Council Recommendations on the Future Role of Bonneville

Summary

For the past several months, the Council has participated in the Regional Dialog on the Future Role of the Bonneville Power Administration in Power Supply. There were at least two immediate factors that were in impetus for the Regional Dialog. First, the power supply contracts of Bonneville's Direct Service Industrial (DSI) customer expire in 2006. The companies must know if they can expect service from BPA post 2006 and BPA must know how much power they must supply so they can secure the necessary resources. A second and very significant factor is that after over a year of discussions, the great majority of Northwest utilities, both public and investor-owned, large and small, urban and rural, appear to have coalesced around a proposal that would significantly alter Bonneville's role in power supply. That these disparate interests would come to agreement over a number of issues that have been in dispute for many years is significant and deserves careful consideration.

These interests did not come together by accident. They came together out of recognition of a set of problems that, if not resolved, could threaten the reliability of our power supply and the ability of the Northwest to retain the benefits of the Federal power system. These problems are not the fault of Bonneville Power Administration and its thoroughly professional staff. Rather, they are the consequence of a mismatch between how BPA is called upon to operate and the realities of the evolving electricity system. The problems include:

- Periodic lack of clarity regarding load serving responsibility;
- Lack of clear economic signals to many parties in the region regarding the true costs of new power supplies and the value of alternatives;
- Exposure of BPA to high electricity market risks resulting from the periodic ability of customers to place load on or take load off Bonneville;
- A perception of inequality in the distribution of the benefits of the federal power system within the region.
- The financial risk to the U.S. Treasury and the resulting political risk to the long-term interests of the region if at some time Bonneville is unable to absorb the risks of a highly variable hydroelectric system and a potentially volatile wholesale market.

These observations are nothing new. They were recognized formally over 7 years ago during the Comprehensive Review of the Northwest Energy System authorized by the region's governors.[1] Many of the aims of the proposal offered by the Joint Utility Customers and the Public Interest Groups reflect the conclusions reached in the Comprehensive Review.

The Council has participated in the Regional Dialog public meetings around the region and has reviewed the written comments and proposal submitted. In light of those

[1] *Comprehensive Review of the Northwest Energy System*, Document Number CR96-26, December 12, 1996.

proposals and comments and the Council's own analysis of Bonneville's situation, the Council makes the following recommendations for Bonneville's consideration as it prepares its own blueprint for its future role in power. The Council's recommendations are primarily concerned with issues of efficiency and less with issues of equity. However, if equity issues are not adequately addressed in any final proposal, the likelihood of a success will be small.

Long Term Contracts –

The Council supports 20 year contracts because they will provide contractual protection from external efforts to appropriate the benefits of the federal system; demonstrate regional commitment to the federal system and buffer Bonneville and thereby the Treasury from the risks of losing or gaining loads with shorter contracts. The Council recognizes the customers' concern that with shorter contract terms, they lose an important level for exercising discipline on Bonneville's costs. However, the Council finds the customer's proposal for a customer advisory committee with enforceable powers to be problematic. Bonneville's political accountability will continue to be an important control on Bonneville's costs. The Council encourages BPA to engage in a dialog with the customer *and* other interests to identify other mechanisms.

Power Products – Slice –

The Council supports the offering of the slice product and expanded use of that product. This product meets the needs of some customers; it results in greater diversity, lessening BPA's impact on the market, its exposure to market and hydro risk and improving the liquidity of the power market; and it provides clarity with respect to responsibility for meeting load growth and clear economic signals regarding the cost of serving loads growth. The Council is concerned about the ability of some individual slice customers to handle the risk associated with the slice product and encourages Bonneville and the customers to make sure the provisions surcharging all slice customers when one or more are unable to make timely payment to BPA are robust enough to not jeopardize BPA's ability to make its Treasury payments. The Council recommends that slice customers be allowed flexibility operation of their slice so long as non-power constraints including fish constraints are not violated. The Council also believes that slice customers are responsible for providing BPA with the information required to operate the system efficiently and should face disincentives for failure to do so. From the standpoint of reliability it is essential that Bonneville retain the ability to take unilateral actions on the whole system in the case of emergency.

Power Products – Requirements --

The Council supports the offering of a requirements product as it meets the needs of many customers in the region. However, the Council is concerned about the lack of clarity regarding responsibility for meeting load growth once any surplus federal base system resources have been absorbed. The Council recommends that Bonneville clearly indicate that the load growth will be served by tiered rates or the equivalent that charges the cost of the new resources needed to meet load growth. To do otherwise would perpetuate conflict between growing and non-growing utilities and not send appropriate price signals to the customers.

Power Products – Block

The Council supports Bonneville providing a block power product independent of the slice product. However, the Council believes that the block power product should be conditioned as described in the Joint Customer Proposal – that the costs Bonneville incurs in shaping power to the blocks be passed on to the block customer and that the block product not contain a load growth element. This is essential to aligning benefits and risks, providing clarity with regard to load responsibility and clear economic signals regarding the cost of load growth.

Investor-owned Utility/Publicly-owned Utility Settlement

The Council supports the settlement of the issue of the level of benefits provided the residential and small farm customers of the investor-owned utilities. To do so will reduce intra-regional animosities and give a broader cross-section of the region a direct stack in the well-being of the federal system. The settlement proposed attempts to achieve a relatively simple and transparent representation of an equitable sharing of benefits of access to federal power based on the residential exchange paradigm. It uses the cost of power from a combined cycle combustion turbine as a surrogate for the cost of providing power the residential customers of investor-owned utilities. There are questions that can be raised about this approach. However, this is an equity issue and agreement among the parties to the settlement is strong evidence that equity has been achieved. However, there are implications for Bonneville's costs and it behooves the parties to be sure that there is broad satisfaction with the equity of the solution reached. If there is not, the customers may ultimately not settle, or even if they do, other parties may challenge the settlement in the courts. This would put at risk the achievement of the goals of the entire proposal.

