SUPPLEMENT TO ADMINISTRATOR'S RECORD OF DECISION ON BONNEVILLE POWER ADMINISTRATION'S SERVICE TO DIRECT SERVICE INDUSTRIAL (DSI) CUSTOMERS FOR FISCAL YEARS 2007-2011

ADMINISTRATOR'S RECORD OF DECISION

Bonneville Power Administration
U.S. Department of Energy

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Supplement to Administrator's Record of Decision on Bonneville Power Administration's Service to Direct Service Industrial (DSI) Customers for Fiscal Years 2007-2011

I. Background

On February 4, 2005, Bonneville Power Administration (BPA) sent a letter to customers and constituents describing a public process for comments on certain issues related to service by BPA to its remaining direct service industrial (DSI) customers that had not been finally decided in the *Policy For Power Supply Role For Fiscal Years 2007-2011 – Administrator's Record of Decision*, published the same day. The issues on which BPA was seeking additional public comment were: 1) the actual level of service benefits it should provide to the DSIs; 2) the eligibility criteria it should apply in determining which DSIs would qualify for such service benefits; and 3) the mechanism or mechanisms it should use to deliver those service benefits. BPA's letter outlined a straw proposal on each of these issues.

BPA received almost 100 written comments from a broad cross-section of customers, constituents, and private citizens, and held an open forum to discuss these DSI service issues, which was attended by approximately 100 individuals. The culmination of this public process was the publication on June 30, 2005, of *Bonneville Power Administration's Service to Direct Service Industrial (DSI) Customers for Fiscal Years 2007-2011 – Administrator's Record of Decision* (DSI ROD).

In the DSI ROD BPA tentatively decided that it would offer a surplus power sales contract to each of its remaining three aluminum company DSI customers, totaling in aggregate 560 aMW, at a capped cost of $59 million per year, and a 17 aMW surplus power sales contract to its one remaining non-aluminum company DSI customer, which would not be subject to the cost cap. The ROD indicated that BPA would attempt to structure the delivery of service benefits through a contractual arrangement that included the public utility in whose service area the DSI is located. The ROD concluded that the default mechanism for providing benefits to the DSI aluminum companies would be financial payments, generated by monetizing the value (relative to expected market prices) of each company's below-market surplus power sales contract, resulting in an equivalent financial value of up to $12/MWh (or $59 million annually) on each megawatt-hour allocated to each aluminum company. Nevertheless, the final decision regarding whether benefits would be provided through these financial payments or through physically delivered power, along with other implementation details, was left to the contract negotiations.

The DSI ROD made clear that the decision to offer contracts to the aluminum companies was expressly contingent on a further review of the cost impacts to BPA associated with an injunction, issued on June 10, 2005, by the United States District Court for the District of Oregon, relating to certain anadromous fish protection measures, and directly impacting the amount of water available to BPA for hydroelectricity

production (the "BiOp Litigation"). BPA stated in the DSI ROD that a final decision to reduce the amount of service benefits to the DSIs, up to and including a decision not to serve any aluminum company load, was possible.

Finally, the DSI ROD stated that following negotiations with the DSIs and the local public utility districts ("Public Utility Partner") whose service territory includes an aluminum smelter, the contracts would be available for public review and comment to ensure consistency between the draft contracts and the principles and decisions contained in the ROD.

II. Draft Prototype Surplus Firm Power Sales Agreement

On November 28, 2005, BPA made available for public review and comment the *Draft Prototype – Block Power Sales Agreement* (Smelter Prototype). The Smelter Prototype is the draft surplus firm power sales contract BPA proposed to deliver service benefits to the DSI aluminum companies during FYs 2007-2011. The Smelter Prototype was the result of several months of negotiations between BPA, the DSIs, and several of the Public Utility Partners. A separate prototype was developed for Port Townsend Paper, and is addressed below at section IV.

The Smelter Prototype is a three-party power sales contract under which BPA makes available for sale to the local Public Utility Partner the amount of surplus firm power allocated by the DSI ROD to the aluminum company DSI located in its service territory.[1] The Public Utility Partner in turn makes an equal amount of power available to the DSI. Because the cost to BPA of physically delivering firm surplus power to the companies during the next rate period (FY 2007-2009) is projected to exceed the $59 million cap established in the DSI ROD, the Smelter Prototype provides that this transaction will be monetized in lieu of physical power deliveries during that three-year period (Smelter Prototype Section 5(a)). The monetization is designed to capture and deliver to the company, within strictly defined limits, the value of the contract, or the difference between the contract rate (a rate deemed equivalent to BPA's Priority Firm rate) and a forecast market price, not to exceed the cap.

Section 6 provides how this monetary benefit is calculated, examples of which are provided in Exhibit D of the Smelter Prototype. In all cases payments are tied to the level of actual smelter operations, capped by each company's firm surplus power allocation under the DSI ROD, with payments made monthly on an after-the-fact basis. In the event that a company is able to operate at or above its full BPA allocation (measured in megawatts), its monetary benefit would be the lesser of the maximum benefits it could receive on each allocated megawatt of operation ($12/MWh), or the difference between a surrogate contract price (assumed to be equivalent to the Priority Firm Power rate) and a

[1] The Public Utility Partners likely will include Flathead Electric (Columbia Falls Aluminum Company); Klickitat County Public Utility District (Golden Northwest Aluminum Holding Company – Goldendale smelter); Northern Wasco Public Utility District (Golden Northwest Aluminum Holding Company – The Dalles smelter); Chelan County Public Utility District (Alcoa – Wenatchee smelter); and Whatcom County Public Utility District (Alcoa – Ferndale smelter).

forecast market price. Consistent with the DSI ROD, the Smelter Prototype requires that each company access at least one-half of its allocated benefits in order to access any benefits; that is, if a company fails to access at least one-half of its benefits in a month (with some limited exceptions), it receives no benefits at all. However, if due to high market power prices or other factors a company operated (measured in megawatts) at less than its full BPA allocation, the Smelter Prototype provides that the company may access the full difference between the equivalent Priority Firm Power rate and the forecast market price, up to a maximum of $24/MWh for each megawatt of operation, as long as its operating level does not fall below one-half.

Section 6 of the Smelter Prototype makes clear that a company is not entitled to benefits from BPA that exceed its actual cost of power, and requires that a company inform BPA if it knows it will not require all its monetized benefits in order to reduce its actual power costs to a level equivalent to the Priority Firm Power rate. Overpayments are set off against future benefits, and BPA may audit a company's power purchase data, including the cost of such purchases.

BPA retained the right to physically deliver firm surplus power for the final two-years (FY 2010-2011) of each contract (Smelter Prototype Section 5(b)). In the event physical power is delivered, the provisions of Section 4 of the contract apply, and the contract rate for such sales would be established by BPA (using its then-effective surplus power rate schedule) at a level no lower than the Priority Firm Power rate for the rate period, and at a cost not in excess of the cost cap established by the DSI ROD. If a company does not wish to assume the take-or-pay risk associated with a physically delivered power sale, or for any other reason, it has the right to terminate the contract pursuant to Section 16(b) prior to its conversion to a physically delivered power sale.

As contemplated by the DSI ROD, the Smelter Prototype also includes provisions for the reallocation of benefit amounts (either monetized benefit amounts or physically delivered power amounts) that a company will likely not be able to access. This is a prospective reallocation of future benefits that is based on a company's failure to access its available benefits over a period of time. Sections 7 and 8 of the Smelter Prototype provide how such amounts are determined, and how they are reallocated. Examples of how benefits could be reallocated are provided in Sections 2 and 3 of Exhibit D of the Smelter Prototype. The purpose of these reallocation provisions is to promote the efficient utilization of benefits provided under these contracts, while still providing the companies with a level of operating flexibility.

In its November 28 letter inviting comment on the Smelter Prototype, BPA noted that steadily rising forward market prices for electric power were eroding the value of the proposed benefits to the companies, and that the DSIs had requested additional flexibilities be built into the contract to allow them to access benefits under a wider range of circumstances. The letter posed the following questions for comment:

- Does the Prototype conform to the decisions and policies contained in the June 30 DSI ROD?

- In light of the fact that when service benefits are monetized each aluminum company DSI may obtain such benefits only if it is operating at certain minimum levels, is the level of operating flexibility provided to the DSIs in the Prototype reasonable? Should DSIs have access to benefits at lower minimum operating levels than discussed in the ROD, or higher levels? Should BPA maintain the $59 million annual limit or should smelters be given additional flexibility to draw benefits early from future fiscal years?

In addition, the November 28 letter noted that the DSI ROD indicated BPA would revisit its decision to offer service to the DSIs once the financial impacts of changes in hydroelectric system operations stemming from the BiOp Litigation were better known. BPA stated that its review of BiOp Litigation impacts would be part of a top-to-bottom review of all BPA costs (the so-called Power Function Review II (PFR II)), but that this review was not scheduled to be completed until April 2006. BPA believed the DSIs needed to know sooner than the conclusion of the PFR II what level of benefits, if any, they could expect from BPA in order to make operating and power purchase decisions, and so BPA indicated it intended to complete its reconsideration of DSI service levels before the overall cost review.

III. Comments and Evaluation on Smelter Prototype

BPA received comments from the Public Power Council (PPC), Umatilla Electric Cooperative, Springfield Utility Board (SUB), Industrial Customers of Northwest Utilities (ICNU), Snohomish County Public Utility District, Pacific Northwest Generating Cooperative (PNGC), each of the DSI aluminum companies (Alcoa, Columbia Falls Aluminum Company (CFAC), and Golden Northwest Aluminum Holding Company (GNAH)), and one private citizen.[2]

At the outset, a number of comments urged BPA to make its final determination with respect to service levels to the DSIs in the context of the PFR II, which was designed to provide a forum for the examination of BPA spending levels and policy

[2] In addition, comments regarding the Smelter Prototype were filed on April 26, 2006, by Columbia Research Corporation (CRC) on behalf of Grays Harbor Public Utility District (Grays Harbor) and Canby Utility. The thrust of those comments challenged BPA's authority to make payments to the DSIs by monetizing the value of the proposed surplus power sales contracts. CRC also commented that BPA should further explain its proposal with respect to Port Townsend. Comments regarding the Smelter Prototype were due to BPA on or before January 4, 2006, and comments on the draft Port Townsend contract were due January 31, 2006. The only DSI issue presented for review and comment in the PFR II process was whether the $59 million annual benefit level was still appropriate in light of the BiOp Litigation. Therefore, CRC's comments regarding the Smelter Prototype and the draft Port Townsend contract were not timely presented to the agency. Nevertheless, the issues raised by CRC are largely repetitive of the issues raised by other parties, which are addressed in this supplement to the DSI ROD, or in the DSI ROD itself. Canby and Grays Harbor, on April 26, 2006, also separately filed identical comments on the Smelter Prototype. Those comments focus on issues regarding audit rights and the possibility of power being physically delivered to the companies in FYs 2010-2011. These comments on the contracts also were untimely filed, but as with CRC's comments, are largely redundant of other timely filed comments, which are addressed herein.

choices impacting power rates. On January 18, 2006, BPA agreed to examine DSI benefit levels as part of that process, and the evaluation in this Supplemental Record takes into account the information and conclusions produced in the PFR II. The PFR II provided additional review of DSI benefit levels in light of more recent information on expected hydro system operations, and a more refined understanding of secondary revenues BPA will achieve during FY 2006.

