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June 13, 2005

Paul Norman
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P.O. Box 3621
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Re: Comments on BPA's Long-term Regional Dialogue

Dear Mr. Norman:

These comments are submitted on behalf of the Western Public Agencies Group ("WPAG"), and respond to the questions posed in your letter of May 11, 2005.[1] The WPAG utilities include nearly every type of preference customer served by BPA, including public utility districts, cooperatives, mutuals and municipalities. WPAG utilities purchase over one-quarter of all the power BPA sells to preference customers, and they do so under Full Service, Block and Slice power contracts. As such, the WPAG is a microcosm of the preference customer class served by BPA. Given this diversity within the WPAG, it is likely that individual utilities will submit separate comments expressing their views on specific issues. Because of their dependence on BPA for the majority of their power supply, the WPAG utilities have been active participants in the regional dialogue process.

[1] The utilities that comprise the Western Public Agencies Group are Benton Rural Electric Association, the Cities of Port Angeles, Ellensburg and Milton, Washington, the Town of Eatonville, Washington, Alder Mutual Light Company, Elmhurst Mutual Power and Light Company, Lakeview Light and Power Company, Ohop, Parkland Light and Water Company, Peninsula Light Company, Public Utility Districts No. 1 of Clallam, Clark, Grays Harbor, Kittitas, Lewis, Mason and Snohomish Counties, Washington, Public Utility District No. 3 of Mason County, Washington and Public Utility District No. 2 of Pacific County, Washington.

1. Introduction

a. Historical Perspective of BPA's Role

The passage of the Pacific Northwest Electric Power Planning and Conservation Act ("Regional Act") was a sea-change in the role of BPA in the region. The Regional Act was an attempt to comprehensively address the issues confronting the region due to a perceived regional power shortage, and it did so by making a number of changes to the power supply role of BPA.

The Regional Act changed BPA's role from that of a passive marketer of the output of the Federal base system ("FBS") to an agency charged with the duty of acquiring the incremental resources needed to serve regional load growth. BPA was to meld costs of those incremental resources with the embedded costs of the FBS. Regional utilities were encouraged to rely on BPA for their incremental power supply, on the assumption that BPA's centralized resource acquisition would produce material cost savings. BPA was also given the authority to provide monetary payments to the investor owned and preference utilities ("IOUs") to offset the high cost of resources serving their residential and small farm loads under the residential exchange program. And preference customers were provided protection from the costs that BPA would incur by providing the new services and benefits under the Regional Act by operation of the section 7(b)(2) rate test.

During the over twenty years since the passage of the Regional Act, these statutory provisions have provided substantial benefits to the region. However, in recent years changing circumstances, as well as events such as the exodus of load from BPA service in the mid 1990s and its return to BPA service in 2001, and the impact of BPA's load service commitments made during the Subscription process in combination with the melt-down of the California energy market, have taught the region the limits and risks of the BPA's current role as regional power supplier.

In response to these changed circumstances, and the awareness of the limitations and risks with the current role of BPA, the region now appears ready to take the next step in the evolutionary development to the power supply role of BPA. There now appears to be a broad-based consensus that the Regional Act paradigm of reliance on BPA as the primary power regional supplier is no longer the best approach for serving the energy needs of the region, and that melding the costs of new resources with the embedded costs of the FBS is not in the long-term interests of BPA or its preference customers. It appears that the region is in agreement that it is time for major change to the long-term role of BPA.

b. <u>The Nature of the Changes to BPA's Role</u>

The changes being contemplated to the respective resource responsibilities of BPA and its preference customers are not merely modest revisions to business as usual, as set out in the Regional Act. Rather, they are fundamental and far-reaching changes that, if implemented, will alter the materially alter role BPA has played in the region for decades. To implement such changes is a historic undertaking that will impact the provision of electricity in the region for years to come. Making such changes requires careful thought and broad regional support if it is to be done successfully.

To understand the enormity of the changes being contemplated, a comparison of some of the current proposals with the Regional Act provisions is instructive. For example, it has been suggested that preference customers be primarily responsible for acquiring their own incremental power supply. The Regional Act assumed that BPA would procure the majority of the incremental resources needed to serve regional load growth. Similarly, the proposal to charge preference customers the embedded costs of the FBS, and to separately charge incremental resource costs for power supply in excess of the current FBS capability, materially differs from the basic premise of the Regional Act that the costs of incremental resources would be melded with the cost of the existing FBS resources.

