



November 9, 2009

Allen Burns
Deputy Administrator
Bonneville Power Administration

Submitted via www.bpa.gov/comment

Dear Mr. Burns,

The Public Power Council submits these comments in response to your October 30, 2009 letter, announcing that BPA is proposing to sign long-term power sales agreements with Alcoa and Columbia Falls Aluminum Company (CFAC). Under the proposed contracts, BPA would sell up to 320 aMW to Alcoa, and up to 140 aMW to CFAC. The term of the contracts would be broken into two main periods, where the first 19 months of the sale would be guaranteed, and then a sale during the following five years would be made contingent on certain clarifications by the Ninth Circuit not yet received or new “benefit calculations” that BPA has not yet developed.

As you know, based on numerous comments and discussions we have had on this topic, PPC opposes any service to the Direct Service Industries (DSIs) that comes at the expense of preference customers and their end-use consumers in the region.¹ BPA has no duty to provide service to the DSIs, and is permitted to do so only if it demonstrates that sound business reasons underlie such an action.² In the case of the proposed contracts, BPA has once again failed to demonstrate that sound business reasons underlie its proposal.

The Contracts Do Not Represent a Reasonable Business Proposition.

In *Pacific Northwest Generating Coop., et al. v. BPA*, Case No. 09-70228 (“*PNGC II*”), the Ninth Circuit recently reaffirmed that BPA’s decisions regarding service to

¹ PPC and other parties have now submitted numerous comments to BPA on the topic of whether it should sign a long-term contract for service to the DSIs. PPC expects that BPA will include all of these comments in its administrative record on this topic, and believes that the law compels this result. To the extent BPA plans to do otherwise, PPC hereby incorporates by reference all of its previously submitted comments on the topic of a long-term contract for service to the DSIs that have been submitted over the past two years.

² *Pacific Northwest Generating Coop., et al. v. BPA*, Case No. 09-70228, slip op. at 11958 (9th Cir. Aug. 28, 2009).

the DSIs must be grounded in sound business principles. Specifically, the agency may only engage in a transaction with the DSIs if it is expected to result in a benefit to the federal system.

BPA claims that the proposed contracts comport with the *PNGC II* case because they will result in a benefit to BPA that equals or exceeds the cost of the transaction. For example, with respect to the Alcoa contract, BPA's analysis purports to show that the agency will make \$11 million during the first eight months of the contract, followed by a loss of all but \$72,262 of that benefit over the next ten months.³ In several respects, however, BPA's analysis, even if it were sufficient to justify the contracts, is improperly executed.

The Transactions Entail Substantial Risks that BPA Has Not Recognized.

BPA's analysis fails to recognize that the transactions place substantial risks on BPA. This risk comes in the form of BPA's acceptance of the risks that power prices change from those it forecasts, which will inevitably be the case. In other words, BPA's calculation of a benefit relies on the ability of its rate case market forecast to predict actual market prices through the first 19-month period of the contract. To the extent this turns out to be incorrect, the costs of the transaction could easily turn out to outweigh any calculated benefit.

Although BPA would benefit to the extent market prices turn out *lower* than expected, PPC believes the risk that the market will be higher than forecast outweighs the risk that BPA has overestimated the market. This is already being played out in the real-time markets, where current power prices are substantially above the output of BPA's model. (*See below discussion of BPA's market forecast.*)

Additionally, even if BPA's market price forecast were reasonable, there is additional risk embedded in the contract due to BPA's inclusion of a curtailment right for the DSIs, which lacks any obligation for them to pay BPA during times they do not operate their plants. If the DSIs were to exercise this right, BPA would be left unloading power in the market instead of selling it to the DSIs. And, current circumstances, where both aluminum prices and power prices are relatively low according to BPA's forecasts, show that there may be a correlation between a DSI's decision to curtail and a low market in which BPA would have to resell such power.

³ See *Summary of BPA's Analysis of the Block Contract for Alcoa*, p. 9 of 10. In the context of the amount of money that would go "out the door" and come "in the door" at BPA in order to achieve this "benefit," BPA's estimated benefit essentially equates to breaking even.

The Contract Still Contemplates BPA Losing Money to Benefit the DSIs.

In addition to the market price risks outlined above, the contracts fail to satisfy the sound business principles standard because it is clear that they are still founded on the notion that BPA will incur losses in order to benefit the DSIs. Indeed, the contracts themselves state that BPA will seek to provide power to the smelters in a manner that does not necessarily result in net benefits to the agency.⁴

Moreover, the simple economics of the transaction confirm that there is an expectation by BPA and the DSIs that the DSIs will benefit at the expense of BPA's preference customers. For example, Alcoa already has another power supply contract lasting through the first period covered by the proposed contract. This means that it will have to unload that power into the market in order to take power from BPA. Thus, if Alcoa and BPA believed that BPA's sale to Alcoa would be priced above the market, there would be no incentive for Alcoa to enter the transaction, since it would simply be increasing its losses.