A. Benefit Level Issues

There are two separate but related questions that BPA posed for comment with respect to benefit levels. The first is whether providing an annual maximum benefit of $59 million (based on an allocation of 560 aMW) to the aluminum companies is appropriate, in light of the cost impacts of the BiOp Litigation and BPA's other spending level commitments. As noted, exploring this question was integrated into the PFR II at the behest of the comments BPA received in the comment period on the DSI contracts. The second is whether, and if so how, the Smelter Prototype should be modified to provide the companies additional flexibilities in accessing benefits. Providing more or less flexibility, in some circumstances, can make it more or less likely that a company will be able to operate and use its benefits. In simplest terms, providing more or less flexibility will likely raise or lower the portion of the $59 million in benefits that can be accessed by the DSIs, and therefore raise or lower the costs borne by BPA's other customers.

1. The $59 Million and 560 aMW Caps

Comments

ICNU commented that the $59 million amount "no longer strikes the correct balance and unnecessarily subsidizes the DSIs." (DS2-007 at 1.) It notes that since BPA issued the DSI ROD additional costs have been imposed on BPA, including approximately $70 million in FY 2005 for additional spill associated with the BiOp Litigation, and that larger cost increases may occur in FY 2006 to pay for additional spill and greater flows. (*Id*. at 2.) ICNU argues that because BPA's proposed Priority Firm Power rate for the FY 2007-2009 rate period represents an increase over the current Priority Firm rate, a "$59 million a year credit to support otherwise uneconomic smelter operations is no longer the right balance." (*Id.*) ICNU argues that its members "overwhelmingly" provide more jobs than the aluminum companies in the region, and that "burdening ICNU's members with these DSI costs is unwarranted." ICNU contends that "under no circumstances" should the benefit level be increased. (*Id.*)

Umatilla Electric Cooperative notes that it did not support the increase in benefits from the straw proposal of $40 million annually to the $59 million annual cap adopted in the DSI ROD, but that it does support "some amount of help for the DSIs." (DS2-001.) SUB commented that given the cost impacts of the BiOp Litigation that the proposed $59 million cap should be halved on a pro-rata basis to $29.9 million, but

that it would also support eliminating altogether benefits to the companies. (DS2-006 at 1.) SUB argues that if BPA does not reduce the benefit level from $59 million then the companies are effectively insulated from the cost impacts of the BiOp Litigation, since those costs will not necessarily be reflected in a higher PF equivalent price in the companies' contracts. (*Id*. at 3.)

PPC (DS2-010) and Snohomish (DS2-008) argued the benefit amount should be reduced to zero based on the BiOp Litigation costs. Short of that, PPC proposed that a reasonable revision would be to link the amount of DSI benefits to events "dramatically affecting" BPA's rates, and that the Smelter Prototype should include a mechanism to adjust benefits in response to present and future costs. PNGC does not address the DSI ROD benefit levels in the context of BiOp Litigation costs or BPA's other program spending requirements, but rather argues that BPA has no statutory authority to offer any benefits of any kind under any circumstances to the DSIs, and should abandon its plan to offer DSI contracts. (DS2-009.) The legal arguments raised by PNGC and by other comments are addressed in section III.C., below.

GNAH argues that its allocation of 100 aMW is too small to allow it to operate given expected near-term forward power market prices, and that its allocation should be increased to a level that is "comparable to what BPA granted Alcoa." (DS2-004 at 2.) For its part, like PNGC, Alcoa argues that BPA's allocation decisions in the DSI ROD are fundamentally at odds with its statutory obligations, and that it constitutes an arbitrary reduction of benefits to the DSIs that assures only that the remaining DSI loads cannot be adequately served. (DS2-005 at 3.) Alcoa proposes that BPA should allocate an amount of power to the DSIs that reflects their aggregated historic load levels, adjusted by "actual DSI loads still capable of being served." Alcoa does not specify how much power it believes this formula would yield to each company, but does argue that BPA is obligated by law to serve any such load at a "fixed, cost-based rate" with firm surplus power that would otherwise be offered out-of-region. (*Id*. at 3-4.)

In addition, Alcoa argues that the energy savings achieved through DSI conservation measures should be considered when determining how much power BPA has to serve DSI load since the conservation is a resource that has been paid for by the DSIs. (*Id.* at 2.) While CFAC argues for certain additional flexibilities that could increase the benefit level above $59 million in any given fiscal year, it states it is not arguing for BPA to increase the total number of dollars provided for in the DSI ROD over the five-year period. (DS2-003.)

<u>Evaluation and Decision</u>

Parties' comments with respect to the appropriate level of benefits in light of the BiOp Litigation were considered as part of the PFR II. At the time comments were due on the DSI ROD, the only BiOp Litigation-related cost that BPA had actually incurred was approximately $75 million related to spill during the summer of 2005. Several comments cite this figure, and note that implementing additional BiOp Litigation costs could cost even more. Since the comment period closed on January 4, BPA has

developed a cost estimate of $60 million for summer 2006 spill required by the BiOp Litigation. After discussion in the PFR II, and examining updated information on expected hydro operations and revenues, BPA decided through the PFR II process not to reduce the maximum DSI benefit level of $59 million based on BiOp Litigation cost impacts. *See Bonneville Power Administration – Power Function Review II Closeout Report* (May 2006).

BPA explained that the original $59 million benefit level was chosen to balance benefits to smelters and smelter communities, with the rate impact on other customers. BPA noted that, had the impact of modified hydro operations on rates been more adverse, it could well have needed to rebalance. However, the information examined in the PFR II process showed that FY 2006 financial results will be at least as good as had been expected when the DSI service decision had originally been proposed. Several comments on the Draft PFR II Closeout Report questioned BPA's proposal to retain the $59 million benefit level, and noted that the positive financial results BPA has experienced over the last year are not necessarily a predictor of the conditions, including secondary revenues, BPA may experience during future years. BPA acknowledges this fact. However, the fact that BPA's revenues vary with market and water conditions has always been an important context for DSI benefit decisions. The purpose behind the reexamination of the $59 million amount was to decide whether the changes in BPA's hydro operations so significantly altered BPA's near-term financial picture, that DSI benefit levels should be changed. BPA delayed the final benefit level decision to gather information about its own operations, and to better understand its near-term financial condition.

The comments in this process made it clear that many of our public utility customers, and their consumers, would rather see their own rates reduced than to pay anything to provide service to the DSIs, largely reinforcing comments they had made previously. These comments highlight the importance of BPA's decision to have a known capped cost on the DSI benefit level, even though DSIs have been equally clear they would like to see higher benefit levels. While the costs of changes to hydro operations have impacted BPA's revenues, BPA concluded in the PFR II process that these costs are not enough to require a change in the balance originally proposed on this issue, and that the maximum benefit level should remain at $59 million per year. Having made the foundational decision, BPA addresses in this supplement to the DSI ROD other benefit level issues raised in comments on the Smelter Prototype.

PPC argued in its comments that a mechanism should be developed in the contract that allows for adjustment of DSI benefits in response to BPA cost levels. (DS2-010 at 2.) The approach offered by PPC would not provide a workable power supply for DSI loads, since they could face a substantial or complete termination of physically or financially delivered benefits, whenever some future unknowable event occurs. BPA does not believe the level of uncertainty this would create is a reasonable contingency to place on any customer's power supply contract. This challenge is compounded in the case of the aluminum companies which already face marginal economic conditions. The DSIs make operating and purchasing decisions extending over long periods of time into the future. It would be difficult for a company to

commit to other long-term purchases required to run its business without a reasonable amount of certainty with respect to the level and duration of service benefits from BPA.

Moreover, the DSI benefit level is effectively subject to reasonably defined adjustments reflecting BPA cost increases, since the companies' benefit level is tied to the Priority Firm Power rate, which in turn will be subject to adjustment (under the cost adjustments proposed by BPA in the pending power rate case), within parameters, reflecting increased BPA costs. Therefore, an increasing Priority Firm Power rate that reduces the spread between that rate and market power prices may reduce the amount of benefits that a company would receive from BPA under the Smelter Prototype, reducing costs to other customers. PPC's proposal will not be adopted, but BPA will continue to ensure that increases in the Priority Firm Power rate impact the benefits DSIs receive, such that higher Priority Firm rates have the potential to reduce the benefits that will be available to the smelters.

GNAH argues that high power market prices are increasing the value of BPA's surplus power, making it feasible for BPA to increase GNAH's allocation to a level that would support minimal operations at its Goldendale smelter "without any significant impact on other customers." (DS2-004 at 2.) GNAH asks that its allocation be increased to a level "comparable" to that of Alcoa, which is 320 aMW, an increase of approximately 200 aMW for GNAH. It is not readily apparent how increasing GNAH's allocation would help it operate in the near term, since it states in its comments that forward power market prices are too high to make market power purchases economical even with a $24/MWh benefit. (DS2-004 at 1.) Furthermore, the PFR II process looked holistically at BPA revenues and budgets, and could have decided to either raise or lower the $59 million benefit cap. BPA decided that the original level still struck a fair balance between the issues raised. This balance is highlighted by the fact that the PPC asked BPA to reduce the cap levels based on a focus on potential increases in BPA *costs*, while GNAH's request to increase benefits is based on potential increases in *revenues*.

As BPA noted in the DSI ROD, BPA is already proposing to allocate over two times as much power to the DSIs as they have chosen to purchase under their current BPA power sales contracts. As more fully explained in the DSI ROD, BPA believes it has struck a fair balance between providing a level of power system benefits to the DSIs, including to GNAH and Alcoa, that will enhance the prospects for smelter operation under a reasonable number of power and aluminum market scenarios, but not substantially increasing the rates to other customers. For these reasons, Alcoa's proposals to "aggregate" DSI historic loads, and to tally historic DSI conservation measures as federal base system resources paid for by the DSIs, all of which apparently would result in an allocation to Alcoa alone of 625 aMW, will not be adopted.

2. <u>Flexibilities</u>

BPA's November 28 letter asked whether the companies should be given more or less flexibility in how they are permitted under the Smelter Prototype to access their

monetized benefits. First, BPA asked whether the minimum operating levels necessary to draw benefits should be increased or decreased. Under the Smelter Prototype the minimum level of operation required to access any benefits is one-half of each company's allocation of surplus firm power. Second, BPA asked if the companies should be given additional flexibility to draw benefits early from future contract years, thereby potentially raising the annual cap in any one year beyond $59 million (but not increasing the total available benefits over the full 5-year contract term).

Some companies argued for two additional flexibilities. In the event that a company is operating at one-half of its surplus firm power allocation, the Smelter Prototype caps the level of payments BPA will make to a company at $24/MWh. Some companies argued, in conjunction with eliminating the minimum operating level condition, that BPA should remove the $24/MWh limit (while maintaining the overall cost cap), allowing reduced operations in higher priced power market. Likewise, some companies argued, again in conjunction with eliminating the minimum operating level condition, that BPA should eliminate the provisions of the Smelter Prototype providing that companies operating at less than certain defined levels over a specified period of time forfeit future benefits.

Comments

CFAC stated that absent additional flexibilities, including the ability to "borrow dollars" from later years it was unlikely its smelter could operate. (DS2-003.) CFAC also argues that BPA should eliminate both the $24/MWh limit and the unused benefit provisions in the Smelter Prototype. CFAC argues the unused benefit provisions penalize a company in future years for actions which result in savings for BPA's other customers in early contract years.