Service to Direct Service Industries

The contracts for service to the Direct Service Industries expire in 2006. The companies need to know if they will continue to receive power at Bonneville's average cost to make decisions about the future of their plants. Bonneville needs to know whether it needs to acquire resources for those plants. Current contracts would supply approximately half of the smelter load in the region. However, at current world aluminum prices and Bonneville power rates, little smelter load can operate economically. If aluminum prices improve and Bonneville rates are not too high, more of the region's capacity could operate. The Council recognizes that the Direct Service Industries are important to local economies in the region but also recognizes that acquiring power to serve these loads will increase costs for other consumers and industries in the region.

The Council supports some level of service to the DSI. This service should be conditioned on capturing the benefits of interruptibility of the DSIs for both reliability and short and long term market reasons. The Council encourages Bonneville to consider variable rate structures that are tied to the world price of aluminum such as were used in the past. The Council would recommend an initial allocation of 100 MW per smelter. If not all allocation is taken, the remaining MW would be offered to those smelters who might wish to take more. A smelter could take additional increments of 100 MW provided they brought a resource to Bonneville to serve that 100 MW. Bonneville may

purchase the power, provided that it is competitively priced, and sell it back to the DSI at BPA's melded rate. If the DSI were to stop taking power from BPA, BPA's obligation to purchase the power would stop. The Council also supports giving consideration to providing credit support to DSIs who develop incremental generating resources that they are willing to contractually dedicate to serving their in-region smelter load not served by BPA.

Conservation

The Council believes it is imperative that any proposal to fundamentally change BPA's role in power supply include a realistic approach to ensuring that the region develops cost-effective conservation. The fact that Bonneville's customers can bring loads back to Bonneville at the end of the contract period makes the achievement of all cost-effect conservation a continuing priority. The thrust of the customer proposal that makes more customers responsible for meeting their load growth is a major step in the right direction. It is, however, not sufficient given the disincentives to utility investment in conservation even though it is a lower cost resource.

The Council supports elements of the Joint Customer and Public Interest Group proposals including reliance on the Council's plan to define the cost-effective resource, reliance on proven delivery mechanisms, stabilized and enhanced funding for conservation over the duration of the new contracts, reinforcing and the role and capabilities of the Regional Technical Forum and a mechanism for ensuring that cost-effective conservation is in fact implemented.

The Council supports the use of a mechanism like the Conservation and Renewables Discount to support local implementation. However, the mechanism must be redesigned to ensure cost-effective acquisitions, encourage best practices and minimize the cost of acquisition consistent with achieving the savings, limit expenditures on activities that do not clearly support the development of tangible savings, and ensure accountability. The Council believes the mechanism should be designed to reduce the need for any BPA backstop mechanism. A better alternative is to work with utilities at the outset to identify good opportunities and approaches; provide the discount incrementally, addressing the local utilities immediate cash flow requirements but providing subsequent payments on demonstration of progress. Bonneville would step in only as a last resort.

The Council believes there is the need for a broader range of activities carried out at the regional level than envisioned in the customer proposal. This is because there are number of activities can be carried out more effectively if they are approached on a coordinated regional basis with local implementation.

Further details regarding the mechanism for conservation are still underdevelopment.

Renewable Resources

In general the Council supports some level of acquisition of renewable resources whose cost may be above market. The level of above market support should reflect the environmental and risk management benefits of such resources as determined in the

Council's planning process as well as the need to develop additional information about the integration of such resources into the regional power system. The Council does not support the Public Interest Groups recommendation that all regional load growth above that met through conservation be met through renewable resource acquisition.

Fish and Wildlife

The Council supports the joint customer's intent that the combination of slice/block/requirements operations will not affect the determination and implementation of Bonneville's fish and wildlife obligations. Under the proposal, Bonneville, the Corps of Engineers and the Bureau of Reclamation will continue to meet the federal government's Indian trust and treaty responsibilities. No changes are proposed in river operations required by NOAA Fisheries and the Council. In addition, Bonneville's customers will continue to pay the costs associated with Bonneville's fish and wildlife obligations. To the extent that slice contracts reduces pressure on Bonneville to alter system operations to meet load, this would be beneficial to fish and wildlife. Furthermore, greater clarity with respect to load responsibility should result in more timely development of new resources and reduce the potential periods of resource inadequacy. This should reduce the frequency with which the region leans on the hydro system.

Overall Cost Implications

Being analyzed

Background

Over the last decade, the Northwest Power Planning Council has observed and participated with the Bonneville Power Administration as it worked to define its role in the rapidly changing electricity industry. In the mid-1990s, Bonneville was buffeted by changes in the competitive wholesale power market. Very low market prices for power caused Bonneville customers to seek modification of their existing contracts to allow them to "diversify" their power supplies by taking load off Bonneville. This caused real concern about the ability of Bonneville to continue to meet its financial obligations to the U.S. Treasury. At the same time, it was recognized that in the long run, after Bonneville's obligations for repayment of the Washington Public Power Supply System had been fulfilled, Bonneville power would be extremely attractive in almost any electricity market. There was concern about whether Bonneville could remain solvent and continue to deliver the long-term benefits of the Federal Columbia River Power System to the region.

