

Attachment 1

Overview of the Proposed Avista Deemer Settlement

January 28, 2009

I. Background

Section 5(c) of the Northwest Power Act established the Residential Exchange Program (REP). Under the REP, a Pacific Northwest utility may sell power to BPA in the amount of the utility's residential and small farm loads at the utility's "average system cost" (ASC) of resources. The utility's ASC is determined pursuant to a methodology that BPA develops in consultation with regional parties. In exchange, BPA sells the same amount of power to the utility at BPA's cost of power (plus applicable transmission) as reflected in BPA's Priority Firm Exchange Rate (PF Exchange Rate). The purchase and sale do not literally occur. Instead, the dollar amounts are netted and the net payment is made to one party. In simple terms, the net difference between BPA's PF Exchange Rate and the utility's ASC, multiplied by the utility's residential and small farm loads, equals the payment the utility will receive under the REP. The REP implements a key component of the Northwest Power Act. Through it, BPA accomplishes the important Congressional goal of spreading the benefits of the Federal Columbia River Power System to all eligible regional residential and small farm consumers, while providing certain rate protections to BPA's preference customers.

After passage of the Northwest Power Act in 1980, BPA and regional parties began two key processes necessary to implement the REP. First, the parties worked to determine the major components of a methodology that would be used to establish utilities' ASCs for the REP. This methodology, the 1981 ASC Methodology, was completed in August 1981 and filed shortly thereafter with the Federal Energy Regulatory Commission (FERC) for approval.

Simultaneously, the parties began the process of negotiating the agreements that would implement the REP. The first set of these agreements, referred to as Residential Purchase and Sales Agreements (RPSAs), was negotiated in 1981. During the negotiations, a debate occurred over whether a utility participating in the REP would be required to pay BPA in the event its ASC fell below BPA's PF Exchange Rate. Although the Northwest Power Act was clear that BPA must pay a utility when its ASC was above the PF Exchange Rate, it provided little guidance on what BPA must do when a utility's ASC fell below the PF Exchange Rate.

To resolve this matter, the parties included in the 1981 RPSA a provision that allowed a utility to "deem" its ASC equal to the PF Exchange Rate. By doing so, the negative REP benefits that a utility would otherwise have had to pay to BPA (if the utility's ASC was lower than BPA's PF Exchange Rate) would instead accumulate in an account known generally as a "deemer account." Interest accrued on the outstanding deemer account balance. If the ASC of a utility with a deemer balance subsequently exceeded the PF Exchange Rate, the resulting REP benefits would first be applied to extinguish the deemer balance. Once the balance was zeroed out, REP benefits would again be paid to the utility. Any outstanding deemer balance at the end of the 1981 RPSA was to be carried forward to any new or succeeding agreement.

From 1981 to 1984 the deemer account provision operated in many respects as expected. In 1984, however, BPA substantially revised the 1981 ASC Methodology. The new ASC methodology (1984 ASC Methodology) removed significant costs from the calculation of ASC in reaction to what BPA viewed as abuses and irregularities by certain utilities. These changes to the ASC Methodology had a dramatic affect on exchanging utilities' ASCs. In a short time, payments to utilities under the REP were reduced or eliminated altogether. Utilities that had deemed their ASCs equal to the PF Exchange Rate saw their ASCs fall further below BPA's PF Exchange Rate. Deemer balances that were small or marginal at the beginning of 1984 grew significantly in only a few months.

As the deemer balances began to grow to unprecedented levels, deeming utilities faced the added difficulty of having no ability to terminate or otherwise suspend their respective RPSAs. The provisions of the 1981 RPSAs only allowed a utility to terminate or suspend its agreement with BPA when the PF Exchange Rate went above the utility's ASC as a result of an allocation of costs pursuant to section 7(b)(3) of the Northwest Power Act. Because BPA had not allocated any costs under section 7(b)(3) to the PF Exchange Rate in the 1985 rate case, the rate case that immediately followed BPA's change in the ASC Methodology, exchanging utilities had no right to terminate or suspend their RPSAs. With no option to suspend or terminate their agreements, several utilities, including The Washington Water Power Company (presently known as Avista), were forced into accumulating deemer balances that far exceeded the benefits they had received under the REP.

Two years later, in BPA's 1987 rate case, BPA allocated costs to the PF Exchange rate pursuant to section 7(b)(3). This action afforded exchanging utilities in deemer status the right to suspend or terminate their respective RPSAs. Avista and BPA executed a suspension agreement effective June 30, 1987, which stopped the accumulation of deemer principal amounts. The 1987 Suspension Agreement specified that Avista's deemer balance as of June 30, 1987, was \$39.3 million and that simple interest at the prime rate would accrue on this balance beginning October 1, 1987.

