

# 2003 Safety-Net Cost Recovery Adjustment Clause Initial Proposal

## Direct Testimony

| <u>BPA Exhibit No.</u> | <u>Witness</u>                                       |
|------------------------|--|
| SN-03-E-BPA-04         | Keep, Leathley, Andrews                              |
| SN-03-E-BPA-05         | Hirsch, Mисley, Klippstein, Clark,<br>Kerns, Schiewe |
| SN-03-E-BPA-06         | Lefler, Homenick, Steele                             |
| SN-03-E-BPA-07         | Conger, Wagner, Lovell                               |
| SN-03-E-BPA-08         | Oliver, Mainzer, Anderson, Petty,<br>Wagner          |
| SN-03-E-BPA-09         | Wedlund, Hirsch, Klippstein, Wagner                  |
| SN-03-E-BPA-10         | McCoy, Lovell, Russell, Miller, Sapp,<br>Normandeau  |

March 2003



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SN-03-E-BPA-04 OVERVIEW AND MANAGEMENT DIRECTION

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TESTIMONY OF  
BYRON G. KEEP, KIMBERLY A. LEATHLEY, AND CLAUDIA R. ANDREWS  
Witnesses for Bonneville Power Administration

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1 TESTIMONY OF

2 BYRON G. KEEP, KIMBERLY A. LEATHLEY, AND CLAUDIA R. ANDREWS

3 Witnesses for Bonneville Power Administration

4  
5 **SUBJECT: OVERVIEW AND MANAGEMENT DIRECTION**

6 **Section 1. Introduction and Purpose of Testimony**

7 *Q. Please state your names and qualifications.*

8 A. My name is Bryon G. Keep. My qualifications are contained in SN-03-Q-BPA-07.

9 A. My name is Kimberly A. Leathley. My qualifications are contained in SN-03-Q-BPA-10.

10 A. My name is Claudia R. Andrews. My qualifications are contained in SN-03-Q-BPA-02.

11 *Q. What is the purpose of your testimony?*

12 A. The purpose of our testimony is to describe the nature and the design of the Safety-Net  
13 Cost Recovery Adjustment Clause (SN CRAC). The purpose is also to discuss, in  
14 general terms, Bonneville Power Administration's (BPA) current financial condition,  
15 which has led to the SN CRAC section 7(i) hearing process.

16 *Q. How is your testimony organized?*

17 A. This testimony is organized in five sections, including this introduction. Section 2 briefly  
18 describes the intent of the SN CRAC. Section 3 describes BPA's current financial  
19 condition and what led to it, beginning with the completion and filing of BPA's 2002  
20 Supplemental Wholesale Power Rate Proposal (Supplemental Proposal) in June 2001.  
21 Section 4 describes the actions BPA has taken so far to remedy its financial condition.  
22 Finally, Section 5 describes an overview of the SN CRAC proposal and management  
23 direction given to staff developing the SN CRAC rate design.

1 **Section 2. Intent of the SN CRAC**

2 *Q. Please describe the SN CRAC.*

3 A. The SN CRAC is one of three Cost Recovery Adjustment Clauses (CRAC) that are part  
4 of BPA's power rates design. The other two CRACs are the Load-Based (LB) CRAC,  
5 which is designed to recover augmentation costs, and the Financial-Based (FB) CRAC,  
6 which is designed to recover limited net revenue shortfalls. The SN CRAC is designed to  
7 provide a "safety net" in case BPA's financial situation continues to deteriorate despite  
8 implementing the LB and FB CRACs. Together, these CRACs, as established in the  
9 Supplemental Proposal of June 2001, allowed BPA to adopt a general approach of  
10 keeping base rates low and addressing financial shortfalls, as needed, through the  
11 implementation of the CRACs. These tools provided BPA the risk mitigation necessary  
12 to establish an acceptable level of Treasury Payment Probability (TPP) for BPA's  
13 proposed 2002 power rates.

14 As provided in Section II.F.3 of BPA's 2002 General Rate Schedule Provisions  
15 (GRSPs), the SN CRAC enables BPA to implement an upward adjustment to posted  
16 power rates that are subject to the FB CRAC by modifying the FB CRAC parameters.  
17 With this SN CRAC proposal, BPA is proposing changes to the FB CRAC parameters  
18 that, to the extent market and other risk factors allow, will achieve a high probability that  
19 the remainder of Treasury payments during the FY 2002-2006 rate period will be made in  
20 full. BPA's proposal includes, consistent with the GRSPs, changes to the Maximum  
21 Planned Recovery Amount (the amount of revenues planned to be recovered), the  
22 duration (the length of time the SN CRAC would be in place, which can be more than  
23 1 year), and the timing of collection.

