



Department of Energy

Bonneville Power Administration
P.O. Box 3621
Portland, Oregon 97208-3621

POWER BUSINESS LINE

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In reply refer to: P-6

To Our Customers:

On November 8, we kicked off the 8-month formal rate case process that will result in new wholesale power rates effective on October 1, 2006. While our ability to communicate now on rate case matters is somewhat constrained by ex parte rules, it is important that we continue to communicate within the bounds of those rules as we seek to make these rates as low as possible consistent with sound business principles.

As you know, this rate proposal places a heavy emphasis on variable rates that fluctuate from year to year according to actual BPA costs and revenues. Many of you told us that this approach made more sense because a fixed rate that would be high enough to cover BPA's financial risks would simply be too high. With a variable rate, the actual rate in 2007 will depend heavily on water conditions, market prices and litigation outcomes in 2006.

The actual rate also will depend on the success of our efforts to bring costs down and manage risks. We have both significant opportunities to bring costs down as well as significant risks of cost increases. We must manage both our costs and risks aggressively. It will be crucial that BPA and customer utilities work closely together on both fronts over the next 6 months. I believe the highest priority areas of focus are the following.

Salmon issues

The plaintiffs in the biological opinion litigation have proposed a set of hydro operations that would add very substantially to 2006 costs, which would likely drive up the 2007 rates. Attaining a river operation in 2006 that both does the right thing for fish and is cost effective is our highest priority. This is an issue that largely will be decided by the court, but we will work diligently to make our case.

Risk management

As you know, BPA and customers have been working for months on a lower-cost approach to managing risk in BPA rates. These efforts include focusing on methods of improving BPA's cash flow. If successful, these methods could reduce the risk allowance in rates by 2 mills/kWh or more. Some of the proposals being discussed require significant actions by customers and others to make them dependable. This is by far our biggest opportunity to bring rates down from our initial proposal. We will continue working with customers on these cash flow improvements and hope to be able to reflect our successes in the final rates.

Cost management

We have committed to revisiting our entire cost structure, which will include soliciting additional public review early next year. Any further cost reductions will be reflected in the final rates. Here are major areas we are currently looking at:

- **Hydro system O&M:** The costs of the Federal hydro system compare well in North American hydro benchmarking studies. However, as suggested by customers during the Power Function Review, we are now also benchmarking Federal hydro project costs head-to-head with costs of other Northwest utility-owned hydro to identify possible further cost reductions. We appreciate the active involvement of the utilities that own these other projects. This additional benchmarking will be completed early next year so that any savings identified can be reflected in the final rates.
- **CGS:** The useful life of the Columbia Generating Station nuclear plant should extend at least to 2024, and yet its capital costs are being recovered in rates by 2018. Extending the capital recovery period to 2024 would reduce revenue requirements in FY 2007-2009. BPA is exploring this option with Energy Northwest.
- **Internal Costs:** While major costs involve our Federal partners and Energy Northwest, we are not ignoring internal operations costs. We are in the middle of an intensive effort to improve the efficiency of our internal processes. These internal costs are only 4 percent of total power costs, but they remain a major focus. Our staffing has been declining steadily for the last 4 years and will continue to do so. Our initial proposal reflects progress to date in bringing those costs down, and the final proposal will reflect additional progress we make over the next 6 months.

Right now, these are our highest priorities in our effort to reduce costs and rates, and to avoid increases. We will be starting up a follow-on to the Power Function Review early next year to gather additional ideas and input on cost reductions. But we would welcome suggestions on further areas to explore for cost reductions before this process kicks off. There is a huge amount of in-depth information on BPA's FY 2007-2009 program costs on the Power Function Review website you may find this helpful in understanding BPA's power costs and the opportunities to reduce them.

Many of you have worked with us on cost reductions and risk management through the Power Function Review, the Customer Collaborative, Public Power Council forums and other processes over the last year. I appreciate that, and look forward to continuing that effort over the next several months.

Sincerely,

/s/

Paul E. Norman
Senior Vice President