

**DRAFT – “BPA’s Proposed New Business Arrangement with the IOUs”**  
**Public Power Council**  
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The latest plan BPA offered the IOUs has a number of components affecting rates in the near term and in the FY07-11 period. Puget and PacifiCorp will abandon their claim to \$100 million of the Reduction of Risk Discount (the poison pill or litigation penalty). The remaining \$100 million will be deferred to the FY07-11 period. Payment of the deferred amount will now be spread over five years instead of two (FY05-06), thereby lessening its annual rate impact even further.

This scheme implies that the IOUs will pick up 25% of this cost by virtue of a higher RL rate used to calculate their benefits in the FY07-11 period. Currently, the only IOU that would pick up a portion of the cost is PGE because it is the only remaining IOU purchasing power from BPA. An additional saving comes from a lower interest rate applied to the deferred amount (3.09%), instead of what the Conditional Deferral Agreement called for (4.46%).

Another feature of the proposal is how BPA will handle all the IOUs’ benefits in the FY07-11 period. The contracts now in place require BPA to offer *either* power *or* monetary benefits, based on the same calculation that was used this rate period. BPA takes the forward price forecast derived in its rate case and subtracts from that the RL rate (or lowest PF rate), applies this to 2200 aMW, and then divvies it up across the IOUs. If these amendments are adopted, BPA will offer *only* financial benefits based on a methodology that varies slightly from the method contained in the IOUs’ existing contracts. In exchange for benefit certainty, Avista, Idaho Power, Northwestern and PGE will forego about \$3.5 million of deferred FY03 benefits that BPA still owes them.

**The “New” Methodology (the One in the Failed Settlement Agreement that is Carried Over to BPA’s Proposal) – What is Significantly New and Different from the Existing Contracts**

- The “new” methodology does not use the rate case forward price forecast as do the existing contracts. Instead, a qualified third-party would survey the forward price data used by each of two IOUs, two publics, and two marketers (from a long list) on a day randomly selected for each entity surveyed, in each of four calendar quarters. The survey will drop the highest and lowest price forecast in each quarter, and calculate the arithmetic mean from the remaining price forecasts, to determine the forward flat block market price forecast for that quarter. Once 12 months

of quarterly data have been collected, the outside party will determine the arithmetic mean of the quarterly averages to arrive at the annual forward price forecast used to calculate the IOU financial benefits in a given contract year. Forward price data are the forecasted forward price for a flat block of Firm Power for delivery at the Mid-C trading hub during a contract year. The third-party will begin the survey 21 months before a contract year and end 12 months later (or nine months before a contract year). The intent of this elaborate process in the “new” methodology is to infuse some impartiality into the benefit calculation.

- The “new” methodology subjects the level of total IOU benefits to a cap of \$300 million (implying a market price forecast/RL rate differential of 15.6 mills) and a floor of \$100 million (implying a market price forecast/RL rate differential of 5.2 mills). The contracts now in place have no cap; they were written to bypass the IOU benefit-limiting nature of the 7(b)(2) rate test. The original Settlement negotiators spent a good deal of time working out the cap value. The IOUs were utterly unwilling to go lower than \$300 million.
- The “new” methodology calls for IOU benefits to be recalculated every year instead of in accordance with the frequency of rate cases. On the pro side, if in a given year a large differential exists between the market price forecast and BPA’s rates, and the IOUs receive benefits that reach the cap, we will not be stuck with this scenario for more than a year (assuming that the market price forecast/BPA rate differential shrinks the next year). Again, this change is intended to make the level of IOU benefits more up-to-date than what the existing contracts allow for. On the con side, this could swing in the opposite direction with just as much probability. Or it could not swing at all, and the market price forecast/BPA rate differential could remain large. The cap of \$300 million offers more protection against paying out benefits that are too high than does the status quo of zero cap.
- The “new” methodology defines “RL Rate” and “Lowest PF” (used to calculate the benefits) includes all applicable rate adjustment clauses.