GNAH stated that power market prices are too high for it to operate even with a $24/MWh benefit, but that allowing it to draw benefits early from future years may allow it to operate a portion of one pot-line in FY 2007. (DS2-004.) GNAH notes this would also allow it to protect itself from losing future years' benefits it may otherwise forfeit under the Smelter Prototype's unused benefit provisions. However, GNAH also notes it is not practical for it to operate its Goldendale smelter at below 50 MW (one-half its DSI ROD allocation), and so it does not support modifying the Smelter Prototype to allow companies to collect benefits on operations below the existing one-half minimum criteria, since it believes this will only increase the likelihood that Alcoa, which is more likely to operate at lower levels given its greater maximum allocation, will qualify for a reallocation under the Smelter Prototype at GNAH's expense. However, GNAH's comment presumed that if BPA provided this operating level flexibility, that it would also double the level of benefits available on each megawatt of operation at these reduced levels from $24/MWh at one-half operation to $48/MWh at one-quarter operation.

Alcoa, however, opposes modifying the Smelter Prototype to allow companies to draw benefits forward from future years. (DS2-005 at 6.) Alcoa essentially argues that allowing weaker companies to borrow benefits from future contract years undermines the

unused benefit provisions of the Smelter Prototype, diminishing the amount of future benefits that might otherwise be available to "save" a smelter that is more viable on a long-term basis (citing as an example its Intalco smelter) during periods of high power market prices.

PPC (whose comments Snohomish indicated it generally supported) opposes allowing companies to draw future benefits forward, arguing that they will simply front-load all their benefits into the early years of the contract, and then cease operations. (DS2-010.) PPC argues this fundamentally undermines the balance struck in the DSI ROD between an annual capped level of benefits for each company, and the possibility of rate relief to other customers in the event a company cannot operate within the confines of that cap. ICNU argues that the same principle prohibiting unused benefits to be carried into future years should prohibit borrowing benefits from future years. (DS2-007.) ICNU states that allowing this flexibility violates the "known and capped" benefits principle because it fails to account for the fact the equivalent Priority Firm rate, established under the Smelter Prototype at the beginning of each contract year, serves as one input determining the actual level of benefits a company may receive in a year. In other words, a company could receive more benefits than it would have been entitled to if it had actually collected them in the future year. ICNU also argues that allowing the companies to access benefits at lower operating levels than provided in the Smelter Prototype will only result in a short-term subsidy that supports fewer jobs and reduces the likelihood of long-term DSI survival. Finally, ICNU argues that allowing a company to collect benefits while operating at less than one-half its allocation would effectively "increase the credit" and cause it to exceed the expected Priority Firm Power rate.

For its part, SUB stated it believed the level of flexibility provided by the Smelter Prototype is reasonable, that the minimum operating level required to access benefits should not be adjusted, and that the companies should not have any right to draw benefits early from future contract years. (DS2-006.)

<u>Evaluation and Decision</u>

(a) <u>Minimum Operating Level and $24/MWh Cap</u>

Only CFAC and Alcoa support allowing access to benefits in circumstances where the company is operating at less than one-half of its surplus firm power allocation. GNAH believes providing this additional flexibility, absent also increasing substantially GNAH's allocation, will increase the likelihood GNAH will be forced to forfeit future benefits under the unused benefit provisions of the Smelter Prototype. Each of the companies argued that BPA should also eliminate the $24/MWh limit in conjunction with eliminating or reducing the minimum operating level requirement, which would allow a company to access the full amount of its benefits even if operating at less than one-half of its allocation of surplus firm power. Other comments argued against this additional flexibility, arguing it would undermine the balance struck in the DSI ROD and provide the companies with a power rate effectively below the Priority Firm Power rate.

As explained in the DSI ROD, the principal reason for permitting the DSIs to draw financial benefits even when they operate at less than their full contract allocation – down to as low as one-half that amount, while simultaneously increasing the rate of financial benefit to a maximum of $24/MWh - was to further increase the probability of some smelter operations over a wider spectrum of power market prices. With a capped benefit, as power markets rise, the companies can afford to offset the high cost of fewer megawatts, so this flexibility was seen as important. However, BPA also felt it was important to establish a minimum level of operations in order to encourage the DSIs to work to maintain a level of smelter employment approximately equal to current levels. BPA did not feel it was reasonable to ask other customers to pay the costs associated with DSI benefits in cases where those costs were incurred to support diminishing, as opposed to stable or increasing, levels of smelter employment.

BPA believes it is important to maintain these balances, but does recognize that persistently high forward power market prices could make it difficult for the companies to meet the operating level requirements in the Smelter Prototype. The companies have argued that in these circumstances they might have to operate at levels lower than one-half, and that without the flexibility to receive benefits at lower operating levels they may be forced to shut down all operations now, putting into doubt the likelihood of the smelter's long-term survival. BPA understands that the economics of smelting are made significantly more challenging, due to the high cost of smelter restart, once a smelter shuts down, and that maintaining a reduced operating level may well be a short-term strategy to bridge to a time when operating levels can be increased. BPA is willing to provide the companies with slightly more operating flexibility, but only in a way that concomitantly reduces the overall cost to other customers in the event a company elects to operate at levels below one-half of its full allocation of surplus firm power. Therefore, BPA will reduce the minimum operating requirement to one-quarter of each company's allocation of surplus firm power, but will not adopt the companies' proposal that the Smelter Prototype be modified to provide more than $24/MWh for each megawatt of actual operation. With this change, a company will be able to access benefits if it decides that it makes economic sense for it to operate at levels as low as one-quarter of its allocation, but the overall cost to BPA's other customers will be reduced (though still higher than if the original one-half operating level requirement was retained) since the existing cap of $24/MWh will be paid out on fewer megawatts. BPA believes this approach strikes a fair balance between the business needs expressed by CFAC and Alcoa, as well as the challenges described by GNAH, and the rate concerns expressed in other customers' comments.

The fact that the $24/MWh amount will not be increased addresses the concern raised by GNAH that higher payments, in conjunction with lowering the minimum operating levels, would make it more vulnerable to having its allocation of benefits acquired by another DSI in later years. As structured, when a DSI operates at less than one-half of the megawatt level it has received, it also receives less than the maximum financial benefit that could be available under its contract. But if a company acquires unused benefits of another DSI, and benefit levels are increased above the current maximum of $24/MWh as its load decreased below one-half its new total allocated

amount, this could result in higher financial benefits than the company was entitled to under its initial allocation, without a corresponding increase in operations. Maintaining the $24/MWh maximum eliminates this potential outcome, reducing the incentive to rapidly acquire unused power from GNAH, potentially providing a longer window for GNAH to find a way to start-up operations. In any case, under the Smelter Prototype if a company has unused benefits, the right to that amount of benefits in future years is *either* reallocated to one or more of the other companies operating in excess of their full allocation, *or* eliminated from the 560 aMW amount permanently. So, if GNAH is unable to operate in the early years of the contract its benefits will ultimately be forfeited, whether another company acquires the benefits or not.

(b) Drawing Benefits Forward and Eliminating the Unused Benefits Provisions

To recap, CFAC and GNAH support allowing the companies the flexibility to draw benefits from future years for use in earlier years, and eliminating the unused benefit provisions of the Smelter Prototype. Alcoa and each other party that commented on these issues oppose making either of these changes to the Smelter Prototype.

As BPA reviewed and analyzed the comments it became clear that the approach BPA ultimately decided to take on flexibility was of primary importance to whether the DSI contract would result in smelting operations or not. The companies face forward power market prices, at least during the first two years of the contract, that are at or above the high end of the price distribution projection in the DSI ROD. While disparate solutions were proposed in comments, it was clear that a fundamental need of the companies was for some additional consideration on flexibility. This need was further highlighted by letters that BPA received during its deliberations from political leaders from Montana and Washington State that called on BPA to continue to work on creative approaches that would allow the DSIs to access their benefits.

Although BPA continued to hear about a desire for more flexibility, it had not decided whether to maintain the $59 million benefit level in light of BiOp Litigation costs, since that question was being explored in the PFR II process. Through that process, the rate concerns of the other customers were reiterated. Hearing from both groups of customers also reinforced the need to maintain the principle in the DSI ROD of creating a balance between rate impacts on other customers and the DSI benefit levels offered. For this reason, BPA continued to think about the flexibility in the context of ensuring that any annual benefit cap was maintained. The concept of allowing dollars to be shifted forward between years presented a number of problems, some of which are described in the comments. As PPC notes, an unlimited right to draw benefits forward could result in the companies front loading all their benefits under the contract into the early years, which is contrary to the principle adopted in the DSI ROD that benefits would be capped at $59 million annually. PPC also correctly notes such flexibility would make it almost certain that all the benefits (approximately $300 million over the contract term) would be consumed in the early years, increasing the chance of the smelters closing in the later years.

ICNU correctly notes that the Smelter Prototype establishes an equivalent Priority Firm Power rate each year, and that the annual level of available benefits is established, in part, by that rate. Since it will be unknown what the PF rate will be in the year from which benefits are drawn forward, allowing companies to draw benefits forward could result in an effective "rate" under the contract that is below the Priority Firm rate, contrary to the principle adopted in the DSI ROD that the companies would not get a better deal than the Priority Firm rate. Likewise, the Smelter Prototype provides that a market rate be forecast by the start of each contract year, another factor in establishing the level of available benefits. Allowing a company to pull forward benefits from contract years in which neither the Priority Firm rate nor the forecast market rate are yet established could result in a company receiving benefits that it would not have otherwise been entitled to.

For its part, Alcoa argues that the Smelter Prototype, as structured, properly enhances the long-term prospects of the more viable smelters, by making unused benefits available to those companies that can establish and maintain higher levels of operation at the proposed annual benefit levels. It is true that the DSI ROD contemplated that the reallocation provisions would provide companies that could successfully operate an opportunity to acquire the unused benefits of a less successful company. However, it was also BPA's intent to allocate an amount of benefits, at terms and conditions for their access, that would give each company a reasonable opportunity, under a range of expected power market prices, to increase its operations over current levels.

The principal argument by CFAC and GNAH in support of this flexibility is that current forward market prices for the early years of the contract term are too high for them to operate, even if they can access their full annual benefit. GNAH stated that this flexibility "potentially could" allow it to operate a portion of one pot-line in FY 2007. Operating at some level will also help it reduce the loss of access to benefits under the unused benefits provisions of the Smelter Prototype. CFAC indicated that it needs to be able to shape its monetary benefits in the early years of the contract to close the gap between prevailing forward power market prices and the expected Priority Firm rate. CFAC has stated it will be forced to cease operations completely at the start of the upcoming rate period unless BPA provides this additional flexibility. Under the Smelter Prototype, if CFAC or GNAH fail to operate at all for a period of 12 consecutive months, those companies would likely end up forfeiting all future benefits.

Nevertheless, BPA is not convinced that allowing the companies to move benefit levels between years would lead to a long-term stable result. The comments of both GNAH and CFAC seem to highlight the fact that they are seeking a solution that allows them to hang-on in the short-term, leaving a high likelihood that each would use up its allocated benefits well before the contract expired. This was further highlighted by Alcoa's concerns about having benefits burned-up before they were made available to other smelters, and by the PPC's concern that moving values between years would greatly increase the likelihood that most of the benefits would be consumed. This could ultimately lead to a result where BPA's other customers' rates reflect the full cost of

proposed DSI benefits, but communities see significantly diminished smelting operations and jobs. This result is inconsistent with BPA's intent expressed in the DSI ROD, and will not be adopted.