Implementing such fundamental changes is a task of historic proportions, and requires a process that ensures that such changes are made in a well considered and thoughtful manner, and with a regional consensus supporting them that includes BPA's utility customers and major stakeholders. Absent such a regional consensus, implementing such changes will inevitably result in distrust, recrimination and, ultimately, litigation that will cast a cloud of uncertainty over the efficacy and durability of any changes so implemented.

c. <u>The Revised Regional Dialogue Process</u>

During the last six months, there have been discussions with BPA staff on some, but not all, of the issues set out in the May 11 letter. In particular, recent discussions with BPA staff regarding how power from the FBS should be apportioned to preference customers have been fruitful and productive, with both sides seeking to understand the interests of the other, and to find mutually acceptable solutions. Discussions on the topic of cost control have not been so productive, as they have failed to produce a mutually acceptable resolution. And there have been no discussions between BPA and its utility customers on the topics of contract enforceability, or on IOU and preference customer exchange benefits.

The WPAG utilities understand that as a result of the comments made at the June 8, 2005 meeting, BPA has reconsidered its future process for discussing and resolving these issues. It is understood that BPA will forego issuing a draft record of decision, and instead will issue at the

end of July a discussion draft containing its ideas on how the issues listed in the May 11 letter should be addressed. And instead of regional hearings to receive formal comments, BPA intends to hold focused workshops on each of these issues with the objective of seeking agreement and regional consensus on how to address these issues. These are positive steps taken in response to customer input, and BPA is to be congratulated for both the speed with which it has reacted and its willingness to change its plans to achieve a better outcome, not only for the customers and stakeholders, but for BPA as well.

Finally, the underlying premise of the regional dialogue process, and the proposed changes that will be considered in it, is that the proposed changes to BPA's long-term role will benefit BPA's utility customers. However, BPA's utility customers are not the only beneficiaries. The proposed changes will also benefit BPA in a number of ways. Having its customer base signed to long-term take or pay contracts will remove a major revenue uncertainty for BPA, which will provide it a firmer political footing. Further, by relieving BPA of the role of primary resource provider, the preference customers will reduce the cost volatility faced by BPA, and the political exposure that such volatility engenders.

To achieve these benefits, BPA, its utility customers and major stakeholders all must be willing to compromise. Accomplishing large goals, such as a moving to the next stage in the evolution of BPA's long-term power supply role, will call for all parties to occasionally rise above their parochial self-interest in order to achieve regional consensus. When it commences this process to forge a regional consensus, BPA should make it clear that all participants in this process, including BPA, must be willing to occasionally make the sacrifices that will be necessary to develop the regional consensus to support such a fundamental change in the way BPA, and the region, conduct the electric business.

2. Comments on Specific Issues Listed in the May 11, 2005 Letter

a. Service to Public Utilities

How much power each public utility is able to purchase at BPA's lowest cost-based rates and how this amount is adjusted as utility loads and resources change?

The WPAG utilities support the proposal approved unanimously by the PPC Executive Committee, and explained in documents dated August 8, 2004 and February 24, 2005, copies of which have been provided to BPA. These papers address the issues of how the capability of the FBS should be apportioned among preference customers, and how load and resource changes over time should be accommodated. These papers are premised on three bedrock principles:

1) Any apportioning of the output of the FBS among preference customers must be done in a durable and enforceable manner in a power sales contract with BPA;

2) The amount of FBS capability apportioned to a preference customer should be stated as a percentage, and should not be subject to alteration by BPA; and

3) Customers must have the contractual right to undeclared non-federal resources in order to protect their right to purchase their full apportionment of FBS power.

While such an apportioning of FBS capability among preference customers will require a price differential between power from the FBS and power from incremental resources, this is not a "tiered rate" proposal. Under a tiered rate construct, the amount of power that can be purchased at the embedded cost of the FBS can be altered in each rate proceeding. Such an approach offers no stability to the preference customers for resource planning and acquisition. There is no support for a tiered rate approach.

How to provide customers with more stability and predictability about their rates by establishing a long-term rates methodology?

It is an absolute prerequisite to apportioning to preference customers the FBS capability is the need to establish a dividing line between the embedded costs of the FBS, and the costs of incremental resources needed to serve preference customer loads in excess of the FBS capability. Because of the importance of this issue, a discussion paper was provided to BPA on this topic in February, 2005, a copy of which is attached to these comments as Exhibit A.

The dividing line between the costs of embedded and incremental resources could be done in a rate methodology. However, there are a number of requirements that must be satisfied:

1) The rate methodology cannot be established by a notice and comment process, but must be the product of meaningful negotiations so that utility customers have confidence that the methodology will appropriately separate embedded and incremental costs;

2) The rate methodology should be made an exhibit to the long-term power sales contracts, with contract provisions that address and will resolve issues regarding its duration and how it may be modified.

3) The rate methodology cannot be subject to change by BPA after a notice and comment process, but must require the concurrence of the preference customers.

4) The provisions of the rate methodology must be subject to enforcement by preference customers by way of a neutral third party, and not by recourse to the

9th Circuit, which has demonstrated a lack of interest in requiring BPA to abide by the terms of its contracts.

