Updating BPA's Financial Plan

Technical Workshop #2
Financial Risk Metrics

March 12, 2008

Financial Disclosure

- This financial information is provided for use in Financial Plan workshop discussions and is supplied for discussion or exploratory purposes only. The data included may be hypothetical in nature, does not represent in any manner the official position of BPA, and will not necessarily agree with externally released Agency Financial Information. Such information should be used only for the purpose for which it was provided and should not be re-communicated by the recipient without the foregoing qualification.

Financial Plan Risk Metric Presentation Objectives

Today’s objectives are to:

- Discuss the primary rate setting risk metric – Treasury Payment Probability (TPP), including the background and future expectations
- Introduce and discuss a new concept of Vendor Payment Probability (VPP)

Financial Risk Metrics Link to BPA's Strategic Objectives

- Financial Risk Metrics are linked to two objectives

F3
Cash Flow
BPA maintains adequate cash flow for liquidity

I6
Risk Management
Risks are managed within acceptable bounds

Financial Plan Risk Metrics Agenda

- Origin of the Risk Metrics Issue
- History of risk mitigation measures and origin of TPP standard
- Application of TPP standard in past rate cases and to individual business units
- Application of the TPP standard in future rate cases
- The Vendor Payment Probability concept and its impact on liquidity needs
- How the VPP metric might be modeled and current status of BPA’s deliberations concerning VPP
- Possible impacts of the VPP standard on rate making
- Next Steps
- Summary

Why We Are Addressing Risk Metrics

- BPA's Regional Dialogue Policy (July 2007) committed BPA to updating its 10-Year Financial Plan on several topics including "the appropriate Treasury Payment Probability standard for rate-setting."
- From time to time BPA's TPP standard has been challenged. BPA wants to review this standard and affirm its continued application in future rate cases
- BPA's cash flow profile has changed since the 10-Year Financial Plan was issued in 1993.
  - BPA is now paying EN's operating expenses directly rather than through net billing
  - BPA is now direct funding COE, Bureau, and US F&W Service
  - Timing of cash receipts has changed due to changes in BPA's product offerings (Slice, etc.)
- Therefore, BPA is exploring a new concept called Vendor Payment Probability (VPP) to assess intra-year liquidity needs that TPP does not measure.

Origin of Risk Metrics in the 10-Year Financial Plan

- BPA has made its Treasury payment for 24 years in a row. However, at the time of the 10-year Financial Plan, BPA was not far removed from a series of years of little or no principal payments, as well as some years in which interest payments were also partially deferred.
- The risk metrics portion of BPA's 10-Year Financial Plan was developed in response to perceived threats regarding BPA's access to capital and Treasury repayment. As stated in an attachment to the 1991 Rate Proposal's Revenue Requirement Study:
  - "In the next several years, in the presence of continuing Federal budget constraints, BPA believes it will be judged by stricter standards. BPA believes that the perceptions of Congress and the Executive Branch regarding BPA's financial practices and the volatile nature of the Federal fiscal situation are likely to constrain future access to 100 percent Federal debt financing."
- In addition, during this time BPA faced potential changes to the repayment methodology from the Executive Branch that would have imposed higher annual payments.

Origin of TPP Standard

- In 1990, BPA proposed a long-term policy that would impact its rates for FYs 1992-1993 that included the financial objective of assuring “at least a 95 percent probability of making payments to the Treasury in full and on time.”
- In its 1993 10 -Year Financial Plan, BPA reinforced the 95 percent, two-year TPP as a rate-making standard:
    - BPA shall establish rates to maintain a level of financial reserves sufficient to achieve a 95 percent probability of making its U.S. Treasury payments in full and on time for each 2-year rate period.
    - This decision was widely discussed during the formulation of the plan and it was generally accepted that achieving a 95 percent probability of making all Treasury payments was acceptable to regional stakeholders.

Have We Considered Raising or Lowering the Standard?

- In general, yes, we have considered changing the standard, and have deviated from it from time to time. We may do so again.
- Over the 14 years we have set different TPP levels depending on the circumstances at the time not the least of which is the impact on rate payers.
- Increasing the standard doesn't seem warranted since we have been able to make the Treasury payment every year for the past twenty-four years under this standard.
- Lowering the standard would generate significant concerns in the Administration and Congress, where BPA's ability to meet its Federal obligations is an important issue.
- Lowering the standard may also raise questions about cost recovery.
- We want to test our tentative conclusion that this standard continues to strike the right balance between rates and cost recovery assurance.

TPP Standard for Different Length Rate Periods

- Since 1995 BPA has had rate periods of different lengths, so it has translated the two-year TPP standard into equivalent standards for such rate periods:
  - 88.0% for five-year rate periods
  - 92.6% for three-year rate periods
  - 97.5% for one-year rate periods
- However, the standard did not define a particular TPP for individual years within a rate period.

