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2003 Safety-Net Cost Recovery Adjustment Clause

Rebuttal Testimony

SN-03-E-BPA-11 OVERVIEW AND MANAGEMENT DIRECTION

May 2003

BONNEVILLE
POWER ADMINISTRATION

INDEX

REBUTTAL TESTIMONY OF

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

Witnesses for Bonneville Power Administration

SUBJECT: Overview and Management Direction

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SUBJECT: OVERVIEW AND MANAGEMENT DIRECTION

Section 1. Introduction and Purpose of Testimony

Q. Please state your names and qualifications.

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

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

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

Q. What is the purpose of your testimony?

A. The purpose of our testimony is to respond to the direct testimony of the Public Power Council (PPC), Pacific Northwest Generating Cooperative, and Idaho Energy Authority; the Northwest Requirements Utilities (NRU); the Coalition Customers; the Washington Public Agencies Group (WPAG); the Columbia River Inter-Tribal Fish Commission and Yakama Nation (CRITFC); the Save Our Wild Salmon Coalition and Northwest Energy Coalition (NWEC); the Springfield Utility Board (SUB); the Generating Public Utilities (GPU); and the Joint Customers regarding management direction and overview issues.

Q. How is your testimony organized?

A. This testimony is organized in 15 sections, including this introduction. Section 2 addresses causes of BPA's financial condition. Section 3 discusses current economic conditions. Section 4 addresses BPA's financial policies. Section 5 addresses the purposes of the SN CRAC. Section 6 addresses triggering the SN CRAC process. Section 7 addresses retriggering the SN CRAC. Section 8 addresses the term of the SN CRAC. Section 9 addresses proposed cost reductions. Section 10 addresses debt extension proceeds and other financial tools. Section 11 addresses alternative rate designs. Section 12 addresses IOU settlement benefits. Section 13 addresses conservation and renewables. Section 14 addresses rate case settlement discussions. Finally, Section 15 addresses the Section (7)(b)(2) rate test.

Section 2. Causes of BPA's Financial Condition

Q. The Coalition Customers argue that BPA failed to take steps to achieve the Cost Review recommendations, noting that BPA has now obtained "assurances" from Energy Northwest (ENW), the Corps of Engineers (Corps) and the Bureau of Reclamation (Reclamation) to control their costs to current budget levels, but BPA did not do so in adopting BPA's May 2000 base rates. Faddis, et al., SN-03-E-CC-01, at 19. Please respond.

A. BPA disagrees with the assertion that BPA failed to take steps to achieve the Cost Review recommendations. BPA adopted the overall cost reduction target recommended by the Cost Review. However, it should be noted that BPA and the Cost Review itself acknowledged that there were challenges to achieving all the cost reductions. Nevertheless, considerable effort and planning took place from 1997 through 2000 within BPA to achieve the overall cost reductions defined in the Cost Review, though with a somewhat different mix of actions than specified in the Cost Review. Additionally, BPA targeted cost increases that were associated with offsetting revenue increases as consistent with the cost reduction goal, even though gross costs were higher. A non-exhaustive list of examples of BPA's efforts and planning follows.

First, BPA established a staffing plan in 1999, which anticipated the fundamental relationship between BPA and its long-term power customers would change substantially. It assumed that many traditional customer support services no longer would be provided and Power Marketing would focus on maximizing the value from the seasonal and monthly changes in the hydro system. This staffing plan assumed customers would not exercise their statutory rights to obligate BPA to provide new resources and expanded services, and assumed power rates would be established and remain in place for many years at a time. Further, the staffing plan was predicated on greatly simplified billing, scheduling and inventory systems, and an assumption that complex and highly tailored products and support services would not be offered.

Second, BPA developed plans to work with retail utilities and states to secure funding for conservation market transformation through state public purpose funds, as recommended by the Cost Review.

Third, BPA transformed its approach to conservation, moving to a market-oriented approach that involved drastic reductions in staffing and funding.

Fourth, BPA established plans to fund renewable resource projects up to a maximum of $15 million in any one year above the revenues obtainable from those renewable resource projects, and has managed renewables costs within this limit ever since.

Fifth, BPA developed a major program to automate many aspects of its system planning, scheduling, and billing to reduce staff requirements and increase revenues. Collectively, these efforts are called the Efficiencies Project.

Sixth, a joint committee was established, and continues today, which is composed of the Corps, Reclamation, and BPA to facilitate the development and implementation of a consolidated, integrated capital/asset management strategy directed at maximizing value, including both financial returns and public benefits of the Federal Columbia River Power System (FCRPS). This is referred elsewhere in this testimony as the Asset Management Strategy. Performance measures have been explicitly developed and are reported publicly. Accountabilities have been established and incentives have been created to ensure the asset management success of the FCRPS. O&M aspects of the FCRPS assets have been benchmarked against industry practices.