The Governors of the Northwest States were sufficiently concerned that they convened the Comprehensive Review of the Northwest Energy System. The Review, which was facilitated by the Northwest Power Planning Council, engaged 20 regional leaders in 30 day-long meetings and many additional working group meetings over the course of a year. While the Comprehensive Review was concerned generally about the changes going on in the electricity industry, much of its attention was focused on the future role of the Bonneville Power Administration. The goals of the Comprehensive Review with respect to Bonneville were stated as follows:

> *The Steering Committee's goals for federal power marketing are to: 1) align the benefits and risks of access to existing federal power; 2) ensure repayment of the debt to the U.S. Treasury with a greater probability than currently exists while not compromising the security or tax-exempt status of the Bonneville Power Administration's (Bonneville's) third-party debt; and 3) retain the long-term benefits of the system for the region. This recommendation is also intended to be consistent with emerging competitive markets and regional transmission solutions.*

Some of the key elements of the Review's recommendations were:

- Marketing the output of the system to regional customers at cost under long-term (preferably 20-year) contracts;
- An equitable sharing of the benefits of the federal system with the residential and small farm customers of the region's investor-owned utilities;
- Limiting Bonneville's exposure to the risk of resource development by acquiring new resources to serve customers' load growth only through bilateral contracts with those customers.
- Ensuring that conservation and renewable resources continued to be developed by providing sustained funding through a "system benefits charge" amounting to approximately 3 percent of revenues from the retail sale of electricity.

Subsequently, efforts were made to implement elements of these recommendations through a "subscription" process, in which customers entered into new contracts for service for Fiscal Year 2002 and beyond. The contract lengths turned out to be predominantly for 10 years rather than 20. Bonneville remains responsible for meeting the load growth of many of these customers and does so by "melding" the cost of new resources with the power of the Federal Base System. However, a number of customers decided to purchase a new product – "a slice of the system" -- that gives them a percentage of the output of the Federal Base System, what ever that output might be. Those customers are responsible for meeting their load growth and paying the cost and managing the risk of the variable output of their slice of the system.

Unfortunately, the timing of the subscription process and signing of new contracts coincided with the onset of a drought and a dramatic upturn in the power market prices. The net effect was a significant increase in the loads placed on Bonneville in fiscal year 2002 and beyond and the need for Bonneville to secure additional resources to serve those loads during a period when prices were at historical highs. Bonneville's current financial difficulties are in large part the consequence of those high costs, combined with lower-than-expected revenues from secondary power sales in the recently depressed power market. In retrospect, it could be argued that if responsibility for meeting load growth had been more clear in the late 1990s, additional resources might have been added to the system and the power crisis of 2000/2001 might not have been as severe.

As part of the new contracts, Bonneville, investor-owned utilities and the state utility regulatory commissions worked out a means of sharing the benefits of the federal system between residential and small farm customers of investor-owned utilities. This

arrangement, however, has been challenged in the courts. Unless that challenge is settled amicably, the region could face continued animosity between public and private power entities.

Based on the experience of the last decade, the Council believes that changes in the way Bonneville markets federal power in the future are necessary. In less than 10 years, Bonneville has gone through a swing from losing load and increased risk of not making its Treasury payments to increased load and additional power supply costs during adverse market conditions. This could force either large rate increases or reduced probability of Treasury repayment. The ability of public utility customers to periodically place load on Bonneville or take it off exposes Bonneville to inordinate market risk. Unlike other wholesale suppliers, Bonneville cannot refuse a public customer's request to serve its load. Customers will want to take load off of Bonneville when market prices are low and Bonneville's fixed costs make it difficult for it to compete. Conversely, customers will want to place additional loads on Bonneville when market prices are high, forcing Bonneville into a high-cost market. This translates into risk that Bonneville will not be able to make full and timely payment of its Treasury debt. With much of the rest of the country envious of the Northwest's access to federal system power at cost, failure to make Treasury payments increases the risk that the region may not be able to preserve the benefits of the system.

A corollary to the risk associated with load uncertainty is the uncertainty of developing new resources. Will Bonneville be purchasing for a customer's load growth or will the customer purchase for its own needs? When would the purchase decision be made? How does the timing of that decision fit with the timing of resource development? Will it be a short-term purchase that doesn't support development of new resources or will it be long term? This uncertainty puts reliability and price stability at risk. In the most recent situation, had Bonneville known earlier what its load obligation was going to be, it might have been able to enter into supply contracts at attractive prices rather than at the inflated prices in 2000-2001. The same would be true if the customers had been acquiring the resources.

Bonneville also has a very large presence in the power market. One of the basic characteristics of a well-functioning, competitive market is many buyers and many sellers. Bonneville is frequently a very large seller, such as when it is marketing secondary power, and sometimes a very large purchaser, as when it must acquire additional resources to meet new loads placed upon it or to shape the output of the system to load. In either event, Bonneville's actions can move the market, frequently not to its own advantage or the advantage of other regional participants. This is not market manipulation. This is just the effect of the size of Bonneville's presence in the market.

The pricing of Bonneville's power at average or melded cost is also a long-standing issue affecting the efficiency of the market. Average pricing shields the customer from the true costs of load growth and inefficiency. It does not provide the price signal that would make, for example, the development of local efficiency improvements or combined heat and power applications attractive. The cost of new resources added to meet the needs of

growing customers also raises the rates of those with stable or declining loads and creates animosity between those two customer groups. While Bonneville could change its pricing practices, it has not.

Allocating benefits of the Federal Columbia River Power System between the customers of publicly owned utilities and those of investor-owned utilities is also a continuing issue. The Northwest Power Act was created at least in part to ensure an equitable sharing of those benefits. The Act created the "residential exchange" that was intended to share the benefits of the federal system with the residential and small farm customers of investor-owned utilities. However, implementation of the exchange satisfied no one. Public utilities believed the benefits to residential customers of the investor-owned utilities were too high. The investor-owned utilities believed the exchange was manipulated to reduce the benefits their customers were due. The resulting animosity is dangerous when regional unity is needed to protect the benefits of the federal system.