In BPA's 1993 rate case, BPA once again allocated costs to the PF Exchange Rate pursuant to section 7(b)(3). This time Avista expressed an interest in terminating its RPSA. Because Avista's Suspension Agreement was still in effect, BPA maintained that Avista could not terminate the RPSA without first addressing the terms of the Suspension Agreement. BPA was willing to accept Avista's termination, provided that Avista agreed to certain additional conditions. Specifically, BPA wanted Avista to concur with the stated sum of the deemer balance, agree that the deemer balance would accrue compound interest, and concur that any deemer balances would be carried forward to apply to any new or succeeding RPSA. BPA requested that Avista submit a letter that restated these terms. On September 29, 1993, however, Avista sent a letter notifying BPA that it was terminating its RPSA. Avista's letter made no mention of BPA's stated conditions. BPA responded in a letter on October 19, 1993, restating the conditions BPA originally requested, and adding that BPA would not accept Avista's termination unless Avista assented to the additional terms. Avista never responded to BPA's request, and subsequently filed a request at FERC to cancel the 1981 RPSA, which FERC granted. BPA did not intervene or otherwise participate in the FERC proceeding.

From 1993 to 2000, the issue of Avista's deemer balance remained a constant source of contention between BPA and Avista. In comments submitted on BPA's Subscription principles, Avista argued that BPA should not assert that a deemer balance could be carried forward from the 1981 RPSA to future RPSAs. Avista also argued that it never agreed to the conditions BPA requested in its October 19, 1993, letter. Later, in 2000, Avista submitted substantial comments on the 2000 RPSAs, again arguing that BPA could not carry over the deemer balance developed under the 1981 RPSA to a future RPSA. BPA responded to Avista's position in the 2000 RPSA Record of Decision. The issues related to Avista's deemer balance became moot, however, when BPA and Avista entered into an REP Settlement Agreement, which held the deemer issue in abeyance.

When the Ninth Circuit issued a May 2007 decision finding BPA's 2000 REP Settlement Agreements unlawful, Avista's deemer balance once again became a live issue. As part of the WP-07 Supplemental Rate Case, BPA established "reconstructed REP benefits," which were used to determine the amounts that IOUs were overpaid under the unlawful REP Settlement Agreements (Lookback Amounts). Because deemer balances are a factor in determining the REP benefits investor-owned utilities would likely have received from FY 2002-2007, BPA decided to account for the deemer balances when calculating individual utility Lookback Amounts. In taking this position, BPA was clear that the deemer balances presumed to exist for purposes of calculating Lookback Amounts were only assumptions. BPA was not finally deciding the deemer issues within the case, and would replace the deemer balance assumptions with whatever numbers were determined to be appropriate after settlement or litigation of the deemer balance issues.

During the WP-07 Supplemental Rate Case, Avista and other parties presented a number of arguments against BPA's treatment of the deemer issues. These parties forcefully objected to BPA's decision to include the deemer balance issues within the scope of BPA's proposal. They also presented a variety of contractual, regulatory, and statutory arguments against the validity of the deemer balances. BPA responded to these arguments in the WP-07 Supplemental ROD, noting throughout that it was not making a final determination of the deemer issues. Instead, BPA stated that it expected the deemer issue to be addressed in forums outside of the Supplemental Rate Case and welcomed settlement discussions with the deemer utilities on these issues. BPA also noted that it would adjust Lookback Amounts to reflect any settlement or other resolution of the deemer issues.

Disputes over BPA's treatment of deemer balances also arose during the development of new RPSAs. Throughout the summer of 2008, BPA was engaged in negotiations with regional parties over the terms for the FY 2009-2011 Bridge RPSA and the FY 2012-2028 Long-Term RPSA. Avista and other parties strongly objected to BPA's decision to include the deemer provision in the final Bridge and Long-Term RPSAs.

Following BPA's publication of the final RPSA ROD, on December 1, 2008, Avista filed a petition in the Ninth Circuit challenging BPA's Bridge and Long-Term RPSAs. In addition, on December 16, 2008, Avista filed a petition seeking review of BPA's WP-07 Supplemental ROD.

After extensive negotiations, BPA and Avista have arrived at a proposed settlement of Avista's deemer balance. The proposed settlement would resolve all issues related to the creation, accumulation, and calculation of Avista's deemer balance. It also would require Avista to drop all claims against BPA pending before the Ninth Circuit that seek to challenge BPA's decisions related to the deemer balance provisions. The proposed settlement balances BPA's risk and cost of litigating the deemer disputes in court with the equitable considerations surrounding the unique set of circumstances that led to the creation and accumulation of Avista's deemer balance.

The following describes the reasoning underlying the proposed deemer settlement and the impacts on Avista's deemer balance, Lookback Amount, Definitive Benefit Amount and expected Interim Relief and Standstill Agreement true-up.

II. Description of Proposed Settlement

In the WP-07 Supplemental Rate Case, BPA assumed a beginning of FY 2002 deemer balance for Avista of \$85.6 million. This figure was not agreed to by Avista, and was a contested issue throughout the WP-07 Supplemental case. Under the proposed Avista Deemer Settlement, BPA would replace this number with \$55 million, recalculate Avista's beginning FY 2009 Lookback Amount and beginning FY 2009 deemer balance, (referred to as the Balancing Account balance in the Bridge RPSA), and would use these recalculated amounts to implement the REP in FY 2009 and beyond. BPA would also use the results of the recalculation to determine the Definitive Payment Amount that will be used to implement Section 9 of the Residential Exchange Interim Relief and Standstill Agreement, Contract No. 08PB-12438 (Interim Agreement), between BPA and Avista.

