Letter to the region

May 11, 2010

To BPA customers, tribes, constituents and interested parties:

The Bonneville Power Administration kicked off its Integrated Program Review with a public meeting in Portland on May 10.

The intent of this review is to give our customers and other interested parties an opportunity to participate in a rigorous evaluation of our programs, their value and their associated spending levels before we begin the joint Power Services and Transmission Services rate case for fiscal years 2012-2013.

BPA developed the IPR prior to the last rate case as a way to consolidate discussion of all the agency's program levels and costs in one forum. We believe that evaluating the benefits and costs of these programs together will lead to a clearer understanding of the value these programs provide to the region.

Program levels are the starting point for rate setting. The final rates for the 2012–2013 fiscal years will not be set for another 15 months or so. Much can happen between now and then that will affect these rates. But, in the meantime, we are beginning the discussion with this IPR and related processes. Depending on the outcome of fiscal 2011, there will be more or less discussion next year on rate levels and the tradeoffs that may be necessary.

Context

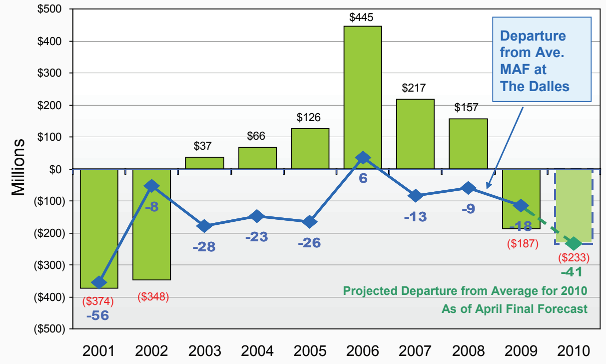
The Pacific Northwest has been particularly hard hit by the global recession. While the regional economy is showing signs of recovery, it is far from fully recovered. Such signs are of little comfort to those who are still out of work, who have taken lower paying jobs or are experiencing other financial difficulties. In addition, many businesses remain closed. As BPA plans its program expenses for the upcoming rate period, we are mindful of these conditions and the impact our expenses have on rates.

This year is proving difficult financially for BPA. Being in the hydropower business is much like being a farmer — we never stop worrying about the weather, and this year the weather has given us a lot to worry about with runoff expected to be 65 percent of average. Our current expectation is that this will be the fifth lowest runoff since 1929 when recordkeeping began and the tenth below-average water year in the last 11 years. As you may know, we use revenues from the sale of surplus power to keep rates to Pacific Northwest customers low. Without the water inventory, we have less secondary energy to sell, and our revenues have suffered substantially.

The picture below shows the relationship between water and our modified net revenues.

Annual Agency Modified Net Revenues and Streamflows

FY 2001–2009



BPA's modified net revenues were negative $187 million in fiscal 2009. As of the second quarter of fiscal 2010, we are projecting a loss of $233 million for the year. While we were well positioned to manage through these difficult years, we are concerned about the impact of the drain on our financial reserves. This affects our Power business in particular because of the relationship between the water supply and revenues. Expenses are generally not contributing to the problem. They are forecast to be at or below levels set for this rate period and reflect the ongoing savings we created through the Enterprise Process Improvement Project and the previous IPRs.

Although Transmission Services is in the midst of an expansive capital investment program to sustain aging infrastructure and expand the grid, revenues have been expanding mostly due to making more capacity available for sale. Consequently, we do not anticipate upward rate pressure in transmission rates although there are significant issues associated with wind integration that will need to be addressed.

The Integrated Program Review

We face difficult choices as we approach BPA's next rate-setting process. Updates to our Asset Management Strategies continue to reveal aging generation and transmission systems that need significant investment and maintenance.

Expectations for BPA program results continue to increase with evolving fish and wildlife obligations, new targets for energy efficiency acquisition, increasing regulatory requirements and the need to facilitate renewable energy development, smart grid and other emerging "green" technologies. We are proposing program levels that we believe are sufficient to meet these objectives and provide necessary services to the region.

The following graph is a high-level summary of drivers for BPA program levels. These will be discussed in greater detail in the IPR.