The only rational reason Alcoa would want to purchase power from BPA at the IP rate is if it perceives that BPA's IP rate will be below the market in which it can unload its power—the same market into which BPA could sell the power if it were not selling to Alcoa. In other words, the only explanation for why the 19-month portion of the contract would be agreed to by Alcoa is if it perceives an opportunity to unload some of its costs onto preference customers. There is no reason why BPA and Alcoa could not seek to enter into only the contingent portion of the contract at this time if they believed that was the real “benefit” of the contract. Doing so would relieve BPA of the risks during the first 19-month portion of the contract, and ensure that Alcoa does not have an opportunity to unload its costs onto preference customers during that period.

Further evidence that the contract is not purely based on a business decision by BPA is the fact that the October 30th letter, as well as the contract itself, indicates that one of the main reasons for which BPA is proposing to enter the deal is to continue to try to advance its policy goal of prioritizing smelter jobs over other jobs

⁴ See RECITALS (“BPA believes that a portion of the Court’s opinion in PNGC II (the “Opinion”) implies that BPA must find that BPA derives benefits equivalent to the cost of providing Alcoa with electric power service (“Equivalent Benefits”). Alcoa and BPA believe that the Equivalent Benefits standard is an erroneous standard and may seek rehearing of the Court’s Opinion concerning this and other elements of the Opinion.”). Additionally, BPA agrees to sell power to Alcoa at a loss of up to \$330 million if it is allowed to do so by the Court. See Exhibit B (setting out Cost Caps that will govern the power sale if BPA determines it is able to sell power at a loss to Alcoa).

in the region.⁵ The Ninth Circuit has now twice rejected this rationale for offering service to the DSIs.⁶

The Contract Does Not Seem to Fall Within the Types of Transactions BPA Would Enter When Seeking to Maximize its Revenues From Available Inventory.

After reviewing the contract and discussing it with BPA staff, it is evident that the transaction is not the type that BPA would normally enter into when taking actions to carry out the most valuable disposition of its power. In other words, in the ordinary course of business, where BPA seeks to maximize its revenues from the sale of its inventory of power, BPA evaluates its options through applying certain criteria that are calculated to reflect sound business principles. PPC understands that under normal conditions BPA would not enter into a 19-month sale of this amount of power in exchange for the revenues it forecasts it would receive from Alcoa and CFAC.

This is significant because under *PNGC II*, BPA should be evaluating any offer from the DSIs to buy power by comparing it to the other options available for disposing of that power. In this case, the other option is to sell the power to the market. If BPA's normal business procedures would dictate that BPA sell power into

⁵ See October 30th letter ("BPA's goal has been, and remains, to craft a set of contracts that will strike a balance between minimizing impacts to BPA rates and providing the direct service industries (DSI) a chance to continue operating in the Pacific Northwest and, in doing so, retain family wage jobs in these trying economic times such that there are 'net' employment benefits for the region."); See also Exhibit G of the contracts, setting forth minimum employment levels at the DSIs' facilities.

⁶ See *PNGC II*, slip op. at 11987 (explaining that a desire by the agency to preserve smelter jobs, especially when at the expense of BPA's preference customers, is not a valid justification for entering into a contract to serve them). Specifically, the Court explained,

BPA nonetheless argues that the decision to execute the amendment 'advances [its] business interest in numerous respects.' First, the agency maintains that the amendment was necessary to avoid 'any unnecessary interruption of smelter operations, especially given the difficult economic times and potential loss of additional jobs.' This justification is essentially identical to one we rejected as invalid, while sympathizing with its humanitarian goals, in *PNGC*. In *PNGC*, BPA had attempted to justify the monetization provision of the 2007 Contract, in part, on the ground that the 'monetary benefits' were necessary to ensure the continued operation of the aluminum smelters and to protect 'DSI jobs.' We held that this goal, while 'laudable,' was 'simply not reflective of a 'business-oriented philosophy.'" We also noted that BPA's counsel had conceded at oral argument that '[i]t's not Bonneville's responsibility to ensure that [the DSIs] exist.' For these same reasons, BPA's first justification does not demonstrate that the agency's decision to enter into the amended contract was a reasonable business decision.

(citations omitted).

the market in order to maximize its revenues rather than lock up a 19-month sale obligation, BPA should not undertake the sale set out in the proposed contracts.

BPA's Analysis Erroneously Assumes that a "Demand Shift" Would Benefit BPA.