BPA stated in the DSI ROD that it would not adjust the overall benefit levels based on changing forward power market prices. However, it is becoming clearer as the next rate period approaches that flat forward power market prices, in at least the first two years of the contract, are likely to remain at levels above the high end of the range of the price distribution used by BPA in the DSI ROD. BPA is persuaded that the companies, and in particular CFAC and GNAH, are unlikely to operate in the early years of the contract, absent some additional flexibility in how they access their benefits. The likely result would be that those two companies will forfeit all future benefits under the unused benefits provisions of the contract. This is not the result BPA was aiming to achieve in the DSI ROD. Therefore, BPA is willing to provide a mechanism for additional flexibility to all the companies, in a way that enhances the prospect of smelter operations over the full term of the contract, but that does not create a risk of rate impacts exceeding the $59 million cap, or otherwise substantially erode the other interests addressed in the DSI ROD and the Smelter Prototype.

In the January 18, 2006, posting announcing the decision to reexamine the $59 million benefit level in the PFR II, BPA noted there was a possibility that the DSI decision would be accelerated to meet DSI business needs. Within that context both Alcoa and CFAC each separately approached BPA in late March to indicate that with some additional flexibility from BPA, they could likely make market power purchase decisions that would allow them, in turn, to make firm operating decisions for much or all of the full term of the Smelter Prototype. Specifically, they asked that BPA consider allowing them to lock in a market price equivalent to their power purchases over a multi-year period, thereby providing certainty that they would be reimbursed under the Smelter Prototype, up to the annual cap, for their purchase power expenses. While forward market prices remain relatively high, they have moderated from their highest levels over the past twelve months. As currently structured, the Smelter Prototype resets the amount of benefits available each year based on a forecast of market prices. Each company argued this construct creates a substantial risk for them that the annual market forecast price could be below the price it pays now for a forward-block of power over the same period. They argue this risk prevents them from locking in such purchases now, which could allow them to maintain current levels of operations during most, if not all of FY 2007-2011. They argued that, unless this risk can be mitigated, they will be forced to wait until the beginning of each contract year to make power purchasing decisions. But if the market begins to rise again above current forward prices, the chances of the companies making such purchases later are slim, with the result that smelter operations will likely be shut down. The ability to make longer-term purchases now would also allow the DSIs to spread out the costs of higher and lower market prices in these years, since forward market prices are currently highest in FY 2007, dropping in the out-years of the contract.

Although a key part of the companies' request involved moving up the timing on moving forward with final decisions regarding the level of service benefits, BPA decided to allow the PFR II process to run its course because that process was moving towards conclusion, and would be disrupted by accelerating decisions on DSI service benefits. However, BPA saw merit in exploring the flexibility they requested. As noted, forward market prices for power – while still high – have moderated. In addition, market prices for primary aluminum (the product produced by the smelters) have increased over the past year, but have only marginally improved the economics faced by Northwest smelters since most of the increase is due to an increase in the cost of alumina, the raw product from which aluminum is made. These two factors together have improved the prospects for more stable smelter operations, but it is becoming more apparent that power prices now play the key role in the decision of the Northwest aluminum smelters to operate, or not. BPA believes modifying the contract so that the companies can lock in power prices offers an approach that will significantly increase the likelihood of continuous smelter operations over the term of the contract, but at a cost to BPA that is still within the annual cap on benefits. However, while power market prices have moderated recently, they remain high enough that locking-in the market price in the Smelter Prototype will also lock in the rate impact to other customers near the cost cap established for the DSI benefits. The actual impact of removing the year-by-year test on market prices is unknown, but by locking-in prices near the cost cap other customers will lose a potential rate benefit if market prices drop. BPA remains mindful of the balance that it has worked to strike between DSI benefits and rate impacts on other customers, and believes that a decision to offer the requested flexibility should be accompanied by some other form of rate benefit for its other customers.

Based on these considerations, BPA has decided to provide an option in the contract that allows a company to lock in its power purchases for a minimum of three years, and up to the full five-year term. BPA will use the cost of a company's purchase as the market price in the contract in later years, rather than updating the market price forecast on an annual basis. The DSI will be required to provide documentation that allows BPA to verify its market purchase price within a reasonably short period after exercising the option to lock in. During the time the DSI locks in a purchase price, BPA will continue to compare the actual Priority Firm rate (including all adjustments) with the net rate paid by the DSI (purchase price less the monetary benefits). Payments to the DSI will be reduced if a company's average net power cost over the period is less than the average effective Priority Firm rate. To balance this option with the interests of other customers, BPA will discount the monetary benefits if a DSI chooses to lock in its power price, reducing the maximum monetary benefit by 8% in FY2007-2009. If each company locks in its market price this will result in approximately $15 million of savings to other customers over a three-year period, compared to the case where the companies were entitled to access the full amount of benefits, up to the cap. Given the current markets for power and aluminum, BPA believes this level of discount will still allow a company to execute a multi-year power purchase that will keep some of the plants operating, thus preserving jobs. It is also a number that BPA believes will result in a reasonable probability that actual payments to the DSIs will not exceed the $53 million dollar level of benefits projected in BPA's pending wholesale power rate case to be accessed by the

companies. This will help insure no increase in Priority Firm rates over what is already assumed in the rate case. If a DSI chooses not to exercise the contractual option to lock in its purchase price, the year-by-year calculations for determining benefits will continue to apply. Because the period to lock in a purchase price may exceed three years, BPA will also adjust the contract provisions around the right to convert the monetized power to a physical power sale to align with rights provided to lock in the power price.

Finally, BPA will not modify or eliminate the unused benefits provisions of the Smelter Prototype, as requested by CFAC and GNAH. The provision to lock in power purchase prices provides a significant flexibility for all of the smelters to use. Although the economics of smelting remain challenging in the Northwest, BPA believes that the additional flexibilities adopted here provide a reasonable opportunity for each company to access its benefits. If, even in this context, a DSI is unable to access its benefits within the generous time-lines provided in the Smelter Prototype, BPA continues to believe the unused benefits should be made available, on a timely basis, for another company that has the ability to utilize them.

B. Other Smelter Prototype Provisions

Parties raised a number of other comments regarding specific provisions in the Smelter Prototype, or proposals for additional provisions. Each such comment, or related group of comments, will be presented and evaluated here in turn.

1. Benefit Repayment if Court Holds Payments "Illegal"

Comments

PNGC (DS2-009) commented that there is a "material risk" for BPA that petitioners will prevail on DSI rate and service issues currently pending before the Ninth Circuit Court of Appeals, and that the Smelter Prototype will likewise (or as a consequence of the outcome of those other pending actions) not survive legal challenge. PNGC notes the Prototype does not contain "adequate creditworthiness and credit support provisions" that will allow BPA to recover any "illegal" benefit payments made to the DSIs under the Smelter Prototype in the event the court later voids the contracts.

Evaluation and Decision

By "illegal" payments PNGC suggests that the Ninth Circuit could find BPA lacks statutory authority to serve DSI load, or if it does have such authority that some essential element or elements of the Smelter Prototype is outside that authority, or is otherwise contrary to law, and that the contracts are therefore void. BPA believes the service construct embodied in the DSI ROD and the Smelter Prototype is within the statutory authority of the BPA Administrator, and is a prudent use of the Administrator's discretion to serve DSI load. Even if not, a provision requiring the companies to refund payments in the event the Ninth Circuit holds that the contracts are void is unreasonable under the circumstances.

In the unlikely case the contracts are held void (so that no contract ever existed as a matter of law) and the payments are "illegal," the companies will have little realistic prospect of operating their smelters during the next rate period. Yet they may, at their own risk and expense, have made commitments with respect to operating their facilities, including making market power purchases, in anticipation of benefits being available under the Smelter Prototype. The Smelter Prototype makes clear that the companies may not seek damages against BPA in the event the contract is terminated if successfully challenged on certain grounds, and as discussed below, that language will be modified to be more expansive, as proposed by PPC in its comments. In these circumstances, BPA does not believe it is equitable also to require the companies to refund benefits paid. PNGC's proposal will not be adopted.

2. Audits and Recovering Overpayments

Section 6 of the Smelter Prototype provides that a company is not entitled to monetary benefits in any year in excess of the amount actually incurred to close the gap between its market power costs and the equivalent Priority Firm Power rate. This is the case even if the forecast market price for such contract year, as compared to the equivalent Priority Firm Power rate, would otherwise provide for monetary payments in excess of the company's actual power purchase expense. To prevent a windfall, the Smelter Prototype contains certain audit and repayment provisions, in addition to an affirmative duty on the part of the company to advise BPA if it believes it has procured power at a cost that will require it to access less than the full available monetary benefits to bridge the gap to an equivalent Priority Firm Power rate. However, these issues are largely eliminated if a company elects to lock in its market purchases, as described above. However, even under that scenario refunds could be due in the unlikely event that the company's net power cost falls below the Priority Firm Power rate.

Section 6 also provides BPA with an audit right to confirm a company's power purchase cost. If the company's actual cost was less than the monetary benefits paid to it over the course of the contract year, then such overpayment is netted against any monetary benefits available to the company in the next contract year, or subsequent contract years until fully recovered by such offset. If the contract terminates prior to full recovery of an overpayment through offset, then the company must pay BPA directly. *Id*.

Comments

PPC believes that the repayment construct has certain weaknesses. PPC commented that the companies' self-reporting requirement is inadequate, and that in any case the contract language is unclear regarding what constitutes "knowledge" by the company that its power purchase costs will under-run available monetary benefits during the course of the contract year. In addition, PPC commented that BPA's audit right at the end of each contract year is inadequate since it will allow for potentially substantial overpayments to occur before they are discovered through an audit. PPC notes that this problem is not addressed by the repayment mechanisms since if the DSI fails to operate,

enters bankruptcy, or declines the future benefit without simultaneously terminating the contract (thereby triggering the direct repayment obligation) then BPA may not be able to recover overpaid amounts. PPC recommends that the contract be amended so that BPA conducts quarterly audits of any company receiving benefits, which PPC believes would lead to timely discovery of overpayments, and a greater likelihood of repayment.

PNGC commented that BPA should require the DSIs to provide credit support to insure they repay any overpayments, and that BPA should make a "commitment to vigorously police and enforce repayment" of overpayments. In addition, PNGC commented that the contract should contain specific credit support requirements to address the take-or-pay risk to BPA associated with a physically delivered transaction, and that the current contract language requiring the application of "then-current credit policies," and the reference to the prepayment of damages included at the end of curtailment provisions in Section 4, is insufficient.

Evaluation and Decision

On its face PPC's proposal for quarterly audits appears reasonable, and BPA considered the feasibility of such an approach as it developed the Smelter Prototype. However, a quarterly audit regime raises many difficult implementation problems. The quarterly approach is not practical in light of the seasonal nature of both power prices and the Priority Firm rates that set the amount of benefits that would be available. Market prices may be exactly $24/MWh higher than the Priority Firm Power rate over the course of the year, but within individual quarters the gap will almost certainly be both higher and lower. Breaking the benefit levels into quarterly amounts would greatly complicate the implementation of these benefits since to insure that a company received the amount of annual benefits it was entitled to under the contract, BPA would need to establish balancing or true-up mechanisms, allowing a company to take greater amounts in one quarter and less in other quarters. This would be further complicated by the fact that changes in the Priority Firm Power rate, due to rate adjustments that could occur several times during a year, could cause BPA to have to revisit any quarterly result. BPA does not believe such a regime could be easily or accurately implemented. BPA believes that an annual audit meets the intent of making sure benefit levels do not exceed what a company is entitled to under the contract, while minimizing costly and burdensome administration steps. Ultimately the quarterly approach would increase the cost of implementation, but would not provide BPA with a more accurate picture of whether a company was receiving overpayments.