Finally, BPA performed a shared services review and adopted a corporate and shared service organizational structure, which redesigned financial, information, procurement, human resource management, and other processes. BPA also performed benchmarking techniques and implemented private sector-based "best practices" in the "shared services" area. Additionally, BPA secured and implemented "enterprise software."

Regarding the "assurances" BPA obtained from ENW, Corps and Reclamation to control their costs to budget levels recommended by the Cost Review, BPA acknowledges that those generating partners did not commit to those cost targets and budget levels. However, BPA has worked extensively with ENW, Corps and Reclamation on their expense forecasts included in this rate proceeding. BPA works very closely with the Corps and Reclamation, through the Joint Operating Committee, to set and manage to budgets. Through this process, BPA is confident that the three agencies will stay within budgets, absent force majeure-type events. ENW has expressed its intent to keep its costs for Columbia Generating Station (CGS) as low as it can, consistent with safe and reliable operation of the plant.

Q. *The Coalition Customers argue that BPA assumed that its secondary revenues would be high even though the price spike had collapsed, BPA had $800 million in reserves, and BPA therefore felt no need to control its costs and went on a spending binge. Faddis, et al., SN-03-E-CC-01, at 19. Please respond.*

A. On the contrary, despite major increase in demands, BPA's internal operations costs for the FY2003-2006 period have been brought down to within one percent of actual spending in 2001, with no allowance for inflation and no allowance for offsetting revenues. Increases in costs for operating the hydro system and nuclear plant have occurred, but have been necessary to maintain the reliability and efficiency of the system. None of this can reasonably be called a "spending binge," particularly in view of the increasing complexity of the market, the load obligations placed on BPA by its customers, the service-level expectation of BPA's stakeholders and the required functional split between the power and transmission business lines. The increasing risks and revenue opportunities in the power market have required increased effort to manage those risks and maximize surplus revenues, and to manage increases in spending on automated systems to manage business and operational functions. Conservation and renewable resource development was required in the face of West Coast supply deficits revealed during the 2000-2001 drought and energy crisis. A constant flow of regional policy issues has required ongoing staffing, as has RTO development and administration of the Asset Management Strategy with the Corps and Reclamation. The split of power and transmission business lines and compliance with Federal Energy Regulatory Commission (FERC) standards of conduct and other requirements have increased costs and staff demands. Increases include:

- The number of duty schedulers, prescheduling staff, after-the-fact accounting staff and real-time trading staff on each shift to handle FERC mandates; the need to schedule transmission separately; Slice scheduling; handling a greater volume of transactions due to Subscription power sales contracts and augmentation contracts.
- The workload associated with implementing the three CRACs.
- Hydro operations planning staff, to manage fish operations requirements and improve system optimization.
- Generation oversight staff, to develop and manage the hydro system Asset Management Strategy with the Corps and Reclamation.
- Information technology systems development and maintenance staffing and contract costs, for the development of enhanced systems to meet FERC requirements and to optimize system operation.
- Transmission acquisition and management staffing and systems, to comply with

FERC standards of conduct.

- Regional transmission organization development staffing.
- Risk management staffing.
- Legal staffing.
- Communications staffing.
- Again, despite these increased demands and effort, BPA's overall internal operations costs are being held within one percent of 2001 actual levels, with no allowance for inflation or offsetting revenues.

Q. The Coalition Customers and WPAG argue that BPA failed to respond in a timely manner to its FY 2001 financial problems because BPA projected it would incur significant cost increases through FY 2006 even though its costs exceeded its revenues by $1 billion (when not counting fish credits) in the fiscal year ending one month later, and BPA therefore was increasing spending in the face of the largest loss in agency history. Faddis, et al., SN-03-E-CC-01, at 19; Saleba, et al., SN-03-E-WA-01, at 11. Please respond.

A. BPA disagrees with the parties suggestion that BPA failed to respond in a timely manner to its FY 2001 financial problems.

First, it is inappropriate to exclude "fish credits" (credits from the Fish Cost Contingency Fund and section 4(h)(10(C) of the Northwest Power Act) when evaluating the Power Business Line's financial results, given that the primary driver of the Power Business Line's financial losses stem from the severe drought in 2001 which "fish credits" are intended to mitigate. Even so, the Power Business Line's financial losses were driven by power purchase expenses (power purchases and conservation load reduction expenses), which exceeded $2.2 billion while "fish credits" only mitigated just over 25 percent of this expense ($601 million).

Second, BPA disagrees with the parties' assertion that BPA was increasing spending in the face of the largest loss in agency history, which has the implication that this spending was controllable and imprudent. As previously noted, BPA's spending was a direct result from the increasing complexity of the market, the load obligations placed on BPA by its customers, the service-level expectation of BPA's stakeholders, the required functional split between the power and transmission business lines and compliance with FERC standards of conduct and other requirements. Additionally, deregulation and restructuring along with the West Coast power crisis in 2000-2001 required expense increases in order to respond to increase in complexity of the electricity market, scheduling protocols, congressional and FERC enquiries, etc. Also, conservation and renewable resource development was required in the face of West Coast supply deficits revealed during the 2000-2001 drought.

