B O N N E V I L L E   P O W E R   A D M I N I S T R A T I O N

2007 Wholesale Power Rate Case Initial Proposal

REBUTTAL TESTIMONY

FINANCIAL STRATEGY AND RISK TOLERANCE

March 2006

WP-07-E-BPA-30

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Witnesses for Bonneville Power Administration

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Witnesses for Bonneville Power Administration

SUBJECT: FINANCIAL STRATEGY AND RISK TOLERANCE

Section 1. Introduction and Purpose of Testimony

Q. Would you state your names?

A. My name is Roy B. Fox. My qualifications are contained in WP-07-Q-BPA-12.

A. My name is Valerie A. Lefler. My qualifications are contained in WP-07-Q-BPA-29.

A. My name is Claudia R. Andrews. My qualifications are contained in WP-07-Q-BPA-55.

Q. Have you previously submitted testimony in this proceeding?

A. Mr. Fox and Ms. Lefler, along with Kimberly Leathley, submitted direct testimony identified as exhibit WP-07-E-BPA-08. Ms. Andrews has not previously submitted direct testimony in this rate case.

Q. What is the purpose of this testimony?

A. Our testimony responds to direct testimony submitted by several parties in the WP-07 rate case. The parties are: Columbia River Intertribal Fish Commission, Nez Perce Tribe and the Yakama Nation (Tribes) (*See,* Sheets, *et al.,* WP-07-E-CR/NZ/YA-01); NW Energy Coalition/Save Our *Wild* Salmon Coalition (NWEC) (*See,* Weiss, WP-07-E-JP8-01); the Joint Customer Group (*See,* Early, *et al.*, WP-07-E-JP01-01); Northwest Requirements Utilities (NRU) (*See,* Saven and Carr, WP-07-E-NR-01); the Public Power Council (PPC) (*See,* Crinklaw, *et al.,* WP-07-E-PP-01); and Western Public Agencies Group (WPAG) (*See*, Saleba and Piliaris, WP-07-E-WA-01).

Q. How is your testimony organized?

A. Our testimony is organized in several sections, besides this introductory section. Section 2 addresses concerns raised by parties regarding BPA’s proposed rate levels.

Section 3 addresses several issues raised regarding BPA's stated policy objectives and whether BPA has provided appropriate fish and wildlife funding. Finally, Section 4 addresses some miscellaneous issues such as conservation amortization.

Section 2. Proposed Rate Levels

Q. Several parties raise concerns that BPA's proposed rate levels are too high. The Public Power Council stated that, "[t]he proposed rates are higher than necessary." (See, Crinklaw, et al., WP-07-E-PP-01, at 3, line 4) The Northwest Requirements Utilities similarly declared that, "the FY07 increase is simply too large, and in general the overall rate levels must be reduced." (See, Saven, et al., WP-07-E-NR-01, at 4, lines 15-16) Western Public Agencies Group also expressed a concern that the proposed rate is "extremely disappointing" (See, Saleba and Piliaris, WP-07-E-WA-01, at 4, line 2-3) and also noted that, "we strongly recommend that BPA rededicate itself to finding a combination of cost and risk reductions that will permit it to provide a rate decrease (including the expected value of CRACs) for the rate period…" Id. at 9, lines 8-11. The Joint Customer Group argued that, "the rate increase seems excessive." (See, Early, et al., WP-07-E-JP9-01, at 1, lines 17-18) Conversely, the Tribes are concerned that BPA's rates are too low and that BPA could incorporate additional costs. (Sheets et. al.,WP-07-E-CR/NS/YA-01 at 72) How do you respond to the various concerns that BPA's proposed power rates are either too high or too low?

A. As we have indicated, BPA strives to ensure that power rates are as low as possible, consistent with sound business principles including meeting its statutory obligations (*See,* WP-07-E-BPA-08 at 5 lines 11-12). We also understand the Tribes' desire for BPA to spend more on fish and wildlife restoration. Our response to both of these concerns is basically the same. BPA's rates are cost-based and must be set to recover costs. Our costs, which are established outside the confines of a 7(i) rate proceeding, reflect BPA's commitment to:

- Generation Reliability – The proposed rates include O&M program levels that account for investment in the hydro and nuclear infrastructure;
- Environmental Stewardship – The proposed rates include significant alteration of hydro operations and direct spending for fish and wildlife, cultural resources, and conservation;
- Regional Responsiveness– BPA established the program levels and other costs through extensive public processes including the Power Function Review 1, Power Function Review 2, Regional Dialogue, workshops, and other public forums;
- Low Rates – These efforts have resulted in some of the lowest firm power rates in the country.

