

Slice Settlement Proposal - Background and Summary

Prefatory Note: The settlement documents comprising the Proposed Settlement are very lengthy and complex. This Background and Summary is provided as a service to provide a basic overview of the documents. Given the very focused and time-consuming efforts of the settling parties to negotiate settlement terms that were understood and agreed to by the parties, BPA wishes to make clear that this Background and Summary is not intended, and should not be relied upon, to in any way interpret, recast, amend, or otherwise change what is set forth in the documents, which should speak for themselves.

I. Background and Context

A. The Slice Product

Traditionally, Bonneville sold power to its customers based on the amount of power the customers needed to serve their loads. The Slice Product, in contrast, is based on the Slice Customer purchasing a fixed percentage of firm power of the Federal Columbia River Power System (FCRPS) in the shape of the generation output and thereby obtaining rights to a “slice” of the system capability output.

The Slice Customers are comprised of 26 of Bonneville’s publicly-owned utility customers, including a consortium of such customers. Bonneville executed a contract with each Slice Customer for the sale of the Slice Product on or about October 1, 2001. The Slice Contracts expire on October 1, 2011. In total, the Slice Customers purchase approximately 22.6% of the capability of the FCRPS.

In Bonneville’s 2002 rate proceeding, Bonneville developed the Slice Rate, which includes the Slice Rate Methodology, Slice Revenue Requirement and the Slice True-Up Adjustment Charge. The Slice Rate was expressly incorporated into the Slice Contracts.

As a result, under the Slice Rate as incorporated into the Slice Contract, the Slice Customers pay Bonneville a fixed amount each month during the Contract Year for the purchase of the Slice Product. The monthly payment is based on Bonneville’s forecasted costs. At the end of the Contract Year, Bonneville calculates an annual Slice True-Up Adjustment Charge based on the difference between Bonneville’s actual costs and forecasted costs to provide the Slice Product for that Contract Year (CY). If actual costs are less than forecasted costs, the Slice Customers are entitled to a refund for the difference. If actual costs exceed forecasted costs, each Slice Customer owes Bonneville its share of the difference.

The Slice Contract includes a dispute resolution provision which provides that final actions taken by Bonneville pursuant to the Northwest Power Act, including rate implementation, are reviewable exclusively in the U.S. Court of Appeals for the Ninth Circuit, but disputes arising out of the terms of the Slice Contract are subject to binding arbitration.

B. The 2002 True-Up Adjustment Charge

In January 2003, Bonneville notified the Slice Customers that it had determined the amount of the Slice True-Up Adjustment Charge for CY 2002, the first year of operation under the Slice Contract. Bonneville determined the Slice True-Up Adjustment Charge, representing the amount the Slice Customers owed Bonneville, was approximately \$50,830,000.

The Slice Customers, pursuant to the Slice Contract, hired an accounting firm to conduct an audit of Bonneville's determination. The Slice Customers' auditor concluded that the Slice Customers did not owe Bonneville \$50,830,000, but rather Bonneville owed the Slice Customers approximately \$33 million. As a result, the amount in dispute between Bonneville and the Slice Customers for CY 2002 is approximately \$84 million.

On August 5, 2003, following many meetings between Bonneville and the Slice Customers, the Slice Customers served Bonneville with a Notice of Arbitration to initiate binding arbitration over Bonneville's implementation of the 2002 Slice True-Up Adjustment Charge.

On August 18, 2003, Bonneville issued a Final Response to the Slice Customers' audit, agreeing with some of the findings of the Slice Customers' auditors, but rejecting the majority of the findings. Bonneville stated in the Final Response that the decision contained therein was a rate determination that was a final action under the Northwest Power Act subject to judicial review exclusively in the Ninth Circuit.

As a result, Bonneville rejected the Slice Customers' demand for arbitration because the exclusive jurisdiction of the Ninth Circuit over this rate dispute precluded arbitration.

C. The Litigation

1. Nos. 03-73849 & 03-74179

On October 23, 2003, Northwest Requirements Utilities (NRU) initiated Northwest Requirements Utilities v. BPA, No. 03-73849, by filing a petition for review of Bonneville's Final Response in the Ninth Circuit. NRU represents "non-Slicers," that is, a consortium of small cooperatives and publicly owned utilities that opted not to sign the Slice Contracts or purchase the Slice Product.