Finally, Bonneville's responsibilities for developing conservation and renewable energy resources are difficult to fulfill in the current environment. In the mid-1990s, Bonneville found itself competing in an competitive wholesale power market. This was made more difficult because other market participants did not have similar responsibilities. When the Comprehensive Review addressed this issue, Bonneville's customers assured the Review that they would continue to develop conservation independently. Some clearly did. However, in aggregate, conservation acquisitions fell to levels well below the cost-effective levels identified in the Council's Fourth Northwest Power Plan (1998). While conservation enjoyed a resurgence during the high market prices of 2000-2001 and the subsequent retail rate increases, it is unclear how it will fare in the future. Conservation and renewables expenditures have historically been treated as relatively discretionary when Bonneville experiences rate pressures. This inevitably leads to the roller-coaster pattern of activity observed in the past. The Review recommended sustained funding for conservation and renewables supported through a system benefits charge. While two states in the region followed through on this, at least in part, others have not yet done so. It is time to re-examine how conservation and renewables are developed, and the role of Bonneville in that development.

Goals for Bonneville's Future Role in Power Supply

The Federal Columbia River Power System managed by the Bonneville Power Administration is the centerpiece of the Northwest's power system. Significant changes in Bonneville's future role in power supply are not trivial considerations. On the other hand, there are indications that the current structure may not be sustainable and may lead to inefficiencies in the development and operation of the power system. A careful consideration of changes to the system probably is overdue. However, changes should only be undertaken if the goals are clear, and only if the region has reasonable confidence that the changes will lead to achieving those goals. The Council believes the relevant goals are:

- To preserve and enhance the benefits of the Federal Columbia River Power System for the Northwest;

- To not increase and, preferably, to reduce the risk to the U.S. Treasury and taxpayers;
- To achieve an equitable sharing of the benefits of the federal power system;
- To develop and maintain widespread support for the federal system and reduce conflicts within the region
- To better align the costs and benefits of access to federal power;
- To maintain and improve the adequacy and reliability of the Northwest power system;
- To improve clarity regarding responsibility for meeting loads;
- To provide clear signals regarding the value of new energy resources;
- To lessen Bonneville's exposure to market risk;
- To lessen Bonneville's impact on the market;
- To satisfy Bonneville's responsibilities for conservation and renewable resource development;
- To satisfy Bonneville's responsibilities with respect to fish and wildlife; and
- To accomplish these goals at an acceptable cost to the region's consumers.

The Council has reviewed the proposals and comments received during the Regional Dialog process on the future of Bonneville in order to identify those elements that do or do not further the goals. The focus was primarily on "efficiency" issues, i.e., how to make the regional system function better, rather than issues of equity. However, unless the relevant parties are satisfied that equity issues have been successfully resolved, it is unlikely that any of the proposals can go forward. Consequently, achieving an equitable resolution of those issues is a necessary condition.

Recommendations

Contract Term

- The Council supports 20 year contracts because:
    - Contractual protection from external efforts to appropriate benefits of FCRPS
    - Demonstrate Regional commitment to FCRPS
    - Will buffer BPA and, thereby, Treasury from risk associated with shorter contract periods, at which times Bonneville can gain or lose load
        - Still some risk at initial contract and at end of 20 years
- The Council recognizes that customers lose leverage on Bonneville cost control with the longer contract period (i.e. ability to take load off Bonneville) but
    - Advisory committee with enforceable powers is problematic – it's ultimately the Administrators decision
    - Contract provisions that tie some penalty (e.g. ability to take some portion of customer's load off Bonneville) if contractual cost targets not met also problematic
        - Has to be limited to costs that are truly controllable by Bonneville
        - Can't be a back door to, for example, reducing F&W costs or expenditures for conservation and renewables

        - Taking load off would increase BPA rates for remaining loads
    - Other options
        - The Comprehensive Review called for the creation of a customer advisory committee and a contractual ability for the customers to call for binding arbitration on specific matters unrelated to fish and wildlife spending. If Bonneville can subject itself to binding arbitration, this may be a viable approach provided that this is not a back door to cutting back important but not customer-popular activities.
        - Bonneville could include spending and cost issues in its rate cases. We recognize that makes rate cases a more difficult and demanding exercise for BPA. It does, however, provide customers and others with the venue they seek. The ultimate decision resides with the Administrator.
        - Customers have had success in keeping Bonneville costs in check during previous 20-year contract through political pressure. We would expect that Bonneville's political accountability would continue to be an effective means of influencing Bonneville's future decisions.
    - Continue dialog – Customers have indicated their desire for a dialog with Bonneville on this issue. Council supports such a dialog with broader participation. Other interests are involved beyond those of the customers.

- Twenty years has to mean twenty years – benefits of a long contract are lost if customers can force renegotiation at shorter intervals

Slice Service

- Council favors a significant portion of FCRPS being sold as a "slice of the system" with customers responsible for management of their slice
    - Demonstrated to be operationally feasible, at least at the current level. We see no reason why it cannot be expanded.
    - Provides diversity benefits – large number of slice participants, each with somewhat different characteristics (loads, resources)
        - Lessens BPA's impact on the market
        - Results in more buyers and sellers – more liquid market
        - Potentially lessen overall risk (it is unlikely that everyone is going to make the same decisions)
    - Lessens BPA's exposure to hydro and market risk
    - Slice customers' responsibility for meeting their load growth is a positive aspect of the slice product
        - Aligns the costs, risks and benefits of resource acquisition
        - Because slice customers are exposed to the market alternatives, they see clear economic signals to guide decisions between generation, demand-side management and conservation
        - Provides clarity with regard to customer's responsibility for meeting load growth should result in more efficient resource

acquisition, greater assurance of maintaining resource adequacy (except possibly toward the end of the contract period), smaller and more dispersed resource expansion decisions
    - Reduces BPA's and Treasury's exposure to risk of resource acquisition

- Council is concerned about exposure of individual slice customers to hydro/market risk – risk could be large in relation to individual customer's ability to hedge that risk. If customers fail to make timely payment to Bonneville, Treasury payment could be at risk.
    - There are already contract provisions intended to ensure financial ability of current slice customers to handle risk. Are they adequate?
    - Provisions in customer proposal where slice customers would accept a surcharge to cover the shortfall if there are customers who experiences a problem also needs to be developed in considerable detail. Is there a timing issue that might leave the Treasury payment at risk even though in the long run, BPA would recover the costs? How robust a mechanism is this? What if multiple customers find themselves trouble? The Council encourages Bonneville and the customers to make sure that the provisions are robust enough to ensure against Bonneville being unable to make full and timely payment to the Treasury.