24 *Q. When is the SN CRAC available to the Administrator?*

25 A. The SN CRAC is said to "trigger" if the Administrator determines that, after  
26 implementation of the FB CRAC and any Augmentation True-Ups, either (1) BPA

1 forecasts a 50 percent or greater probability that it will nonetheless miss its next payment  
2 to Treasury or another creditor, or (2) BPA has missed a payment to Treasury or has  
3 satisfied its obligation to Treasury but has missed a payment to any other creditor.  
4 Triggering the SN CRAC starts an expedited 40-day section 7(i) hearing to establish  
5 changes to the FB CRAC.

6 On February 7, 2003, the Administrator sent a letter to customers, tribes,  
7 constituents and interested parties advising them of his determination that the SN CRAC  
8 had triggered, based on the first of the above criteria. That same day, BPA's Manager of  
9 Power Products, Pricing, and Ratemaking sent a second letter to interested parties and  
10 customers informing them of this determination. This letter included the documentation  
11 used by BPA to determine the SN CRAC had triggered, the amount of the forecasted  
12 shortfall, and the time and location for a workshop on the SN CRAC. This workshop was  
13 held February 11, 2003. Those letters reflected BPA's financial condition at that time.

### 14 **Section 3. BPA's Current Financial Condition**

15 *Q. What are some of the important indicators BPA uses to monitor its financial condition?*

16 A. BPA reviews three important indicators: (1) financial reserves; (2) net revenues, which  
17 are a function of revenues and expenses; and (3) the credit rating on BPA-backed bonds.

18 *Q. What are financial reserves?*

19 A. BPA's financial reserves consist of cash in the Bonneville Fund, including working  
20 capital, and any deferred borrowing balance. "Deferred borrowing balance" refers to  
21 capital expenditures that will be funded by borrowing from Treasury, but have been  
22 temporarily financed with revenues. Estimates of start-of-year reserves in this rate  
23 proposal reflect total BPA reserves. In modeling this initial proposal, all reserves are  
24 projected as cash in the Bonneville Fund, with no reserves reflecting a deferred  
25 borrowing balance.

26

1 Q. *Why are financial reserves important?*

2 A. Financial reserves are important in two ways. First, financial reserves serve as a buffer  
3 for solvency from the cyclical and unanticipated impacts of conducting business in an  
4 uncertain environment. Generally speaking, in low water years BPA can draw upon its  
5 reserves to make its Treasury payments; in good water years BPA can replenish its  
6 reserves to prepare for later low water years. BPA, like other hydroelectric utilities,  
7 forecasts a range of potential future financial outcomes. High reserve balances can  
8 mitigate the financial risk of some of the bad potential outcomes. The higher the reserve  
9 balance, the more negative outcomes the reserve balance can mitigate in terms of  
10 duration and/or magnitude. The reserve balance in FY 2001, combined with access to  
11 fish credits against payments to Treasury, helped BPA to remain solvent through a  
12 particularly difficult period both in terms of duration and magnitude.

13 The second reason reserves are important is that, by providing a financial buffer,  
14 they help maintain BPA's TPP while minimizing rates. For example, BPA started  
15 FY 2001 with a relatively high reserve balance, which allowed base rates to be set lower  
16 than they otherwise would have been if reserves had been lower.

17 Q. *Please describe BPA's current financial reserves.*

18 A. BPA ended FY 2002 with \$188 million of reserves, \$53 million attributed to the Power  
19 Business Line (PBL), and \$135 million attributed to the Transmission Business Line  
20 (TBL). *See* SN-03-E-BPA-01, Chapter 7. This amount was a reduction from agency  
21 reserves of \$625 million (\$496 million attributed to PBL) at the start of the rate period.  
22 The drop in reserves during FY 2002 was primarily related to PBL's net revenue loss of  
23 \$87 million. When PBL's net revenues are adjusted consistent with the FB CRAC  
24 methodology, which uses the May 2002 Final Proposal forecast of Energy Northwest  
25 (ENW) debt service and removes FAS 133 adjustments, this -\$87 million becomes  
26

1 -\$390 million. During FY 2003, PBL's net revenues have remained negative, thereby  
2 continuing to adversely impact agency reserves.

