Updating BPA's Financial Plan

Technical Workshop #2
Cost Recovery Policy

March 12, 2008

Process Objectives

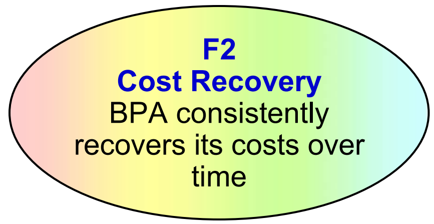
- Discuss the context of cost recovery issues
- Review the statutory and policy context
- Discuss standards for evaluating change

Agenda

- What is the Issue?
- Cost Recovery History
- Considerations
- Next Steps

Cost Recovery Link to BPA's Strategic Objectives

- Cost recovery is a central component of BPA's strategy map.



What is the issue?

- Slice customers have raised questions about the long-term rate effects of the Debt Optimization Program (DOP).
- They expressed concern that the increased non-Federal debt service from Energy Northwest debt extensions into the FY 2013-2018 period would not have a corresponding Federal reduction in revenue requirements during that period. Therefore, they believe that they would be charged twice for the EN debt.
- There are related issues surfacing in the Tiered Rates Methodology (interest income for the Slice revenue requirement).
- These issues have led to questions about what cost recovery means to BPA.
- Before discussing these specific concerns, it is important to review the statutory and historical context of cost recovery for BPA.

Cost Recovery History – The Requirement

- The Bonneville Project Act of 1937 (as amended)

  "Rate schedules shall be drawn having regard to the recovery . . . of the cost of producing and transmitting such electric energy, including the amortization of the capital investment over a reasonable period of years."

- The Flood Control Act of 1944 (as amended)

  ". . . the Secretary of Energy who shall transmit and dispose of such power and energy in such manner as to encourage the most widespread use thereof at the lowest possible rates to consumers consistent with sound business principles [emphasis added]. . . . Rates schedules shall be drawn having regard to the recovery . . . of the cost of producing and transmitting such electric energy, including the amortization of the capital investment allocated to power over a reasonable period of years."

- Federal Columbia River Transmission System Act of 1974

  "[R]ate schedules… shall be fixed and established (1) with a view to encouraging the widest possible diversified use of electric power at the lowest possible rates to consumers consistent with sound business principles, and (2) having regard to the recovery . . . of the cost of producing and transmitting such electric power, including the amortization of the capital investment allocated to power over a reasonable period of years. . . ."

- Pacific Northwest Electric Power Planning and Conservation Act of 1980

  "[BPA's] rates shall be established and, as appropriate, revised to recover, in accordance with sound business principles, the costs associated with the acquisition, conservation, and transmission of electric power, including the amortization of the Federal investment in the Federal Columbia River Power System (including irrigation costs required to be repaid out of power revenues) over a reasonable period of years. . . . "

Cost Recovery History – The Costs

- In 1946 BPA released its first Report on Repayment of Operating Expenses and Construction Costs.
- This is one of the earliest documents that reveals how BPA interpreted its cost recovery requirements, which have always been somewhat unusual for a Federal agency:

"The essential elements of "cost" in the Federal Power Commission system and in the generally accepted commercial cost accounting sense are:

- Operation and maintenance expenses . . .
- Interest on the investment
- Depreciation"

"[The Bonneville Project Act] requires more than merely keeping the initial investment unimpaired. It requires that the investment actually be paid off… over a reasonable period of years, and appears to require repayment with interest. . . . For purposes of depreciation, a good deal of the investment in the Bonneville Dam Project has an estimated useful life of 100 years, but the legal requirement for payout 'over a reasonable period of years' has been fixed as 50 years. . . . Amortization is the greater annual requirement. At the end of 50 years, the project will be debt free and will still be in sound operating condition."

"(footnote: The cost of items that must be replaced during the repayment period is treated as an additional capital investment to be amortized within the amortization period [emphasis in original] despite the fact such replacement may be made in the later years of the repayment period, and may have useful life extending beyond the end of the period.). . . ."

Cost Recovery History – The Costs

- In the second supplement to the repayment report (1947), an appendix described the differences between costs and cash:

  "The payout schedule for the Administration conforms to the financial statements and therefore in like fashion shows the gross repayment of the Federal investment. While certain details as to expenses and interest are presented, the schedule does not show the amount of amortization, which as explained, can only be approached on the basis of arbitrary assumptions or plans. The reason for this situation is to be found in the fundamental difference between an indebtedness repayable in cash on the one hand and cost accounts on the other."

- The reference to the amount of amortization only being "approached on the basis of arbitrary assumptions or plans" is to the use of annual net revenues being applied as additional amortization. As water conditions vary from year to year, net revenues would likewise vary. Therefore, the full repayment capability is uncertain from year to year.

  "In addition, revenues were applied to advance amortization of plant investment (i.e., additional amortization in excess of that provided by depreciation expense reservations) and to irrigation subsidy in the form of payment of operating expenses allocated to irrigation."

Cost Recovery History – The Costs

- Third Powerplant, Grand Coulee Dam Authorization - 1966

“The Secretary of the Interior shall prepare, maintain, and present annually to the President and the Congress a consolidated financial statement for all projects heretofore or hereafter authorized, including the third powerplant at Grand Coulee Dam, from or by means of which commercial power and energy is marketed through the facilities of the Federal Columbia River power system and for all other projects associated therewith to the extent that the costs of these projects are required by law to be charged to and returned from net revenues derived from the power and energy, or any power and energy, so marketed, and he shall, if said consolidated statement indicates that the reimbursable construction costs of the projects, or any of the projects, covered thereby which are chargeable to and returnable from the commercial power and energy so marketed are likely not to be returned within the period prescribed by law, take prompt action to adjust the rates charged for such power and energy to the extent necessary to assure such return.”