BPA's analysis of the benefits associated with the contract is further flawed in that BPA erroneously counts a "demand shift" toward the benefits it will achieve under the contract (through causing an increase in the market price for power compared to a no-DSI-service option). There can in fact, however, be no demand shift through BPA's selling of power to Alcoa. This is because Alcoa has already secured power in the market, which it will have to unload into the market in order to take BPA's power. This means that precisely the same amount of power will be available in the market whether BPA sells the power to Alcoa or not.

It appears that BPA seeks to counter this fact by arguing that Alcoa would not operate if it did not have the second-period contingent power sale. It is difficult to believe that Alcoa's contractual right to do things it already has the right to do (e.g. seek to petition the *PNGC II* Court for rehearing, try to negotiate a new power supply with BPA) would really make the difference between whether Alcoa operates or not. Additionally, the notion that Alcoa will choose to operate or close based on a contingent opportunity in the future to get power at the IP rate runs counter to BPA's statements in its own analysis that Alcoa's decision to operate will be independent of power prices.⁷

Furthermore, it is troubling and inconsistent for BPA to count a "demand shift" to be a benefit, while at the same time not recognizing the costs imposed on it and its customers from transmission problems that are caused by high loads at the Alcoa Intalco facility. As described more fully in the comments of individually affected utilities, the continued or increased operations of Alcoa's Intalco plant create numerous and costly transmission constraints in the Puget Sound area. BPA's analysis of the costs of the proposed contract does not take this into account, and is therefore in error.

The Transaction Precedes BPA Determinations Required by the Court.

In *PNGC II*, the Court remanded for the second time in the past year specific questions to the agency, including whether BPA is owed money by Alcoa. This

⁷ See *Summary of BPA's Analysis of the Block Contract for Alcoa*, p. 1 of 10 ("BPA believes its decision to operate will be made based primarily on the prices for its output which are independent of power prices.").

question has yet to be addressed by BPA. Nevertheless, BPA is now proposing to enter a 7-year contract with the DSIs before getting to that question. BPA cannot plausibly argue that any exigent circumstances compel this cart-before-the-horse approach, since BPA's own analysis shows that Alcoa should be basically indifferent to whether BPA offers the 19-month sale or not.⁸

BPA's Market Forecast Appears Unreasonably Low.

BPA proposes to use its rate case market price forecasts (updated with a new gas price forecast) to evaluate whether it would be better off selling power into the market, or selling it to the DSIs at the IP rate. This evaluation overlooks important realities that BPA must consider if its decision is to be found in accordance with sound business principles.

First, BPA's market forecast appears to be unreasonably low when compared against market prices being seen by many of PPC's members. For example, a utility submitted comments on the Port Townsend Paper Company contract (which used the same BPA market price forecast), showing that forward prices for power were substantially above what BPA's model predicted they would be in the next few months. Additionally, PPC understands that some parties will submit evidence indicating that regional investor-owned utilities' comparable long-term price forecasts are significantly above BPA's, even though they are forecasting prices in the same western market.

Second, even if BPA's market price forecast was modeled in a reasonable manner, it would be unsupportable for BPA to blindly adhere to the model's output, without considering actual prices available in the current market. BPA can now be certain that, at least for the coming few months, it could obtain higher revenues for power in the market than those forecast in the rate case model since it could actually sell power at those higher prices today. If BPA were rigorously seeking to determine at what price it could dispose of a 19-month block of power, it would not price such a sale on its rate case model forecast prices when it is clear that higher than expected prices over the next few months have altered the overall expected revenues from such a sale. Said differently, it would be irresponsible for BPA to make a sale into the market by looking only to a forecast to determine the actual going price in the market. BPA cannot overlook the disparity that exists between the market and its rate case model when seeking to determine what approach makes business sense in disposing of power.

⁸ Compare *PNGC II*, slip op. at 11991-92 (finding that prior agreement with Alcoa was not demonstrated to be tailored to address any exigencies that may have existed).

Comments on Contractual Language:

PPC makes the following observations regarding the contract's language.

Cost Caps and the Equivalent Benefits Test

It is unclear from the contract whether BPA intended the cost caps to be an alternative to, or backstop to the Equivalent Benefits test. From discussions with BPA staff, PPC understands that BPA intended the cost caps to have no effect if BPA were required to satisfy the Equivalent Benefit test (e.g. if the Court declined to reconsider *PNGC II*). However, the contract in multiple places refers to instances where both the Equivalent Benefits test *and* the Cost Caps could be met.⁹ This erroneously implies that the Equivalent Benefits test could be complied with even if BPA were losing up to \$330 million on the transaction.¹⁰ If this were BPA's intent, the approach would be clearly inconsistent with *PNGC II*.

Lack of Take-Or-Pay Provisions

The contracts impose no take or pay obligation on the DSIs. All of BPA's other power customers are required to sign take or pay agreements, which guarantee that BPA will be paid for power committed to be purchased, even if the purchaser ultimately declines to take it. BPA's decision to relieve the DSIs of such an obligation, therefore, is not comparable with its other sales, and seems to be a decision to favor the DSIs at the potential expense of BPA's preference customers. Moreover, BPA's prior DSI service proposals contained such a provision, and BPA has provided no explanation for why it should not include one here.