A topic that deserves additional comment is how the separation between embedded and incremental resource costs can be enforced by a neutral third party, and not be forced into the 9th Circuit Court of Appeals. Customers have little confidence that the 9th Circuit Court will enforce contract provisions if such enforcement is resisted by BPA. To solve this dilemma, the customers made a written proposal to BPA some months back on how to address this issue, a copy of which is attached as Exhibit B. To date there has been no response from BPA on this proposal. This is one of the fundamental issues that must be addressed successfully addressed to change BPA's power supply role, and it should be addressed sooner rather than later.

What ability new formed public utilities will have to purchase power at the lowest cost- based rate?

The question of how to deal with new public utilities is complicated by two facts. First, when new a public utility is likely to be form, the entire capability of the FBS will be committed to serving the loads of existing preference customers. And second, absent statutory change, a new public utility will have the right to participate in the residential exchange program, which will result in new resource costs being spread to the rates of other preference customers. This is exactly the opposite of what is intended by apportioning to preference customers the capability of the FBS.

Given these facts, it seems desirable that new public utilities that may form in the future be encouraged to forego participation in the residential exchange program. There are a number of steps that could be taken to accomplish this goal:

1) At the time a new public forms, it could be given first access to any entitlement to FBS power at embedded cost that is available because it is in excess of a utility's net requirement and has not been protected by the undeclaration of non-federal resources. This embedded cost power would have to be subject to recall by the utility that was originally entitled to it.

2) The new public could be given access to a limited pool of power priced at the embedded cost of the FBS, on condition that it agreed to forego participation in the residential exchange. The power made available to new public utilities would be acquired by BPA, and the costs of such acquisition would be spread to the rates of all other customers. Such power would only be purchased if and when a new public utility requests service from BPA.

Such an approach would minimize the costs to existing preference customers, while providing a reasonable incentive to newly formed public utilities to not participate in the residential exchange.

Whether BPA should make modifications to the Full and Partial Requirements, Block and Slice products now provided?

It seems apparent that the Full Service product will need to be modified to permit customers to use non-federal resources to serve a portion of their load, if they elect not to place their load growth on BPA, without the need to go to an administratively more complicated product. This was accommodated by BPA when these customers diversified in the 1990's. Essentially, they were permitted to use resources that were not dispatchable to serve their load without moving to a more complex product. The same approach should be utilized in the post-2011 period.

As to possible changes to the Partial Requirements, Block or Slice products, it is really too early to tell. Whether these products should be changed will become clearer when the fundamental issues have been addressed, so that the context in which these products will operate is better understood.

b. Cost Control and Dispute Resolution

A fundamental prerequisite to a long-term take or pay contract with BPA that apportions the output of the FBS are cost control provisions that give preference customers confidence that they are not signing a blank check. To date, cost control mechanisms have been short-lived and put in place to deal with specific situations. In order to convince preference customers that signing a long-term take or pay contract is in their interest, cost control mechanisms that are durable, and which ensure those paying BPA's bills a meaningful voice in BPA policy decisions that impact its costs, are imperative.

Discussions between BPA staff and customers produced a proposal for a cost management group ("CMG") that had many of the attributes necessary to make such a long-term take or pay commitment viable. The existence of the CMG was to be memorialized so that it would be durable over the life of the long-term contracts. It was to be representative in nature by including all major interests, and it was to deal with the issues that drive BPA costs. And in particular, it contained a provision under which BPA and interested parties would have as their goal reaching agreement on the spending levels that would be used to construct the revenue requirement for the initial proposal in BPA's rate cases. A number of write-ups on this topic were provided to BPA during these discussions.

The approach outlined in the papers discussing the CMG is fundamentally different than the current Power Function Review ("PFR") approach. The PFR approach relies heavily on the rate

case paradigm in which all parties make their pitch, and BPA acts as judge by picking and choosing among the competing arguments. Such an approach accentuates the differences between groups, fosters positional advocacy, and does not foster compromise or agreement. In contrast, the CMG approach was specifically intended to foster negotiation rather than confrontation, and to result in compromise and agreement.

That said, the CMG approach conspicuously lacked an element to encourage BPA and its customers to reach compromise on difficult cost issues. In short, it did not contain an outcome in the absence of an agreement that all sides would consider less desirable than making that last compromise needed to reach agreement. Such an element is key if all parties, including BPA, are to be motivated to resolve difficult cost issues. There are a number of options for providing such motivation if consensus is not reached on all spending levels, such as:

1) Those items still at issue are open to testimony and cross-examination in the rate case;

2) Those items still at issue are referred to the Pacific Northwest Regional Conservation and Planning Council ("Council") for decision, and the decision of the Council on such items is used in the initial rate proposal;

3) Those items still at issue are referred to a neutral third party for decision, and that decision is used in the initial rate proposal;

4) If all spending items are not resolved, the next rate period is limited to one year; or

5) If all spending items are not resolved, customers can elect to remove load from BPA service under their long-term power sales contracts.