On November 16, 2003, the Slice Customers initiated No. 03-74179 by filing a "protective" petition for review challenging Bonneville's Final Response, but asserting the Court lacked jurisdiction over the case because the dispute was a contract dispute subject to arbitration.

On November 21, 2003, Bonneville filed an Urgent Motion under Circuit Rule 27-3(b) in No. 03-73849 to enjoin the arbitration proceeding initiated by the Slice Customers. On December 17, 2003, Bonneville's motion was granted and the arbitration proceeding was stayed pending disposition of No. 03-73849.

On December 19, the Ninth Circuit consolidated Nos. 03-74179 and 03-73849.

The two consolidated cases have been fully briefed and were argued to the Court on November 16, 2005. On July 17, 2006, the parties filed a joint motion to stay the disposition of these cases because, after literally years of meetings and negotiations, the parties had developed a settlement proposal. On July 19, 2006, the joint motion was granted and the cases have been stayed for 90 days from the date of the order.

2. No. 04-71311

As noted, the true-up charge is an annual determination. Shortly after Bonneville determined the true-up charge for CY 2003, the Slice Customers served Bonneville a notice of arbitration to arbitrate Bonneville's 2003 true-up determination. At the same time, NRU challenged the 2003 determination by filing a petition for review in the Ninth Circuit.

In response, Bonneville filed a motion for a preliminary injunction to enjoin that arbitration while Nos. 03-73849 & 03-74179 were pending. Bonneville's motions were granted. As a result, the arbitration over Bonneville's 2003 true-up determination was enjoined and No. 04-71311 was stayed pending disposition of Nos. 03-74179 and 03-73849.

3. Threatened litigation

Bonneville conducted true-ups for 2004 and 2005 while the litigation described above proceeded. Disputes over the 2004 and 2005 true-ups have been held in abeyance pending the outcome, through decision or settlement, of the litigation.

D. Bonneville's Reasons for Seeking Settlement

Bonneville, the Slice Customers, and NRU have been attempting to settle these lawsuits for more than three years. In 2004, the Honorable Judge Edward Leavy, senior judge on the Ninth Circuit Court of Appeals, agreed to act as mediator. In each mediation session, the parties were represented by their highest-level senior executives. Bonneville was represented by the Administrator, the Slice Customers were represented by certain Chief Executive Officers, and NRU was represented by its Executive Director. These senior executives, with support from their attorneys, invested many hours in the settlement; they personally participated in and led virtually all negotiation sessions over the next two years. In early July 2006, the parties arrived at this comprehensive settlement proposal. Based on this settlement proposal, the parties, as noted above, filed the joint motion to stay the litigation.

Bonneville strongly believes this settlement proposal is a reasonable resolution of this dispute and is in the best interests of the region for the following reasons:

- This dispute has been very bitter, protracted and divisive. It has created great acrimony between Bonneville's Slice Customers and Bonneville, as well as acrimony between the Slice Customers and non-Slice Customers. The settlement proposal is an important step towards mending those divisions and moving forward to conduct future business in a more harmonious and productive fashion.
- The Settlement Agreement was negotiated at the very highest levels. The Administrator of Bonneville, as well as the General Counsel, personally spent many hours over a three-year period negotiating this agreement with CEOs of the Slice Customers and the Executive Director of NRU. The Administrator believes he has negotiated an agreement that is fair and reasonable and in the best business interests of Bonneville and the region.
- The true-up dispute resulted from the calculation of the true-up for the first year of a ten-year contract. The 2002 amount in dispute was approximately \$84 million. As a result, the true-up issue over the term of the ten-year contract involves hundreds of millions of dollars. With so much money at stake, Bonneville believes it is far better and more prudent to settle this dispute under reasonable terms acceptable to the parties rather than leave it to the Court where the outcome is not certain.
- The issues in dispute are very complex. The Court could misunderstand some important aspects of the ratemaking, accounting and financing issues in dispute and issue a decision that provides no clear direction for future true-ups. Without this settlement, the parties could be facing years of further contentious and protracted litigation.
- A fundamental issue in dispute is jurisdiction – whether this dispute should be resolved at the Ninth Circuit because it involves a rate determination, or whether it should be resolved through arbitration, because it involves a contract dispute. The Court could issue a decision that does not provide clear guidance. Thus, the dispute could enter another phase with further proceedings and no resolution in sight, a result that would be unsatisfactory to all parties.
- An important component of the settlement proposal is a comprehensive dispute resolution provision that provides for improved communication between the parties. The dispute resolution provision also provides for non-binding arbitration, which should help facilitate dispute resolution. These mechanisms should foster a better understanding of the issues and help avoid or minimize future litigation.