Commitment to Sell Power Even After Contract is Ruled Invalid

Section 4.3 of the contract seeks to guarantee that BPA would continue to sell power to the DSIs even after the Court finds the contract invalid, in order to allow them to wrap up business (assuming they were unable to operate with another

⁹ See, e.g. Section 7.1 ("The Cost Caps specified in Exhibit B of this Agreement represent the maximum cost BPA will incur to support sales to Alcoa. . ."); Section 5.2 (stating that BPA will increase the amount of power sold to 320 aMW if BPA determines "(i) that it will achieve Equivalent Benefits from such Firm Power sales during such period, and (ii) that the cost to serve the Alcoa Load with 320 aMW will not exceed the applicable Cost Caps in Exhibit B during such period"); RECITALS (stating that the agreement "anticipates: a) potential extension of the Initial Period of this Agreement in the event BPA determines that it derives Equivalent Benefits by providing Alcoa electric power service under this Agreement for the period of such extension and that such service can be provided at a cost to BPA at or below the applicable Cost Caps . . .").

¹⁰ Exhibit B, Section 3.1.

power supply). This provision should be removed. Including the provision only tends to foster the notion that BPA does not recognize a need to strictly comply with the Ninth Circuit's rulings when it comes to its efforts to deliver a benefit to the DSIs.

Waiver of Damages

As PPC has stated in previous comments, section 20.11 of the contract containing a "waiver of remedies" is an unlawful attempt to deprive preference customers of a remedy for invalid BPA actions. This section of the draft contract states,

In the event the Ninth Circuit Court of Appeals or other court of competent jurisdiction issues a final order that declares or renders this Agreement, or any part thereof, void or otherwise unenforceable, *neither Party shall be entitled to any damages or restitution of any nature, in law or equity from the other Party, and each Party hereby expressly waives any right to seek such damages or restitution.* For the avoidance of doubt, the Parties agree this provision shall survive the termination of this Agreement, including any termination effected through any order described herein.

(emphasis added).

This provision seeks to guarantee a benefit to Alcoa regardless of the legality of the contract. However, BPA cannot guarantee a benefit to Alcoa if the mechanism for providing that benefit is found to be unlawful. And, to the extent the contract is found unlawful, BPA has an obligation, as a governmental agency, to seek to recover money paid or losses incurred under it.¹¹ BPA cannot avoid that obligation by agreeing that it will not undo what a Court tells it cannot lawfully be done. Section 20.11 is not a lawful or appropriate provision for BPA to include in a contract to serve Alcoa. Especially in light of the fact that BPA's two most recent contracts with the DSIs have been declared invalid, the promise to guarantee a benefit to Alcoa regardless of the legality of the contract is extremely ill-advised, and constitutes

¹¹ See *Fansteel Metallurgical Corp. v. U.S.*, 172 F. Supp. 268, 270 (Fed. Cl. 1959) ("[W]hen a payment is erroneously or illegally made [by an agency] it is in direct violation of article IV, section 3, clause 2, of the Constitution. Under these circumstances it is not only lawful but the duty of the Government to sue for a refund thereof, and no statute is necessary to authorize the United States to sue in such a case."); See also *Wisc. Cent. R.R. Co. v. United States*, 164 U.S. 190, 212 (1896) (explaining that "parties receiving moneys illegally paid by a public officer are liable *ex aequo et bono* to refund them").

separate grounds to challenge the contract. BPA should not be searching for creative contract mechanisms to try to ensure that its policy goal will not be frustrated by a Court's declaration of the invalidity of the construct.

Lack of Provision Regarding Lookback Repayment

The contract lacks any provision ensuring repayment of DSI lookback amounts that may be established. BPA has represented that it will engage in a good faith process to determine whether and how much it is owed by the DSIs, given that BPA unlawfully provided substantial monetary payments to them in the past. Once BPA concludes that process, it will then be required to seek repayment from Alcoa. It would be odd indeed for BPA to agree to forego a contractual provision guaranteeing such a payment by Alcoa.

Conclusion

Although the proposed contracts recognize the Ninth Circuit's determination that BPA must justify any sale to the DSIs by producing an analysis that shows its decision is based on a reasoned business case,¹² the analysis and contracts fail to faithfully implement this standard. Instead, it appears that the agency is once again seeking to benefit the DSIs at the expense of its preference customers, who must absorb losses incurred by the agency.

For all of the reasons contained in these comments, and the previous comments submitted by PPC on this topic, BPA should not sign the proposed contracts.

¹² *PNGC II*, slip op. at 11989.