, 2004 and last for 12 months. Under the proposal, BPA would determine whether it needs an SN CRAC on a year-to-year basis. The paper outlines a way to achieve an acceptable Treasury payment probability (TPP) by creating "a reserve of last resort" from $100 million in Energy Northwest (ENW) refinancing proceeds, cutting millions of dollars in costs, and increasing forecasts of net secondary revenue. An electronic version of the complete proposal entitled "Suggestions for Addressing BPA's Financial Situation" is available on the March 7th Workshop page on BPA Power Business Line web site (www.bpa.gov/power/psp/rates/meetings/030307ws/index.shtml).

Pat Reiten (PNGC) said PNGC, PRM, and EWEB jointly sent comments regarding an alternative to the Saven proposal. (The PNGC, PRM, EWEB suggestions are at the same web page listed above.) There are differences between Saven's suggestions and what we propose, but I'd like to focus on the similarities, he indicated. We are not anxious to see an SN CRAC imposed because of the economic circumstances in the region, Reiten said.

We don't want to see a multiyear trigger and would prefer to deal with the situation year to year, he added. BPA needs to endeavor to get its costs below FY 2001 actuals and should adhere to the principles and intended uses of the CRACs in the existing GSRPs, he said. In particular, there should be no cost shifts among customers, Reiten stated. In addition, we believe the ENW funds should be used in a limited way and only as needed, he concluded.

Norman acknowledged that Saven's proposal is different in significant ways than BPA expected, so the agency scrambled to prepare a response. Our take on the $754 million in reductions from 2003 to 2006 is that the majority "and perhaps all of it is potentially doable," he said. We are very interested in almost all of these things and are willing to pursue them, Norman added. We could potentially drive the rate increase down, maybe to zero, if we are successful with these reductions, he said.

While most of these reductions ought to be doable, we are concerned about getting on a path that could turn our financial crisis into a disaster next year, Norman stated. The approach we feel most comfortable with is to continue forward with an SN process, but restructure it so that as the reductions are accomplished, the size of the increase is reduced, he said. Then if we are not successful with the reductions, "there is not a train wreck at the end of 2004," Norman said.

Have you thought through what this process would look like, a combined rate proceeding and collaborative process? **Marcus Wood (PacifiCorp)** asked. We could have a settlement or a final decision by the Administrator based on a record that includes this type of approach, Norman responded.

In 2001, when the three CRACs were put into place, two were automatic and the third was not, **Jack Speer (Alcoa)** said. That was done intentionally, and the SN CRAC was supposed to be "a last resort," he said. Now, it seems you want us to agree to another automatic rate increase, Speer stated.

I'm proposing we move forward with the SN process, so if we're unsuccessful in making the reductions, the SN CRAC is in place; if we are successful, the SN CRAC goes down, maybe to zero, he said.

Is your suggestion a one-year or multiyear approach? **Terry Mundorf (WPAG)** asked. We can't afford to pay now for "forecast disasters" that may or may not happen, he stated. Are you talking about taking an annual look or locking in an SN CRAC level for the remainder of the rate period? Mundorf asked.

Ours is a multiyear approach, Norman responded. If the grim forecasts play out, there would be a safety net; but if better things happen, the increase would be much lower, down to perhaps zero, he added.

We have a proposal we think assures you of a 100 percent TPP this year, along with the possibility of imposing an SN CRAC on April 1 next year, Saven stated. We are asking you to suspend the SN proceeding so we can work on resolving rate-related issues constructively, as opposed to having an SN CRAC we could "buy our way out of," Saven added.

At the last meeting, John described the customers' understanding of the SN trigger, which was originally based solely on the TPP, Reiten said. Now it seems we're adding criteria for the trigger beyond what we envisioned when the SN was negotiated, he said. We don't have "a fully fleshed-out alternative," but we're advocating an approach that would get us all to the same rate outcome, Norman replied.

We would have a real problem with a mechanism that has an automatic multiyear SN CRAC, **Kevin O'Meara (PPC)** stated. Our experience thus far with the Slice and with automatic adjustments is not a happy one, he added.

Rick Lovely (Grays Harbor PUD) said he is seriously concerned that BPA is focused on the necessity of building reserves over three years and making capital expenditures. That doesn't constitute an emergency in our view, nor does it justify the SN CRAC, he said. Our proposal addresses the circumstances that trigger the CRAC – that is, missing a Treasury payment – not all the other "financial whims" BPA wants to put into it, Lovely stated.