There may be other, more useful proposals for motivating all parties to compromise. However, the important point is that if agreement on spending levels is to be achieved, failure to do so must carry a consequence that all parties, including utility customers and BPA, will find unattractive.

Some have suggested that such an incentive is unnecessary, since everyone has recourse to the Congressional delegation as the final arbiter of what should be done with regard to spending. Relying on the delegation to resolve these matters is a false path that does not offer the customers who pay the bills a meaningful role in the BPA decision process, for two reasons. First, by virtue of both its constant contact with the delegation, and its expertise and control of the relevant information, the delegation will most likely defer to the judgment of BPA on financial matters. And second, the delegation is neither designed, nor will it appreciate, being placed constantly in the role of referee over financial spats between BPA and its customers. Such an approach is no better than we have now, and we must do better than that if BPA's power supply role is to be fundamentally changed.

c. Benefits to residential and small farm consumers of investor owned utilities

The May 11 letter asks whether benefits should be provided to residential and small farm customers of IOUs under the residential exchange program as it existed prior to 1997, or if a mechanism similar to that currently employed by BPA in the settlement agreements should be employed. In fact, neither of these alternatives offers any hope of achieving a regional consensus on this issue.

Return to the traditional residential exchange, using the current average system cost methodology, would find little to no support among the IOUs and the state regulators. This is due to the highly volatile level of benefits that have been provided over the years, caused in large measure to BPA's shifting interpretations of the average system cost methodology and the changing application of the section 7(b)(2) rate test. Similarly, the current settlement methodology finds little support among preference customers. This is a result of the level of benefits being set too high due to the use of market prices from the California market meltdown. It is exacerbated by the provision that contractually eliminates the protection Congress provided preference customers under the section 7(b)(2) rate test. Clearly, if BPA and its customers are to find a generally acceptable resolution of this issue, fresh thinking must be brought to bear.

There seems to be general agreement that the benefits to the residential and small farm customers of the IOUs should be made in the form of monetary payments, and not the failed Subscription concept of power sales at the preference customer rate. That said, there are two ways that monetary benefits can be paid to the IOUs that comport with the current statutory provisions.

The first would be to negotiate a lump sum settlement amount based on a discounted value of the expected benefits of each IOU under the current average system cost methodology. The lump sum payment could be negotiated for a ten, fifteen or twenty year period, and could be paid out in annual or monthly installments. The discounting would take into account the inherent uncertainty of forecasting future benefits, and the possibility that the rate test may trigger during the settlement period. Such a settlement would not prohibit the IOUs from sharing the settlement amounts among themselves in a manner that differs from the settlement amounts each IOU might negotiated with BPA. This approach was used in the 1980s to settle BPA's residential exchange liability with dozens of preference customers and IOUs without provoking a single lawsuit, which attests to its consistency with the Regional Act.

The second method would be to implement a more traditional residential exchange program, but not based on the current average system cost methodology. Rather, a simplified average system cost methodology could be implemented that uses the average residential rate (weighted by

actual load served) of each of the participating utilities for the prior calendar year, adjusted by a contractually stipulated factor that would be designed to remove from the retail residential rates non-resource costs, such as administrative and general expenses. The residential and small farm load used to calculate the monetary benefits would be the actual load served by the participating utility in the preceding calendar year. To make such an approach durable, the contract would have to contain clear and complete stipulations regarding the assumptions that could be used in the calculation of the section 7(b)(2) rate test.

Also notable were the residential exchange issues that were not raised by BPA in the May 11 letter. The first of these is the treatment of the section 7(b)(2) rate test. This was the major protection provided to preference customers in the Regional Act, and is directly implicated by any proposal to deal with the benefits available to residential and small farm customers of IOUs. While ignoring this provision might be convenient, the fact is that it is a part of the existing statutory framework, and it must be dealt with if the changes contemplated for BPA are to be durable.

The second omission was the absence of any discussion of the treatment of preference customers who are entitled to participate in the residential exchange, and have a reasonable likelihood of receiving benefits under that program. During the Subscription process, the residential exchange rights of these preference customers were studiously ignored, and they were excluded from the residential exchange settlement fashioned by BPA for the residential and small farm customers of the IOUs. Taking such an approach this time is not viable, since doing so will result in either a large number of preference customers participating in the traditional residential exchange program with the attendant costs, or in a flurry of lawsuits that will raise uncertainty regarding the whole enterprise.

As part of the effort to reach a regional solution to these problems, BPA should include in any negotiations regarding the residential exchange benefits not just the IOUs, but also the existing preference customers who have a plausible claim for benefits under the residential exchange program.

d. <u>Service to DSIs</u>

The question of service to the DSIs raises difficult issues of employment in rural communities, the cost of subsidies in the face of international competition and what, if anything, is owed to long time customers of BPA. These questions are complicated by the fact that under a system that has been fully apportioned to existing preference customers, any concession to the DSIs comes at a cost to all preference customers. The letter asks whether, and in what form, benefits to the DSIs should take. There is a single answer to both of these questions.

