

April 4, 2011

Mr. Thomas R. Boyko
Regional Manager
Western Area Power Administration
Sierra Nevada Region
114 Parkshore Drive
Folsom, CA 95630

Subject: Palo Alto Comments on Notice of Proposed Power, Transmission, and Ancillary Services Rates

Dear Mr. Boyko,

City of Palo Alto Utilities (Palo Alto) provides the following comments in response to the Notice of Proposed Power, Transmission, and Ancillary Services Rates published on January 3, 2011 by Western Area Power Administration (Western) in the Federal Register, Vol. 76, No. 1. Palo Alto appreciates the opportunity to provide comments on this most important rule making process. Palo Alto recognizes and acknowledges the significant time and effort Western and its staff have committed to develop its final proposed rates, including the informal process. Given the growing challenges and ever changing nature of the electric utility industry, Palo Alto understands and greatly appreciates the value of being Central Valley Project (CVP) Preference Power customer.

Western and the CVP Preference Power customers have now operated under the Post-2004 Power Marketing Plan for over five (5) years. One goal of the Post-2004 Power Marketing Plan was to develop a rate structure that treats all CVP Preference Power customers equally, regardless of customer size, power allocation or host balancing authority area. Palo Alto believes that equal and fair treatment of all CVP Preference Power customers should be a primary and key objective of Western when developing power, transmission and ancillary services rates. Palo Alto's comments provided herein are focused on developing rates that are fair and equitable to all CVP Preference Power customers. Furthermore, Palo Alto provides comments on related issues not specifically addressed in the Federal Register Notice or the 2012 Rate Brochure, but which are issues that Palo Alto believes are important and impact the value CVP Preference Power customers receive from the CVP.

Variable Resource Scheduling, Portfolio Management and Scheduling Coordinator Charges

Western is proposing to use a three percent (3%) inflationary adder to annually index its Variable Resource Scheduling Charge, which Western charges as part of the Custom Product Power service. Rather than using a fixed inflationary adder to adjust the Variable Resource Scheduling Charge, Palo Alto recommends that Western conduct an annual review of its actual costs of providing this service to ensure that charges assessed by Western for Variable Resource Scheduling are set to recover actual costs, and to ensure

that customers who subscribe to such services are charged accordingly. It is Palo Alto's understanding that the former Variable Resource Scheduling Charge was increased twenty-three percent (23%) because Western had no standard mechanism or process in place to properly assess the actual annual costs of the service. Palo Alto believes Western should institute a charge that is equal to the actual cost of providing this service, rather than using an assumed inflationary adder that may not be sufficient to cover costs of providing this service. Palo Alto also suggests that the annual cost review performed by Western take into account both over and under collections from prior periods, and factor such over or under collected amounts into the next effective rate.

In addition to reviewing the Variable Resource Scheduling Charge annually, Palo Alto requests that Western also adopt and implement policy to conduct an annual review of actual costs for its Portfolio Management and Scheduling Coordinator services. During a recent cost study, it was discovered that rates charged for Portfolio Management and Scheduling Coordination were not sufficient to cover the costs of providing the services. This type of under collection has a direct and negative impact on customers who are not utilizing the services by increasing their costs; therefore Palo Alto proposes that Western implement a policy to review its costs of service for providing Portfolio Management and Scheduling Coordination on an annual basis to ensure Western properly charges for these services in the future.