It is a misimpression that we are driven to get our reserves up, Norman responded. It is the TPP that is driving this SN process, he said.

Over the past two years, we have instituted rate increases of 67 percent, Lovely stated. Last year, we raised rates 11 percent, but the effect of those increases has not been to increase net revenues, he said. You won't get more revenue if you impose the SN increase, Lovely contended.

Our goal is not to have an SN CRAC increase, Norman responded. We're disagreeing about what that means in terms of process – do we put a safety net in place that we can pull back or do we stop the process and resume it later, he said. We are very concerned about the financial risk of taking that latter course, Norman stated.

The BPA proposal is flawed, according to **Paul Murphy (Golden NW)**. You are talking about a formulaic approach that ignores important variables, he said. You have to choose between the lesser of evils, and you need to consider whether raising rates in a very weak economy isn't the most severe evil, Murphy stated. In addition, your proposal would eliminate the opportunity to make reasoned judgments in real time, he continued. Most entities would try to avoid raising rates now, and they would, if necessary, restructure debt, he said. It would be a mistake to move to the formulaic approach, Murphy urged. BPA's finances are only one of many relevant circumstances here, he said.

Steve Weiss (NWEC) offered his preliminary thoughts on the proposal. Many of the ideas in the proposal are good – having no rate increase is positive, and we advocated for taking the year-to-year approach, he said. We would like to explore why you think the proposed lag time for possibly implementing an SN CRAC won't work, Weiss said. Limited borrowing of $100 million should be part of the picture, and we would favor that, he stated.

Some pieces of the proposal make us nervous, Weiss continued. This approach leaves BPA "coasting on the edge," and it means a yearly battle, he said. In these battles, fish and conservation often get cut, Weiss added. Running BPA on the edge year after year tends to threaten these important, long-term programs because it adds to cost-cutting pressure, he stated. We would need more certainty about conservation and fish budgets, Weiss asserted. If we could be assured these budgets would be "roped off" and there wouldn't be any emergencies, during which "we lean on the river," we think this proposal could be positive, he indicated. We don't need the automatic mechanisms – the future is too hard to predict, Weiss added

Marc Hellman (OPUC) pointed out that the Oregon PUC agreed to continue deferral of the IOU benefits in 2003. The PUC hasn't seen this proposal, which includes additional deferrals, he said. But the PUC wants some resolution of the out-year issues, so it can see that for the sacrifices that are being made now, there will be benefits coming to customers in the future, Hellman stated.

Ed Sheets (CRITFC/Yakama Nation) said the tribes want to learn more about the customer proposal and BPA's response. We are particularly interested in how either approach would affect fish and wildlife (F&W) budgets and other issues Don Sampson of CRITFC has raised, he stated.

There is a strong perception among your customers that when the money is in hand, the enthusiasm abates for making hard cuts and hard choices and forcing others to do the same thing, Mundorf said. The idea of putting an increase into effect and then reducing it tends to bring that concern to the fore, he added.

The presence of an automatic mechanism for recovering cost increases has an effect on the way other entities react, too, O'Meara commented. It affects the incentives of other parties with whom you negotiate, he said.

If there is a way to allocate our time to issues like solving "the $200 million problem," rather than arguing in a rate case, I vote for solving the problem, Speer said.

Steve Oliver (BPA) asked for clarification on the proposed mechanism to deal with the $200 million. Right now, the $200 million is a revenue item we are trying not to collect, he said. It would have the same overall impact on rates regardless of which CRAC it is credited to, Oliver said.

We were trying to give you $200 million in a way that does not result in a cost shift between customer groups, Saven explained. We are still talking about the technicalities of how to achieve that, he stated. We think there are a number of ways of doing this that avoid the cost shift, Mundorf added. He indicated that avoiding a cost shift is "a precondition" to making the proposal work and that customers are still talking about it.

Can you explain the importance of shifting the revenue out of the LB CRAC reduction? Oliver asked. The LB and SN "land on folks differently," Mundorf clarified. People who would not pay the LB versus the SN would look at this differently, and we need to reconcile those points of view, he stated.

It's fair to say this issue was at the heart of why PNGC, EWEB, and PRM sent you a separate missive, Reiten stated. We are engaged in finding a way that makes the numbers work, but does not shift costs, he said.

This $200 million would reduce our rates by roughly the same amount, whether it comes out of the LB CRAC or is used to avoid the SN CRAC proposal, Norman said. Another reason we are wary of dropping the SN CRAC is that this proposal relies on an assumption "we can perform the jujitsu" necessary not to shift costs, he pointed out.