- Council does not agree with the argument that slice will result necessarily in a less than optimum operation of the system. This is a question of what is the appropriate objective function.
    - The Council agrees that there may be some sub-optimization of the physical output of the system.
    - However, Slice customers will optimize operations for themselves within the flexibility allowed to maximize the ***value*** they derive from the system, given their own loads, resources and so on.

Slice Operations

- The Council also recognizes that Bonneville cannot operate the system efficiently if it does not get good information from the customers regarding their forecast loads, and so on. There should be disincentives for failure to provide needed information or for providing information that is outside tolerance limits of accuracy.[2]

- Council does not support Public Interest Groups' proposal that slice customers get no flexibility in the operation of their slice
    - Would forego diversity benefits of slice
    - Would forego potential for greater value derived from the system

[2] The Council realizes there will be circumstances beyond the customers control that will cause forecasts to be incaccurate. It is not the Council's intent that customers be penalized in such circumstances.

    - It is Bonneville's responsibility is to establish the constraints on flexibility accorded slice operators to ensure meeting fish and wildlife and other non-power constraints
- Imperative that Bonneville retain rights to take unilateral actions on the whole system in case of emergency. Should be proportionate sharing of any costs/revenues from such operation with the slice customers
- BPA PBL to provide ancillary services to TBL as a system obligation, with revenues credited to the defined FBS until such time as market established at which time slice customers can participate directly
- Council generally support the operational considerations in the JCP
- Agree with JCP that communications between BPA Operations and Trading Floor should be shared with slice customers on as close to real-time basis as possible. To do otherwise would confer an advantage to BPA, potentially at the expense of the slice customers.

Requirements Service

- Council support offering of requirements product
    - Many smaller customers not interested in slice product, want to maintain traditional relationship with BPA
- However, the Joint Customer Proposal is not clear where responsibility for meeting load growth resides. If it resides with BPA with the costs of load growth melded into the cost of the requirements pool, many existing problems remain:
    - Intra-pool disputes between growing and non-growing
    - Potentially poor market signals for development
    - Level of concern proportional to size of the pool.
- Council is concerned about lack of clarity in JCP proposal regarding responsibility for the load growth component of requirements product.
    - Council accepts the concept of any FCRPS capacity left after allocation to the slice pool be available for requirements pool and that if there is any "head room" left over, it can be used to meet load growth in the requirements pool.
    - In the longer-term, however, Council believes that if Bonneville is providing load growth services, the cost to the customers should reflect the cost of new resources needed by those resources. This is consistent with the recommendations of the Comprehensive Review.
    - If not,
        - Will not have alignment of costs, benefits and risks;
        - There will be continued conflict between growing and non-growing customers;
        - Customers will not have a clear view of the cost of new resources;
        - It will be a disincentive to some customers to take the slice product.
- Customer representatives have said that once load growth in the requirements pool exceeds the unused capacity of the federal system available to the requirements pool, if any, load growth should be met through a tiered rate

mechanism. The Council supports that approach and asks that it be made explicit in any BPA proposal.

- Option for requirements customers to acquire resource to serve their load growth OK as long as notice provisions are such Bonneville is not left held holding a resource bag as result

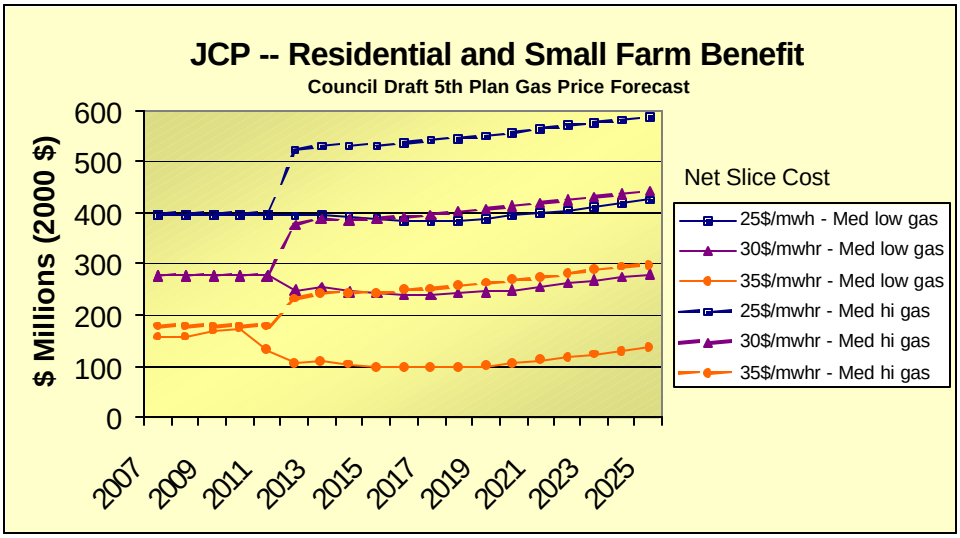
Other Service Options – Block Sales

- The JCP proposes that slice customers may *convert* all or part of slice purchase for all or part of the contract period to a block product provided that the cost of the block product (after true-up) equals the cost to BPA of providing the product and that the block product not include a growth component.
- JCP does not permit purchase of block independently
- Council understands Joint Customers desire to see a large proportion of Bonneville sales to be slice sales
    - Diversity benefits
    - Reducing Bonneville's market footprint and exposure to market risk
- On the other hand, since customers can convert their slice to a block sale anyway, why not offer a block product on the same terms initially
    - Benefits –
        - Long term contracts
        - With right conditions, it could achieve the goals of alignment of costs and risks, clarity regarding responsibility for load growth, and clear economic signals
    - Necessary conditions include
        - Shape of product fixed for term of contract
        - No load growth component except on a bilateral or tiered rate basis
        - Customer bears Bonneville's costs of shaping to the customers requested block shape