Main Program Drivers in 2010 IPR

Summary of 2012–2013 Expense Changes

WP10 Rate Case to May 2010 IPR ($ millions)

	Expenses	Change from Avg 10/11 to Avg 12/13	% Change in Rates[1]
1	Non-federal Debt Service	$ 81.1	4%
2	Columbia Generating Station	56.1	3%
3	Fish and Wildlife / USF&W /Planning Council	32.9	2%
4	Bureau of Reclamation	25.9	1%
5	Corps of Engineers	25.8	1%
6	Net Interest Expense	14.0 to 24.0[2]	1%
7	Depreciation and Amortization	6.5 to 10.4[2]	0% to 1%
8	Hydro Projects Insurance	10.0	1%
9	Power Non-Generation Operations	8.2	0%
10	G&A	6.4	0%
11	Purchased Power Expenses	?	?
12	Residential Exchange	?	?
13	DSI Service	?	?
14	Other expenses, net	-1.3	0%
15	Transmission Acquisition	-4.3	0%
16	Renewable and Conservation Generation	- 37.2 to 90.7[2]	-2% to 5%
17	**Net Change in Expenses**	**$ 224 to 366**	

[1]Estimate using $65 million change = $/mwh rule of thumb, Base = $28.77/mwh.
[2]Range reflects capitalizing vs. expensing all conservation acquisitions.

Power debt service

While the table shows nonfederal debt service in fiscal 2012–2013 to be higher, on average, than fiscal 2010–2011 by about $80 million, this amount is roughly the same as the expected change in total power debt service. The increase in federal and nonfederal debt service includes the impact of federal principal payments not shown on this table.

Columbia Generating Station

The costs included for Columbia Generating Station's operation and maintenance are from the Energy Northwest Long Range Plan. Increases are primarily due to the purchase of nuclear fuel as the uranium inventory is being replenished. Fiscal 2013 is a refueling year.

Fish and wildlife

Increases in fish and wildlife funding are driven by the anticipated additional requirements in the 2008 biological opinion to benefit salmon and steelhead listed under the Endangered Species Act and the implementation of projects under the Columbia Basin Fish Accords with regional tribes and states.

Hydro system

Several factors are driving expense increases for the aging hydro system. Nonroutine maintenance costs are rising significantly. A prime example is the overhaul of the generating units in the third powerhouse at Grand Coulee Dam. Increased operation and maintenance budgets also reflect our ongoing experience with large costs for repairing failed generating units, spillway gates, penstock tubes and other vital components.

We also are seeing increased costs from new or revised compliance directives. The Federal Energy Regulatory Commission and North American Electric Reliability Corporation have implemented new reliability standards as have several safety regulatory agencies. These increased compliance measures are reflected in the increased U.S. Army Corps of Engineers and Bureau of Reclamation staffing at the projects.

All of these efforts are necessary to keep the hydro system reliably producing the carbon-free generation the region relies on to fuel its economy.

Other programs

Costs have not yet been forecast for two Power Services programs — service to the direct-service industries and the Residential Exchange Program. At this point we don't know what level of service will be provided to the DSIs in the upcoming rate period. We are still evaluating the ongoing lawsuits and the ability of the DSIs to operate economically.

The REP amounts are determined in the rate case. BPA is currently in mediation with parties to litigation over the program. If the participants have the will to come to a settlement, the REP costs will reflect that outcome.