Energy Exchange Program Rate

Palo Alto requests that Western adopt an annual rate for the Energy Exchange Program. The Energy Exchange Program, as currently designed, applies a monthly rate to energy that is exchanged in the program. Use of a monthly rate can negatively impact Palo Alto because its assignment of Base Resource percentage to NCPA, when combined with other NCPA Palo Alto assignments of Base Resource percentage, results in NCPA's aggregated load being of a size where surplus Exchange Energy is able to be absorbed a majority of the time; therefore the collective NCPA Pool tends to be allocated Exchange Energy during months when total Base Resource deliveries are lower than average. This results in Palo Alto being charged a rate for Exchange Energy that in many cases can be disproportionately high as compared the rates charged for Exchange Energy during month where the amount of Base Resource deliveries are above average. To improve equity in the Energy Exchange Program Palo Alto proposes that Western use an average annual rate for Exchange Energy to levelize the cost of the program over the course of the year. Palo Alto feels that use of an annual rate is equitable because all recipients of Exchange Energy will pay similar rates for such energy, and the Power Revenue Requirement (PRR) that is used to derive the Energy Exchange rates is also an annualized cost. Palo Alto proposes that Western establish an annual rate for the Energy Exchange Program using the following formula:

$$\text{Annual Energy Exchange Rate} = \frac{\text{Annual PRR [Oct - Sept]}}{\text{Total Forecasted CVP Base Resource [for the period of Oct - Sept]}}$$

Since the proposed annual Energy Exchange Rate formula utilizes forecasted data, Palo Alto also proposes that Western should review and update the rate as part of Western's annual mid-year budget evaluation process that is conducted in April of each fiscal year. Pending such review, if either the Annual PRR or forecasted CVP Base Resource are updated, Western should make adjustments to the annual Energy Exchange Rate to be applied prospectively for the balance of the fiscal year, while also factoring amounts over or under collected during prior months of the fiscal year.

Proposed Rate Schedule CV-RFS4 - Regulation and Frequency Response Service

Palo Alto proposes that Regulation and Frequency Response Services be restructured to be consistent with how services are provided under Rate Schedule CV-SPR4 (Spinning Reserve Service) and Rate Schedule CV-SUR4 (Supplemental Reserve Service). Palo Alto believes that CVP generation capacity should not be reserved "off-the-top" to provide regulation and frequency reserves to a subset of customers who take such service in the Western sub-balancing authority area. Palo Alto believes this practice is not fair and equitable for all CVP customers, including Palo Alto, because the "off-the-top" reservation of CVP generation misappropriates CVP generation that could otherwise be made available to all CVP Preference Power customers as Base Resource. Even though Western is proposing cost-of-service rates for this service those CVP Preference Power customers who do not take regulation and frequency response services from Western are harmed due to lost opportunity cost and the cost of acquiring alternative sources of power that can be more expensive than Base Resource energy.

Rather than reserving CVP generation capacity and energy "off-the-top" to provide this service to customers located in the Western sub-balancing authority area, Palo Alto proposes that customers who have such obligations be required to self-provide their need, and Palo Alto proposes that these customers be able to use their respective allocation of Base Resource capacity and energy to meet their regulation and frequency response obligations. During periods when the amount of Base Resource capacity and energy allocated to customers who have a regulation and frequency response obligation is not sufficient to self-provide their needs, Western should procure such services from the market and pass the associated costs onto the customers who require this service, rather than utilizing the capacity and energy of CVP generation to benefit a sub group of customers.

Palo Alto believes this proposal will result in a more equitable and fair use of CVP generation for all Preference Power customers, and that this is consistent with other services provided Western.

Central Valley Project Composite Power Costs "Safety Value"

As discussed in the 2012 Rates Brochure, in addition to the CVP PRR, CVP Preference Power customers are allocated costs attributable to the CVPIA Restoration Fund, and power customers are required to pay a larger share capital costs due to the irrigators' inability to pay capital costs. Palo Alto is most concerned with the ever increasing cost of

the CVPIA Restoration Fund obligation which Western collects as a surcharge to the CVP PRR on behalf of the United States Bureau of Reclamation (Reclamation). CVPIA Restoration Fund obligations are forecasted to escalate over time given current CVP operations. Increasing CVPIA Restoration Fund obligations are even more concerning when viewed in tandem with looming CVP operational changes that may reduce the amount of generation made available to Preference Power customers. If operational constraints result in decreased water deliveries, power customer's contributions to the CVPIA Restoration Fund will continue to increase due to the irrigators' inability to pay capital costs. In fact, Palo Alto has contributed over \$38 million to the CVPIA Restoration Fund since its inception, and such costs are in addition to our Base Resource funding obligations. If CVPIA Restoration Fund obligations continue to increase, and the amount of generation available for Preference Power customers declines in the future, the cost of taking service from the CVP may put intense pressure on Palo Alto's financial relationship with Western.