IOU/POU Settlement

- Council supports resolution of the issue of benefits for the residential and small farm customers of IOUs for a significant period.
    - It is an attempt to achieve an equitable sharing of the benefits of the FCRPS
    - It would resolve the public-private disputes at least for contract period
    - Gives broader cross-section of the region a direct economic stake in the well-being of the FCRPS
- Council does not have a legal opinion regarding the applicability of the 7(b)(2) rate test
- Council recognizes that settlement does have rate implications –
    - Approximately 1.4 to 1.6 $/mw for each $100 million **over the current exchange settlement**. BPA estimates those benefits to be as low as $26 million (low market prices) to as much as $330 million ($2000) for high market prices for the 2007-2011 period.

- Estimates of the possible benefits are shown below. They were developed using the formula in the Joint Customer proposal and gas prices corresponding to the Councils Draft 5th Plan gas price forecasts. Data are presented for the medium high and medium low price forecast. These span the 'most likely' range.



- Proposal needs to be recognized for what it is
  - It is a settlement
  - It is an attempt to achieve a relatively simple representation of an equitable sharing of benefits based on the residential exchange paradigm
    - The residential exchange paradigm
      - Amount of the exchange payment equal to the difference between BPA's average system cost and that of the exchanging IOU times the IOU's residential and small farm load
      - The exchange should make the cost of power to serve the residential and small farm loads of the IOU equivalent to the cost of power to serve a public customer.
      - In practice, there were concerns on both sides that the Average System Cost calculation was manipulated
    - Joint Customer Proposal paradigm –
      - Replace the Average System Cost calculations with a clear surrogate that is not subject to manipulation.
        - A combined cycle combustion turbine to serve the residential and small farm customers of the IOUs
        - The cost of the slice product net of the value of secondary power sales

        - Benefit to residential and small farm customer – a cash payment intended to make the cost of power to serve them approximately = to net cost of slice product
    - Lots of second guessing possible that can move the level of payment one direction or another
        - Why the cost of a new CCCT as surrogate for cost of power for res/small farm customers?
        - Why the Net slice cost (which does not included net revenues for risk and shaping costs) instead of requirements cost
        - Why only 3300 of residential and small farm load when existing res and small farm load is greater?
    - The Council recognizes this is an equity issue. Agreement between the parties is strong evidence that equity has been achieved.

    - Nonetheless, it behooves the parties to be sure that there is broad satisfaction with the equity of the solution reached. If there is not, the customers will ultimately not settle, or even if they do, the settlement will be challenged in the courts by other parties. If either of these happen, it is likely that the goals sought by the parties and the Council will not be achieved..

Initial Allocation

- The JCP proposes that slice customers are allocated their slices of the system first and then the remainder is available for requirements service. This is predicated on analysis that indicates that there should be sufficient power available for requirements service with some headroom for growth.
- If, for whatever reason, that analysis proves incorrect, additional resources would have to be added to the system and the cost would fall entirely on the requirements pool.
- Requirements customer representatives have indicated that is a gamble they are willing to take in return for the possibility that there would be sufficient headroom to cover their load growth for some time. The Council is concerned that gamble may not look as attractive as planning evolves over the coming months and could prove a stumbling block to a final settlement. The Council encourages Bonneville and the customers to consider alternatives that would lessen that possibility.

Service to Direct Service Industries

- Background
    - Bonneville's current contracts with the Direct Service Industries (DSIs) expire in 2006. Whether they have a legal right to new contracts is in dispute.
    - The amount of power made available by Bonneville to DSIs has been limited in recent years. The current contract calls for approximately 1400 average megawatts for the DSI's although only a fraction of that is

currently being taken. Total active smelter load is approximately 2800 average megawatts.

- Near-term future for the *entire* regional aluminum industry uncertain
  - Most are relatively high cost, price of aluminum is low
  - A few, however, can operate with electricity prices in the low 30s
- Longer-term
  - Power costs in the low thirties and Aluminum prices increasing by $100 – 200 /Metric ton -- a few more smelters can operate economically
- Providing power to DSIs would require augmenting the system and increase the costs of BPA power to other customers – some estimates:
  - At medium power market prices ($40/mwhr)—cost increases of between $0.5 and $0.6 $/mwhr for each 500mw DSI load
  - At high power prices ($51.3 $/mwhr) power prices -- between $1.2 and $1.7 $/mwhr per 500 MW DSI load
  - At low power prices (27.1$/mwhr) – Slight cost decrease – DSI's provide higher than market revenues

- The Council recognizes that the DSI's are important to many local economies in the region.
- The Council recommends that some amount of power be allocated to DSI service with the following conditions:
  - Contracts would be structured to capture for BPA the benefits of interruptibility for the following purposes:
    - Very short term system stability
    - Opportunity value – there is a growing potential for aluminum smelters to reduce their operations during peak electricity price periods – e.g. summer afternoons when West Coast prices very high
    - Long term displacement (drought insurance) – ability to displace smelter loads entirely during a drought – cheaper than the cost of building, maintaining and infrequently running a CT for comparable time
  - Contracts should be structured to limit BPA's risks associated acquiring resources to serve DSI load should that load taken off BPA in the future.
  - Bonneville should explore the feasibility of a variable rate structure similar to what the DSI's had in the past. This would allow BPA to charge higher prices when aluminum prices are high to offset the additional costs incurred in serving the DSIs at a melded rate.
  - An initial offer of 100 MW per smelter. If not all of the power allocated to DSI service is taken, a smelter could take an additional 100 MW provided that they brought a resource to Bonneville to serve that 100 MW. Bonneville may purchase the power, provided that it is competitively priced, and sell it back to the DSI at BPA's melded rate. If the DSI were to stop taking power from BPA, BPA's obligation to purchase the power would stop.