In consideration of BPA's use of the lower FY 2002 deemer balance, Avista would accept the establishment of the new deemer account balance, agree to resolve all past deemer issues, agree not to challenge BPA's use of deemer amounts to determine the Lookback Amounts pursuant to the WP-07 Supplemental ROD, and agree not to challenge the Balancing Account provisions in the Bridge and Regional Dialogue RPSAs.

The revised FY 2002 deemer balance of \$55 million was determined as follows. When BPA and Avista entered into an REP suspension agreement in 1987, Avista's deemer balance stood at \$39.3 million. Instead of applying the prime rate to the \$39.3 million deemer balance established in the 1987 suspension agreement to arrive at the beginning of FY 2002 deemer balance, BPA escalated the \$39.3 million using the consumer price index. The result is an outstanding balance of \$55 million at the beginning of FY 2002.

BPA believes that using the CPI strikes a fairer balance between the interests of BPA ratepayers in general (who benefit from the accumulation of interest on outstanding deemer balances) and the interests of Avista and, in particular, its residential and small-farm consumers (who incur the costs of the accrued interest). During 2008, BPA proposed and took comment on new Bridge and Regional Dialogue RPSAs. One of the issues in the new RPSAs was the appropriate rate of interest on outstanding deemer (Balancing Account) balances. In its September 2008 record of

decision on the new RPSAs, BPA concluded that outstanding deemer balances should be escalated using the CPI.

The interest component makes up a large portion of the beginning FY 2002 deemer balance. Avista agreed to the use of the prime rate for the term of the suspension agreement, 1987 through 1992. As noted above, Avista contends that it did not agree to use of the prime rate from 1993 through 2001. Given fairness considerations and the uncertainty regarding the application of the prime rate from 1993 through 2001, BPA believes that use of the CPI for the 1987 through 2001 period is an appropriate basis for settlement of the deemer issue.

With the smaller FY 2002 deemer balance, “reconstructed REP benefits” determined in the WP-07 Supplemental Rate Case are now sufficient to pay off Avista’s deemer balance in FY 2008, with some remaining benefits that are apportioned between an amount applied against Avista’s Lookback balance and an amount that is the Definitive Benefit Amount. This apportionment is the same percentages used to apportion PGE and PSE’s FY 2008 reconstructed REP benefits between the amounts applied toward the Lookback balance and the amounts that constitute the Definitive Benefit Amounts. For Avista, the FY 2008 reconstructed REP benefits applied to Lookback and the Definitive Benefit Amount are \$5.84 million and \$12.01 million, respectively.

Avista received a \$9.57 million in Interim Payment under the Interim Agreement. Based on a Definitive Benefit Amount of \$12.01 million, the expected Interim Agreement true-up payment amount would be \$2.44 million plus interest that BPA would pay to Avista after all legal challenges to BPA’s WP-07 Supplemental ROD have been finally resolved.

As noted above, \$5.84 million of Avista’s FY 2008 reconstructed REP benefits would be applied toward its Lookback balance under the proposed deemer settlement. This reduces Avista’s beginning FY 2009 Lookback Amount from the WP-07 Supplemental Rate Case Final Proposal amount of \$75.77 to \$69.93 million.

To summarize, as a consequence of the proposed settlement, Avista’s beginning FY 2009 deemer balance is zero and its Lookback amount is \$69.93 million. The impact of these alternative beginning FY 2009 amounts on FY 2009 REP benefits paid and Lookback Amount returned can be viewed from two perspectives; the perspective of the information contained in the WP-07 Supplemental Rate Case Final Proposal including errata, or the perspective of our current estimate of FY 2009 results. The latter differs from the former primarily due to the ASCs and forecast exchange loads that exchanging utilities filed on or about October 15, 2008, the associated re-allocation of the 7(b)(3) surcharges resulting from the as-filed ASCs, and actual exchange loads invoiced for the month of October through December, 2008. This current estimate is an estimate because actual REP benefits paid are a function of actual exchange loads over the course of FY 2009 and of final ASCs that will be determined in late April 2009.

The following table compares the proposed settlement to no settlement based on the WP-07 Supplemental Final Proposal and based on current estimates, in millions of dollars.

	WP-07 Supplemental Final Proposal (Sep 2008)		Current Estimate (Jan 2009)	
	No Settlement	Proposed Settlement	No Settlement	Proposed Settlement
Beginning FY09 Lookback Amount	\$ 75.8	\$ 69.9	\$ 75.8	\$ 69.9
FY09 REP Benefits Before Adjustments	\$ 22.1	\$ 22.1	\$ 18.6	\$ 18.6
Deemer Payoff	\$ 15.1	\$ 0	\$ 15.0	\$ 0
Lookback Amortization	\$ 3.3	\$ 10.2	\$ 2.2	\$ 8.6
Expected FY 09 REP Benefits Paid	\$ 3.7	\$ 11.9	\$ 1.5	\$ 10.0
Estimated Ending FY09 Lookback Amount	\$ 75.7	\$ 62.5	\$ 77.6	\$ 64.8