What was your thinking with regard to using $100 million from the debt optimization revenues versus using money from the $250 million note? Was there a preference? **Jim Curtis (BPA)** asked. This proposal was submitted from the perspective of, "what do you think?" Saven responded. I'm anxious to hear BPA's response – we want to hear what you have to say, he stated. To us, this is a responsible proposal; it involves paying back the money borrowed before the end of the rate period, it's easy to understand, and that's why we went this way, Saven said.

We are looking at the least costly way to bridge the gap; if there are less costly ways, let's look at them, **Geoff Carr (NRU)** added.

Howard Schwartz (Washington) called the proposal "a big step forward," but said it is important to get a sense of where year-to-year budget cuts would be made. He pointed out that the customer proposal assumes the IOU payments will continue to be deferred and a settlement reached, which suggests that a resolution of post-2006 issues will be needed to make the fiscal package work. Can this be resolved soon enough to assure the numbers will pencil out? Schwartz asked.

Saven said the proposed cuts are from the categories BPA already laid out. We made assumptions about achieving the things they identified, he indicated. We believe it would be a mistake not to have a time-out to see if we can resolve issues related to post 2006, Saven said. It's clear if we don't resolve them, we'll be facing "whatever number Paul and his staff produce," he stated. We believe taking a time-out and deferring the SN CRAC process offers a better opportunity to negotiate the issues, as opposed to a, "we want your money, while we work it out" approach, Saven contended.

If the SN CRAC is deferred, can you get to a comprehensive solution of the issues? Schwartz asked. Yes, there would be a much stronger possibility because the environment would be better and the window of opportunity clear, Saven responded.

The vast majority of the money in the customer proposal is IOU money, **Scott Brattebo (PacifiCorp)** pointed out. We offered to defer the benefit payments months ago, but BPA declined for what I think were process reasons, he said. If we continue with this SN process, it could stand in the way of making a deal, Brattebo said. We want to make a deal here, he stated. Let's set the SN CRAC aside so we have no impediments to working together, Brattebo advised.

<u>BPA's Analysis</u>

Byrne Lovell (BPA) explained Case 10 in BPA's handout. The case considered the financial outcomes if the SN CRAC process were cancelled and BPA took a $100 million cash loan in 2003. He outlined assumptions that went into the analysis and the consequences of such a scenario for TPP, cash generated, and for the magnitude of SN increase that might be needed in 2004. There were a number of clarifying questions on the analysis. Saven pointed out that none of the BPA-proposed cost cuts were included in the analysis. I don't think this is useful for our discussion, he stated.

We have no guarantee we can accomplish the cuts, Norman responded. We are looking at a potential financial catastrophe, and we think the situation is so dire that we need a backstop, he stated. We are totally with you on driving our costs down, but we can't persuade ourselves it is a fiscally responsible course not to have a backstop, Norman added.

Kevin Clark (Seattle) said the BPA analysis did not reflect $70 million in cuts that would reduce BPA's costs to 2001 actuals. Steve Wright said in November those would be achieved, but they are still not in your analysis, he pointed out. *(Editor's Note: Case 10 includes $120 million of the already-identified $140 million of cost reductions for FY 03-06. Additional cost reductions proposed by BPA and/or the customers are not included in Case 10).*

Kim Leathley (BPA) said the agency is committed to managing 2003-06 internal expenses down to 2001 actuals and has achieved all but $20 million of $140 million in identified reductions. I don't know where the $70 million comes from, she acknowledged. We're not done with making cuts and are still looking to see how we can more efficiently run a $3 billion enterprise, but the additional savings beyond $140 million are not yet clear, Leathley stated.

But even the $20 million isn't integrated into your analysis, Clark responded, adding that the $70 million the customers have in their proposal comes directly from BPA material. It isn't even the base case for the agency to have those cuts incorporated, he contended. BPA is not building customer trust with such analyses, Clark indicated.

Sheets asked about estimated cost cuts to fish programs. We are looking at whether we can meet the Biological Opinion (BiOp) obligations through a more cost-effective fish recovery program, Norman stated. We estimate we could reduce costs as much as $160 million with operational and direct program changes, he said. Sheets asked for details on the line item amounts. Norman suggested he call Therese Lamb, acting head of BPA's F&W program.

There were other questions and clarifications about an additional $140 million in debt service reductions that BPA has projected.