3 *Q. Is PBL's net revenue condition different from what BPA expected when completing its*  
4 *Supplemental Proposal in June 2001?*

5 A. Yes. On June 29, 2001, BPA filed a Supplemental Proposal with the Federal Energy  
6 Regulatory Commission (FERC), and received interim approval on September 28, 2001.  
7 In that filing, PBL predicted higher net revenues than in BPA's May 2000 Final Proposal.  
8 Net revenues are defined as revenues minus expenses. PBL expected both higher  
9 revenues and lower expenses than it actually experienced. There were two primary  
10 reasons driving the expected increased revenues. The first was secondary sales. BPA's  
11 secondary sales are a function of both market prices and available surplus hydro  
12 generation. Secondary sales were forecasted to provide higher revenues due to BPA's  
13 expectation of continued high market prices. At the time, the West Coast was  
14 experiencing very high electrical demand relative to supply. The development of new  
15 resources, which BPA expected would eventually help bring market prices down, was  
16 anticipated to take up to two years. BPA believed high market prices would continue  
17 until these new resources came on line. Lower-than-forecasted revenues for BPA in  
18 FY 2002 resulted from an unanticipated and rapid decline in market prices. A number of  
19 factors contributed to this decline, including lower demand as a result of a downturn in  
20 the economy.

21 The other variable in secondary sales revenues is how much hydro production is  
22 available for BPA to sell. In BPA's Supplemental Proposal, BPA expected an average  
23 amount of hydro production for all years of the rate period. However, actual hydro  
24 production in FY 2002 was lower than expected. Hydro conditions in FY 2003 are  
25 expected to be below average, thereby also contributing to the decline in BPA's revenues.  
26 Although the hydro conditions appeared to be about normal over the January-July 2002



1 period, it was necessary to store a significant amount of water to partially replenish the  
2 low reservoirs resulting from the 2001 drought. This storage resulted in less 2002 hydro  
3 production than forecasted in BPA's Supplemental Proposal.

4 The net result of these two factors (lower than expected prices and less than  
5 expected hydro production) resulted in BPA selling less energy at lower prices than  
6 forecasted in the Supplemental Proposal.

7 The second source of expected increased revenues in BPA's Supplemental  
8 Proposal consists of credits toward BPA's Treasury payments based on fish-related costs  
9 and impacts on operations (fish credits). These credits were expected to contribute  
10 significantly to BPA's total revenues, in part due to high market prices. Fish credits  
11 contribute to BPA's overall revenues through a credit against BPA's payment to the  
12 U.S. Treasury. However, these credits are now expected to be substantially lower over  
13 the rate period than previously forecasted. The reasons include a reallocation of project  
14 purposes at Grand Coulee, lower wholesale power prices, and, finally, reduced  
15 availability of Fish Cost Contingency Fund (FCCF) credits that were all but exhausted at  
16 the end of 2001 because of the severe drought.

17 *Q. Are there other factors that have contributed to BPA's financial condition?*

18 *A. PBL cost increases of approximately \$1.5 billion in total over the rate period have*  
19 *contributed to BPA's eroding financial condition (not including [a] offsetting increases in*  
20 *revenue due to the increase in expenses and [b] the risk to certain expense categories*  
21 *embedded in the NORM assessment). These increases include PBL Internal Operations,*  
22 *Corporate Overhead, Residential Exchange Settlement Agreements, Power Generation,*  
23 *Renewable projects, Transmission Acquisition, Civil Service Retirement Payments,*  
24 *Terminated Projects, Fish and Wildlife, Conservation and Renewable Discount, Other*  
25 *Public Benefits, Non-Federal Debt Service, Depreciation, Amortization, and Net Interest*  
26 *(not included are Power Purchases and Augmentation). Associated with these expense*

1 items are approximately \$500 million in offsetting revenues over the rate period, such as  
2 increased generation from the hydro system and Columbia Generating Station, and  
3 approximately \$120 million over the rate period from non-operating risks.