However, BPA agrees with PPC that the obligation of the companies to notify BPA if it believes its power costs will not require full access to benefits under the contract should be strengthened and clarified. To the extent that a company elects to lock in its market purchases and use the cost as the contract market price, then the company will be required to provide documentation that allows BPA to verify the purchase price within 30 days of providing BPA notice of its decision. A company that does not elect to lock in its market price will be required, within 90-days following the end of each contract year, to provide BPA a written certification by its chief financial officer that the

average annual purchase power cost to serve its total smelter load was equal to or greater than the forward market price established under Section 6, and provide BPA access to contracts, invoices, or other documentation sufficient to substantiate such certification.

PNGC commented that BPA should require each company to post a letter of credit or issue a parental guarantee to cover any possible repayment obligations that are not recovered by BPA through setoff or otherwise. BPA believes the risk of overpayment will be greatly reduced in the event that the companies that operate lock in their power purchases and the contract market price, as BPA expects they will. This is because BPA will know up front the level of benefits that a company will be entitled to. Under the Smelter Prototype as currently structured, BPA makes payments based on a forecasted market price, and does not necessarily know what the companies actually paid for its market power until the end of the contract year, following an audit. Knowing the companies' market power costs up front will allow BPA to monitor on an on-going basis the gap between those costs and the Priority Firm Power rate. This provides a kind of natural hedge against overpayments, allowing BPA to prevent overpayments from ever occurring. Of course, if an overpayment does occur, BPA may setoff the company's repayment obligation against future benefit payments. To the extent no setoff is available, the company is obligated by the Smelter Prototype to pay BPA cash. The chance of overpayments are slim; if one occurs it will likely involve a very small amount of money, and the chances of recovery using the tools already available are high. In BPA's business judgment, the administrative burden associated with securing and maintaining credit instruments to cover the small risk outweighs the very marginal benefit.

Finally, PNGC commented that the Smelter Prototype's provision that "then-current credit policies" will be applied to a company in the event BPA exercises its option to convert to a physical sale in FY 2010-2011, is inadequate. PNGC suggests BPA secure "robust credit support" from the companies now to mitigate the various risks associated with a physically delivered power sale. BPA understands the concern expressed by PNGC, but believes the better business approach is to review a company's credit quality when, and if, BPA decides to convert the transaction to a physical sale. Any credit assurance instruments secured now would likely either require too little (leaving BPA exposed) or too much (burdening the company with unnecessary costs) credit support, since BPA could only guess at the nature and financial scope of the risks involved. Much can happen over the course of three years (the earliest BPA could exercise its option) that can impact a company's risk profile. BPA does not want to lock itself into contract credit support language that may end up being insufficient later, and so PNGC's proposal will not be adopted.

3. Physically Delivered Power and the Cap

Comments

Section 5(b) of the Smelter Prototype gives BPA the option to convert the transaction to a physically delivered power sale for the final two years of the contract.

PPC commented that the Smelter Prototype does not provide sufficient mechanisms to guarantee that the cost cap would not be breached in the event that BPA elects to exercise this option under one or more of the contracts. PPC correctly notes that BPA would face market price risk, which in this case (where BPA is structuring a deal that provides the companies with a $59 million benefit) will arise in circumstances where market prices are more than $12/MWh above the contract rate. This could result either from foregone market sales of BPA surplus being used to serve DSI load at a below market rate, or where BPA must purchase power in the market to serve some or all of the DSI load. PPC recommends that the contract specify that BPA's obligation to serve DSI load with physically delivered power would be limited by the amount of cost (forgone revenue and/or power purchase costs) actually incurred by BPA, up to the $59 million cap.

Alternatively, PPC recommends that the amount of cost incurred by BPA to serve the DSI load be tracked in relation to changing market prices. In either case, PPC recommends that BPA's obligation to deliver power would terminate as soon as the cap is reached, which it describes as "a major part of the deal BPA described when it justified these benefits" to its customers and constituents. PPC notes that any operational uncertainty to the DSIs caused by such a provision is consistent with the principle in the DSI ROD that BPA is not attempting to "guarantee any particular level of DSI operations, even minimal levels." Finally, PPC suggests that before any decision to physically deliver surplus firm power, BPA conduct a public comment process, in which the preference customers could participate. (DS2-010 at 6.)

SUB commented that BPA's option to convert the transaction to physically delivered power "complicates the contract and should be eliminated." (DS2-006 at 4.) Short of that, SUB recommended that the contracts should clarify that any such sale is subject to BPA Transmission Business Lines (TBL) Open Access Tariff, business practices, and applicable records of decision, to avoid what SUB describes as "super-preference" transmission rights. SUB also suggests that the contract clarify that a company may not resell any physically delivered power.

Evaluation and Decision

PPC is correct that BPA concluded in the DSI ROD that it was not prepared to guarantee DSI operations at any price. Rather, the megawatt and dollar caps were established at a level that balanced the competing goals of providing a level of benefits that will provide some opportunity for smelter operations at current or increased levels, at the least cost possible to other customers. PPC's proposal would fundamentally undermine the first goal, inasmuch as none of the companies will base a plan of smelter operations on a power supply that is essentially subject to termination at any given time. Yet there may be scenarios where it is more advantageous for BPA, a company, or both to physically deliver power in lieu of monetizing the transaction. Certainly the companies, and some other parties as well, expressed a strong desire for physically delivered power in the earlier round of comments leading to the DSI ROD. PPC rightly notes that a physically delivered deal more fully hedges the companies against rising market prices. Nevertheless, from BPA's perspective, while monetizing the value of the

contract mitigates the risk of breaching the $59 million cap, physically delivering power to the companies is, in some ways, a simpler proposition.

As BPA stated in the DSI ROD, it will proceed with physically delivering power under the contract only where any credit (default) risks associated with providing a physical supply to a company have been addressed, and where BPA can supply a company's load, including locking down any necessary market supplied purchases, on a fully hedged basis at a cost at or below the cost cap. In circumstances where BPA forecasts that the cost to serve one or more of the companies would not exceed the cap, it is probable that BPA could hedge any risk on the margins of that forecast (and include any costs associated with the hedge against the cap). Absent this, BPA will not exercise its option to physically deliver. Therefore, it is not necessary to adopt the PPC's proposals on this issue. However, BPA will adopt PPC's proposal to conduct a public process before exercising its option to convert to a physically delivered sale. The purpose of the process will be to explain why BPA wants to exercise the option, and how the transaction can be executed such that the cost to BPA will be within the capped cost levels established in the DSI ROD.

It is not clear to BPA what issue SUB is raising in its comment that the Smelter Prototype may create "super-preference" transmission rights for the companies. Section 4(g) makes clear that the DSIs are responsible for securing transmission service to get the power to their facilities. The language in section 4(g) stating that BPA would take actions necessary to facilitate the delivery of power to the DSI consistent with whatever transmission services the DSI secures, is standard language contained in most of BPA's Subscription power sales contracts. The manner in which the DSI secures transmission services from the TBL, and how that service is provided, is subject to the same tariff and other rules and regulations applicable to every other customer of TBL, and nothing in the Smelter Prototype does, or can, alter that. Therefore, SUB's proposed language appears to be superfluous, and will not be included in the final contract.

With respect to SUB's comment that language should be added that the DSI is prohibited from reselling physically delivered surplus firm power, Section 4 of the Smelter Prototype already expressly provides that all physically delivered surplus firm power provided by BPA under the contract "is solely for service to Total Plant Load." In addition, Section 4(e) specifies how a company may curtail its load, including that any such curtailed load is remarketed by BPA, not the company. Therefore, SUB's proposed language appears to be superfluous, and will not be included in the final contract.

4. Interruption Rights

Comments

Section 4(i) of the Smelter Prototype gives BPA a one-time right, on 90-days prior notice, to interrupt power deliveries to a company for a period of not less than 6 or more than 12 months, provided it anticipates that the average market prices for a flat

block of power will exceed $125/MWh over the period of the proposed curtailment. In exchange, the company will be paid $24/MWh for amounts interrupted.

PPC commented that this interruption right is "wholly insufficient as a DSI benefit risk-mitigation strategy." PPC believes the notice period should be shortened so BPA could interrupt the load sooner in a high-priced market, and that BPA should not be obligated to resume deliveries if market prices remain at such high levels. (DS2-10 at 5.) PPC also commented that the $24/MWh payment, some or all of which must be used to compensate employees, provides an inappropriate windfall for those employees. PPC reasons that in such a high-priced market it is unlikely that the companies would be operating their smelters, and that BPA should not be paying employees "under conditions in which the DSIs are not viable." PPC recommends that BPA delete the interruption right from the contract, and instead "focus on enforcing the cap on its actual costs."

Evaluation and Decision

PPC misconstrues the purpose of the interruption right. It was not intended to be, and therefore is not designed as, a risk mitigation tool. As BPA stated in the DSI ROD, and reaffirmed above, it will not exercise its option to physically deliver surplus firm power to a company unless it has fully hedged all risk that the cost of serving DSI load will exceed the cost cap. If BPA is not able to put positions in place that will allow it to meet this test, then it will not move to exercise its option to convert to physical delivery. That is the baseline from which the interruption right was devised, the purpose of which is to give BPA the opportunity to take advantage of a prolonged high price market.

With respect to the $24/MWh payment, PPC's comments fail to take into account that if BPA is delivering power to a company on a take-or-pay basis, at a fixed cost that incorporates the benefit, then the company is likely indifferent to the market price for power. Each company has been allocated an amount of BPA surplus firm power to enable a reasonable level of smelter operations, without additional market power. Therefore, if BPA elects to interrupt the company's BPA-supplied power, there is no reason to presume it will be for a period of time that the company would not have otherwise operated its smelter. A company may terminate the contract in response to BPA exercising its option to commence physical deliveries. If a company elects to accept the take-or-pay obligation associated with physical deliveries, then presumably it will have determined that operating its smelter was otherwise economically desirable. In these circumstances the payment to the company for the interruption of its load is appropriate, and would not provide a windfall to workers.

5. Termination

Comments

Section 16(a) of the Smelter Prototype provides that BPA may terminate the contract without liability in the event BPA is legally prohibited from recovering from its Slice customers DSI service benefit costs allocated to those customers by BPA. PPC

notes that the legality of BPA's collection of money from preference customers for payments to the DSIs during the current rate period is being challenged in the Ninth Circuit by various parties, including a challenge by PNGC to the DSI ROD. (DS2-010 at 7.) PPC also comments that Section 11(b) of the Smelter Prototype, which specifies that the uncontrollable force provision of the contract is not applicable during periods when the transaction is monetized, should be amended to make an exception for court orders.

Evaluation and Decision

In the event any of the pending challenges to BPA's fundamental authority to serve DSI load are successful, one likely result would be that the Smelter Prototype would be *void ab initio* and not enforceable by or against BPA. That would not be the case in a more narrow action by Slice customers challenging their obligation to pay for the costs associated with DSI service under the Smelter Prototype. Nevertheless, PPC's comment regarding Section 16(a) is well taken, and the provision will be amended to clarify that the contract will terminate without liability to BPA if a court issues a final, unappealable order that expressly prohibits or has the effect of preventing BPA from performing its obligations under the contract. With this change, it is not clear that PPC's recommended change to Section 11(b) is either necessary or appropriate. If a court holds that providing benefits to the companies is beyond BPA's authority, that will trigger the termination of the contract (both by operation of law and pursuant to the language amending Section 16). Stating that it would also constitute an uncontrollable force event is therefore not necessary, and may create an ambiguity regarding the enforceability of the contract.