Saven asked BPA's view of the customers' numbers on secondary revenues and its forecast of market prices and 4(h)(10)(c) credits. Oliver said BPA's analysis indicates that $23 million in additional surplus revenues "is not unrealistic," although the runoff forecast tends to go up and down regularly. Our analysis for market prices shows we are a little lower, but basically we're in the middle of your high and low cases, he continued. We think your estimate of increases in the 4(h)(10)(c) credits is overly optimistic, Oliver said. Overall, the work you did is good, he added, cautioning that the $23 million in additional secondary revenues looks only at "the upside" of what the market could do, but not at a possible downside.

This discussion indicates that part of the issue is how much risk people are willing to take on or push to the future, Schwartz observed. Is there a way to model some of the risks? he asked, adding that BPA seems more reluctant than its customers to postpone the SN CRAC and risk having a higher increase in 2004. It could help to have more modeling and attempt to come to a common understanding of what the risks are, Schwartz said.

BPA is worried about the risk of getting to October and needing a rate increase that couldn't be collected until the following April, Weiss commented. What about tightening up the customers' suggested schedule? he asked. You could take another look in August rather than October, Weiss said.

One reason for these dates is to give us a chance to see the next water year and to have a look at the early-bird runoff estimate, Wolverton responded. You'd know about whether some of the cost cuts had been realized by August, Weiss stated. While you wouldn't get the look at water, if you get great water in January, you can change things, he said.

It seems like we're getting a third alternative on the table – the Weiss compromise, Norman stated.

Sheets pointed out that the region would soon face serious questions with F&W. We should have the BiOp lawsuit settled and there is a check-in on whether the BiOp is being implemented, he stated. There are concerns the BiOp is not being implemented, Sheets said, adding that the federal agencies have failed to meet flow targets 11 of 28 times since 1995. In your modeling, have you looked at the possibility of increased F&W costs? he asked. No, we have not, Norman responded.

Saven described new scenarios for BPA to analyze, which incorporate proposed savings, additional secondary revenues and 4(h)(10)(c) credits, and a settlement of the $200 million in IOU benefits. Our proposal tried to stay away from F&W issues, he noted.

Norman said BPA would provide the additional analysis Saven described.

Jim Luce (State of Washington) said there is a lot of focus on cost cuts in the proposals, and he suggested BPA undertake a "Priorities of Government" exercise to get to what is critical and what is not. He said the exercise, which the State of Washington undertook last year, would help BPA determine what programs are needed and where there are opportunities for downsizing.

Norman said BPA is working actively to accomplish an additional $50 million in power resource O&M cost reductions and $30 million in power resource contract savings. **Vic Parrish (ENW)** noted that his agency is committed to making further cuts to O&M. We have set some strenuous goals for ourselves, including a $5 million reduction in each remaining year of the rate period, he said, noting that ENW is facing additional security costs as a result of September 11. Parrish noted that ENW may need to capitalize some costs "that are legitimately financed over a number of years" to meet its goals.

We just finished a review of our nuclear program, conducted by an independent consultant currently working in the nuclear industry, **Margaret Allen (ENW E-Board)** pointed out. She noted the industry is facing additional safety and security expenses in the aftermath of recent events. We feel uncomfortable having "an arbitrary number out there" with regard to the ENW budget, Allen stated. We aren't saying there are no savings left, but the Executive Board is not comfortable with an arbitrary number or date, since there are significant safety and reliability issues that need to be addressed, she said.

ENW has agreed to develop agreements with BPA so we can receive $23 million in Bank of America settlement funds, which came from unclaimed bearer bonds, Curtis reported. That is money that will come in and affect the numbers before us, he said.

This is all about risks and perceptions of risk, Curtis stated. In setting its rates, BPA has historically aimed for an 88 percent TPP, he said. In the initial proposal for the SN CRAC, we have a first-year 50 percent TPP, Curtis said. At the end of the next three years, we want an 80 percent TPP and to make up any misses that we've had in the previous year, he stated. We have lowered our standards, Curtis added.

The customer approach does not take into account some of the risks, such as liquidity, Curtis continued. All of the figures you've looked at today "assume a myth" that we can get by on $70 million in liquidity, he said. Curtis pointed out that many arguments are based on changing assumptions about what might happen, but simply making different assumptions can create additional risk. We set rates based on what we think is reasonably likely to happen, he added. I am going to very conscious of what we are doing with numbers and how that affects our risk, Curtis stated.

Clark pointed out that BPA's numbers have changed from one presentation to another. The customers have been asking since last summer for month-by-month cash-flow information, he said. We need to build trust in each other's numbers so we can get to a successful outcome, Clark added. What are the consequences for you in being “in the red” at some point in the year? he asked.