Other major rate drivers

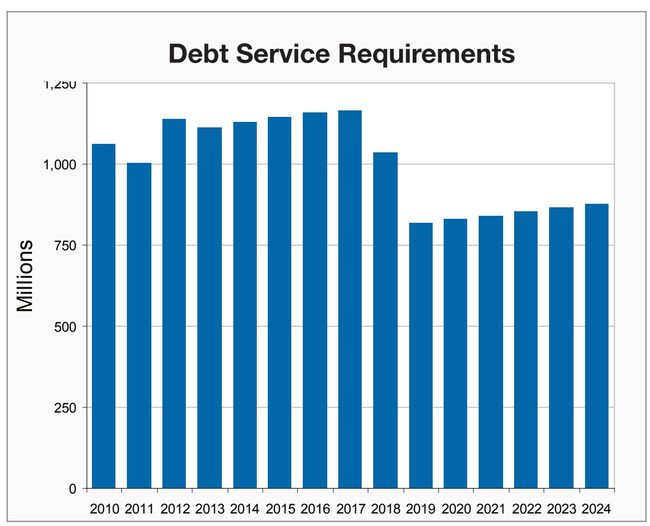
Given the state of the economy, we cannot just sit back and wait to see what comes next while we set rates for fiscal 2012-2013. Under these circumstances, we believe we should consider other regional actions in addition to the IPR process to address a potential increase in power rates before the formal rate case. These actions will require active participation from regional parties and anticipate rate case issues such as revenue requirements, risk mitigation and debt service. There are other components of power rates that we can investigate collaboratively now before we get into the formal rate case with its restrictions to on-the-record discussion.

We do not know if fiscal 2011 will provide ample water or that the economy will improve significantly. The economic forecasts we follow do not expect regional unemployment, job growth, population growth, housing starts or energy demand to reach pre-recession levels until late in 2013 or early 2014.

Debt management

The largest Power Services cost increase going into fiscal 2012–2013 is an annual average increase of $81 million in nonfederal debt service, which is followed by some dramatic decreases in fiscal 2017–2018. This pattern is demonstrated in the graphic below.

We need to consider whether we want to increase debt service costs in fiscal 2012–2013 knowing that it is likely they will decrease in 2018 and beyond. We plan to have a public discussion on possible solutions to this pattern that would be mutually acceptable to Energy Northwest and our ratepayers.



Risk management

We have several tools for managing risk — reserves, planned net revenues for risk, cost recovery adjustment clauses and Treasury line of credit among them. Our preliminary estimates of reserves through fiscal 2011 indicate that we should plan that there will be relatively few power reserves available for risk when setting power rates.

Fiscal Year 2009–2011 Reserves Available for Risk ($millions)

	ACTUAL	FORECAST	
	2009	2010	2011
Power	$ 551	$ 184	$ 31
Transmission	516	501	486
Agency	**$1,067**	**$686**	**$517**

Notes:

1. Reserves available for risk are reserves generated by operating cash flows and exclude funds deposited by customers for designated expenditures. Estimates for Power and Transmission are calculated approximations of year-end outcomes.
2. FY 2010 data is based on the 2nd Quarter Review for FY 2010 (unaudited).
3. FY 2011 data is based on most recent estimates of FY 2011 spending levels.

We anticipate that, at the end of fiscal 2011, Power Services may have $31 million in reserves available for risk. Transmission is expected to have $487 million available. With minimal reserves for risk, Power Services is looking at including substantial planned net revenues for risk in its rates. Some of this impact could be offset through an increased reliance on a Cost Recovery Adjustment Clause. Liquidity from Treasury will continue to be available to offset the impact of planned net revenues for risk. As in the past, it is helpful to have a discussion regarding the level of the rate relative to the likelihood of a CRAC.

One new area worth exploring is the possibility of setting power rates based on the availability of some amount of Transmission's reserves. The maximum amount would be what Transmission has available after setting aside sufficient reserves to meet its Treasury payment probability standard.

Next

We thoroughly understand that this is a difficult year and that the upcoming rate case will be challenging. In the IPR, we expect to hear reasons for decreasing costs and for increasing them as we address both the short- and long-term perspectives. There are opportunities to mitigate rate impacts, but finding these opportunities relies on collaboration, cooperation and compromise.

What I can promise you is that we will be open to your ideas. As you know, we are a nonprofit business. Our commitment is to do what's best for our customers, our stakeholders and the region overall. We are very aware of the economic conditions in the Pacific Northwest and of the hardships our citizens face. It is our goal to mitigate these hardships as much as possible without sacrificing the investments necessary to maintain the value of the federal system or compromising the long-term needs of the region.

The Integrated Program Review and the discussions on debt management and risk management are your opportunities to participate and help us meet some big challenges. I look forward to your participation.

For the full workshop schedule, go to *www.bpa.gov/corporate/Finance/IBR/IPR/*.

Sincerely,

Stephen J. Wright
BPA Administrator and CEO