C. Legal Issues

Comments

Some parties raised legal issues in their comments. PPC raises three such issues. First, PPC comments that the Smelter Prototype does not include a mechanism for recovering from the DSIs costs that exceed the section 7(b)(2) rate ceiling. PPC states that section 7(b)(2) requires BPA to either make some provision in the contract to do so, or to otherwise "make certain that it can collect these amounts from some source" other than the Priority Firm Power rate. (DS2-010 at 6.) Likewise, Snohomish commented that the Smelter Prototype "appears to be contrary to several provisions of existing law" including the section 7(b)(2) rate test. PPC next comments that the Smelter Prototype "sets and guarantees the DSIs a rate outside of the [section] 7(i) rate-setting process." (*Id.* at 7.) PPC states it believes the rate construct contained in the contract should be determined in a rate case. Finally, PPC questions whether BPA can "sidestep" section 5(d)(1)(A) of the Northwest Power Act, which provides that sales to the DSIs pursuant to that section shall provide a portion of reserves for firm power loads within the region, simply due to the fact that the sale in this case is a surplus power sale.

PNGC comments that BPA failed in either the Regional Dialogue record of decision or the DSI ROD to "identify any legal authority" for providing benefits by

monetizing the value of the contract, for selling physically delivered surplus power at "heavily discounted rates" to the companies, or for charging its preference customers the costs associated with providing these benefits. (DS2-009 at 1.) PNGC notes that some of these issues, and other issues regarding service by BPA to the DSIs, are currently pending before the Ninth Circuit in *Golden Northwest Aluminum, et al. v. BPA*, Nos. 03-73426 *et al*. (consolidated cases) (*"Golden Northwest"*). PNGC states that if the court accepts its arguments in that case, then BPA cannot "enter into 'sleeving' or conduit arrangements with cooperating preference customer distribution utilities to do indirectly what it is unlawful to do directly." (DS2-009 at 2.) Snohomish also commented that it believes BPA has no statutory authority to provide "financial subsidies of the type proposed" in the Smelter Prototype, but does state that it is in the discretion of BPA to serve DSI load. (DS2-008.)

PNGC comments that BPA has failed to offer the surplus power being allocated to the companies in the Smelter Prototype to its preference and priority customers, and that the contracts "constituted administrative allocations of surplus power" in violation of public preference. PNGC notes that to the extent the contracts operate as power sales to the local public utility partner, that "it is obvious that BPA is providing service for customers that are new large single loads of those utilities." Finally, PNGC argues that the Smelter Prototype reflects "discriminatory and preferential treatment" for the local public utility partner. They argue that other public preference customers have similarly situated industrial load that could benefit from the benefits provided through the Smelter Prototype, but that even if it were lawfully able to do so, BPA could not reasonably offer similar contracts to other similarly situated parties.

For its part, Alcoa comments that BPA's own estimates show it will have sufficient surplus in 2006 through 2008 to serve all of the 560 aMW allocated to the companies in the DSI ROD, and that under average water conditions BPA will have large amounts of surplus power for the full five-year term of the Smelter Prototype. (DS2-005.) Alcoa argues that section 5(d) of the Northwest Power Act expressly establishes for the DSIs "a statutory right to power." As such, if there is surplus available that is unclaimed by BPA's public preference customers, Alcoa reasons, because of its status as a regional preference customer under the Pacific Northwest Consumer Power Preference Act, 16 U.S.C. § 837, *et seq*., (Regional Preference Act), that it is entitled to that surplus power, physically delivered, at "a fixed, cost-based rate."

Alcoa argues that if BPA is unwilling to deliver surplus power at cost directly to the companies, then it should, similar to the service construct contemplated for Port Townsend, serve aluminum company load based on a sale of BPA power at the Priority Firm rate to the public utilities adjacent to the aluminum smelters, including a reasonable margin for those utilities. Alcoa implies, without actually arguing, that BPA may not discriminate between the companies. Citing section 5 of the Flood Control Act of 1944, 16 U.S.C. § 825s, Alcoa argues that BPA's power sales contracts should encourage the most widespread use of federal power, at the lowest rates possible consistent with sound business principles, and on fair and reasonable terms and conditions. Alcoa states that the "fair and reasonable terms" clause is similar to the "just, fair, and reasonable"

standard (presumably in the Federal Power Act, 16 U.S.C. § 824d(a)), which "has been held to prohibit discrimination in rates." (DS2-005 at 5.) Finally, Alcoa cites a clause in section 5(a) of the Bonneville Project Act (16 U.S.C. §§ 832, 832d) directing the Administrator to include terms and conditions in contracts with its utility customers that insure rates for resale that are "reasonable and nondiscriminatory."

Evaluation and Decision

BPA disagrees with the PPC that the Smelter Prototype must contain a provision that would allow BPA to allocate a portion of any section 7(b)(2) trigger costs to the companies, or that some other provision must be made to insure public preference customers do not bear such costs through the Priority Firm Power rate. First, BPA's final decisions with regard to the 7(b)(2) rate test, including how any trigger costs will be allocated, will be contained in BPA's 2007 Wholesale Power Rate Case final Record of Decision. BPA also disagrees with the premise of PPC's comment that section 7(b)(2) "puts a ceiling on the amounts that BPA can collect from its preference customers through rates." (DS-010 at 6.) As preference customers have previously admitted in briefing in *Golden Northwest*, the rate test does not provide an absolute rate cap for preference customers. Ultimately, if there are no non-preference loads to allocate such costs to, then such costs are allocated to the Priority Firm rate, consistent with BPA's overarching obligation under section 7(a)(1) of the Northwest Power Act to recover its costs. This issue, however, can be resolved only in BPA's power rate hearings under section 7(i) of the Northwest Power Act.

Furthermore, BPA historically has not allocated any part of the trigger amount under 7(b)(3) to surplus power sales. The Smelter Prototype, a three-party surplus firm power sale by BPA to a public preference customer, with a resale to the DSI, falls squarely into that category. This is true even in cases where BPA has made surplus sales directly to DSI customers under its surplus power rate schedule, which can reflect market prices. Consequently, there is no power sale to the DSIs that any trigger amount can be allocated to, and PPC's proposal will not be adopted.

PPC next argues that the "rate construct" in the Smelter Prototype should be established in a formal rate proceeding. Again, the rate construct in the Smelter Prototype is a negotiated rate established under BPA's existing surplus power rate schedule. Both BPA's existing surplus rate schedule (the Firm Power Products and Services schedule or "FPS"), and its proposed successor, each of which themselves will have been established pursuant to a section 7(i) rate proceeding, provide BPA with the ability to negotiate a contract rate, or rate formula, such as the one in the Smelter Prototype. Notwithstanding the complexity of the Smelter Prototype, the fundamental term in the contract is a formula for the payment of cash, or the delivery of firm power, each based, in part, on a rate equivalent to the Priority Firm Power rate.

It is neither legally required, nor practically possible, for BPA to conduct a section 7(i) rate proceeding every time it executes a power sales deal at a negotiated price under its surplus power rate schedule. In addition, it is worth noting that the proposal for

service to the DSIs for the FY 2007-2011 period, including the amount of benefits (in the form of a rate discounted to market), has been subject to a public review process that is, in many ways, as rigorous as any rate proceeding. A formal rate proceeding is not legally required for BPA to negotiate a rate within an established rate schedule in a surplus power sales contract, and in this case in particular, would add little or nothing to the record already developed regarding the benefit levels established in the DSI ROD, and this supplement thereto. PPC's proposal will not be adopted.

Finally, PPC raised the issue whether section 5(d)(1)(A) of the Northwest Power Act requires the DSIs to provide reserves to BPA, even though BPA is not making a traditional direct sale to the DSIs under the Industrial Firm Power rate, pursuant to sections 5(d) and 7(c) of the Act. Historically, BPA's right to interrupt or curtail service to DSI load provided BPA with valuable stability (transmission system) and operating (power system) reserves. DSI smelter load in particular could provide reserves to BPA due to its interruptible nature. However, these reserves were not provided for free, and section 7(c)(3) of the Act provides that the DSIs are to be compensated for the value of the reserves they provide to BPA through a credit to the Industrial Firm Power rate.

However, both section 5(d)(1)(A) and section 7(c)(3) contemplate sales under, and a credit to, the Industrial Firm Power rate. It is BPA's position that the reserves requirement in section 5(d)(1)(A) does not apply in the event BPA is serving DSI load with surplus power under sections 5(f) and 7(f) of the Act. In fact, BPA has never procured reserves from the DSIs under surplus power sales contracts with the DSIs.

Moreover, beginning with the 2002 Wholesale Power Rate Case and related DSI Subscription contracts, BPA ceased crediting the Industrial Firm Power rate for the value of reserves, and has not procured reserves from the DSIs under their Subscription contracts. DSI contracts since that time have been firm, take-or-pay contracts, without provision for interruption by BPA. This is due primarily to changes in the wholesale power markets which allow BPA to procure needed reserves cheaper and more reliably from other sources. In lieu of a fixed credit to the Industrial Firm Power rate, in the 2002 rate case, through the so-called Supplemental Contingency Reserves Adjustment, BPA established a cap on the amount it could pay a company in the event it wished to procure reserves from a DSI through negotiation. This approach was proposed, adopted, and has been implemented by BPA without objection, and the DSIs have provided no reserves under their Subscription contracts. *See 2002 Final Power Rate Proposal – Administrator's Record of Decision*, WP-02A-02, Part 3, at 15-36. BPA is proposing the same approach in its 2007 rate proceeding. Of course, for at least the first three years of the Smelter Prototype, BPA will monetize the contract, so no power will flow from BPA's system to the DSIs. As a consequence, there are no reserves that can be provided. Nevertheless, there is no apparent reason why BPA could not apply, either directly or by way of guidelines, the cap and criteria in the Supplemental Contingency Reserves Adjustment provision to any reserves it wishes to procure from a willing DSI in the FY 2010-2011 period, in the event the contract is converted to physical delivery.

PNGC raises fundamental issues regarding BPA's authority to provide service to the DSIs in the manner contemplated under the Smelter Prototype. As it notes, some of these issues are currently pending before the Ninth Circuit in the *Golden Northwest* case. PNGC's argument that BPA may not allocate to its public preference customers any costs of serving DSI load is pending before the court in *Golden Northwest*. That case has been briefed and oral argument was held on November 16, 2005. Because BPA has already articulated its position on this issue in *Golden Northwest*, and a decision by the court is pending, BPA will not directly address that issue here.

PNGC also questions whether BPA may provide the benefits of a "heavily discounted" surplus power sales contract to the DSIs, either by monetizing the value of the contract or by supplying physical power at a below-market price. This appears to be raised as a separate issue from the cost allocation issue described above, but is similar insofar as the "cost" of any below market surplus power sale, at least theoretically, means that other customers' rates will be higher than they otherwise could have been absent the below market sale. In fact, PNGC does not appear to argue, in any of its comments regarding BPA's service to the DSIs, that BPA may not enter into a surplus power sales contract with a DSI customer, but rather only that it may not do so at a below market price.

