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November 12, 2003

MEMORANDUM

TO: Council Members

FROM: Dick Watson

SUBJECT: Briefing on the Proposed Settlement of Law Suits Challenging the Contracts Under Which Bonneville Provides Benefits to the Residential and Small Farm Customers of the Investor-Owned Utilities

After several months of negotiations, a proposed settlement has been reached on the subject lawsuits. Utilities in the region have until early next year to decide whether they will sign on to the settlement. If the settlement is approved, it will eliminate the 2.3 percent rate increase for FY 2004 and reduce rates an additional 7.4 percent relative to average FY 2003 rates. Attached are a Bonneville Backgrounder and Q&A on the settlement.

The settlement is very complicated and obviously important to Bonneville, Bonneville's customers and consumers in the region. Steve Oliver, the Bonneville Power Business Line's vice-president for Bulk Power Marketing was a key player in the negotiations and will brief the Council on the settlement and its implications.

attachments

<q:\dw\ww\pwr4\111803\settlementcover.doc>

Settlement Backgrounder

Updated Nov. 5, 2003

What happened?

After months of negotiation, the Bonneville Power Administration and representatives of utility groups have signed a legal settlement that would eliminate the average annual 2.2 percent rate increase for FY 2004 that took effect on October 1, and lower BPA's wholesale rates an additional average 7.4 percent compared to average fiscal 2003 rates.

A combination of the forecasted annual average 2.2 percent increase and the estimated 7.4 percent decrease results in nearly a 10 percent net reduction in rates for the current fiscal year that started October 1. Because it would take four months for the settlement to go into effect, BPA will provide a rolling month-to-month rate refund starting in March to ensure customers get the full benefit of the rate reduction.

The settlement would substantially reduce rates for many public agency customers while clarifying and stabilizing benefits for small farm and residential customers of investor-owned utilities between now and 2011. Any retail rate adjustments would vary by utility.

What is the settlement about?

The lawsuits, filed earlier by more than 75 public agency utilities, DSIs, IOUs, state commissions, and utility associations, challenged contracts BPA entered in 2000 with investor-owned utilities (IOUs). Related suits by other utilities are also involved. Primary among the issues are the benefits BPA provides to the IOUs under the Northwest Power Act of 1980. The Act directs that these benefits go directly to small farm and residential customers of the IOUs in the form of rate relief.

Under the settlement, public agency and other parties will drop their lawsuits. In return, the IOUs will forgo or defer certain monetary benefits between 2004 and 2006. The value of those deferred benefits is \$44 million already deferred in 2003, plus \$75 million a year through fiscal 2006. So the total deferral is \$269 million. Another \$200 million in costs would be eliminated.

The IOUs will receive clarity and predictability about their benefits in 2007-2011. They will receive monetary benefits only in this period. The settlement includes a formula for determining the level of those benefits, based on 2,200 megawatts of power, that also includes caps and floors that bound the level of benefits.

In addition, BPA has committed to work with customers to pursue an additional \$100 million in cost reductions and revenue enhancements for FY 2004 and FY 2005, cumulatively.

What are the next steps?

All public utilities that are parties to the litigation must sign the settlement within 90 days (by January 21, 2004) for it to become final. If any public litigant fails to sign the appropriate settlement documents by the end of the 90-day period, the settlement fails. If all public litigants sign, then BPA, the IOUs, and the publics have 30 additional days to decide whether or not to withdraw should certain events of default occur. If after a total of 120 days all parties remain in agreement, it becomes final (expected in February 2004).

(NOTE: A comprehensive Q&A sheet is available on request for those who wish a detailed description of how BPA calculated the rate adjustments and other items pertaining to the settlement.)

IOU/Public Settlement

Updated November 5, 2003

Questions and answers

1. What is BPA trying to accomplish through the settlement proposal?

There are three goals. The first is to reduce BPA's costs for FY 2004-2006 so the agency can reduce its wholesale power rates for this period. Elimination of the \$200 million risk contingency payment removes that amount from BPA's revenue needs. Deferral of \$269 million allows for further rate reduction in the FY 2004-2006 period. These reductions should have a beneficial impact on public utilities and their many commercial, industrial and residential customers as well as on the direct-service industries (DSIs), and the ratepayers of the investor-owned utility (IOU) that is buying power from BPA.