- An extremely important issue in dispute centers on Bonneville's debt optimization program (DOP). The DOP issue amounts to approximately \$50 million of the amount in dispute for 2002 alone. DOP issue is a very important component of the Administrator's broader plan for efficiently and effectively managing costs and debt. Bonneville depends on DOP to provide it borrowing authority to make needed generation and transmission infrastructure investments. The Settlement Proposal resolves the matter for 2002-2005, and provides that certain protections that the Slice Customers will not challenge DOP in the future.
- The settlement agreement obligates Bonneville to pay the Slice Customers a total of approximately \$26 million. A portion of this is attributable simply to the timing of BPA cost recovery, with the consequence that BPA will recoup a portion of the \$26 million from Slice Customers in later years of the Slice Contract. The settlement amount is reasonable in comparison to the amount and issues in dispute. The amount in dispute for CY 2002 is \$84 million, the settlement agreement resolves all true-up disputes for CYs 2002-2005, and it provides precedent and protections in later years of the current Slice Contract.
- Under the Settlement Agreement, the \$26 million will be paid to the Slice Customers in the form of a credit against each Slice Customer's power bill.

II. Highlights of the Settlement Proposal

The Settlement Proposal is comprised of a Settlement Agreement and numerous attachments. The most important settlement documents are the Settlement Agreement, the Debt Optimization Memorandum of Understanding (Exhibit D), and the Dispute Resolution Provision (Exhibit F). Each of these documents is summarized below.

A. The Settlement Agreement

The Settlement Agreement begins by identifying the Effective Date of the agreement as well as a series of background Recitals.

Section I(B) states that, within 2 business days following execution of the Settlement Documents by all the Parties, the Parties will file with the Ninth Circuit "Exhibit A." Exhibit A is a joint motion to stay and dismiss with prejudice the existing Slice litigation (Nos. 03-73849, 03-74179, & 04-71311).

In Exhibit A, the parties request the Court to stay the litigation for a period of 95 days prior to dismissal of the case. The reason for this request is to determine if any petitions for review are filed with the Ninth Circuit challenging the Settlement Agreement within 90 days of Bonneville's final action. The consequences of such a suit being filed are addressed in section I (G) of the Settlement Agreement, discussed below.

The settlement agreement is specific to the resolution of true-up disputes in CYs 2002-2005. However, the resolution of the majority of substantive issues in dispute, as discussed below, will have precedential effect beyond 2005 and therefore should

substantially limit the scope of future disputes. Similarly, the revised dispute resolution clause (Exhibit F to the settlement agreement), should help to avoid the rate/contract jurisdictional issue.

Nothing in the Settlement Agreement reflects an agreement that the Ninth Circuit does or does not have jurisdiction over these cases.

Section I(C) provides that, within 2 days of execution of the Settlement Documents by all Parties, the Slice Customers will file "Exhibit B," which is a letter to the International Institute for Dispute Resolution withdrawing all pending requests for arbitration of the true-up disputes.

Section I(D) provides that the Settlement Agreement constitutes a full and final resolution of all true-up matters for CYs 2002-2005. The Parties agree to a mutual covenant not to assert any claims they have or may have against each other regarding these matters.

Section I(E) pertains to the Payment of Sums by BPA, wherein BPA agrees to pay a specified sum to each of the Slice Customers as set forth in the agreement. The total amount to be paid by BPA is approximately \$26 million. BPA's calculation of the settlement amount is set forth in "Exhibit C" to the Agreement. The payments are to be made in the form of a credit against each Slice Customer's monthly bill.

Section I(F) is an agreement to defend and reimburse, providing that any settling Party challenging the lawfulness of the settlement agreement will be in breach and liable for recovery of fees associated with defending the agreement.

Section I(G) provides a series of potential outcomes and consequences if the Settlement Agreement is challenged by a third party.

Section I(H) addresses limitations on the settling Parties' rights to challenge BPA's Debt Optimization Program (DOP). In essence, this provision provides that the Slice Customers may challenge BPA's DOP on the same basis that any other Bonneville customer may challenge it, but may not challenge BPA's inclusion of it in the Slice Revenue Requirement in the manner as was done in 2002, 2003, 2004, or 2005, as a violation of the Slice Contract, Slice Rate or Slice Rate Methodology, or as improper ratemaking.