BPA believes it is beyond reasonable dispute that it has the statutory authority under section 5(f) to enter into a firm surplus power sales contract with a DSI customer, and that such sales may be priced at below market rates under BPA's surplus power rate schedule. Since 1996 alone, BPA has entered into dozens of firm surplus power transactions directly with DSI customers under the FPS-96 rate schedule. *See Kaiser Aluminum & Chemical v. Bonneville Power Administration,* 261 F.3d 843, 847-48 (9th Cir. 2001)(noting a number of FPS-96 transactions between BPA and DSI companies), *see also Portland General Electric Co. v. Johnson*, 754 F.2d 1475 (9th Cir. 1985)(approving sales to DSIs under BPA's nonfirm surplus power rate schedule). Apart from referencing its position in *Golden Northwest* that BPA may not charge public preference customer rates for any costs associated with serving DSI load, PNGC does not provide any legal analysis in its comment to support its suggestion that BPA may not otherwise enter into a below-market surplus transaction with a DSI; however, if the totality of PNGC's argument is that BPA cannot do so because any costs associated with such a transaction would necessarily be borne by public preference customers, then BPA's response is contained in its brief in *Golden Northwest*.

PNGC also questions BPA's legal authority to monetize the value of the contracts and make payments to the companies in lieu of delivering the surplus firm power. BPA's business rationale for its preference to monetize the transactions was discussed at length in the DSI ROD. As explained there, the fundamental reason for electing to default to monetization is that it is the best way to mitigate the market and default risks associated with a traditional take-or-pay firm surplus power sale to the DSIs. If BPA has the authority to enter into a surplus firm power sales contract (directly or indirectly) with a DSI customer (and no party has disputed that it does), and if BPA may price that contract under its surplus power rate schedule at a below-market price, then BPA believes it

follows that the Administrator has the authority to structure the transaction to achieve the lowest possible cost to BPA and its other customers.

There is no statutory prohibition against BPA fulfilling a contractual obligation under a power sales agreement by making a financial payment to a counterparty in lieu of delivering power. In fact, there is precedent for doing so both in other BPA power sales contracts, and in the wholesale power industry in general. BPA's program to buy-back its power sales obligations to certain customers in lieu of delivering energy, including with many of its DSI customers, during the west coast energy crisis in 2001, is one example. Another is found in the so-called "sale and exchange" agreements BPA has with California public and investor-owned utility customers, which contain "cash-out" provisions that give the parties the flexibility to make cash payments in lieu of providing energy. Another is found in the Northwest Power Act, where Congress established the Residential Exchange Program, which provides for BPA to buy higher priced power from regional utilities, and to "offer, in exchange, to sell an equivalent amount of electric power" to those utilities for resale to their residential customers. 16 U.S.C. § 839c(c)(1) (section 5(c)). Even though the language of the Act contemplates an actual power sale by BPA to the IOUs, in implementing section 5(c) in 1981 BPA determined that it was more economic and administratively efficient, while still carrying out the Congressional purposes in section 5(c), to monetize the exchange. BPA has always monetized exchange benefits provided to the IOUs, while retaining the right to provide physical power, pursuant to the terms of the applicable Residential Exchange Program contracts, settlements, and policies. Just as BPA is authorized by section 5(c) to provide the IOUs physically delivered power, but has always chosen to monetize the transaction in order to implement the program at the lowest cost, BPA is also authorized to enter into power sales agreements with the DSIs and monetize the transaction (while retaining the option, absent a DSI lock-in, to deliver physical power in the final two years of the agreement) in order to mitigate the financial risks inherent in a power sale to the companies, providing the benefits at a known and capped cost.

In addition, it is common electric utility industry practice to monetize a power delivery obligation rather than actually deliver the energy. Long-term power sales and exchange contracts frequently include provisions that specifically provide the option to cash out an energy delivery under specific circumstances. It is understood that there are times, over the life of a contract, when it is not feasible to deliver power. In those circumstances, a cash-out provision allows the party delivering the power to simply pay the other party the current value of the energy and forego delivery. Some type of predetermined market indexed formula price is commonly how the value is determined. For utilities that trade power to serve load, and that are constantly balancing their portfolio, replacing the undelivered energy is not difficult. In standard commodity trading, where there is no specific cash-out provision, the parties will mutually agree to monetize a delivery when the power cannot be delivered by one party or received by the other. The cash-out payment is designed to cover the purchase cost of the power. The DSI contract utilizes the same monetization approach. BPA elected to provide the DSI's with 560 aMW. To avoid the uncertainty surrounding power deliveries, BPA chose to provide the financial value of the energy to the DSIs, rather than the energy. BPA is

determining the value of the energy to the DSIs through a formula price, taking into account both market prices and BPA rates.

PNGC also argues the Smelter Prototype violates public customers' statutory preference and priority right to federal power. But public preference only applies in the case of a competing demand for Federal power between a public preference customer and a non-public preference customer. Preference applies to all BPA power sold, but it also applies only to the extent that a customer making a competing request has a need for the power to meet its Pacific Northwest energy requirement. If a public utility already has its regional firm load met, and has no firm resources other than hydro used for its loads that are higher cost than BPA's Priority Firm Power, then under section 1(f) of the Northwest Preference Act and section 9(c) of the Northwest Power Act, it has no energy requirement for federal power that could be met by a competing request for a BPA sale. Moreover, BPA's sales of surplus power to one public customer over another are discretionary and BPA may choose not to sell to one public utility while selling to another. *See City of Santa Clara v. Andrus,* 572 F.2d 660 (9th Cir. 1978). Here the sale proposed is to another public utility. The Smelter Prototype is a three-party contract, and BPA is selling surplus power under the contract directly to a public preference customer for resale, and not directly to the DSIs. Public preference is not implicated. In addition, the fact that the transaction is structured to serve DSI load, albeit through a local public utility, does not in any way undermine public preference rights. The Public Utility Partners to the Smelter Prototype have elected to participate in serving the load of the smelters located in their service territories, eliminating any possible public preference issues.

Moreover, even if BPA had elected to make these sales directly to the DSIs, it is not clear that any of BPA's public preference customers would have any practical financial incentive to step in front of the transaction. BPA's statutory obligation under sections 5(a) and (b) of the Northwest Power Act is to serve the net firm power loads of its public preference customers, and to meet the energy requirement of its regional customers as that requirement is defined under section 1(f) of the Regional Preference Act and 9(c) of the Northwest Power Act, as discussed above. BPA is not required to sell power to a public customer solely for the purpose of the customer's arbitrage of the power by resale on the market, particularly when that power can be made available to serve other regional load. BPA made clear in its *Policy For Power Supply Role For Fiscal Years 2007-2011 – Administrator's Record of Decision* (February 2005), that it will meet the net requirements of its public preference customers, at its lowest-cost Priority Firm Power rates, for the FY 2007-2011 period. Because the public preference customers' full net requirements (as defined by statute and any applicable contractual provisions) will be satisfied, BPA also has the statutory authority, but not requirement, to make surplus firm power available to its DSI customers.

PNGC next argues that if this is a sale to a public preference customer for resale to the DSI, then the transaction is for service to a new large single load. The Northwest Power Act definition of "new large single load" includes an existing facility (such as a DSI smelter), which was not served by a public utility prior to passage of the Act, and

which will result in an "increase in the requirements" of the public utility, of ten average megawatts or more, in a consecutive twelve-month period. 16 U.S.C. § 839a(13)(B). PNGC believes the surplus firm power contracts contemplated here would constitute service to a new large single load, and, presumably, must therefore be priced at the rate applicable to such loads, which is the New Resource Firm Power rate. PNGC is incorrect. The DSI loads to be placed on the local Public Utility Partner are not new large single loads, because they will not cause an "increase in the requirements" placed on BPA by those local public utilities under section 5(b) of the Northwest Power Act. Rather, these are discretionary sales by BPA that are "surplus to [the Administrator's] obligations incurred pursuant to [section 5(b)]" and will be made under section 5(f) of the Northwest Power Act. 16 U.S.C. § 839c(f). Neither the new large single load provisions in the Act, nor BPA's policies on new large single loads, have any application in this case.

Finally, PNGC argues that the Smelter Prototype reflects "discriminatory and preferential treatment" of the local Public Utility Partner. It notes that many other public preference customers have industrial load in their service territories that could benefit from the deal contemplated in the Smelter Prototype. It is not clear if PNGC is arguing that the alleged discriminatory and preferential treatment is not only inequitable, but also illegal. BPA presumes PNGC means both. However, BPA disagrees that the deal proposed under the Smelter Prototype is discriminatory or preferential in the first instance, let alone inequitably or illegally (or in the parlance of the Federal Power Act, which does not apply to BPA's power sales, "unduly") discriminatory and preferential. Notwithstanding the fact that BPA service to its DSI customers is discretionary, the remaining DSI companies retain their status as a class of industries that are uniquely situated as eligible to receive direct power service from BPA. Because other industrial customers are not similarly situated to the DSIs, there is no basis upon which to allege that a benefit conferred upon the DSIs by BPA through their local public utility (which could be directly conferred) constitutes preferential treatment for the DSI or the local utility partner. *See Association of Public Utility Customers, et al. v. Bonneville Power Administration*, 126 F.3d 1158, 1171 (9th Cir. 1997) ("*APAC*") (rejecting argument that BPA discriminated in favor of the DSIs for purposes of providing transmission service because the DSIs and industrial customers of public utilities are not "similarly situated").

In any case, the Ninth Circuit has held that public preference does not require that all preference customers be treated equally. *City of Santa Clara v. Andrus*, 572 F.2d 660 (9th Cir. 1978) (interpreting preference clause in the Reclamation Project Act of 1939, 43 U.S.C. § 485h(c)). There is no other non-discrimination standard applicable to BPA's surplus power sales, and the courts will not apply such a standard where Congress has not made one expressly applicable. *See Southern California Edison v. Jura*, 909 F.2d 339, 343 (9th Cir. 1990) (court refused to apply a nondiscrimination standard to BPA's extra-regional nonfirm energy rates where Congress did not expressly provide for one, but had "expressly prohibited discrimination or 'undue' discrimination in other very similar administrative contexts" including section 205(b) of the Federal Power Act, 16 U.S.C. §§ 791a, 824d); *APAC*, 126 F.3d at 1172 (finding "there is no antidiscrimination standard

that applies to BPA's provision of wheeling services to the DSIs but not to APAC's members.")

Alcoa's legal arguments place it on the other end of the spectrum from PNGC. While PNGC argues that BPA has no authority to offer a below-market surplus power sales contract to the DSIs, Alcoa argues that BPA is not only authorized, but required by BPA's enabling statutes to do so. Alcoa appears to argue that its alleged "right" to power service from BPA at a cost-based rate is established by section 5(d) of the Northwest Power Act, and through its status as a regional customer under the Regional Preference Act. 16 U.S.C. § 837, *et seq*. BPA's position with respect to its discretion, but not obligation, to serve the DSIs under section 5(d) of the Northwest Power Act was articulated in *Golden Northwest*. BPA would add here only that the Ninth Circuit has stated that BPA "is not obligated to sell any power to direct service industrial customers" under section 5(d). *M-S-R Public Power Agency v. Bonneville Power Administration*, 297 F.2d 833, 837 (9th Cir. 2002).

Alcoa correctly notes that BPA projected in its 2007 Wholesale Power Rate Case initial proposal that, under average water conditions, the Federal power system will produce substantial amounts of surplus power in the FY 2007-2009 period. *See Wholesale Power Rate Development Study Documentation*, WP-07-E-BPA-05A, Vol. 1, at 129, Table 3.6.2. However, the basis for Alcoa's conclusion that BPA is obligated by statute to use a portion of this projected surplus to provide Alcoa "power service at a fixed, cost-based rate" is not clear. Presumably, by "fixed, cost-based rate" Alcoa is arguing that it is entitled by statute to a surplus power sales contract, physically delivered, and priced at a rate equivalent to BPA's lowest-cost Priority Firm Power rate. But beyond referencing the Regional Preference Act, Alcoa does not provide any statutory support for this position. Section 1(c) of the Regional Preference Act defines "surplus energy as:

> . . . electric energy generated at Federal hydroelectric plants in the Pacific Northwest which would otherwise be wasted because of the lack of a market therefore in the PNW at any established rate.