4 *Q. Were there any other increases in expenses?*

5 A. Yes. Because of the energy crisis in 2001, BPA is still owed about \$90 million by the  
6 California Independent System Operator and Power Exchange. Of this amount, BPA  
7 made an accounting adjustment to PBL's net revenues in 2002 of about \$30 million to  
8 reflect the risk that BPA may never be paid this amount. Additionally, BPA has  
9 take-or-pay contracts that obligate the DSIs to pay damages on IP power that is not  
10 purchased (curtailed), and causing BPA to sell the curtailed amount in the surplus market  
11 when the market value is less than the IP value. The DSIs are obligated to pay BPA the  
12 difference under those circumstances so that BPA is made whole. BPA is at risk of not  
13 being paid about \$30 million of FY 2002 damages due to DSI bankruptcies or other  
14 financial difficulties. So far, the portion of money at risk is \$58 million, which is  
15 reflected as a Bad Debt Expense in BPA's income statement.

16 *Q. What information does BPA have about the bond ratings BPA uses to help monitor its  
17 financial condition?*

18 A. The credit ratings for BPA-backed bonds were recently downgraded by Fitch Ratings to  
19 AA- as well as placed on "negative outlook" by Standard and Poor's (AA- rating), even  
20 in view of the expectation that BPA will proceed with the SN CRAC process and  
21 reinforce its TPP and liquidity positions. These credit concerns will likely reduce the  
22 expected interest savings of ENW April refinancings that BPA expected would reduce  
23 the SN CRAC when incorporated into the final rate proposal study. It will also affect  
24 future refinancings of ENW and other BPA-backed bonds. The Standard and Poor's  
25 report states that a downgrade could be prompted by "the use of any debt restructuring  
26 savings to offset current operating expenses...", "failure to implement an adequate

1 SN CRAC...”, or “any restructuring of federal Treasury obligations”. See Attachment 1  
2 in SN-03 Study, SN-03-E-BPA-01, Chapter 1.

3 *Q. Is PBL expecting continued financial difficulties in FY 2003-2006 despite the use of the*  
4 *LB and FB CRACs?*

5 A. Yes. Aside from the significantly decreased revenues PBL experienced during the first  
6 two years of this rate period, PBL forecasts significant losses for the remainder of the rate  
7 period. These losses are expected to be \$339 million for FY 2003-2006, even with  
8 maximum contributions from the FB CRAC. These losses are referred to as a “net  
9 revenue gap.”

10 **Section 4. Response to BPA’s Financial Condition**

11 *Q. What steps has BPA taken to manage costs in order to address this change in financial*  
12 *circumstances?*

13 A. Faced with a deterioration of its overall financial condition, BPA sent a letter to its  
14 customers (including power rate case parties) and other interested entities in the region on  
15 July 2, 2002, announcing the beginning of a public comment process on BPA’s financial  
16 condition, referred to as “Financial Choices.” The Financial Choices process examined a  
17 variety of financial and program options for addressing PBL’s FY 2003-2006 financial  
18 challenges. In this process, BPA described those financial challenges, the actions BPA  
19 already had taken to address the problem, and the financial outlook for the remainder of  
20 the rate period. Additionally, BPA identified a variety of potential financial alternatives  
21 that, separately or in combination, could form the basis of a solution to PBL’s financial  
22 condition.

23 BPA received significant public comment during the Financial Choices process.  
24 As a result of the process, BPA made decisions to reduce, eliminate, or defer certain  
25 expenses. BPA issued a Financial Choices close-out letter to the region on November 22,  
26 2002, outlining BPA’s plan, in part, for meeting PBL’s financial challenges. The actions

1 BPA has taken, and will take, include the identification of \$350 million in expense  
2 savings, expense deferrals, and other actions for the FY 2003-2006 period. These actions  
3 are largely reflected in this proposal. *See* Lefler, *et al.*, SN-03-E-BPA-06, and  
4 SN-03 Study, SN-03-E-BPA-01, Chapter 3.

5 *Q. Did BPA implement any other options that enhance TPP while minimizing changes to the*  
6 *level of the SN CRAC?*

7 *A.* Yes. BPA has requested, and ENW has implemented, a program to purchase surety  
8 bonds to release bond reserve funds to pay for some near-term debt service costs at ENW.  
9 Also, ENW pursued and won a \$23 million settlement with the Bank of America for the  
10 Bank's role as paying agent on certain BPA-backed bearer bonds. ENW plans to provide  
11 the settlement proceeds to BPA. In addition, BPA is pursuing settlement of power  
12 purchase augmentation contracts, which, if achieved, would likely have the effect of  
13 reducing augmentation costs and increasing TPP.