As BPA has described in other public forums, some of the cost increases from the FY 1997 – 2001 rate period to the FY 2007-2009 rate period include[1]:

- Increased debt management costs of $63 million per year;
- Increased Columbia Generation Station (CGS) O&M of $56 million per year;
- Increased Corps and Reclamation O&M expenses of $94 million per year;
- Increased Settlement Payments to Residential & Small Farm Consumer of IOUs of $240 million per year;
- Increased Fish & Wildlife Direct Program expenses of $43 million per year;
- Increased Internal Operations Charged to Power Rates of $16 million per year;
- Increased Conservation Program Expenses of $51 million per year
- Increased Renewables expenses of $40 million per year; and
- Other increases (including forecasted DSI benefits) of $59 million per year;

All of these increases have produced increased benefits to the PNW.

[1] All costs shown here are rate period average annual amounts.

An additional factor that has contributed to higher rates is BPA's decision to set rates to achieve the Treasury Payment Probability (TPP) standard established in the 1993 Financial Plan of 95% for a 2-year rate period (92.6% for a 3-year rate period).

BPA continues to work to improve our efficiencies via the Enterprise Process Improvement Project as well as to look for further cost reductions in the Power Function Review 2. Finally, one of the areas most promising in the effort to help deliver lower rates is the continued pursuit of "liquidity tools." These are further described below.

Q. Several parties describe in testimony, each with different numerical conclusions, how high BPA's forecasd rate levels are compared to current rate levels. See generally, for example, the testimony of the Joint Customer Group (Early et al., WP-07-E-JP9-01 at 1 lines 23 through 3 line 3); NRU (Saven and Carr WP-07-E-NR-01 at 4 lines 9-16, 5 line 21 – 6 line 30); PPC (Crinklaw, et al., at 3 line 2 – 5 line 20); and WPAG (Saleba and Piliaris WP-07-E-WA-01 at 3 line 13 – 4 line 3). Please respond.

A. As our customers note, there are many different ways of comparing rates. How valid or relevant a comparison is to a customer depends entirely on an individual customer's choices about product purchases, load characteristics, etc., and BPA sees little benefit in debating the appropriate comparison. BPA ultimately must set rates to recover all its costs. As noted in the previous response, BPA is committed to managing those costs effectively to produce the desired results within reasonable costs, and is striving to achieve rates as low as possible consistent with sound business principles.

On a related note, WPAG raises issues comparing preference customer retail rates to IOU residential retail rates. It appears that the calculations used by the parties are incorrect. That issue is discussed in the testimony of Normandeau, *et al*., WP-07-E-BPA-33.

Q. The Joint Customer Group believes that major cost drivers in the FY 2002-2006 rates were the load buy-downs and power purchases that BPA entered into during a time of *high market prices to serve BPA committed load in excess of its resources. (Early, et al., WP-07-E-JP9-01 at 3 lines 11-13) They testify that in FY 2007-2009, BPA's resources will be sufficient to meet its contracted loads, so this eliminates about 26% of upward rate pressure compared with FY 2006. Id. lines 17-19. Is this a correct way to look at these augmentation purchases and their associated costs?*

A. No. BPA encountered requests (and contractual obligations) for FY 2002-2006 that were significantly greater than its resources and therefore embarked on a major effort to meet the increased load in the most economical way possible. This included BPA "buying down" load as a way to avoid high-cost market purchases. After that, much of the expected load growth from public utilities did not materialize due to the slump in the regional economy. Thus, BPA found itself with additional surplus power to sell. The resulting higher-than-expected net secondary revenues helped keep BPA's rates (adjusted for CRACs) lower than they would otherwise have been. This is true particularly over the last couple of years. Now, public agency loads are again growing, including step-ups on the block contracts. The customers are correct that there will be a reduction in purchase power expenses (BPA has shared in other public forums that this expense is forecast in the WP-07 initial proposal to average $522 million less in the FY 2007-2009 rate period than in the FY 1997-2001 rate period). However, this number is the reduction in expenses and doesn't show the corresponding reduction in surplus revenues due to the reduced available surplus inventory.

Q. The Joint Customer Group also suggests that higher prevailing and expected spot market prices should bring in substantial secondary revenues to offset a significant portion of BPA's costs and help BPA reduce its base rates. See, Early, et al., WP-07-E-JP9-01 at 4 lines 4-9. How do you respond?

