BONNEVILLE POWER ADMINISTRATION

P.O. Box 3621
Portland, Oregon 97208-3621

February 7, 2003

To BPA customers, tribes, constituents and interested parties:

I am writing to let you know that the Bonneville Power Administration is initiating a process to raise our power rates on Oct. 1, 2003. The current financial outlook points to a need for an increase of about 15 percent over current levels. The size of the rate increase will be defined through a formal process, and it can still vary depending on how actual water and market conditions play out.

We still have time to get this rate increase down to a lower number. But it will take significant collaboration from cost partners if we are to make further progress to reduce BPA's power costs for the remainder of the rate period.

This is difficult news to deliver. BPA and its cost partners have worked hard to avoid this rate increase. Some of the cost cuts, deferrals and other actions we have taken have affected our basic mission to deliver public benefits to the region. For at least this year, we may also need to call on some contingency cash tools just to cover our day-to-day expenses.

But, as many of you know, water conditions are very poor again this year. We lost more than $300 million in each of the last two years due to a combination of the 2001 drought, volatile market prices and the West Coast energy crisis. We went into FY 2003 with less than $200 million in financial reserves. This puts BPA in a precarious position.

Meanwhile, the region suffers in an economic slump, and I am painfully aware of the impact that a rate increase will have on the people and businesses of the Northwest. We would not take this action if there were any other alternative.

Why do this now?

BPA needs to improve its financial health dramatically and quickly. We must have structures in place by Sept. 30 – when our next annual Treasury payment is due – and before our next fiscal year begins Oct. 1. Now is the latest we can begin the ratemaking process to enable a rate adjustment to be part of the equation that balances our financial situation.

By mid-March, we will need to make decisions on further reductions in our spending levels for FY 04 through FY 06 in order for those reductions to affect the rate level. This will mean more tough choices – not just by BPA, but also by all of our stakeholders.

I am repeating my urgent request to our partners in other programs to achieve additional cost reductions.

A three-part financial challenge

We need to find cost reductions, deferrals or other actions in the FY 03 to FY 06 period that can address three specific financial challenges. Many proposals help address one challenge but can make another area worse. The challenges are:

- **Liquidity.** BPA's financial reserves are at their lowest level since 1988 – $200 million is not even one month's cash flow. Without management action, we could easily deplete these reserves this year and be unable to meet current operating expenses. Going into next winter, we could be in a precarious position if a cold snap or plant outage required large cash outlays to preserve reliability.

- **The revenue gap.** BPA's projected expenditures over the FY 02-FY 06 period exceed our projected revenues.
- **Access to capital.** BPA borrows from the U.S. Treasury to invest in projects that have long-term benefits for the Pacific Northwest (transmission and hydro system investments, conservation and renewable resources, and fish and wildlife projects). Federal law limits our borrowing, and BPA is rapidly approaching the limit – placing all capital programs at risk.

Closing the revenue gap

When I wrote to you in November, I told you that BPA had committed to a set of cost reductions and deferrals to reduce an estimated $1.2 billion gap between our projected revenues and expenses. We described $500 million in additional cost cuts that we committed to pursue.

In that letter, I told you BPA's ability to avoid a rate increase relied, first, on whether we could get these additional cost reductions and, second, on water and market conditions. At that time, we said our chances of avoiding a rate increase were only fifty-fifty. Since then, our financial condition has continued to deteriorate, and the gap has continued to grow.

Expense reductions, expense deferrals and other actions

	FY 2003-2006 ($ million)
Expense Reductions	
PBL Internal Operations	$107
Agency Internal Operations Assigned to Power	30
Energy Web	4
Conservation Augmentation	13
Corps/Reclamation	20
Columbia Generating Station (CGS)	15
Incentive Payments (Corps/Reclamation/ENW)	24
Renewables	4
Other	4
Subtotal	**$221**
Expense Deferrals	
CGS Fuel Strategy	$37
CGS Condenser Tube Replacement	35
Subtotal	**$72**
Other Actions	
Energy Northwest Bond Reserve Fund Free-up	$56
Subtotal	**$56**
TOTAL	**$350**

Numbers do not add precisely due to rounding.

Another drought in 2003

We are now looking at a January-to-July runoff forecast of 74.8 million acre feet, 70 percent of normal. Snowpack in the mountains that feed the Columbia River and its tributaries are at dismally low levels.