14 *Q. How does BPA intend to meet the lower program cost targets decided upon in the*  
15 *Financial Choices process?*

16 *A.* BPA realizes that the practice of assuming significant cost cuts without a complete plan  
17 on how to achieve those cost cuts has contributed to BPA's current financial condition.  
18 BPA has been given assurances by ENW, the Corps of Engineers (Corps) and the Bureau  
19 of Reclamation (Reclamation) that each will rigorously manage its expenses to  
20 established levels. The cost reductions agreed to by these entities in the Financial  
21 Choices process are reflected in this initial proposal.

22 *Q. How does BPA intend to meet its own internal operating costs charged to power rates?*

23 *A.* The cost reductions associated with BPA's internal operating expenses and charged to  
24 power rates in the Financial Choices process are largely reflected in the initial proposal.  
25 Approximately \$20 million of cost reductions were inadvertently omitted but will be  
26 reflected in the final proposal. *See* Lefler, *et al.*, SN-03-E-BPA-06.

1 *Q. Is BPA continuing to pursue additional cost reductions?*

2 A. Yes. BPA is continuing to pursue additional savings, but will not reflect them in the  
3 SN CRAC proposal unless there is a high degree of certainty that they will be achieved.  
4 For this reason, BPA has not modeled probabilities of specific costs being higher or  
5 lower than the point forecasts, as it did through NORM in BPA's 2002 power rate  
6 proposal.

7 *Q. Is BPA doing anything about its Bad Debt Expenses?*

8 A. Yes. BPA is seeking to recover the monies owed by the California Independent System  
9 Operator and Power Exchange through the California refund proceeding at FERC.  
10 Additionally, BPA is continuing to pursue collection of all monies due from the DSIs in  
11 bankruptcy and other proceedings.

12 *Q. Will additional cost cuts alone be sufficient to ensure a high probability of making BPA's  
13 Treasury payment over the remainder of the rate period?*

14 A. No. Even with these cost cuts, by January 2003, worsening water conditions and a  
15 refined secondary revenue forecast increased BPA's expected losses for the  
16 FY 2002-2006 rate period to \$920 million. In February 2003, the Administrator  
17 determined that BPA had a lower than 50 percent probability of making its Treasury  
18 payment in September 2003. The Administrator determined the need to consider an  
19 SN CRAC adjustment to ensure that rates and revenues will be sufficient to recover costs  
20 with a high degree of certainty over the remainder of the rate period.

21 *Q. Has BPA clarified its Fish and Wildlife costs that would impact its financial condition?*

22 A. Yes. In BPA's WP-02 rate proceeding, decisions had not been made regarding system  
23 reconfiguration to aid threatened and endangered salmon. The potential fish and wildlife  
24 costs were reflected probabilistically, based on 13 system-configuration alternatives  
25 arrived at during the development of the Fish and Wildlife Funding Principles. *See*  
26 Revenue Requirement Study Documentation, Volume 1, WP-02-FS-BPA-02A,

1 Chapter 13. These alternatives were developed specifically to inform and guide the  
2 PBL's Subscription Process and power ratemaking. The alternatives kept BPA's options  
3 open because the Subscription and ratemaking processes would be concluded prior to  
4 decisions on system reconfiguration to aid threatened and endangered salmon.

5 In December 2000, the National Marine Fisheries Service (now NOAA Fisheries)  
6 issued a Biological Opinion on the operation and configuration of the FCRPS, which  
7 addressed threatened and endangered salmon. Also in December 2000, the U.S. Fish and  
8 Wildlife Service (FWS) issued a Biological Opinion on the operation and configuration  
9 of the Federal Columbia River Power System (FCRPS), which addressed Endangered  
10 Species Act (ESA) listed sturgeon and bull trout. Implementation of the NOAA  
11 Fisheries' Biological Opinion requires the Action Agencies (Corps, Reclamation, and  
12 BPA) to issue annual implementation plans and 5-year prospective implementation plans,  
13 as well as regular annual progress reporting on the success of the Action Agencies'  
14 implementation actions. On November 6, 2002, BPA, Corps, and Reclamation released  
15 the Final FY 2003-2007 Implementation Plan for the FCRPS. The Implementation Plan  
16 identifies and describes the specific measures the three agencies plan to implement in  
17 FY 2003-2007 and addresses the actions called for in the NOAA Fisheries and FWS 2000  
18 Biological Opinions for the FCRPS. The Implementation Plan and the Pacific Northwest  
19 Power and Conservation Planning Council's (Council) Fish and Wildlife program form  
20 the basis for fish-related hydro operations assumptions and spending level assumptions in  
21 BPA's initial SN CRAC proposal.