BPA is not in the business of providing "benefits" to various customer groups, nor is it empowered to decide the form that such benefits should take. BPA was formed and is in the business of selling power. The provision of monetary benefits to the IOUs required a specific statutory grant of authority that did not exist prior to the Regional Act. See, Regional Act, sections 5(c) and 7(c). No such comparable provision exists to justify the provision of monetary benefits to the DSIs.

The pricing of power sold by BPA is governed by statute, and that includes power sold to the DSIs. And so the "benefits" to be provided the DSIs should be in the form of a power sale. Since BPA will not have any FBS power available to serve the DSIs once the system is apportioned to preference customers, BPA will have to purchase any power sold to the DSIs. Such augmentation power should be priced under the provisions of section 7(f) of the Regional Act, and should reflect the full cost incurred by BPA to obtain such power.

It has been suggested that now that the status of a direct service customer of BPA is no longer advantageous, that DSIs should be permitted to become a load of their host preference utility, and be able to purchase power like any other industrial customer. This change of heart comes too late. When the Regional Act was under consideration, the DSIs elected to retain their unique status as direct service customers of BPA, and specific provisions, such as the new large single load provision, were included in the Regional Act in reliance on that election. To now let the DSIs shift to preference customer service would not only violate the new large single load provisions, but could also result in a noticeable reduction in the amount of FBS capability available to all other preference customers. Such an outcome would destroy preference customer support for the entire notion of apportioning the capability of the FBS, and reducing BPA's role as regional power supplier.

e. <u>Conservation and Renewables</u>

It is apparent that a shift of the load growth service responsibility away from BPA and to the retail utility has major implications for the manner in which BPA fulfills it duty regarding conservation and renewable resources. It also raises questions about how much resource acquisition activity BPA should undertake when the new service approach is being designed around the retail utility making resource acquisition decisions.

A number of things seem clear in this context. First, there will be a continuing role for BPA in the area of regional market development for both conservation and renewable resources. BPA is uniquely situated to provide a regional approach to market development. Second, to the extent that BPA is given the responsibility to provide service to preference customer load in excess of the FBS capability, it will have a rationale to procure conservation and renewable resources to fulfill that obligation to the extent that they are the least cost alternatives. And third, preference

customers will have a new and powerful incentive to acquire conservation and renewable resource on their own account to serve their growing loads.

At this juncture, perhaps the best thing that can be done is to not take any drastic steps to alter existing conservation and renewable resource programs until the shape of the future service arrangements is better understood. In particular, the conservation and renewable resource discount and conservation augmentation programs are working well, and should for the present be left undisturbed. The region should avoid doing harm to these valuable resource programs by taking precipitous actions based on a future that is currently not well understood.

f. Resource Adequacy Standards

Resource adequacy standards sound like a worthwhile goal. However, the consideration of this matter must be done in a way that is consistent with the proposed shift in primary resource acquisition responsibility away from BPA to the preference utilities, and in a manner that does not conflict with local decision making and local control. It would not be a good outcome to give preference customers the primary responsibility for resource acquisition, and then to hem them in with rules and regulations.

At the heart of the change to BPA's way of serving preference customers is that the customers, rather than BPA, will be responsible for making incremental resource decisions. The utilities that will be making these decisions are directly accountable to the customers who provide the money to fund these resource decisions. Resource decisions are heavily influenced by local circumstances and economic conditions, and should properly be made at the local level. Any adequacy standards, if they are deemed necessary, should be done as guidelines to inform these utilities on resource decisions, and not as requirements that will preempt local decision making.

Lastly, any resource adequacy standards must be consistent with the provisions of the BPA power sales contracts. These contracts already contain an exhibit (Exhibit C) that requires that the utility demonstrate a balance of loads and resources for a planning period, usually one year in duration. Given this already existing contractual obligation, it is unclear what additional resource standard is needed.

g. General Transfer Agreements

The use of general transfer agreements will be an issue in any change to BPA's long-term role, since all preference utilities will require equitable access to the Federal transmission system for non-federal power. Absent such access, preference customers that rely on general transfer agreements to move power to their loads will be seriously disadvantaged by the proposed change to BPA's long-term role. Resolving this issue will require thoughtful discussion, particularly

since some IOUs have taken the view that the current transfer agreements do not cover non-federal power deliveries.

3. CONCLUSION

Resolving the issues discussed in the foregoing comments will not be easy or pleasant. However, making the effort is necessary if the region is really going to make a fundamental change to the role of BPA and its preference customers in the area of planning and acquiring resources to serve incremental loads. The WPAG utilities are committed to making the effort necessary to successfully resolve these issues.