16 U.S.C. § 837(c). Section 9(c) of the Northwest Power Act clarified that definition to mean:

> . . . electric energy for which there is no market in the Pacific Northwest at any rate established for the disposition of such energy . . .

16 U.S.C. § 839f(c). The language in section 9(c) made it clear that the phrase "any established rate" used in section 1(c) of the Regional Preference Act meant more precisely "any rate for the disposition of such energy." Rates for the disposition of surplus energy are established pursuant to section 7(f) of the Northwest Power Act. Currently, the Firm Power Products and Services (FPS-96) rate schedule is the applicable schedule for such sales, and BPA is proposing FPS-07 as its successor for the next rate period. *See 2007 Wholesale Power Rate Schedules and General Rate Schedule*

Provisions, WP-07-E-BPA-07, at 57. Power is sold under the FPS schedules at rates mutually agreed to by BPA and the purchaser. BPA may, but is not obligated, to sell surplus power under the FPS schedules to any party, including Alcoa, at a rate equivalent to any of its posted, cost-based rates.

Alcoa appears to argue that because (in its view) it is entitled to a power sales contract under section 5(d) of the Northwest Power Act, that it is entitled to a cost-based rate also, and attempts to distinguish the Ninth Circuit's holding in *Kaiser Aluminum & Chemical Corporation v. Bonneville Power Administration*, 261 F.3d 843 (9th Cir. 2001), which upheld BPA's refusal to sell surplus firm power to the DSIs at the Industrial Firm Power (IP-96) rate. But section 5(d) does not provide Alcoa with a right to a power sales contract, and so Alcoa's attempt to distinguish *Kaiser* on the grounds that there it had "relinquished" its section 5(d) contract is irrelevant. Alcoa is not entitled to a power sales contract as a matter of right under section 5(d) of the Northwest Power Act. The Ninth Circuit in *M-S-R* supported this position. BPA may make surplus power sales to DSI customers, including Alcoa, but it is not obligated to price such sales at a rate equivalent to its lowest cost Priority Firm Power rate, or any other cost-based rate. The Ninth Circuit in *Kaiser* supported this position.

Finally, Alcoa argues that BPA should not discriminate against it and the other smelter companies vis-à-vis Port Townsend, which BPA is proposing to offer (through its Public Utility Partner) a supply of physically delivered surplus firm power priced approximately equivalent to the Priority Firm Power rate. Alcoa cites section 5 of the Flood Control Act of 1944, 16 U.S.C. § 825s, and section 5(a) of the Bonneville Project Act, 16 U.S.C. § 832d. It is unclear whether Alcoa is arguing that the alleged discrimination is merely inequitable, or that it is also illegal. In any case, BPA believes it is neither. Some provisions in BPA's enabling statutes do expressly prohibit undue discrimination by the Administrator. For example, section 6 of the Transmission System Act requires BPA to make transmission capacity in excess of BPA's requirements available to all utilities on a fair and nondiscriminatory basis. 16 U.S.C. § 838d. As noted above, however, no such standard exists with respect to the formulation of rates for discretionary sales of power by BPA to the DSIs, and the courts will not apply such a standard where Congress has not made one expressly applicable. *Jura*, 909 F.2d 339; *APAC*, 126 F.3d 1158. In addition to *Jura*, the Ninth Circuit in *Aluminum Company of America v. Bonneville Power Administration*, 903 F.2d 585 (9th Cir. 1989), in discussing the applicability of section 825s of the Flood Control Act to the establishment of extra-regional nonfirm rates, held that "no 'fair and reasonable' standard is applicable to BPA ratemaking." *Id.* at 591. Alcoa's reliance on section 5(a) of the Bonneville Project Act, 16 U.S.C. § 832d, is also unavailing. Section 5(a), in part, specifies that contracts for the sale of energy by BPA to utilities that resell such energy to the general public shall contain terms and conditions "as the [A]dministrator may deem necessary, desirable or appropriate" to effectuate the purposes of the Act, and to insure that resale by such utilities to ultimate consumers shall be at rates which are "reasonable and nondiscriminatory." Of course, this provision says nothing about rates for the sale of wholesale energy by BPA to *its* customers, including sales of surplus energy, because BPA's power rates are governed by separate, specific statutory provisions. As noted,

there are no nondiscrimination standards applicable to BPA ratemaking, and BPA is not otherwise unduly discriminating against the aluminum company DSIs with respect to the delivery of power during the FY 2007-2011 period.

BPA acknowledges that it is treating Port Townsend differently. But the massive difference in the quantities of energy involved in serving DSI smelter load (560 aMW), compared to Port Townsend (17 aMW), and the comparative cost and financial risk associated with each, justifies the different treatment. Assuming a difference between BPA's lowest-cost Priority Firm Power rate and market prices over the term of the next rate period of $30/MWh, the cost to BPA of serving the Port Townsend load will be approximately $4.5 million each year. If BPA were to offer the same deal to the smelter companies, the cost to BPA would be approximately $147 million per year, or $88 million more per year than BPA proposed in the DSI ROD. In the event the delta between the Priority Firm Power rate and market prices grows, the cost to BPA would increase. The cost associated with this risk, while not insignificant with respect to the 17 aMW deal for Port Townsend, is manageable. However, for every $5/MWh increase in the market price, if BPA were obligated to physically deliver energy to the smelter companies (and was not otherwise able to hedge all the market risk) BPA's costs to serve 560 aMW would increase by $25 million per year. Even if a standard prohibiting undue discrimination or preferential treatment applied, the higher costs and risks associated with service to the aluminum companies, as compared to Port Townsend, fully justifies the different treatment of the two.

In addition, as described more fully below, Clallam Public Utility District, Port Townsend's Public Utility Partner, will be purchasing surplus firm power from BPA under a two-party contract with BPA, and reselling the energy to Port Townsend under a separate two-party agreement. Clallam's obligation to pay BPA under the BPA/Clallam surplus firm power agreement is not contingent on Clallam receiving payment from Port Townsend under the Clallam/Port Townsend Agreement. Given the strength of Clallam's credit compared to Port Townsend, the counterparty risks to BPA associated with physically delivering energy under the contract are mitigated. However, given the much larger amounts of power being made available to the aluminum companies under the Smelter Prototypes, it is not reasonable to expect those companies' Public Utility Partners, unlike Clallam, to manage the counterparty risk directly. BPA's proposal for the sale of surplus firm power (through the Public Utility Partners) to the aluminum companies, pursuant to the terms in the Smelter Prototype, is both fair and reasonable.

IV. Port Townsend

BPA's proposal in the DSI ROD was to offer Port Townsend 17 aMW of surplus firm power at a price approximately equivalent to, but in no case less than, its lowest-cost Priority Firm Power rate. The DSI ROD contemplated a sale by BPA to the local utility (Clallam), and a resale by Clallam to Port Townsend. BPA proposed to provide physical power for the reasons discussed immediately above. On December 22, 2005, BPA made available for public review and comment a two-party, and a three-party version of a surplus firm power sales contract to deliver power to Port Townsend. Because BPA

proposed to provide physical power, without any option to monetize the transaction, the draft contract form is simpler than the Smelter Prototype. Comments were due on or before January 31, 2006.

The only party to comment was ICNU. (PT-001.) ICNU did not comment on the contract itself, but rather urged BPA to reconsider offering any benefits to Port Townsend at all. ICNU argued that it is "highly inappropriate and an abuse of BPA's discretion" to offer Port Townsend a below market rate, since it may be lower than rates paid by ICNU member entities that are competitors of Port Townsend. In a letter to BPA dated July 14, 2005 (after publication of the DSI ROD), ICNU made a similar point, and suggested to BPA that a "better result would be to charge Port Townsend the [Priority Firm] rate plus a typical utility margin in line with the provisions of the [Northwest] Power Act." In its response to ICNU dated August 17, 2005, BPA noted that Port Townsend is not directly interconnected with BPA's transmission system, is not served off the distribution system of Clallam PUD (or any other local distribution utility) and, in fact, owns and maintains several miles of 115 kv transmission line and two substations, infrastructure that is typically utility owned. Therefore, Port Townsend directly pays costs that typically would be reflected in charges or rates paid to the local utility.

Nevertheless, BPA stated it would consider reflecting some or all of the typical industrial margin adopted by BPA in the 2007 wholesale power rate case, if it appeared that the costs incurred by Port Townsend, including any charges assessed by Clallam, were less than the margin. BPA will work with Clallam and Port Townsend to insure that the total cost of power paid by Port Townsend, taking into account any margin-type costs incurred by it directly, is not less than the Priority Firm Power rate, plus the typical industrial margin, thereby addressing ICNU's discrimination concern. To that end, the BPA/Clallam contract will provide that the rates for surplus firm power sold by BPA to Clallam shall be set equal to the corresponding Priority Firm Power rate, plus the typical industrial margin used to establish the Industrial Firm Power rate.

V. Conclusion

For the foregoing reasons:

- While the costs of changes to hydro operations have impacted BPA's revenues, BPA concluded in the PFR II process that these costs are not enough to require a change in the balance originally proposed on benefit levels, and that the maximum benefit level should remain at $59 million per year. Consistent with its decision in the DSI ROD, BPA will not provide benefits that bring the DSIs' power costs below the Priority Firm Power rate, and BPA will administer the contracts and adjust the benefits provided so that the effective power price paid by the DSI does not drop below the Priority Firm Power rate.

- BPA will reduce the minimum operating requirement to one-quarter of each company's allocation of surplus firm power, but will not adopt the companies'

proposal that the Smelter Prototype be modified to provide more than $24/MWh for each megawatt of actual operation.

- Companies will not be permitted to shift benefits between contract years.

- Companies will be given the option to lock in the contract market price for a minimum of three years, up to the full five year contract term. If a company elects to exercise this option its monetary benefit levels will be reduced by 8% in FY2007-2009.

- A company exercising the lock-in option will be required to provide documentation that allows BPA to verify the purchase price within 30 days of providing BPA notice of its decision. A company that does not elect to lock in its market price will be required, within 90-days following the end of each contract year, to provide BPA a written certification by its chief financial officer that the average annual purchase power cost to serve its total smelter load was equal to or greater than the forward market price established under Section 6, and provide BPA access to contracts, invoices, and other documentation necessary to substantiate such certification.

- The unused benefit provisions will not be amended or eliminated.

- BPA won't require companies to post credit instruments before signing a contract.

- A provision will not be included requiring a company to repay any benefits due to a subsequent court order holding the contracts void.

- BPA will exercise its option to physically deliver power under the contract (unless the company has exercised its option to lock in the contract market price) only where any credit (default) risks associated with providing a physical supply to a company have been addressed, and where BPA can supply a company's load, including locking down any necessary market supplied purchases, on a fully hedged basis at a cost at or below the cost cap. Prior to exercising its option (if available) BPA will conduct a public process. The purpose of the public process will be to explain why BPA wants to exercise the option, and how the transaction can be executed such that the cost to BPA will be within the capped cost levels established in the DSI ROD.

- BPA's interruption right in the Smelter Prototype won't be amended or eliminated.

- Section 16 will be amended to clarify that the contract will terminate without liability to BPA if a court issues a final, unappealable order that expressly prohibits or has the effect of preventing BPA from performing its obligations under the contract.

Issued in Portland, Oregon on May 31, 2006

/s/ Stephen J. Wright

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