Section II of the Settlement Agreement addresses the treatment of each specific true-up issue in dispute. Section II(A) states that, except as otherwise provided, the resolution of each issue as set forth in the agreement shall be binding and precedential through the remaining term of the Slice Contract (Oct. 1, 2011).

Section II(C) provides for Exhibit D, a Memorandum of Understanding that recites the procedures BPA will follow to address debt optimization issues in the future.

Section II(E) provides that the Parties have reached agreement on communication protocols BPA will follow with respect to future true-up determinations. The protocols are attached to the agreement as “Exhibit E”, which is not a binding contract.

Section III of the Agreement addresses Dispute Resolution, and provides that the Parties will adhere to the procedures and processes set forth in “Exhibit F,” which is incorporated by reference into the Settlement Agreement, to address the resolution of future disputes. Exhibit F is discussed more fully below.

B. Exhibit D –Summary of Debt Optimization Memorandum of Understanding (MOU)

BPA’s treatment of costs related to its Debt Optimization Program (DOP), and the inclusion of such costs in the true-up adjustment charge, is by far the single largest cost issue in dispute between BPA and the Slice Customers. In CY 2002, the amount in dispute arising from BPA’s determination to include debt optimization costs in the true-up, exceeded \$50 million. Because of the significance of this issue, the Parties negotiated a separate MOU as part of the settlement proposal.

The MOU is intended to provide certain processes and undertakings by BPA regarding the management and communication of its debt optimization practices and its effects on customers. However, the MOU is structured as an MOU because it is expressly not a contract and is not legally enforceable.

Section A of the MOU contains Recitals expressing BPA’s commitment to increase and improve communications related to the DOP and BPA’s management of the DOP.

Section B addresses BPA’s commitments regarding the DOP. Section B(1) explains that one of the fundamental principles underlying the DOP was that rates for each BPA business line (PBL and TBL) would be no higher with DOP than they would have been in the absence of DOP, and that BPA will continue to manage DOP in conformance with this principle. BPA then explains how it will provide certain processes to make the DOP more transparent to assure that this goal is achieved.

Section B(1) – (4) contains language explaining the DOP and how BPA intends to treat DOP costs. Section B(5) provides that in each BPA rate proceeding, BPA will include language that clearly and transparently explains BPA’s treatment of DOP related costs. BPA further agrees to draw the Federal Energy Regulatory Commission’s (FERC) attention to such explanation when submitting its rates to FERC for confirmation and approval.

In section C(1) of the MOU, the parties have requested and BPA has agreed to provide early estimates of potential refinancings associated with debt optimization. In section C(2), BPA has agreed to participate in and conduct annual meetings with participants to explain its refinancings or potential refinancings.

Section C(6) contains a provision that allows for the appointment of a third-party neutral. This provision states that, if BPA, NRU or a majority of the Slice Customers reach different conclusions from the material presented by BPA at its meetings, or if BPA has not complied with the meeting provisions or principles expressed in the MOU, then NRU or a majority of the Slice Customers may notify BPA of the dispute. BPA and the disputing party shall meet in good faith to attempt to resolve the dispute.

If the dispute is not resolved, then BPA and the disputing party will attempt to hire a third party neutral to provide his or her views on the dispute. If the parties cannot agree on a neutral, then the disputing parties will each appoint a representative who will select a neutral. The neutral's findings and conclusions will be based on the record already developed plus additional information that may be generated before the neutral. The findings and conclusions of the neutral shall be submitted to the participants and the Energy Northwest board for its consideration. However, the neutral's findings and conclusions are advisory only, and the MOU does not limit or create any power in the EN board to take any action with respect to the neutral's findings.

In section C(7), BPA agrees that, prior to each power rate adjustment proceeding, BPA will conduct a capital investment review process to review and discuss capital investment forecasts. After expiration of the Slice Contracts on October 1, 2011, BPA will consider whether to continue such process for the remainder of the term of the MOU.

If the processes and procedures related to this MOU would, in the Administrator's estimation, delay any action or the implementation of any action which BPA is obligated to take under law, BPA reserves the right to proceed with fulfilling such obligations in the manner BPA deems appropriate or necessary. BPA will take actions called for by the MOU as soon thereafter as reasonably possible.

The Participants to the MOU understand and agree that the MOU is not a contract, and that it does not create any right, benefit, or trust responsibility, substantive or procedural, enforceable in a court of law against Bonneville, whether by legal or equitable remedy.