•This was the advent of the repayment methodology embodied in the repayment study:

“We no longer follow the severe schedule for paying out each project, individually, over a 50-year period. We have adopted a less severe schedule know as “Consolidated System 50-Year Rate of Payout Plan”. It will still pay out each project within 50 years after completion, but on a system basis by which the continuing revenues from each older project after it is paid out will be used to help repay the remaining balance on newer projects.”

•A key element of the “Consolidated System 50-Year Rate of Payout Plan” was that it tended to create what were known as ‘surplus revenues’ after the power investment costs and irrigation assistance had been repaid.

•The legislative history of the1966 Act states: “These surplus revenues, when the time comes, may be used to assist the repayment of the new irrigation or power projects.”

Current BPA Cost Recovery Standard

- BPA shifted to GAAP accounting in 1985. In the subsequent rate case, WP-87, BPA established that, in conformance with GAAP:
  - Revenue requirements (for both generation and transmission) would be based on total accrued expenses (O&M, purchased power/transmission services, depreciation and net interest).
  - To the extent that cash from operations (largely depreciation) is less than cash requirements (largely Federal amortization), Minimum Required Net Revenues (MRNR) is added to the revenue requirement to ensure that forecasted cash flows remain at least neutral.
  - Note that MRNR is never allowed to be negative.
- If MRNR is not required, it means that cash flows are expected to at least be neutral.
  - Typically, it has meant that cash flows are adding to reserves.
  - Generation revenue requirements have had positive cash flows in most years in the last 18 years, which have provided funds for risk mitigation.

Influence of Debt Management on Revenue Requirements

- In repayment studies, BPA's Federal debt amortization levels are influenced by the agency's debt management actions. High non-Federal debt service payments in a year typically result in low Federal amortization in that year.
- Energy Northwest (EN) debt was refinanced for savings in the 1980s and early 1990's. The shaping of the annual debt service streams created the cash flow situation in generation revenue requirements described above.
- DOP has created a similar situation by moving a substantial amount of EN debt service into the 2013-2018 period. As a result, Federal amortization scheduled in this period will be considerably reduced.
- Since Federal amortization will be at low levels, one can expect that cash from operations in revenue requirements could significantly exceed cash requirements for most of the 2012-2024 period, all other things being equal. The total difference of cash flows and cash requirements for this period is currently estimated to exceed $700 million over the 13 years in total.

Why is This an Issue?

- DOP has distinct accrual and cash effects on revenue requirements and financial statements.
  - EN debt service is an expense that appears on the income statement, but Federal principal payments are not an income statement element.
  - One reason the concept of Modified Net Revenues was created was to better link net revenues and cash flows for the effect on CRACs.
- The Slice true-up was affected by DOP actions that highlights the role of MRNR in rate setting.
- Since MRNR is never less than zero, some Slice customers see the expected cash accumulation in FY 2012-2024 as setting rates to essentially pay twice for the same debt. When EN debt service is high because of the DOP debt extensions, there is not a corresponding reduction in revenue requirements reflecting low Federal amortization.

Does Debt Optimization Similarly Affect Transmission?

- Transmission revenue requirements will not be affected by DOP in the same way as generation revenue requirements.
- Debt Service Reassignment (DSR) is treated differently in transmission revenue requirements. Because the transaction becomes a “debt swap” for Transmission, the interest component appears on the income statement while the principal component appears on the statement of cash flows. The DSR principal combined with Federal amortization will be larger than the cash from operations. This is the inverse of the generation revenue requirement situation and will result in positive MRNR.

What are Some of the Implications?

- Generation Revenue Requirement.
  - What to do about potential cash flows beyond risk mitigation needs?
- Slice Revenue Requirement.
  - What is the fundamental cost recovery requirement?
  - How should interest income be included in revenue requirements?
  - Should revenue financing, if it occurs, be a cash requirement?
  - How are cost shifts avoided by the above situations?
- Transmission Revenue Requirement.
  - What to do about potential cash flows beyond risk mitigation needs?

Considerations

- When examining ways of addressing these concerns, we must consider some basic principles.
  - Is it within the statutory authority of the Administrator?
  - Does it meet statutory requirements for cost recovery, including the amortization of capital investments?
  - Is it consistent with rate making principles, such as no cost shifts among customer classes?
  - Is it consistent with BPA strategic plan and business objectives?
  - Is it congruent with the other Financial Plan subject areas?
  - Are there any accounting implications?
- Are there other considerations for BPA?

How Should We Proceed?

- BPA does not expect to propose a specific change to its cost recovery policy in the 2008 update of the Financial Plan.
  - We do not expect to see the generation cash accumulation issue until after FY 2012.
  - There are significant issues that must be examined before deciding on a change and BPA faces significant time and staff constraints in the near term.
- In evaluating this issue, how should stakeholders be involved?
  - BPA could do the analysis internally and present it in the traditional large, public workshops.
  - BPA could ask for volunteers for a small stakeholder working group.
  - Are there other approaches that would be preferred?

Financial Plan Next Steps

- To provide feedback on the cost recovery policy topic for the development of the Financial Plan, please contact Alex Lennox.
  - Phone: 503-230-3460
  - Email: alennox@bpa.gov
- Based on information presented here, BPA will draft a chapter in the Financial Plan. Stakeholders will have an opportunity to comment on the draft document. We anticipate sending a draft out in May 2008 and publishing the final at the end of July 2008.