Two drought years so close together is a huge hit to BPA's revenue picture. When we set rates, we incorporate a range of average historical runoff from the Columbia River system. Net secondary revenue is a function of hydropower inventory (streamflows) and the price we can get for that inventory.

Given the range of weather and market conditions, estimates of the revenue impact of a dry year can vary widely. Currently, though, we expect our net secondary revenue for this year to be over $200 million lower than we planned on at the beginning of the year. This has increased the size of the revenue gap.

It's important that BPA maintain sufficient financial reserves to cover the variability in both hydro conditions and market prices. With such

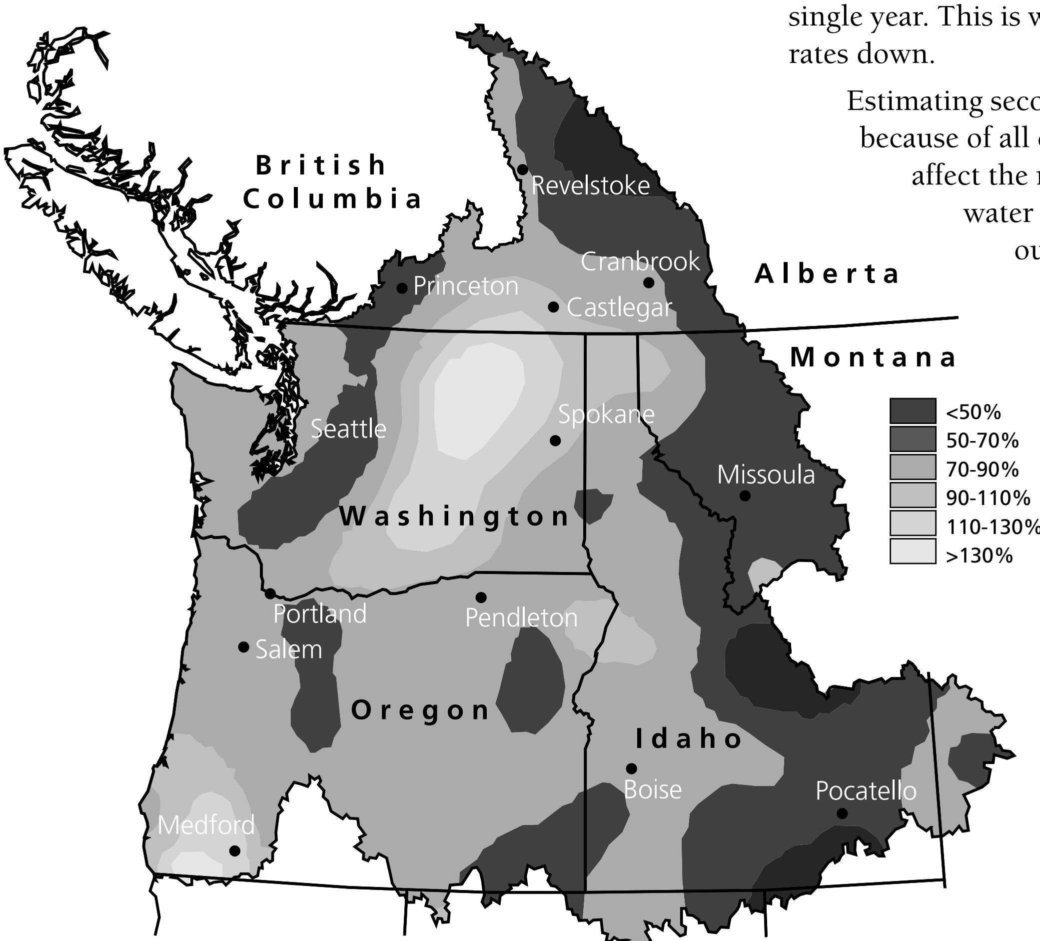
Additional potential cost reductions (Power Business Line)

	FY 2003-2006 ($ million)
Settlement of Litigation over IOU Residential Benefits	$200
More Cost-effective Fish Recovery Program	$80
Additional Energy Northwest O&M Cost Reduction	$50
Power Resource Contract Renegotiation	$30
Additional Energy Northwest Debt Service Reduction	$140
Total Potential Reductions	**$500**

All numbers are approximate.