If we were in the red for one day, Treasury would be shocked and concerned, Curtis responded. Our checking account balance is never below zero, he stated. Curtis explained that BPA could not go into the red without serious consequences.

Clark pointed out that Seattle had to borrow $200 million to get through the energy crisis. We are struggling to keep our utilities solvent; “if we go under, you go under,” he said.

You have a partnership with ENW, and they do have cash that can assist you, Murphy stated. You have a source available to lean on under some circumstances, and there could not be a more appropriate time – after two drought years in close succession and a bad regional economy – for you to do so, he added.

Norman pointed to Case 8, which assumes an SN CRAC and success in reducing costs according to the customers’ suggestions. Over the rest of the rate period, the average rate would be 1 percent higher, and we would exceed our TPP standard, he explained. We think our primary focus needs to be on getting the cost reductions you’ve suggested, Norman stated. This table suggests that if we put the right kind of contingent mechanism in place and we are successful with the cuts, we can avoid a rate increase, he said. The difference between us is whether to drop the SN process and come back later, or put it in place as a backstop, Norman stated.

You’re saying that if you keep the current rates in place, which are higher than at any other time in the rate period, and avoid a rate decrease next October, “we’ll all be happy,” Wolverton stated. We aren’t interested in avoiding a rate decrease, he said. We ought to be focused on things that can bring rates down, Norman responded.

You’ve made statements about going from crisis to disaster, and I’d say I’m willing to wait and see what the additional analysis will say, Saven said. My initial conclusion is that it will show a different picture, he said, adding that he didn’t like the BPA approach of putting the CRAC in place as a safeguard. I believe Steve Wright made a commitment to talk about this further, and I haven’t forgotten that, he stated. I think the customer proposal is viable, but I’m willing to wait for the analysis, he added. I want the opportunity to convince you that our numbers offer a safe-enough approach, Saven said. But if your answer is, we want the SN CRAC for the whole period, then I’ll try to talk to Steve about it, and if that doesn’t get me anywhere, “I’m going to go to other places – that’s the intensity of our position,” he stated.

We’ll look at the numbers, but our worry is about “betting on the come,” Norman stated. It’s a deeply felt position at BPA that we’ve put the agency on the brink, and we don’t want to push it over, Norman said.

John didn't say to give up your backstop, but to have a six-month delay, Clark stated. We're also talking about risk sharing, he said. We're trying to share some of the risk so it doesn't all fall on the ratepayers if things go bad, Clark said.

We disagree about whether to fix this year-by-year or whether to put an increase in place for three years, Mundorf said. You are saying that if we take a time-out, you wouldn't have enough time to collect the money you need to fix the problem, he said. But your analysis doesn't include all of the available facts to determine the true risk, Mundorf stated. That case has not been run, and I think we should wait and look at that, he added. If an April 2004 date for an increase is too late, let's consider that, Mundorf said. I haven't heard a good argument for a multiyear collection, he added.

It sounds like the difference between a crisis and a disaster is how fast you could reopen the SN CRAC, Weiss commented. Why not try moving the collection period from April 1 to February 1 to show two months more of income, he suggested.

The customers realize "the risk is ours," Lovely stated. We believed BPA would adhere to the numbers in the 2000 rate case, and when we created the CRACs, we didn't think we were giving BPA "a blank check," he said. I believe a lot of decisions were made that would not have been made if BPA had had to go through a rate case every time, instead of having the CRACs, Lovely stated. BPA's credibility has gone "down, down, down" with customers, he added. Now you want us to agree to an SN CRAC that has a 25 percent per year cap, and "that creates consternation," Lovely continued. This should be a year at a time process, and if it needs to cover multiple years, prove it to us, he said. If we, the customers, are wrong, and you have to come back later with a higher CRAC, we will pay, Lovely said. There's a level of risk here that we are willing to face down, he stated.

I don't hear a compelling case for the SN CRAC in the out years, Reiten agreed.

We hear the point about "keeping our feet to the fire," Norman responded. But the picture we see that overcomes that point, is "we are worried about driving this agency into a financial ditch," and we believe your proposal puts us in peril of that, he said. This debate is distracting from getting at the cost cuts, Norman stated.

It's a fair summary to say that we weren't persuaded by your presentation, and we want you to present more information and analysis, Mundorf summed up. When shall we have another meeting? he asked.

The group decided to meet again on Friday, March 14.

Adjourn: 5:05 p.m.