- The Council also supports giving consideration to providing credit support to DSIs who develop incremental generating resources that they are willing to contractually dedicate to serving their in-region smelter load not served by BPA.

Conservation

- The Council believes it is imperative that any proposal to fundamentally change BPA's role in power supply include a realistic approach to ensuring that the region develops cost-effective conservation. The intent is to ensure that under any revised federal power marketing approach, least-cost planning and implementation continue to be carried out region wide. At the end of the 20-year contract period, public customers will be able to bring loads back to Bonneville. To the extent that the cost-effective conservation has not been done, those loads could be unnecessarily high.
- The overall thrust of JCP proposal to have more customers see marginal wholesale prices and take more responsibility for meeting load growth is a step in the right direction. It is not, however, sufficient because
    - There is no assurance how many utilities will see marginal wholesale prices
    - There are still disincentives to acquiring conservation from utility interest perspective, even at marginal wholesale prices
        - Capital intensive resource compared to short-run market purchases
        - Some rate impact due to both capital intensiveness and "lost revenues"
    - Conservation is a difficult resource to develop in that it occurs on the retail customers' side of the meter, is widely dispersed, comes in relatively small increments, involves changing technologies and markets.
    - The amount and location of the resource changes with evolution in technology, building and equipment markets, the economy, and what we have already accomplished through programs, codes and standards
    - Securing cost-effective conservation in an effective way requires coordinated planning and implementation among many entities. Best-practices approach requires combination of local utility efforts, regional efforts, local, state and federal governments, System Benefits Charge administrators and market transformation. The mix of best approaches changes over time.

    - The Council believes that capturing cost-effective conservation has great value in reducing long-run regional electricity costs. The Council believes future regional efforts should be structured like Bonneville's Conservation and Renewables Discount (C&RD) that does not require a decrement in the customers net requirements from Bonneville for savings achieved. If it were to decrement customers net requirements it would be a disincentive to active participation by the customers in the development of conservation.

- The Council supports the overall thrust of the Joint Customer Proposal and that of the public interest groups:
  - The goal to acquire cost-effective conservation guided by the Council's integrated resource planning;
  - Reliance on existing institutions and proven delivery mechanisms;
  - Consistency with Bonneville's altered role with respect to long-term contracts and responsibility for new resource development;
  - Stabilizing and enhancing funding for conservation over the duration of the new contracts;
  - Reinforcing of the role and capabilities of the Regional Technical Forum;
  - A mechanism for ensuring that cost-effective conservation is, in fact, implemented.

- The Council supports the use of a Conservation and Renewables Rate Discount – like mechanism to support local utility conservation acquisitions. The existing mechanism was intended to keep regional utilities "in the game" at time when conservation activity was at low ebb. If it is to serve as the primary mechanism for ensuring that the region captures all cost-effective conservation, ***the existing C&R Discount mechanism must be redesigned.***
  - To be effective, the discount mechanism must :
    - Ensure cost-effective acquisitions by qualifying measures and programs based on their cost-effectiveness
    - Tailor its incentives to encourage best-practice approaches and, where appropriate, regionally-coordinated efforts
    - Include incentives to minimize the cost of conservation acquisition to the region, without sacrificing cost-effective savings[3]
    - Provide more specific criteria for as well as maintain limits on expenditures on infrastructure, R&D, contributions, education and information programs and other activities that don't produce or clearly support the development of tangible savings
    - Self-evaluation of local conservation efforts consistent with protocols established by the RTF.
    - Require evaluation of regional programs and measures to improve cost and savings estimates and the efficacy of program design and implementation

- After reflection – believe that the mechanism should be designed to reduce incidence and magnitude of any BPA "backstop". Believe the backstop mechanisms as described in the JCP and Public Interest proposals to ensure development of cost-effective conservation are unlikely to be successful. A backstop in which BPA is expected to collect charges from customers that fail to implement sufficient conservation and use that money to invest in conservation to make up for the shortfall puts Bonneville in a difficult position, is unlikely to be implemented and will result in lost opportunities.

[3] The current C&RD system pays for the value of the avoided power purchases. The result can be very high credits to the utility for little actual investment on the utility's part

- Believe better alternative is to:
  - Work with utilities at the outset to identify and implement good opportunities and approaches
  - Structure incentives appropriately
  - Provide the discount incrementally on demonstration of progress – not try to take back the discount for inaction
    - An initial discount payment would be provided to address the customers' cash flow requirements
    - Subsequent payments on demonstration of progress
  - Bonneville would step in to implement conservation only where the customer consistently does not demonstrate progress
  - A mechanism for resolving disputes regarding demonstration of progress should be established.