When the Power Revenue Requirement is coupled with the CVPIA Restoration Fund surcharge, the total cost of Federal power has at times been greater than alternative power sources. Palo Alto believes that increasing CVPIA Restoration Fund obligations are directly responsible for Palo Alto's total cost of Western power being greater than alternative power sources. For example, during the period of July 2009 thru June 2010 NCPA Pool received approximately 386 GWh of Base Resource, at a total cost of approximately \$16.1 million (Base Resource cost plus CVPIA Restoration Fund costs). During the same period NCPA estimates that it could have procured alternative sources of power for \$14.9 million, or \$1.2 million less than the cost of CVP power.

A major looming threat to CVP generation is California Senate Bill X7 1 (the Delta Reform Act), which directs the California State Water Resources Control Board and the California Department of Fish and Game to implement a program that requires the agencies that operate water storage reservoirs in California to release a minimum of sixty percent (60%) of total inflows into a reservoir measured in every 14-day period. This legislation could have a major impact on storage levels in California reservoirs, and in particular these regulations could have a profound impact on hydroelectric operations in the Sacramento and San Joaquin river systems.

As an example, NCPA operates the Calaveras Hydroelectric project on the Stanislaus river, which is located upstream of the New Melones Federal reservoir. Using historical flow data, NCPA estimates that a sixty percent (60%) flow-through requirement would have reduced the maximum storage levels at NCPA's hydroelectric project by approximately 70,000 acre-feet in 2009 and 2010. Furthermore, due to the combination of natural flows and increased release requirements, spill at NCPA's hydroelectric project would have increased by approximately 19,000 acre-feet, resulting in 38 GWh of lost generation per year.

Palo Alto provides this information to demonstrate that the Delta Reform Act, if implemented as written, can result in major reductions in the amount of storage and generation made available at impacted reservoirs. If CVP reservoirs are similarly impacted

by this legislation, the amount of generation made available from said projects could be drastically less than current levels, which would cause the per unit cost of Western power to increase sharply. Palo Alto fears that this risk coupled with increasing CVPIA Restoration Funding obligations would result in the cost of Federal power products to be much higher than market alternatives; therefore such power could become unmarketable.

Per Western's rules, if a CVP Preference Power customer desires to stop receiving its Federal power allocation, such election would only be available after a new power rate is promulgated. Palo Alto does not want Western to get into a position where some customers seek to terminate their Federal power allocation. Palo Alto proposes that Western implement a mechanism or "Safety Value" to allow Western to adjust or suspend the collection of certain costs during extended periods of low generation. Western currently has discretion in how CVPIA Restoration Fund costs, and other costs due to related legislation, are assessed and allocated to CVP Preference Power customers. Palo Alto requests that Western explore and consider development of a trigger mechanism or threshold under which Western could suspend or terminate certain cost recovery when the composite costs of Federal power exceeds alternative power costs. Since the CVP generation is fuel-constrained, Western is unable to increase generation to manage the average per unit cost of Federal power when CVPIA Restoration Fund and other costs increase. As a result, Palo Alto believes the only practical mechanism available to Western to control the per unit cost of Federal power is to reduce overall costs assessed to CVP Preference Power customers, and to suspend the collection of non essential costs and projects when CVP generation levels are reduced, allowing Federal power to be assessed at rates that are near or equal to alternative power costs.

If the total composite cost of Federal power continues to increase and reduces Western's competitiveness, Palo Alto will press for more stringent cost cutting at Western.