22 *Q. Are any discussions occurring to evaluate changes to hydro operations?*

23 *A. Yes. BPA is currently engaged in regional discussions regarding fish-related changes to*  
24 *hydro operations that were identified in the 2003-2007 Implementation Plan, and are*  
25 *being evaluated in the NOAA Fisheries Regional Forum. The proposed changes are*  
26 *included in the analysis used to prepare BPA's initial proposal. In addition, the Council*

1 is evaluating these and other proposed changes to FCRPS operations in its mainstem  
2 rulemaking proceedings. Upon receipt of the Council's final recommendations, the  
3 Action Agencies, in coordination with NOAA Fisheries and the FWS, may decide to  
4 implement changes to measures as outlined in the Action Agencies' Implementation Plan.  
5 To the extent other decisions are made in these proceedings by the time BPA's Final  
6 Record of Decision (ROD) is prepared, those decisions will be included in the Final  
7 ROD. *See Hirsch, et al., SN-03-E-BPA-05.*

8 Also, BPA's fish and wildlife program spending levels are developed to  
9 implement not only the Action Agencies' Implementation Plan, but also a set of  
10 operational, habitat, harvest, and hatchery measures to protect, mitigate, and enhance  
11 non-ESA listed species affected by the FCRPS. When BPA initiated its Financial  
12 Choices process, fish and wildlife spending levels were presented and comments were  
13 taken. Those spending levels, including expenses and capital, are reflected in BPA's  
14 initial SN CRAC proposal, but are currently under review by the Council. If BPA  
15 changes those levels, based on recommendations by the Council, by the time BPA's Final  
16 ROD is prepared, those changes will be reflected in the Final ROD.

## 17 **Section 5. Overview of the SN CRAC Proposal**

18 *Q. Please describe the features of BPA's proposed SN CRAC design.*

19 A. BPA is proposing a 3-year variable SN CRAC adjustment to power rates, which has a cap  
20 limiting the amount of revenues that can be collected each year. Under BPA's proposal,  
21 in August of each year the level of the SN CRAC for the next fiscal year will be  
22 determined based on the then-current forecast of PBL's accumulated net revenues  
23 (ANR), as defined for the FB CRAC in BPA's 2002 GRSPs, for the end of the  
24 then-current fiscal year. The annual average expected value for the SN CRAC is about  
25 30 percent above BPA's May 2000 base rates or approximately 16 percent, on average,  
26 above FY 2003 rates. The May 2000 base rates are the FY 2002-2006 power rates

1 without any CRACs. The SN CRAC adjustment in a particular year could be as low as  
2 zero, or as high as 41 percent, depending on PBL's financial condition as reflected in  
3 BPA's forecasted ANR.

4 *Q. Can you give examples of what could reduce the SN CRAC?*

5 A. Yes. There are several things that could help BPA's financial situation and lower the  
6 SN CRAC. These primarily include better than expected secondary revenues (either due  
7 to improved hydro conditions or higher market prices) and additional realized cost  
8 reductions (from BPA, ENW, Corps, Reclamation, and other programs).

9 *Q. What directions or criteria support the design of the SN CRAC?*

10 A. First, section 7(a)(1) of the Northwest Power Act states, in part, that BPA shall establish  
11 rates that recover, in accordance with sound business principles, the costs associated with  
12 the acquisition, conservation, and transmission of electric power, and other expenses  
13 incurred by the Administrator. Therefore, direction was given to staff to ensure that the  
14 proposed SN CRAC, as applied to BPA's rates, is sufficient to cover BPA's costs.  
15 Second, BPA is concerned about the impact of any rate increase on the economy of the  
16 Pacific Northwest, so direction was given to staff that the rate design should mitigate the  
17 level of any rate increase, to the extent possible. Third, the FB and SN CRACs apply to  
18 different customers and involve different contractual provisions. In order to simplify  
19 billing and accounting, direction was given to staff to leave the FB CRAC unchanged,  
20 and create a separate SN CRAC. Each of these criteria is discussed in further detail  
21 below.