Terence L. Mundorf
Attorney for the Western
Public Agencies Group

EXHIBIT A

2/22/05

STRAW PROPOSAL FOR COST SEPARATION AND ENFORCEMENT

The following is a proposal for establishing the cost separations necessary for a durable allocation, and the mechanism by which such cost separations would be enforced.

Contract Elements

A. Cost Exhibit

The allocation contract would contain an exhibit, similar to Exhibit I of the current Block/Slice contract, which would specify the cost elements (and credits) of the BPA Power Business Line revenue requirement that would be used to establish the rates for embedded cost service. However, rather than setting out specific dollar amounts, this exhibit would state which power product rate(s) (full requirements, partial, block and Slice) would contain all (or some portion) of each cost element. The purpose of this exhibit would be to establish contractual responsibility for BPA's cost elements and credits, and to contractually establish the costs and credits that are included and excluded from various power product rates. For example, the cost exhibit would specify which rate(s) would include the power purchase costs incurred by BPA to provide load shaping. The exhibit would be subject to revision by agreement of the parties.

B. Rate Methodology

The allocation contract would contain an exhibit that would set out the formula rate methodology. This exhibit would specify a formula for each power product, and depict how each of the costs elements set out on the cost exhibit are treated for purposes of creating each of the power product rates under which embedded cost service will be provided by BPA. It would also reiterate each of the costs elements and credits that are included and excluded from each of the power product rates. Finally, it would delineate how the various power product rates would be responsible for paying for actual costs that exceed forecasts, as well as receiving credits when actual costs are less than forecast.

C. Enforcement

Enforcement of the cost separations established in the cost and formula rate methodology are a key element to preference customer support for an allocation. Some of the options available to provide such enforcement include:

Option 1 – Customer Agreement

The allocation contract signed by all customers could contain a provision under which one or more customers could engage in binding arbitration with other customers if they felt that BPA had allocated costs to their power product rate that, pursuant to the cost and formula rate methodology, properly should be excluded from their rate and included in some other BPA power product rate. The contract could stipulate that all

customers would be bound by the outcome of such arbitration whether or not they participated in the proceeding, and would not appeal or otherwise contest the decision of the arbitration (except for the normal grounds of fraud, misrepresentation, etc.) regardless of whether they participated in the process. A couple of options are being investigated regarding the enforcement of the arbitration decision, since multiple customers shifting money back and forth would be an administrative nightmare. One option is for BPA to run an expedited section 7(i) proceeding to implement the arbitrator's decision, with all customers being contractually obligated to support the adoption of the decision, and BPA being bound to use it as their initial proposal. A second option is to make the correction at the next rate proceeding, and to reimburse at that time the customers that were improperly charged. Assuming two year rate periods, the idea is that the harm would not be too great. And third, BPA could continue to render bills under the erroneous rates, but at the request of the customers make a billing adjustment to reflect the arbitrator's decision until the next rate period.

Option 2 – Non-Judicial Dispute Resolution

Either by allocation contract provision or by adoption of a BPA rule of procedure for the rate case, establish a process whereby customers who think that BPA is proposing to allocate costs in a manner inconsistent with the cost and formula rate exhibits could invoke a binding dispute resolution process presided over by a neutral third party. While the ability to invoke this process could occur as early as the rate case workshops when BPA unveils its cost allocation proposals, or as late as after the draft record of decision, it probably is most logical to make the time to invoke this process after BPA has issued its initial rate proposal. A specific time period could be established during which any party that felt a proposed allocation was inconsistent with the cost and formula rate exhibits could request a hearing before a neutral party. The neutral party could be either the rate case administrative law judge, or some other party, and would act something like a special master appointed to resolve the specific allocation issue presented. The proceeding would be open to any party with a demonstrable interest in the controversy, and those participating would be bound by the outcome and would waive appeals to other tribunals, such as FERC and the 9th Circuit. The question of whether the Administrator could agree by contract to be bound by the decision of the special master on a cost allocation question is being investigated. And it is important to note that this special process would only be available to adjudicate the issue of whether a proposed allocation of costs is consistent with the cost and formula rate exhibits. So such issues as program levels, rate design, market and cost forecasts, or BPA's execution of statutory rate directives (such as sections 7(b)(2) and (3)) would not be the subject of this process.

Other enforcement ideas may arise as the issues related to the above two approaches are investigated.

Rate Elements

The allocation contract (including the cost and formula rate methodology exhibits) would be negotiated and offered for execution by the customers prior to conducting the 7(i)

proceeding for the approval of the formula rate methodology. After the allocation contracts are offered and executed, BPA would conduct a 7(i) proceeding on the formula rate methodology, and upon conclusion of the 7(i) rate proceeding submit it to the FERC seeking approval for the length of the allocation contract. BPA could run a separate 7(i) process for the formula rate methodology, or roll it into the appropriate BPA rate proceeding.