A. We certainly hope that market conditions will be favorable and help offset a significant portion of BPA's costs. However, as the Joint Customer Group notes, "BPA always faces the risk of poor water conditions." *Id*. Unfortunately, when we face poor water conditions, we may need to make balancing power purchases in high-priced markets to meet firm load. Also, the expiration of the augmentation contracts and the increases in PF loads substantially reduced BPA's firm surplus and exacerbated the potential risk of balancing power purchases. The uncertainty around BPA's fuel supply (i.e., hydro conditions) and the market prices in which BPA may be purchasing are the reasons that BPA relies on sophisticated risk analysis in developing its rates. It is also why we are proposing an adjustable rate design. In our proposed rate design, if BPA does, in fact, receive substantial net secondary revenues, our customers will benefit through lower rates.

Q. WPAG states that another reason the preference rates are too high is "due in large part to a significant increase in the base rate costs associated with providing IOU and DSI benefits in the next rate period." (See, Saleba and Piliaris WP-07-E-WA-01 at 7 lines 22-23) How do you respond?

A. The financial benefits BPA forecasts for the IOUs were established in contracts and, as such, are costs that BPA's power rates must recover. To the extent that WPAG's concerns surround issues related to the 7(b)(2) rate test, these issues are dealt with in the rebuttal testimony of Doubleday *et al.,* WP-07-E-BPA-36. WPAG's concerns about the costs of the DSI benefits are misplaced in this rate proceeding; the DSI benefit levels were decided in a separate process and are being reviewed in the Power Function Review 2, currently underway. WPAG's concerns related to the application of the CRACs to the DSI and IOU benefits are addressed in the testimony of Normandeau *et al*., WP-07-E-BPA-33.

Q. Several customers make recommendations about how BPA can achieve lower rates, particularly by looking for additional cost reductions through the Power Function Review 2. See, Early et al., WP-07-E-JP901 at 4-5; Saven and Carr, WP-07-E-NRU-01 *at 7; Crinklaw, et al., WP-07-E-PP-01 at 5-6. How is BPA setting its rates so that they are as low as possible consistent with sound business principles, including meeting its statutory obligations?*

A. As several parties noted (and as we testified in our initial proposal), BPA is continuing to look for additional cost reductions through the Power Function Review 2 process. Another important way that BPA has worked to keep rates low is through the variable rate design. As we stated in our initial testimony, while many of the risks BPA faces are substantively similar as those in the past, the financial magnitude of these risks has increased. (*See, Leathley et al.,* WP-07-E-BPA-08 at 6, lines 10-12). BPA has proposed a package of risk mitigation tools that "allows BPA to meet its TPP standard without setting 'posted' rates at an unacceptably high level or building up significant cash reserves in the FY 2007-2009 rate period." (*Id*. at 14 lines 16-18)

Q. Those customers also responded positively to the potential availability of liquidity tools and encouraged BPA to pursue these tools. In addition to the general encouragement to pursue liquidity tools to keep rates low, the Public Power Council stated, "[w]e encourage BPA to continue to work on these tools." See, Cinklaw, et al., WP-07-E-PP-01 at 12, lines 2-3. The Joint Customer Group urged BPA to "explore every avenue available to it" in order to secure a Line of Credit with the Treasury (See, Brattebo, et al., WP-07-E-JP9-03, at 14, lines 8-9). The Joint Customer Group believes a new net-billing arrangement would have "a significant beneficial effect…" (See, Brattebo, et al., WP-07-E-JP9-03, at 14, lines 23). Similarly, Northwest Requirements Utilities stated that liquidity tools "are our best opportunity for both significantly reducing the size of the base rate and the probability and size of CRAC recovery." (See, Saven and Carr, WP-07-E-NR-01, at 8, lines 8-10) Given these strong recommendations, what is BPA doing to develop liquidity tools?