TPP Standard Applied to Separate BPA Business Units

- When BPA separated its commercial business into the Power Business Line and Transmission Business Line, it determined that the TPP standard should apply to each business line independently.
  - The thinking was that if the two business lines meet the standard independently, then the Agency as a whole would meet the standard
  - This assumption has been the basis for rate making since the FY2002 Power rate case
- This assumption ensures that Power and Transmission rates can be set independently, without cross-subsidization, while supporting the Agency TPP standard.

Application of the TPP Standard in Future Rate Cases

- BPA expects to affirm these long standing rate case TPP assumptions in the revised Financial Plan:
  - Use an equivalent 95 percent 2-year probability standard of making all Treasury payments for rate periods other than 2 years;
  - Conduct separate TPP calculations for Power and Transmission rates

Liquidity Level

- A critical component of the Treasury Payment Probability calculation is the cash reserves level considered as a missed Treasury payment
- In the 2002 - 2006 Power rate case, BPA assumed its within-year liquidity needs were $120M ($100M for Power and $20M for Transmission), of which BPA could rely on the Treasury Note for $50M
- In the 2007 Power rate case, BPA's liquidity need was increased from $50 million (not including the Treasury note) to $175 million based on an assumption about the impacts of directly paying Energy Northwest's costs. However, institution of the Flexible PF program allowed the missed Treasury payment threshold to revert back to $50 million for calculation of Treasury misses
- BPA proposes to conduct more rigorous analysis of the need for within year liquidity to calculate the threshold for a missed Treasury payment, since the TPP standard looks only at annual cash flows.
- The Vendor Payment methodology, when developed, will provide that more rigorous analysis

Introduction of the VPP concept

- What is Vendor Payment Probability (VPP)?
  - The VPP standard will reflect BPA's tolerance for the risk that it may not have sufficient cash on hand in any given month of a rate period to make all its vendor payments
  - The VPP metric will measure the likelihood that BPA can indeed meet all of its vendor payments during a rate period
- What will it do?
  - Development of a VPP standard for use in a rate making setting would inform BPA's need for liquidity reserves (formerly "working capital")

Why Consider a VPP Standard and Metric?

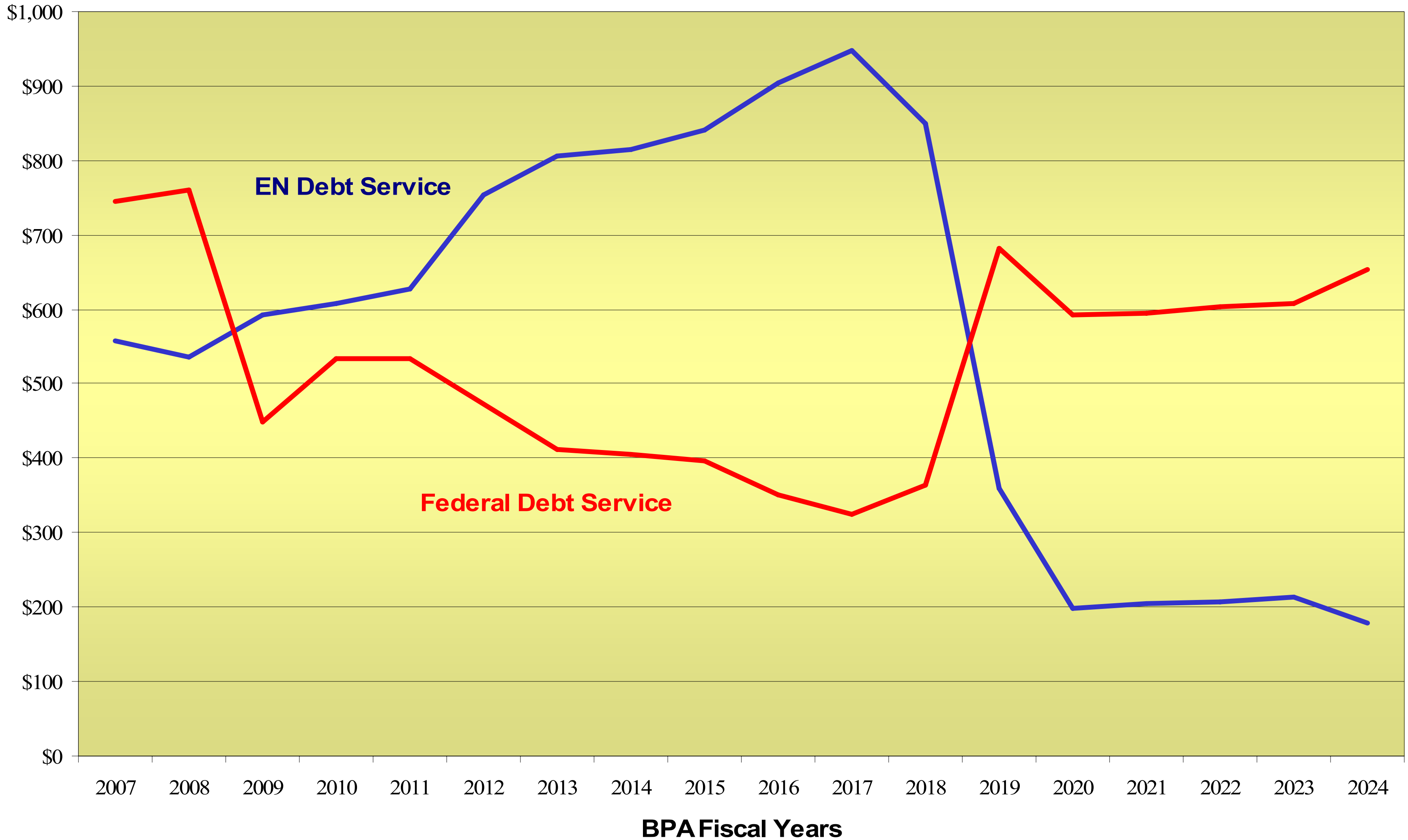
- Since 1993 BPA's fiscal year cash flow profile has changed significantly:
  - Since instituting direct payment of EN's operating and debt service requirements, and because of the impacts of Debt Optimization on end-of-year Treasury payments, intra-year cash outlays could surpass the traditional annual requirements
    - EN debt service will increase sharply between now and 2018
    - While annual Treasury payments will decrease over the same time frame
  - See the following chart which illustrates this phenomenon