- The Council supports recognition in both the Public Interest and JCP proposals that there will continue to be the need for a regional implementation of activities including low income weatherization, R&D, market transformation and evaluation – However, Council believes that there is a broader range of activities that should be carried out at the regional level. This is a result of the nature of much of the conservation resource and the fact that much of it cannot be developed effectively on a piece-meal basis. A coordinated approach on a regional or greater level is necessary. Examples: –
  - The market transforming efforts of the Alliance in developing the retail supply chain was a necessary precondition to the successful local delivery of 8 million CFL bulbs during the 2001 energy crisis. Both regional market transformation efforts and local utility rebates were required.
  - Codes and standards are developed and implemented in cycles at state and national levels. We have had great success with demonstrating new technologies and practices at the local and regional levels and then using those results to push adoption of improved codes and standards. The demonstration part of that cycle requires the most investment. Once codes or standards are adopted, investment needs drop off, until the next increment of technology emerges. Best results are achieved by coordinated planning and implementation efforts at various stages of the cycle.
  - Regionally-designed programs can reduce cost and deployment time for efforts like efficient beverage vending machines where there are few beverage companies that service most of the region's equipment.
  - Regional coordination can identify and address gaps where efforts are needed to address hard-to-reach markets or end users
  - Regionally consistent program designs, standards, specifications and in some cases "incentives" enhance the effectiveness of conservation delivery in certain sectors of the economy so that third-party providers are not faced with inconsistent requirements across utility boundaries.
  - Regional coordination can identify areas where early-stage research and development are needed to facilitate technology transfer and fill the pipeline of emerging efficiency measures and practices

- The remainder of the recommendations on conservation are still under development. They address:
    - The extent of the conservation obligation – all public customer loads or only the portion of loads placed on BPA.
    - How the funding for conservation would be collected –
    - The basis on which the conservation would be paid
    - The respective roles and responsibilities of the Council, BPA, the Regional Technical Forum, and the customers.

Renewables

In general the Council supports some level of acquisition of renewable resources whose cost may be above market. The level of above market support should reflect the environmental and risk management benefits of such resources as determined in the Council's planning process as well as the need to develop additional information about the integration of such resources into the regional power system. The Council does not support the Public Interest Groups recommendation that all regional load growth above that met through conservation be met through renewable resource acquisition. The details of the Council's recommendations are still under development.

Fish and Wildlife

The joint customers intend that the combination of slice/block/requirements operations will not affect the determination and implementation of Bonneville's fish and wildlife obligations. Under the proposal, Bonneville, the Corps of Engineers and the Bureau of Reclamation will continue to meet the federal government's Indian trust and treaty responsibilities. No changes are proposed in river operations required by NOAA Fisheries and the Council. In addition, Bonneville's customers will continue to pay the costs associated with Bonneville's fish and wildlife obligations.

The Council agrees that these are appropriate objectives. The proposal must not alter any of Bonneville's and the Council's current fish and wildlife obligations and responsibilities. Fish and wildlife operations must continue to be decided under the guise of "non-power" constraints that are developed and decided in forums that are not focused on maximizing power generation. As well, Bonneville's direct expenditures on fish and wildlife activities must continue to follow the process currently guided by the Council, the regional fish and wildlife managers, and Bonneville to meet the objectives of the Northwest Power Act, Endangered Species Act and other federal statutes.

There are three primary areas relating to fish and wildlife operations and expenditures that concern the Council, in general: 1) river operations, 2) Bonneville's budgeted and actual fish and wildlife funding levels, and 3) fish and wildlife project review and selection.

With regard to river operations, the Council would not support changes to the current processes that specify operational parameters for the FCRPS, and does not believe the JCP would result in such changes. The biological opinions and the Council's program must be taken into account as they are currently. Except in the case of power

emergencies, the FCRPS must be operated in a manner to meet the objectives of the biological opinions, and the Corps and Bureau must take the Council's program into account during their decision-making processes. Bonneville will continue to be required to act in a manner consistent with the Council's program.

The Council historically has been concerned about, and involved in, determining the annual funding level of Bonneville's fish and wildlife program. Although the JCP should not affect the process by which Bonneville's expenditure levels are established currently, the Council would support a more regular, if not formal, regional process to determine annual spending levels. For example, the reestablishment of a process to develop formal memoranda of agreement that would specify funding levels for rate periods, or some other period of time, would be welcomed in assuring the region's fish and wildlife interests that Bonneville's obligations will be met. But regardless of the method used, a transparent process that involves all regional entities and the public must be established and made available to ensure adequate funding levels.

The JCP will not alter the current regional process for reviewing and selecting fish and wildlife projects funded by Bonneville. Section 4(h)(10)(D) of the Northwest Power Act will still be in effect, which requires independent scientific review by the Independent Scientific Review Panel, and final funding recommendations to Bonneville will still be made by the Council after examining the reviews made by both the fish managers and the ISRP. The JCP in no way alters this process or diminishes the responsibilities of any of the parties that implement this section of law.

The Council also recognizes that there are potentially direct advantages for fish and wildlife that may result from implementing the JCP. For example, slice contracts may result in a significant and direct benefit to fish and wildlife populations by reducing Bonneville's obligation to serve loads in excess of the output of the federal base system in low water years. Bonneville would be under less pressure to alter spill and flow to squeeze more electricity out of the system to satisfy its power sales contracts if a greater portion of its obligations were capped by the system's firm energy generating capability. It is unclear exactly what the overall impact would be of a combination of slice/block/requirements contracts, but it appears that for every slice contract there would be a diminution of pressure on Bonneville to alter system operations to meet load. If so, this would be beneficial to fish and wildlife.

In addition, one of the important objectives of the JCP is to clarify who has responsibility for acquiring new generating resources. Having a clear understanding of this, in combination with a properly functioning electricity market that provides the appropriate economic incentives for the development of new resources, would make it more attractive for the region's utilities to acquire new resources. The development and acquisition of new resources would reduce pressure to alter hydrosystem operations in low water years, and thus would be beneficial to fish and wildlife populations.

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