If the formula rate methodology adopted by the Administrator at the conclusion of the 7(i) process and approved by the FERC comports with the formula rate methodology exhibit in the allocation contract, each customer could elect to begin receiving service under the allocation contract, or elect to delay taking service under the allocation contract until the expiration of their Subscription contracts.

In the event that the formula rate methodology either adopted by the Administrator or as approved by the FERC differs in any material respect from the formula rate methodology exhibit of the allocation contracts, then there are some options to consider, such as:

- All of the allocation contracts automatically terminate, and customers continue to take service under their Subscription contracts.

- Each customer decides whether to amend its allocation contract formula rate exhibit to comport with the formula rate methodology adopted by the Administrator (or approved by the FERC), or to terminate its allocation contract and continue to take service under its Subscription contract.

- All allocation contracts are either amended to comport with the formula rate methodology adopted by the Administrator (or approved by the FERC) or terminated automatically with the customer continuing to take service under its Subscription contract, based on a vote of the preference power customers that requires both a supermajority of the preference customer load and a supermajority of the utilities voting individually.

In the event that the formula rate methodology adopted by the Administrator and approved by the FERC comports with the formula rate methodology exhibit of the allocation contract, but is approved for a term less than 20 years, then there are some options to consider, such as:

- Reduce the term of the allocation contract to equal the period for which the formula rate methodology has been approved.

- Contractually require BPA to resubmit the formula rate methodology to the FERC for approval for the remaining term of the allocation contract in a timely manner before the expiration of the first FERC approval, and give the customers the right to terminate the allocation contract and revive their Subscription contract if the FERC does not grant approval for the remaining term of the allocation contract.

- Contractually require BPA to resubmit the formula rate methodology to the FERC for approval for the remaining term of the allocation contract in a timely manner before the expiration of the first FERC approval, and if the FERC approves a formula rate methodology that differs in any material respect from the formula rate methodology exhibit in the allocation contract, one or more of the options discussed immediately above could be available to the customers

EXHIBIT B

3/23/05

STRAW PROPOSAL FOR ENFORCEMENT OF COST SEPARATIONS

The following is a proposal for enforcing the cost separations that would be established in the formula rate methodology.

Explanation of Why Enforcement Mechanism Is Needed

Currently under discussion is the idea of offering long-term contracts that contractually commit the entire output of the Federal power system to preference customers. This proposal would provide service from the current Federal power system priced at embedded cost, and service in excess of the current Federal system priced at market or incremental cost (there would be no melding of embedded and incremental cost resources). Under this approach, customers would pay only for the service they receive from BPA, and would not pay the costs of services they do not receive from BPA. For example, a block purchaser that is serving its own load growth with non-federal resources would not pay any of the costs BPA incurs to acquire the resources to serve the load growth of utilities purchasing full requirements service from BPA.

The formula rate methodology would establish the costs that a purchaser under each power product rate would, and would not, pay. To commit to a long term contract of this sort, customers must have confidence that the cost allocations to the various power product rates made by the formula rate methodology will endure for the term of the contract, and that such allocations will be enforced even if BPA finds it inexpedient to do so for some reason in the future. If these allocations are not enforceable by the customer against BPA, the customers will not sign such long term contracts.

There are issues regarding whether the 9th Circuit can act in a timely manner, and whether it can be relied upon to ensure BPA compliance with contract provisions. Therefore some means must be found to place disputes about whether BPA has complied with the formula rate methodology before a neutral decision maker in a manner that binds BPA.

It is also important to state what this straw proposal does not address. The mechanisms described in this paper are not intended to create a forum to dispute the wisdom of BPA in making a particular expenditure, whether BPA should have made a particular expenditure, or the size of a particular expenditure. Those topics are being discussed under the heading of "cost control". This straw proposal only addresses the following narrow issue: Once the formula rate methodology has established cost categories and allocated them to the various power product rates, how can the customer obtain enforcement of those cost allocations.

A. Costs Are Allocated to Power Product Rates

The long term contract will contain a cost exhibit specifying the cost elements (and credits) of the BPA Power Business Line revenue requirement that would be used to establish each of the power product rates under which BPA will provide embedded cost and incremental cost service. This contract would contain an exhibit setting out the formula rate methodology. This exhibit will specify a formula for calculating the rate for each power product, and depict how each of the costs elements set out on the cost exhibit are treated for purposes of creating each of the power product rates under which embedded cost and incremental cost service will be provided by BPA. It will state each of the costs elements and credits that are included and excluded from each of the power product rates. Finally, it will delineate how the various power product rates will pay for actual costs that exceed forecasts, as well as receiving credits when actual costs are less than forecast.