A. BPA continues to actively pursue four liquidity tools: direct payment of the annual budget of Energy Northwest (EN); a liquidity facility from the U.S. Treasury; deferred payment of advanced amortization from the debt optimization program; and prepayment by customers of their power bills under certain circumstances. Much progress has been made on all four of these tools – but none are yet available to BPA with certainty. BPA intends to include in its final studies any of these tools which BPA determines it can rely on with confidence. Specifically:

- <u>Monthly Direct Payment of EN Costs:</u> BPA and its tax counsel have worked closely with the IRS docket attorneys to ensure they have all the information they need to make a timely decision on any tax implications with respect to the EN bonds. BPA believes an IRS ruling that EN bonds would remain tax exempt is likely to occur. In addition, BPA has met with EN staff and management, bond counsel and rating agencies in order to be prepared to implement this once a favorable ruling occurs.
- <u>Liquidity Facility:</u> BPA and Treasury are continuing work on developing a short-term "liquidity" note.
- <u>Deferred Amortization:</u> BPA has done additional analysis on the possibility of deferring advanced amortization. This is not a useful tool unless a short-term Treasury note is agreed upon, and even then does not provide a great deal of liquidity. However, BPA remains prepared to pursue it should the EN Direct Payment alternative not be successful.
- <u>Customer prepayment:</u> BPA has had several discussions with customers on how the "customer prepayment" alternative could work. Customers agreed to discuss alternatives for providing BPA assurance that such payments could be relied upon with certainty.

See, Normandeau *et al*., WP-07-E-BPA-33 for specific discussions related to these tools.

Section 3. Policy Objectives

Q. The Tribes raise concerns that the financial and policy objectives identified in BPA's Financial Strategy and Risk Tolerance testimony do not address several legal and policy requirements. See, generally, Sheets, et al., WP-07-E-CR/NZ/YA-01 at 4-6. Is this a valid concern?

A. No. As stated in the cited testimony, these are six major financial and policy objectives that helped shape the WP-07 Initial Proposal. Leathley *et al.*, WP-07-E-BPA-08 at 5, line 8. The panel did not intend to identify every statutory or policy objective that guides all BPA power rate cases. The Revenue Requirement Study, Chapter 5, identifies many of BPA's legal requirements that inform BPA's operations and rate-setting. Moreover, in Power Function Review 1, BPA considered all of the concerns that the Tribes have raised here. *See*, BPA Data Response to CR-BPA-32 and the electronically linked attachments.

Q. The Tribes specifically express concern that in the cited financial and policy objectives, BPA does not expressly address treaty and trust obligations to Indian tribes, (See, Sheets, et al., WP-07-E-CR/NZ/YA-01 at 4 lines 16 –19) and that Bonneville did not analyze in its proposal how equitable treatment requirements and treaty and tribal trust requirements have been addressed. Id. at 6. How do you respond?

A. While it is true that there is no specific analysis on these two points, that does not mean that BPA does not address them. Assumptions about hydro operations, capital construction projects, system configuration and funding of the Council's direct programs reflect how BPA meets these requirements. The fact that the Tribes could find no specific references in BPA's initial power rate proposal to factors that are arguably outside the scope of the rate case, does not indicate, as the Tribes seem to imply, that BPA is not meeting its equitable treatment requirements and treaty and tribal trust requirements. BPA has dealt with this issue previously. *See, RODs: WP- 02-A-02, at 18-42, 43* and SN-03-A-01, at 2.8-2.

Q. The Tribes state that they could not find in the initial proposal any principles similar to the Fish and Wildlife Funding Principles used in the WP-02 rate case. See, Sheets, et al., WP-07-E-CR/NZ/YA-01 at 5 lines 13-17. How do you respond?

A. The Tribes are correct. The Fish and Wildlife Funding Principles were developed in a regional forum, and adopted by the Administration, specifically to address a particular set of circumstances and uncertainties relevant to developing rates for FY 2002-2006. They were not intended to apply to future rate-setting processes nor did the Administration direct BPA to develop new principles for this rate-setting process. BPA has included in its initial rate proposal risk mitigation measures to account for the current uncertainties surrounding costs and operational impacts related to fish and wildlife.

Q. The Tribes also testify that BPA did not analyze NEPA requirements in its proposal. Sheets et al., WP-07-E-CR/NA/YA-01 at 6 lines 16-18. How do you respond?

A. BPA did not analyze NEPA requirements in its proposal because NEPA compliance issues are outside the scope of issues to be litigated in the WP-07 rate proceeding. BPA conducts environmental reviews under NEPA of its ratemaking actions separately from, but generally concurrent with, BPA's Section 7(i) evidentiary hearings. Accordingly, BPA's NEPA review for this ratemaking is being conducted as a separate but parallel review to the evidentiary hearings, and BPA's NEPA documentation for this ratemaking will not be included as part of the evidentiary record developed by the Hearing Officer. Nonetheless, BPA's NEPA documentation will be included in the general administrative record for the WP-07 rate proceeding for consideration by the BPA Administrator. The Federal Register Notice for the WP-07 proceeding described BPA's anticipated approach to NEPA compliance for this ratemaking proceeding. *See*, 70 Fed. Reg. 67685 at 67690.