### **Level of Benefits Under Varying Assumptions**

The IOUs now receive about \$360 million in benefits, excluding the poison pill for PacifiCorp and Puget. This level of benefits is the result of several different calculations, all using the same method, but different market price assumptions and rate values. Had all the IOUs elected to receive monetary benefits in the current rate period, then they would be receiving \$303.9 million annually. As a reminder, this is calculated as follows:  $(\text{Mkt-RL}) \times 8760$

hours\*1900 aMW, where Mkt was forecasted to be 38 mills and the RL at 100% load factor was about 19.74 mills.

Geoff Carr performed an analysis showing how much the IOUs would be receiving in FY04 if their benefits had been calculated using the current proposal (including the step-up to 2197 aMW from 1900 aMW). Using a method approximating the one that has been proposed, the forward market price forecast for FY04, developed over FY02 and FY03, is 34 mills. Given an RL of about 26.3 mills, the annual benefits for FY04, for the current 1900 aMW, would be about \$129 million, excluding any poison pill payments. (The assumed RL is reduced through an iterative process, and lower than the actual observed RL at the moment to reflect the lower level of benefits this calculation has produced compared to what is currently paid). If applied to the 2197 aMW contained in the proposal for the FY07-11 period, the IOU benefits would be about \$144 million, excluding any poison pill payments. Adding in one year's worth of the halved poison pill amount (\$19 million) results in benefits of \$163 million.

Last November we analyzed the implications on the IOU benefits of the now failed Settlement. The example we included in that analysis was as follows: if the market price forecast for FY07 ends up being closer to 40 mills, as some think it might be (including the Northwest Power Council), and BPA ends up charging an RL of 28 mills, then the IOU benefits would be  $(\text{Mkt} - \text{RL}) * 2197 * 8760 = (40 - 28) * 2197 * 8760 = \$231 \text{ million/year}$ .

### **The “New” Methodology—What’s “New” and Different Compared to ASC Residential Exchange/7(b)(2) Rate Test Regime (1980 Act-FY01)**

In Kevin O’Meara’s November 2003 paper, *Background And Analysis Of The Proposed Settlement Over The IOU Subscription Contracts*, he notes, “If the Residential Exchange program were in place today with current IOU loads and resources and the existing ASC methodology, the level of Exchange benefits would be \$340m/yr. This would increase to \$380 million/year if IOU return on equity and income taxes were placed in ASC before applying the rate test. We would therefore be heavily relying on BPA correctly applying the rate test to hold down the level of IOU benefits if we returned to the Residential Exchange.” (One analyst believes that the 7(b)(2) rate test would trigger and limit the level of IOU benefits to approximately \$90 million.)

The rate test would trigger to such a large degree because “rate test assumes that public power would have served much of the DSI load in the absence of the Northwest Power Act, which would make the without-Act alternative (the basis for the rate test) more expensive for public power with high levels of DSI service. With today’s much lower levels of DSI service, this cost largely goes away,

making the without-Act comparison case more favorable for public power,” O’Meara explains.

Most would doubtless agree that the existing IOU benefit situation, and the proposed changes for the FY07-11 period, result in a level of benefits that is greater than what the 7(b)(2) rate test would allow, if it were applied. This is what we hope our Ninth Circuit Subscription challenges will achieve (the same challenges we are *not* required to settle for this proposal to be implemented) – the existing IOU contracts (and their subsequent amendments) would be held invalid and remanded to BPA, and new contracts would be executed to reflect IOU benefits calculated in such a way that “follows the law” (assuming the IOUs do not apply supreme political pressure preventing such an outcome).

We are not there yet. Evaluating the merits of BPA’s new proposal by comparing it to the 7(b)(2) rate test regime is helpful for our court arguments but it is not the most relevant comparison in light of our current situation. Comparing the refined method of IOU benefit calculation to the status quo might prove more enlightening in terms of evaluating what this proposal now brings to the table. For example, the \$300 million cap holds much value compared to the status quo if one anticipates a larger than 15-mill differential between market prices and BPA’s rates. If the rate test were allowed to function according to the Act’s proscriptions and BPA didn’t manipulate its calculation, the \$300 million cap loses much of its value. Those are a lot of “ifs”, and the Subscription process bypasses the 7(b)(2) rate test.