Second, beyond the economic impacts, the settlement will eliminate litigation, which should have a beneficial impact on the business relationships among all the utilities and direct-service industries in the region and allow the region to focus on the future.

Third, the dismissal of the suits will provide the investor-owned utilities (IOUs) with some certainty on their benefits under their Subscription contracts through FY 2011. This certainty for the IOUs also produces less volatility in BPA's rates.

2. Under the final settlement, what would be the change in the level of BPA's FY 2004 power rates when all the cost recovery adjustment clauses (CRACs) have been accounted for?

If the settlement succeeds, BPA would eliminate a forecasted annual average 2.2 percent FY 2004 rate increase that took effect Oct. 1 and reduce rates an estimated 7.4 percent below 2003 average rates. The net effect, compared to current average FY 2004 rates, would be a nearly 10 percent reduction in wholesale rates. A refund starting in March 2004 (on a rolling month-to-month basis) would give the utilities the full benefit of the rate decrease.

As described in the Sept. 18, 2003, rate case workshop, the actual rates will be calculated once the final details of the settlement are known. They will reflect a zero Safety Net CRAC for FY 2004, which is possible because of the administrator exercising the discretion granted to him under the General Rate Schedule Provisions (GRSPs).

3. How did BPA reach that reduction?

The GRSPs provide the administrator with the discretion to reduce the SN CRAC if he believes it is appropriate. In the Sept. 18 workshop, the administrator indicated that, if there were a settlement of the IOU litigation that provided the proper level of cost reduction and deferrals (that is, elimination of the \$200 million litigation contingency payment from the

Load-Based CRAC and deferral of the \$44 million from FY 2003 and \$75 million per year in FY 2004-2006 to the next rate period), he would agree to set the SN CRAC to zero for FY 2004. As the effect of that change works its way through the other two CRACs (the Load-Based and the Financial-Based), the net effect is expected to be an average 7.4 percent overall rate reduction in FY 2004 compared to FY 2003.

4. How can BPA afford to set the SN CRAC to zero?

BPA will see significant cost reductions and deferrals from the FY 2003-2006 period into the FY 2007-2011 period as a result of the settlement. Those cost savings and deferrals, along with adjusting the SN and Financial-Based CRAC thresholds for FY 2005 and FY 2006, allow the agency to achieve a zero SN CRAC in FY 2004 while still achieving an 80 percent Treasury payment probability (TPP) for the balance of this rate period.

BPA is also agreeing to look for an additional \$100 million in cost savings and revenue enhancements over FY 2004 and FY 2005 in order to limit the size of SN CRAC adjustments in FY 2005 and FY 2006. In addition, BPA has agreed as part of the settlement to consider a forward-looking TPP measurement and in doing such calculation to take into account the anticipated changes in the agency's financial condition when setting the FY 2005 SN CRAC. If the changes to costs or revenues support a lower SN CRAC adjustment while still maintaining an adequate TPP, the administrator may implement the lower SN CRAC.

5. What are the other terms of the proposed settlement?

In broad terms, the public litigants agree to drop their litigation challenging BPA's Residential Exchange Program settlement agreements with the IOUs as well as other related litigation. Puget Sound Energy and PacifiCorp forego a \$200 million litigation contingency payment as a result. All six IOUs will defer a total of \$75 million a year of benefits from the remaining three years of the current rate period into the FY 2007-2011 period in addition to the \$44 million deferred from FY 2003. The total net savings for the current rate period are expected to be \$469 million – \$200 million in the foregone litigation contingency payment and \$269 total in deferrals to the FY 2007-2011 period. The reduction from the FY 2003 deferral of \$55 million (described at the Sept. 18 workshop) reflects the change that Portland General Electric will not defer its portion (\$11 million) of those benefits in order to minimize a rate increase to its residential and small-farm customers.