B. Types of Costs Covered

The cost assignments to the various power product rates established in the cost and formula rate methodology exhibits must be enforceable. However, the type of enforcement mechanism chosen should match the type of cost at issue. Therefore, it is first necessary to differentiate the types of costs that could be subject to dispute.

The first category of costs over which disputes could arise is "mis-assigned costs". These are costs that were clearly identified and allocated in the formula rate methodology, but which for some reason BPA has in its initial rate proposal allocated in a manner contrary to the formula rate methodology.

The second category of costs that could cause a dispute are "new costs". These are costs which are not identified when the formula rate methodology was drafted, and that are not allocated to any power product rate under the formula rate methodology.

C. Enforcement of Formula Rate Methodology Cost Allocations

Mis-assigned Costs

The enforcement of cost allocations for mis-assigned costs is, in essence, a factual dispute. It would arise when BPA proposes in an initial rate proposal to allocate costs to power product rates in ways that are contrary to the formula rate methodology. Resolution of these disputes could be done in conjunction with the rate process.

After the BPA initial rate proposal, a time period could be established within which a party would have to file a motion alleging, with specificity, how the initial proposal allocates costs in a manner contrary to the formula rate methodology. At this juncture, either the presiding administrative law judge (ALJ) or a special master could conduct a brief fact-finding hearing to determine if the contested cost allocation complied with the formula rate methodology. It is envisioned that this would be done completely by written submittals with no testimony or cross-examination. Oral argument would be permitted. It is expected that this process would take no more than 30 days.

When the fact finding process is concluded, the ALJ or special master will find facts that establish how the formula rate methodology required the cost to be allocated. This finding would be binding on the parties to the rate case, and on the Administrator as well. The Administrator being bound by this fact finding process is the crucial element of this approach, since if the Administrator is not bound, there is essentially no way for the customer to obtain enforcement of the cost allocations made in the formula rate methodology.

It is important to emphasize what the foregoing process would not consider. Specifically, questions regarding whether the cost should be incurred, or whether the amount of the cost is too great (or too little), would not be eligible for consideration or decision in the foregoing process.

New Costs

While expected to be relatively rare, it is virtually certain that during the course of a 20 year contract some cost will emerge that has not been identified and allocated to the power product rates by the formula rate methodology. This is the dreaded "new cost" that the formula rate methodology did not foresee.

It is suggested that the long term contract contain a section establishing a process to resolving the allocation of such new costs. First, it would state the appropriate criteria to be applied in deciding how a new cost should be allocated, such as allocating it to the power products that benefit from the expenditure. This section would also contain procedural requirements, such as obligating BPA to give notice of such a new cost to the customers prior to the initiation of a rate proceeding, and to provide factual information about the nature of the cost.

The question of which power product rate to allocate the new cost to would, in the first instance, be taken up by the CMG. The objective would be to determine if there was a proposed allocation of the new cost that could be supported by a super-majority of the CMG representatives and by BPA. A super-majority of the CMG representatives would be defined as six of the nine representatives, with minimum of three of the six being representatives of public utility customers.

In the event that such a CMG/BPA supported allocation proposal is developed, the long term contract would provide that the formula rate methodology would be revised to implement the CMG/BPA supported allocation proposal. The fact that the CMG and BPA had supported the allocation proposal would not prohibit a customer from challenging the final action of BPA implementing the CMG/BPA supported proposal in the 9th Circuit.

If the CMG process did not produce a CMG/BPA supported allocation proposal, the long term contract would provide that an arbitration process would be initiated, with BPA and the customers with long term BPA power contracts being eligible to participate as parties. The arbitration process would be initiated when at least two CMG members representing constituencies that have long term contracts with the formula rate methodology as an

exhibit (one of which must be a public utility representative) request arbitration within 60 days of the conclusion of the CMG process.[1] In the absence of such a request, BPA would be permitted to revise the formula rate methodology to include the new cost using its normal notice and comment process.

The arbitration would be conducted in baseball style (the arbitrator must choose from among the solutions proposed, and cannot fashion a remedy of his/her own design), and would be conducted on written submittal only without testimony or cross examination. The arbitrator could elect to conduct oral argument, but would not be required to do so. The obligation of the arbitrator would be to choose the allocation proposal for the new cost that most fully and completely conforms to the standards set out in the formula rate methodology for allocating new costs. All eligible parties would be bound by the result of the arbitration, regardless of whether they participated or not. Upon the conclusion of the arbitration process, the formula rate methodology would be revised to reflect the outcome of the arbitration.

Once again, it is important to emphasize what the foregoing process would not consider. Specifically, questions regarding whether the new cost should be incurred, or whether the amount of the new cost is too great (or too little), would not be eligible for consideration or decision in the foregoing process.

[1] One Joint Customer representative feels one CMG representative, rather than two, should be able to invoke the arbitration process.