22 *Q. What standards did BPA use to demonstrate it is meeting its cost recovery obligations?*

23 A. Staff was instructed to meet three standards. First, any proposed SN CRAC should solve  
24 PBL's forecasted rate-period accumulated net revenue problem of \$920 million. That is,  
25 the design of the SN CRAC should produce PBL net revenues that are at least zero



1 over the rate period. As with the FB CRAC, PBL net revenues are adjusted for ENW  
2 debt service and removal of FAS 133 adjustments.

3 Second, in order to meet BPA's twin goals of moving toward a financially  
4 healthier BPA while limiting the rate effect on the regional economy, in this proposal  
5 BPA is reducing its TPP standard to a 50 percent probability that BPA can make all of its  
6 Treasury payments in the FY 2004-2006 3-year rate period. This is relaxed from  
7 87.5 percent, which is the 3-year probability that corresponds to 80 percent for a 5-year  
8 rate period, and is different from that used in prior rate cases. BPA is concerned that a  
9 rate increase of the magnitude necessary to achieve the 80-88 percent 5-year TPP  
10 standard used to develop BPA's proposed 2002 power rates is not sustainable in the  
11 current economy. However, BPA is not abandoning its long-term goal of 88 percent TPP  
12 and is only proposing this lower standard for this SN CRAC rate case.

13 Third, to demonstrate that BPA has a sufficiently high probability of repaying the  
14 Treasury, BPA is introducing a new Treasury repayment standard. The new  
15 measurement, Treasury Recovery Probability (TRP), is the probability that BPA will be  
16 able to make all of its FY 2006 payments to the U.S. Treasury, including repayment of  
17 any amounts it might miss in fiscal years 2003-2005. The new standard is that the TRP  
18 be at least 80 percent. This additional standard is needed to demonstrate that over the rest  
19 of the rate period BPA is still, on a probabilistic basis, setting rates high enough to  
20 achieve 80 percent probability of making its Treasury payments. This is important to  
21 restore BPA's financial health and to meet the minimum standard in BPA's Supplemental  
22 Proposal that BPA have between an 80 and 88 percent probability of making all  
23 payments in this rate period to Treasury in full, if not on time. For further discussion of  
24 how the TRP is calculated, *see* the SN-03 Study, SN-03-E-BPA-01, Chapter 7.

25 Fish and Wildlife Funding Principle number 3 provides that "Bonneville will  
26 demonstrate a high probability of Treasury payment in full and on time over the 5-year

1 rate period.” See Revenue Requirements Study Documentation, Volume 1,  
2 WP-02-FS-BPA-02A, Chapter 13. BPA believes that the combination of TPP, TRP and  
3 accumulated net revenue targets will put BPA on a path to meet the intent of the Fish and  
4 Wildlife Funding Principles, given the state of the economy. In addition, BPA reserves  
5 the ability to adjust rate levels under the SN CRAC again if revenues from the first  
6 adjustment under the SN CRAC prove inadequate. See GRSPs, SN-03-E-BPA-03.

7 Together, these three standards provide a high level of assurance that BPA’s  
8 obligations to the U.S. Treasury will be satisfied by the end of FY 2006, consistent with  
9 the original intent of the SN CRAC to restore a high probability that Treasury payments  
10 during the remainder of the rate period will be made on time, if and to the extent market  
11 and other risk factors allow.

12 *Q. Did BPA take any other actions to mitigate the rate impact on customers?*

13 *A.* Yes. In the SN CRAC proposal, BPA is using agency reserves to calculate the TPP and  
14 TRP, temporarily departing from BPA’s standard of a PBL-only TPP. Using agency  
15 reserves allows BPA to set the SN CRAC to minimize the effect on ratepayers overall  
16 while ensuring an adequate probability of making all payments, including Treasury  
17 payments, for the entire agency. Therefore, direction was given to staff to make this  
18 modification. Chapter 7 in the SN-03 Study, SN-03-E-BPA-01, describes how the net  
19 revenues generated by the two business lines are converted into agency net revenues and  
20 agency reserves. See also McCoy, *et al.*, SN-03-E-BPA-10. This change is also only  
21 proposed for this SN CRAC process and should not be construed as a permanent change  
22 in policy.