6. What benefits do the IOUs receive?

The settlement establishes that the region's IOUs will receive only monetary benefits (as opposed to actual power) in FY 2007-2011. It also establishes a formula used to determine the level of benefits for the IOUs' residential and small-farm customers for FY 2007-2011. The monetary benefit will be calculated annually and will be based on 2,200 average megawatts of benefits multiplied by the difference between a flat market price forecast and BPA's Residential Load Firm Power (RL) rate, or, in certain circumstances, BPA's lowest-cost PF rate. The annual flat market price forecast will be based on actual market quotes and determined by a third party with no interest in the outcome.

Finally, a cap of \$300 million per year and a floor of \$100 million limit these out-year annual benefits.

As a result, the IOUs and other customers gain more certainty about the level and type of benefits in the FY 2007-2011 period as compared to the terms in the Subscription contracts.

7. What benefits do the publics receive from the settlement?

If the settlement is successful, BPA's rates for the remainder of the current rate period will be lower than they would otherwise have been. Some of this decrease is due to a deferral of \$269 million while the rest is due to actual cost reductions of \$200 million. Even though some of this decrease will be paid in later years, the state of the region's economy tipped the balance toward including the deferrals and having a larger decrease now.

The administrator has also made certain pledges to the public utilities that include the periodic sharing (at least quarterly) of pertinent BPA financial information. In addition, BPA will have collaborative ongoing consultations with customers and other parties on how best to achieve \$100 million in cost reductions and revenue enhancements over the balance of the rate period with the objective of keeping a zero percent SN CRAC increase for FY 2005. BPA has expressed an intent to use outside expertise to define opportunities for process improvement and to recalibrate the caps for the SN CRAC and the thresholds for the FB and SN CRAC for later years to maintain the equivalent of the three-year 80 percent TPP if the administrator elects to use his discretion to lower the SN CRAC in FY 2005 or FY 2006.

8. What is the impact of the IOU deferrals on rates in the FY 2004-2006 period and in the post-2006?

The overarching goal of the settlement was to balance as much as possible the costs and benefits to all parties over the current rate period and the next.

For the rest of the current rate period, public power rates should be generally lower because of elimination of the \$200 million risk contingency and deferral of IOU benefits. In addition, BPA has committed to its customers that it will seek \$100 million in additional cost cuts and revenue enhancements over FY 2004 and FY 2005 in order to keep rates in FY 2005 and FY 2006 as low as possible. However, the nature of the SN CRAC is that it is variable, designed to accommodate situations over which BPA has no control, such as poor hydro or market conditions. If those conditions create the need for an SN CRAC, BPA will be able to use that tool in order to ensure its ability to pay the Treasury.

BPA has not yet established wholesale power rates for public utilities for post-FY 2006. Rates in that period will need to recover an additional \$269 million of IOU benefits deferred out of this rate period that would not otherwise have been a cost that BPA faced in that time period. A very rough estimate is that the deferrals will add about 1 mill per kilowatt-hour (\$1 per megawatt-hour) to BPA's wholesale power rates in the FY 2007-2011 period.

9. Do the Slice purchasers receive benefits?

Yes. BPA has negotiated a Slice Settlement Agreement to ensure that Slice customers get the benefits of the cost savings during the current rate period and pick up the proportionate share of the increased costs during the next rate period regardless of BPA's accounting treatment of the deferred payments to the IOUs.

10. What benefits do the direct-service industries receive from the settlement?

Those that are operating and buying power from BPA will pay lower rates than they otherwise would have paid, consistent with any reductions that occur through BPA CRAC processes.

11. What about the pre-Subscription utilities?

Representatives of the pre-Subscription utilities were involved in the settlement discussions and are aware of the proposed terms.

Pre-Subscription utilities were very helpful in 1998 when they stepped forward and made an early commitment to purchase BPA power for the FY 2002-2006 period. As a result of that decision, they protected their customers from the effects of the West Coast energy crisis of 2000-2001 and from the rate impacts associated with BPA's subsequent financial difficulties.