Seasonal Accumulated Precipitation

Oct. 1, 2002 through Jan. 27, 2003



Prepared by the Northwest River Forecast Center

The Columbia Basin power system relies on the snows in the Northern Rockies from British Columbia to the Grand Tetons – where snowpack this year is at dismally low levels. Streamflow and precipitation in these key areas were low in the fall. The forecasted spring runoff is 70 percent of normal.

low reserves this year, we could face a challenge in covering our day-to-day expenses.

Beyond FY 03, if our rates are set to cover our costs, we have financial tools available that we could use to enhance our liquidity in almost any situation. We reserve these contingency tools for only the most dire circumstances. We are looking at all of our options. If we must use these tools, we will use the lowest impact options.

Lower net secondary revenue for 2004-2006

Net secondary revenue from our seasonal power surplus is far and away the key variable in determining our financial fate. This revenue often provides 20-25 percent of BPA's total revenues in a single year. This is what helps keep firm power rates down.

Estimating secondary revenue is complicated because of all of the dynamic factors that affect the results – regional firm loads, water supply and secondary markets outside the region. BPA is continuing to work on improving our analytical approaches to projecting and managing this critical revenue source.

Previous secondary revenue forecasts were far in excess of actuals, and this is a large part of the reason for BPA's current financial shortfall. We do not want to repeat this pattern. We have brought our FY 04-to-FY 06 secondary revenue forecasts down to more realistic levels. However, this increases the net revenue gap that must be closed through rates or cost reductions.

Borrowing to preserve liquidity

Some have urged BPA to consider borrowing money now to reduce rates. We understand the appeal because it will lower rates in the near term. But borrowing creates many costs – some of which will hit in the current rate period. The tradeoffs must be weighed very seriously. Depending on the amount of borrowing, the impacts could include:

- Reductions in the infrastructure investment program in areas such as transmission, energy efficiency, hydro capability, and fish and wildlife because BPA's borrowing authority is statutorily limited.

- An increase in BPA's near-term interest costs because more debt will be outstanding.
- Penalties and expenses incurred associated with rescheduling the debt previously planned to be repaid.
- A potential negative effect on BPA's credit ratings, increasing interest and other financial program costs.
- Limits to BPA's ability to borrow for further emergencies such as cold snaps and plant outages during the next few years.

Essentially, borrowing creates a short-term benefit but long-term costs.

Setting the safety net cost recovery adjustment

We are also sending another letter to our customers and others notifying them that BPA is initiating a rate case under the provisions of section 7(i) of the Northwest Power Act. The rate case will set the level and design of the Safety Net Cost Recovery Adjustment Clause. Our 2002 General Rate Schedule provisions provide for BPA to trigger the safety net adjustment when BPA forecasts a 50 percent probability that it will miss a payment to the U.S. Treasury or other creditor, or if it actually misses a payment to Treasury or other creditor. BPA currently is projecting a Treasury payment probability in 2003 of about 26 percent.

A hearings officer will set the 40-day rate case schedule, probably beginning sometime in March or early April. BPA intends to put the new rate in place in October.

BPA's costs and rates in the future

While any rate adjustment will be determined in the rate process, a rate increase as high as 15 percent would put BPA's average rate at about $37 per megawatt-hour. BPA rates this high are a huge burden for the regional economy, and we are committed to doing everything we can to bring them down in the future.

BPA is developing our proposal for how we will market power and distribute the costs and benefits of the federal hydro system after this rate period ends in 2006. A critical focus for us will be making sure our cost structure is as low as possible, is consistent with carrying out our mission and allows for a comfortable gap between BPA rates and the cost of alternative power resources.

As we take actions to recover our financial health and effectively position the agency for the future, it is particularly important that we focus on improvements for managing through the remainder of this rate period. While BPA has been buffeted by forces outside our control, we also are looking carefully at our own decisions and actions over the last couple of years and learning what we can change for the better.

I am grateful to those who have worked side by side with us over the past several months, especially those who have helped with cost reductions and deferrals. I'm again asking all of our partners to help because lower BPA rates help us all. I expect that we will manage through this financial crisis and ultimately preserve for the region the many benefits that BPA was established to deliver.

Sincerely,

Stephen J. Wright
Administrator and Chief Executive Officer