Q. The Tribes state that they believe that BPA can increase spending for fish and wildlife recovery and still benefit the Northwest economy. See, Sheets et al., WP-07-E-CR/NZ/YA-01, at 72. How do you respond?

A. This proceeding is not the proper forum for raising concerns about BPA funding levels for fish and wildlife. BPA funding levels for fish and wildlife were determined in separate public processes outside of this proceeding and the results of those processes were imported into this proceeding.

Section 4. Miscellaneous Issues

Q. The Joint Customer Group asked "that BPA fully reflect in its final rate proposal the full effects of updated data on water conditions, secondary revenues, forward market prices, realistic risks and opportunities for cost control." (See, Early, et al., WP-07-JP9-01, at 5, lines 12-14) What is BPA's plan to update numbers for the final proposal?

A. For the final proposal, BPA will update forecasts for loads and resources, market conditions, secondary revenue forecasts, revenue requirements, debt optimization, and any settlement or judgments due to legal proceedings known in time to be included in the final studies, which will be published in July 2006. In addition, the basic risk mitigation package we have proposed (i.e., a CRAC and a DDC) provides customers with another look at expected rate levels, prior to rates actually going into effect October 1, 2006.

Q. PPC stated that they "believe that BPA should incorporate those [financial] updates in such a way that rate case parties have an opportunity to evaluate them" prior to the release of the final proposal. (See, Crinklaw, et al., WP-07-PP-01, at 6 line 23 – 7 line 2.) Please respond.

A. Neither BPA's 7(i) procedures nor time constraints or work load allow for another opportunity for rate case parties to evaluate the final rate proposal. BPA has dealt with this issue in the past. *See,* SN-03-A-02 at 3-36 – 3-39.

However, we note that the Power Function Review 2 provided an opportunity for customers to see approximate impacts of several updates referenced by PPC witnesses that will be made in the final proposal. *See,* Homenick, *et al*., WP-07-E-BPA-10 Section 5. *See* February 8, 2006 PFR workshop handout at www.bpa.gov/Power/queue/review/02-08-2006_Workshop/02-08-2006_pfr_workshop_handout.ppt

Q. The Joint Customer Group states that they "strongly urge BPA to reconsider this change [in its amortization policy for conservation investments] in assumptions and to apply the 20-year amortization-period assumption to conservation investments in FY07-11, and keep the assumption unchanged for the post-2011 period." See, Brattebo, et al., WP-07-E-JP9-03 at 13. They argue that shortening the amortization period in the future may serve to erode customer support of BPA's capitalized conservation activities. How do you respond?

A. BPA does not agree that a 20-year amortization period is appropriate. BPA's conservation program is designed to implement its portion of the 5th Power Plan, where the Northwest Power and Conservation Council identified a median asset life of fifteen years for conservation investments installed after FY 2006. Accounting standards rely on the estimated life of the measure put in place as the basis for the amortization estimates, with consideration for other factors that may result in an alternative amortization period. With conservation, there are no factors present that would extend the amortization period beyond fifteen years, therefore fifteen years would be considered the maximum amortization period that would be considered under these standards.

As noted in direct testimony, the initial proposal reflects BPA's accounting policy, which was developed taking into consideration a number of factors to determine the appropriate useful life of conservation acquisition investments. *See,* Leathley *et al.*, WP-07-E-BPA-08, at 10-11. Among other factors, BPA considered the important fact that when compared to longer amortization periods, a five-year amortization period for FY 2007-2011 conservation investments results in significantly less pressure on borrowing authority.

In addition, BPA considered industry practice. While some utilities do amortize conservation investments over five, ten, or rarely, more than ten years, the most common method in the utility industry is to expense conservation investments in the year incurred.

Changing from a five-year period to a fifteen-year period would have minimal effect in the revenue requirement for the FY 2007-2009 period, about a $248,000 decrease per year as described in the Power Function Review 2. *See*, www.bpa.gov/Power/queue/review/02-08-2006_Workshop/02-08-2006_pfr_workshop_handout.ppt for the workshop handout that describes the effect. BPA does not believe that this would cause significant erosion of customer support for BPA's conservation program.

Q. Does this conclude your testimony?

A. Yes.