The settlement will add \$269 million to preference rates for all public utilities in the FY 2007-2011 period, which represents about an additional \$1 per megawatt-hour. In exchange for their portion of that increase, they gain a level of certainty regarding the benefits that will be paid the residential and small-farm customers of the region's IOUs in the post-2006 period. Much of that certainty comes from the ceiling placed on the IOU benefits, which may result in lower benefits than the IOUs would otherwise have received.

By accepting the settlement, the pre-Subscription utilities will help the region's economy by providing the overwhelming majority of the region's public utilities with a substantial rate reduction.

12. What commitments has the administrator made for rates for FY 2005 and FY 2006?

The administrator has made no firm commitments regarding rate levels for FY 2005 and 2006. The process outlined in BPA's GRSPs and further described in BPA's Sept. 18 workshop will determine rates for subsequent years. The Load-Based CRAC adjustment will be determined every six months based on the formula in the 2002 GRSPs, and the Financial-Based and SN CRAC adjustments will be determined based on third quarter financial projections as applied in the formula in the 2003 SN CRAC GRSPs. The administrator has agreed to work to identify an additional \$100 million in cost reductions and revenue improvements that, if achieved, would reduce the SN CRAC for FY 2005 and FY 2006, all other things remaining equal. And, as mentioned above, the administrator has agreed to consider a forward-looking TPP analysis when setting the SN CRAC for FY 2005 and FY 2006.

13. What documents will the litigants be signing?

The series of agreements includes a Stipulation and Agreement for Settlement (Stipulation), Amendment(s) to Existing IOU Settlement Agreement (IOU Amendment) and Slice Settlement Agreement (Slice Agreement). In order for the settlement to be implemented, all public utilities that are parties to litigation (public litigants) challenging BPA's Residential Exchange Program (REP) settlement agreements with regional IOUs, or the underlying rates, have 90 days to sign the appropriate Motions to Dismiss, the Covenant Not to Sue and, if applicable, the Motion to Limit Issues on Certain Rate Claims. If any public litigant has not signed by the end of the 90-day period, the settlement is terminated.

The Covenant Not to Sue is a contractual promise not to file any future challenges that might undermine the package of settlement agreements or aspects of BPA's power rates. They may also sign the Stipulation itself, which allows them the right to opt out if certain events occur. Electing the option to sign only the attached motions and covenants precludes them from exercising the right to opt out after the 90-day period.

Other public agencies that have challenged BPA's current wholesale power rates are also asked to consider signing the Motion to Limit Issues on Certain Rate Claims as well as the Covenant Not to Sue. By signing the Motion to Limit Issues on Certain Rate Claims, the other public agencies would limit their challenges to BPA's wholesale power rates.

BPA's Slice customers will be offered a Slice Settlement Agreement that guarantees that Slice customers receive the benefits of the IOU deferrals in FY 2004-2006 and pay the increased costs in FY 2007-2011 regardless of the accounting treatment (see question 9).

IOUs will be offered an Amendment to their existing Subscription contracts that commits them to the terms of the Stipulation – elimination of the \$200 million risk contingency payment and the \$269 million of deferred benefits.

14. What is the process for bringing the settlement to reality?

Once BPA, one IOU and one public litigant have signed the Stipulation, the remaining litigants, Slice customers and IOUs will have 90 days to sign the required documents. Most, if not all, public litigants will need to gain board approval before signing. The IOUs may need the approval of their respective state regulatory commissions.

15. What makes the settlement final?

The settlement becomes final through a complex process. There are events of termination that automatically void the agreement and events of default that give certain parties the right to terminate participation but may or may not terminate the settlement. The events of termination are a public litigant failing to sign or withdrawing from the stipulation as a result of an event of default. There are several events of default itemized in the Stipulation. They include litigants (such as the DSIs) continuing to maintain existing legal challenges, litigants

filing new challenges to this settlement, litigants that have also challenged BPA's rates failing to sign a Covenant Not to Sue and Motion to Limit Issues on Certain Rate Claims, any IOU not signing its contract amendment, a Slice customer not signing the Slice agreement or the IOUs not providing \$75 million per year in deferred benefits for FY 2004-2006.