The MOU is effective upon signature by all parties, and remains in effect through Oct. 1 2024, or until such later date when debt service reassignment bonds have been retired.

B. Exhibit F – Dispute Resolution

Exhibit F addresses dispute resolution prong. Exhibit F begins by acknowledging the different jurisdictional positions of BPA and the Slice Customers, noting that the issue of whether true-up disputes are rate disputes subject to Ninth Circuit jurisdiction, or contract disputes subject to arbitration, remains unresolved. Nevertheless, for all true-up disputes that arise in CY 2006 through the term of the contract, the parties agree to address this issue as provided in Exhibit F.

1. Executive Slice Facilitation Process

In section B(1)(a), the parties agree that, as a condition to, and prior to initiating any permissible dispute resolution regarding a True-Up Matter arising for CY 2006 and after, the Slice Customers must first utilize a sixty day discussion period to conduct the Executive Slice Facilitation Process (ESFP) to attempt to resolve the matter. Unless otherwise agreed, no matters may be subjected to further dispute resolution unless first addressed in the ESFP.

In section B(1)(a)-(d), the parties describe the make-up and conduct of the ESFP. In short, if the ESFP cannot resolve all disputes within the 60 day period, then the Administrator shall issue a draft report addressing the resolved and unresolved and True-Up Matters, within ten business days setting forth the Administrator's rationale and conclusions. The Administrator shall not issue a final decision until the period for initiating non-binding arbitration has expired. If arbitration is not initiated by the Slice Customers within the time permitted, the Administrator will issue a final decision that adopts the draft report as final.

2. Non-binding Arbitration

As a condition to, and prior to, filing a petition for review in the Ninth Circuit regarding any True-Up Matter, the Slice customers and Bonneville must engage first in non-binding arbitration. However, if the Slice Customers notify BPA that they waive their right to arbitration, the Administrator shall issue a final decision, which may then be timely appealed to the Ninth Circuit.

If arbitration is invoked, then the record of the proceeding will vary depending upon whether the nature of the dispute concerns a matter of consistency with the Slice Rate, or, if it is not addressed in the Slice Rate but is expressly dealt with in the Slice Contract, whether it is consistent with the Slice Contract. If the dispute centers on the latter, then evidence of contract intent may be admitted.

BPA preference customers shall be allowed to intervene and participate in arbitrations initiated pursuant to the Agreement. Other customers may be allowed to intervene and participate in the arbitration if they demonstrate and the arbitrator determines that such customers have standing.

Within 15 calendar days of issuance of the arbitrators' decision and award, BPA shall issue a final written decision that (i) decides the disputed True-Up Matter(s) and explains why BPA accepts or rejects the arbitrator's decision and award on each of the disputed True-Up Matters, and (ii) makes final without change the disposition in the Administrator's earlier draft report of the resolved True-Up Matters. In the event the Administrator accepts the arbitrators' decision and award on a disputed True-Up Matter, then the Slice Customers and any other party to the arbitration shall be bound by the Administrator's decision on that disputed True-Up Matter and may seek no judicial review or any relief concerning the decision on that disputed True-Up Matter, except that any party may seek review of the arbitration upon any of the grounds referred to in the Federal Arbitration Act, 9 U.S.C. §§ 1-16 (1988).

In the event BPA rejects the arbitrators' decision and award on any disputed True-Up Matter, any party may timely file a petition for review of BPA's final decision on that disputed True-Up Matter with the Ninth Circuit. The Agreement provides that no party waives any argument it may have that the true-up matter is or is not subject to the Ninth Circuit's exclusive jurisdiction.

The administrative record submitted by BPA to the Ninth Circuit shall include, but not be limited to, the Slice Contract, the final audit report, the record of the arbitration, the arbitrator's decision and award, the Administrator's final decision, and the evidence provided to the Administrator pursuant to the arbitration proceeding.

In the event that, following arbitration, a party files a petition for review in the Ninth Circuit and the Court rules that the True-Up Matter (or Matters) in dispute is outside its exclusive jurisdiction, then unless the Ninth Circuit's ruling is reversed on appeal, the parties that participated in the arbitration shall treat the decision of the arbitrator on that True-Up Matter as binding arbitration. As a result, in that circumstance, the arbitrator's decision and award will be binding on all of the parties, provided however that any party may seek judicial review of the arbitration based upon any of the grounds referred to in the Federal Arbitration Act, 9 U.S.C. §§ 1-16.