23 *Q. Why is the SN CRAC adjustment proposed to be a 3-year adjustment?*

24 *A.* There are two reasons. First, PBL is expecting persistent negative net revenues over the  
25 remaining 3 years of the rate period. If PBL only needed to collect additional revenues to  
26 cover the actual losses from FY 2002 and expected losses in FY 2003, or the projected

1 shortfall over FY 2004-06, a 1-year SN CRAC adjustment may have been sufficient.  
2 However, trying to solve the rate period net revenue problem in only 1 year would have  
3 required a large SN CRAC and would not have met the criterion to mitigate rate impacts.  
4 Second, the SN CRAC, as proposed in BPA's June 2001 Supplemental Proposal and as  
5 adopted in BPA's 2002 GRSPs, is intended to restore a high probability that Treasury  
6 payments during the remainder of the rate period will be made on time, if and to the  
7 extent market and other risk factors allow. The 3-year rate design goes hand-in-hand  
8 with the new TRP standard. By adopting the TRP standard and establishing a 3-year rate  
9 period, BPA can set a lower rate because it allows for better years later in the rate period  
10 to make up any shortfalls that preceded them.

11 *Q. Why is the SN CRAC adjustment proposed to be a variable adjustment?*

12 A. The SN CRAC is proposed to be a variable adjustment because this rate design feature,  
13 like the 3-year feature, allows for a lower rate while still ensuring a sufficiently high  
14 probability of payment to Treasury. Alternatively, a fixed SN CRAC would be levied  
15 under all future circumstances, including those in which BPA's financial condition had  
16 improved; for example, if BPA had a very good hydro and surplus marketing year where  
17 secondary revenues exceeded expectations. In contrast, a variable SN CRAC adjusts to  
18 changes in circumstance, and can adjust down to zero if BPA's financial condition  
19 improves sufficiently. In addition, BPA remains committed to meeting all of its fish and  
20 wildlife obligations. The variable rate helps BPA accommodate the continued  
21 uncertainty with respect to fish and wildlife costs. Yet another reason is that the variable  
22 SN CRAC is able to provide additional financial support in especially adverse financial  
23 conditions. This means that even if a fixed SN CRAC provided the same TPP as BPA's  
24 variable SN CRAC, the magnitude of the adverse financial conditions would be reduced  
25 by the increase in the SN CRAC, up to the capped amount.

1 *Q. Why does the SN CRAC not simply replace the FB CRAC?*

2 A. The GRSPs permit BPA to change the parameters of the FB CRAC. One of those  
3 parameters is whether to redefine the existing FB CRAC or to develop an SN CRAC with  
4 its own set of parameters to supplement the existing FB CRAC. BPA chose the latter  
5 approach. Developing a separate SN CRAC accomplished a number of things. First, it  
6 simplifies billing and accounting. Second, certain contracts BPA has with some of its  
7 customers cause a reduction to the LB CRAC if the amount of the SN CRAC is greater  
8 than the maximum FB CRAC. *See Wedlund, et al., SN-03-E-BPA-09.* In these instances  
9 the accounting and billing are also simplified if the FB and SN CRACs are separate.  
10 Third, there is a true-up of the FB CRAC. Keeping the CRACs separate facilitates the  
11 true-up process. Finally, BPA's flexible proposal allows for one or both of the CRACs  
12 (FB or SN) to adjust, which prevents BPA from over-collecting revenues.

13 *Q. Why does the SN CRAC not have a true-up like the LB and FB CRACs?*

14 A. The primary reason the SN CRAC is designed without a mid-year true-up is that the  
15 SN CRAC will automatically adjust the next year. Therefore, it has an automatic true-up  
16 in its design.

17 *Q. Is BPA considering any other rate design options?*

18 A. Yes. Given the customer concern about BPA's internal operating expenses charged to  
19 power rates, and the particular concern that a variable multi-year SN CRAC rate design  
20 would reduce the pressure on BPA to control costs, BPA is open to a way that BPA could  
21 be precluded from recovering excess BPA internal operating costs in the SN CRAC rate  
22 design, if those costs exceed the further-reduced limits for FY 2003-2006. *See McCoy,*  
23 *et al., SN-03-E-BPA-10.* BPA may need to consider the possibility of internal operating  
24 expense increases under extremely limited and defined circumstances (*e.g., costs related*  
25 *to force majeure, acts of war, etc.*).

26

1 Q. *Does this conclude your testimony?*

2 A. Yes.

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