16. What about the payments that non-Slice customers have made to BPA between Oct. 1 and the time the settlement becomes effective that are made at a rate higher than that in the settlement?

Assuming the settlement is final in the 120 days allotted to the process, BPA would begin to bill non-Slice customers under the new rates in the bills mailed in March (referred to as the February bills) for power consumed in February. Refunds will be calculated to reflect the difference between the current FB and SN CRAC adjustments customers are paying and the recalculated rates (reflecting a zero SN CRAC adjustment). These amounts will be refunded on a monthly basis – for example in March for the October refund and in April for the November refund.

17. Can the terms of the proposed settlement be changed during the 120-day period?

No. The terms are set and there is no mechanism to reopen the negotiation over the document without starting the process all over again.

18. Can public interest groups that were not included in the negotiations have an influence on the outcome or the terms of the proposed settlement?

No. The terms of the settlement have to remain unchanged after BPA, one public and one IOU sign. This settlement hinges in part on knowing the challenges to the settlement filed by various entities, including public interest groups. If terms or conditions are changed in the settlement documents after the start of the 90-day period, it would only serve to restart the 90-day period.

19. Why weren't the DSIs included in the negotiations?

The DSIs original Subscription contracts, sometimes referred to as the DSI compromise approach agreements, contained provisions that state that the DSIs will not challenge the BPA contracts with the IOUs, provided that the IOUs not challenge the DSI Subscription contracts. The IOUs have agreed not to challenge the DSI contracts, and, on that basis, we expect the DSIs to dismiss their participation in any public litigant challenges to the IOU contracts.

20. Can new litigation be filed during the signing and review process?

Yes. Parties may file placeholder suits as a way of protecting themselves if the settlement fails. If all required parties sign, the placeholder suits will be withdrawn.

21. Does the Federal Energy Regulatory Commission have to approve the settlement?

No. FERC does not have authority over BPA contracts. The impact of the settlement on the SN and FB CRACs was anticipated in the GRSPs that BPA submitted to FERC in July. BPA received interim approval on the SN CRAC rate case Oct. 1, 2003. BPA explained the implementation of the GRSPs with respect to the IOU settlement at the Sept. 18 rate case workshop.

22. What is in the record of decision (ROD) on the settlement that is being released?

The settlement ROD provides a history of the development of BPA's Subscription contracts, the development of BPA's power rates, current pending litigation and settlement discussions. This ROD also describes the provisions of the proposed settlement and the reasons for those provisions. The initial signing of the Stipulation for Settlement and issuance of the ROD start a 90-day statute of limitations in which parties might file petitions for review challenging the settlement. This 90 days is the same 90 days in which public litigants and others have to sign the appropriate documents to finalize the settlement.

23. What is the current schedule?

- Effective Oct. 23 – BPA, one public litigant and one IOU sign the Stipulation, establishing the effective date. BPA releases the ROD.
- Jan. 21 – Deadline for all public litigants to sign the Covenant Not to Sue and any appropriate Motion to Dismiss or motion to limit issues. Failure of all public litigants to sign results in automatic termination of the settlement. Deadline to file legal challenges to the Stipulations.
- Jan. 22 through Feb. 5 – IOUs may opt out if certain events of default have occurred.
- Feb. 6 through Feb. 20 – BPA and publics may opt out if an event of default has occurred. If BPA or a public litigant opts out, the agreement terminates.
- Jan. 22 through Feb. 20 – BPA, an IOU or a public litigant may withdraw because of legal challenge to the settlement or a legal challenge filed challenging BPA's WP-02 rates by an entity that has not signed the Covenant Not to Sue and the Motion to Limit Issues on Certain Rate Claims.
- March – New settlement rates go into effect; first of monthly refund credits appear on bills mailed in March.

24. What happens if the settlement does not become final?

If the settlement is voided because of an event of termination, all the agreements are terminated as though they were never signed. The IOUs continue to take service under their existing contracts and litigation already filed remains in place. The current forecast average 2.2 percent rate increase relative to FY 2003 average rates remains in effect for FY 2004 and the SN CRAC adjustment is not reduced to zero percent.