SVS Transmission Cost Repayment

As discussed above, Palo Alto believes that Western must develop rates that are fair and equitable to all Federal power customers. Such rates must recognize and be designed to equitably allocate the costs of products and projects to those customers who are the beneficiaries of the services. Palo Alto remains strongly concerned with the proposed allocation and assignment of costs attributed to the construction of the Sacramento Voltage Support (SVS) project. Palo Alto shares many of the concerns raised by Calpine Construction Finance Company, L.P., in its comments filed in this rate making process. Over time Western has claimed that the SVS is being constructed to support the continued reliable operation of Western's transmission system, therefore costs associated with the project should be allocated equally to all CVP Preference Power customers. Over time the term "reliability" has become more a term of art rather than science, and Palo Alto questions Western's assumptions as to which customers receive the predominate benefits of the SVS project. Since the early 1990's it has been well known that voltage issues in the Sacramento and Placer counties have resulted from increases to native load. Numerous technical studies have been conducted over time, and such studies have indicated that

increasing load in the Sacramento and Placer County region is the primary cause of voltage issues. The Findings of the Sacramento Area Voltage Support Project (DOE/EIS-0323S1)¹ state the following:

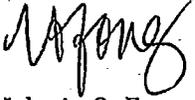
Western's Sierra Nevada Region (SNR) includes the greater Sacramento, California area. SNR maintains and operates numerous substations and more than 1,200 miles of transmission lines. These transmission lines are interconnected to other greater Sacramento-area transmission system owners, Load Serving Entities, and utilities, including Sacramento Municipal Utility District (SMUD) and the City of Roseville (Roseville). Western's system contributes to and is affected by voltage stability, reliability, and security of the greater Sacramento area transmission system. Transmission system studies in 2001/2002 and 2006/2007 showed that existing transmission lines in the greater Sacramento area have reached their maximum power transfer limits for serving the area's energy needs, particularly in the northern portion of the greater Sacramento area. Load Serving Entities and utilities in the area have taken interim measures to avoid potential uncontrolled system-wide outages. As a last resort, operators may be required to implement post-contingency load shedding and/or rotating blackouts. These measures provide limited voltage stability improvement and are not always available or preferred. In addition, load shedding and rotating blackouts can have significant negative impacts on utility customers. The transmission system studies showed that additions and upgrades are need to maintain system voltage stability, reliability, and security in accordance with NERC and WECC Planning/Operations Reliability Standards, and for Western to continue to meet its legislative and contractual requirements. The resulting system additions and upgrades would provide additional power-importing capabilities to the greater Sacramento area.

While Palo Alto agrees that studies have shown that the SVS is required to support reliable operations, and for that reason Palo Alto does not challenge the project itself, but as described above a limited number of Federal power customers will receive direct benefits from this project. In accordance with the principles of cost causation, customers who receive the lion's share of the benefits should carry a lion's share of the costs. Palo Alto disagrees with Western's decision to allocate all \$87 million of construction costs equally among CVP Preference Power customers. Palo Alto does not argue that it receives zero benefit from the project, but Palo Alto, who is located in the California Independent System Operator (CAISO) Balancing Authority Area, does not receive equal benefits as those Federal power customers directly impacted by the SVS. Therefore, Palo Alto encourages Western to reevaluate its decision to spread SVS construction costs evenly across all Federal power customers, and rather adopt a cost allocation method that recognizes the level of benefits received to ensure Western's costs remain just and reasonable.

¹ Federal Register Vol. 73, No. 88, published on May 6, 2008

For questions regarding these comments submitted on behalf of Palo Alto please contact Tom Kabat at 650-329-2659 or tom.kabat@cityofpaloalto.org. Thank you again for your effort throughout this rate making process, and thank you for the opportunity to submit these comments.

Sincerely,



Valerie O. Fong
Director of Utilities