Note: these data are from the Access to Capital Base Case + Debt Opt scenario as presented in the March 4 Financial Plan workshop # 1.

Annual EN and Federal Debt Service Payments

For FY 2008 through FY 2024

($ millions)



See Financial Disclosure on Page 2

Implications for Intra-Year Liquidity Need

- Changes in patterns of year-end and within-year cash obligations motivate us to examine whether BPA's traditional planning for liquidity is adequate
  - Since 1993, BPA has implicitly assumed that the year-end Treasury payment is an adequate buffer to protect BPA's ability to pay creditors throughout the year
  - The large expected future EN debt service payments, which occur mostly in the May to June time frame could have a significant impact on this assumption

Modeling Intra-Year Cash Flows and VPP

- BPA has begun to develop tools for modeling monthly cash flows.
- Methodology will be roughly comparable to TPP modeling, but
  - There will be monthly instead of annual time steps; and
  - The probability of making all vendor payments every month instead of making a Treasury payment at the end of the fiscal year is computed (hence “Vendor Payment Probability”)
- The ultimate standard would reflect BPA’s tolerance for the risk of being unable to pay a vendor on time due to insufficient cash

Status of VPP Modeling and Analysis

- There is much work yet to do before BPA is confident in its VPP modeling
- As the effort to model VPP progresses BPA will hold meetings or workshops to involve interested stakeholders
- Within-year liquidity concerns are separate from the year-end liquidity issues addressed in TPP, but will be integrated with TPP issues
- However, preliminary analysis indicates that the TPP standard will provide adequate risk coverage until the EN Debt Service payments become large with respect to Treasury payments

VPP, Liquidity & Rate Making

- If BPA determines that within-year liquidity is important for ensuring the financial security of BPA and its regional benefits, BPA may develop something like a VPP standard
- A VPP standard could be adopted via an update to the Revised Financial Plan we are now developing
- Tools for ensuring adequate liquidity (including rate setting) would be addressed
- A VPP standard might be added to the two cost recovery standards (cash flow and net revenue) and the TPP standard now used in rate setting

Next Steps

- BPA will continue internal work on the VPP standard and related liquidity issues, and will design public involvement processes to match future developments and needs
- Due to the press of current work requirements (e.g. the Power Services FY 07 Supplemental Rate Case and Regional Dialogue processes), we do not anticipate making significant progress on these issues until some time after August 2008
- However, the draft revised Financial Plan will include a qualitative discussion of the VPP standard and how it might be modeled, which will provide interested stakeholders an opportunity to comment

Summary

- BPA expects to maintain the current 2-year equivalent 95 percent TPP standard for each business unit the foreseeable future
- Changes in BPA's intra-year cash flow profile have necessitated a look at within-year liquidity needs
- Therefore BPA has begun considering modeling the probability that it will make all payments to creditors for each month of a rate period
- As BPA develops these concepts further, there will be a public process to discuss the VPP standard and BPA's liquidity needs during which BPA will consult with interested stakeholders before adopting or changing any risk metrics

Financial Plan Next Steps

- To provide feedback on the risk metrics topic for the development of the Financial Plan, please contact Alex Lennox.
  - Phone: 503-230-3460
  - Email: alennox@bpa.gov
- Additionally, 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.