Despite these major increases in demands, BPA's internal operations costs for the 2003-2006 period have been brought down to within one percent of actual spending in 2001, with no allowance for inflation and no allowance for offsetting revenues. Increases in costs for operating the hydro system and nuclear plant have occurred, but have been necessary to maintain the reliability and efficiency of the system. Further, as previously noted, the expense increases during 2001 were driven by power purchase expenses (power purchases and conservation load reduction expenses), which exceeded $2.2 billion.

Q. WPAG argues that BPA overestimated the amount of augmentation power it would need, which resulted in BPA signing a number of load buy-down agreements. Saleba, et al., SN-03-E-WA-01, at 11. WPAG argues the five-year load buy-down agreements with the IOUs moved Puget Sound Energy and PacifiCorp from loads that helped share BPA's costs to being part of BPA's cost base and the fixed price five-year agreements have saddled BPA with augmentation power in excess of load requirements at a cost BPA cannot retrieve by selling the power on the market. Id. WPAG argues the SN CRAC *must be designed to avoid a repetition of these events. Id. Please respond.*

A. There are many reasons for why BPA may have "over-augmented" its power resources to serve its expected regional firm power loads, and there is an indisputable reason why BPA offered its regional customers load buy-down and load reduction agreements — avoidance of potentially significant rate increases. Regional customer loads were being placed on BPA during a period of historically high power costs in the West. The design of the SN CRAC allows BPA to recover augmentation costs that the LB CRAC and FB CRAC do not recover. In fact, there are no limits to the types of costs that the SN CRAC can recover. The SN CRAC is allowed to recover these types of costs, otherwise it does not provide the "safety-net" it was intended to be. However, if Public Agency customers and IOUs reach a settlement of litigation challenging the IOUs' Residential Exchange Program settlements, BPA's costs will be greatly reduced and could reduce affect the level of the SN CRAC.

The five-year buydown agreements with Puget and PacifiCorp included specific provisions to ensure that those loads would share in the SN CRAC, if one were to be put in place. Thus those loads continue to help share in BPA's costs.

Q. The Coalition Customers argue that BPA failed to make any significant cost cuts until the summer of 2002, when it announced the Financial Choices Process, but that process only eliminated some increases in projected budgets; BPA only started to reduce budget projections to 2001 levels, and then only because of arbitrary reliance on forecasted "offsetting revenues," and as of yet BPA has not seriously addressed actual cost cuts for the FY 2004-06 period. Faddis, et al., SN-03-E-CC-01, at 20. Please respond.

A. BPA disagrees with the assertion that BPA failed to make any significant cost cuts until the summer of 2002. BPA began to make significant expense reductions in winter 2001-2002. Those efforts early in the year are clearly summarized in the letter from Paul Norman, Senior Vice-President of the Power Business Line, to BPA customers, tribes, constituents, and interested parties dated May 2, 2002. *See* Attachment A. As the letter indicates, BPA established a multi-faceted management plan to reduce approximately $100 million from expenses and take actions to improve BPA's overall financial health.

By the spring of 2002, excluding the costs of augmentation purchases, BPA brought expense budgets for 2002 down to the aggressive targets in the rate case which were based on the 1998 Cost Review, through net reductions of $102 million relative to the start-of-year estimates for FY2002. During this time, BPA put interim financial controls in place to limit new financial commitments, both capital and expense. BPA reduced internal operations expenses in the areas of travel, training, overtime, labor and non-labor contracts and other expense categories. BPA also began actively seeking opportunities within its contractual rights to reduce the costs of the higher-priced individual purchases in BPA's augmentation portfolio. Additionally, BPA focused on maximizing revenues from secondary sales, and to optimize river operations within the various non-power constraints to make power available during the highest-value periods. BPA continued to stand firm on its take-or-pay obligations and began encouraging its IOU and Public Agency customers to reach a settlement of litigation challenging the IOUs' Residential Exchange Program settlement agreements.

Furthermore, the assertion that BPA's reliance on offsetting revenue is "arbitrary" is flawed. It is appropriate and financially prudent to recognize the increases in revenue associated with several of the expense categories. For instance, in the PBL Internal Operations category, several expenses are paid for by other parties (such as Market Development and Slice) or have offsetting revenues due to increases in generation or more efficient use of the hydro system (such as PBL Efficiencies Projects). Similarly, higher O&M spending than included in the rate case has resulted in higher generation output from ENW and the hydro projects, which offsets some of the expense increases.

Q. *The Coalition Customers argue that as of yet BPA has made no actual overall cost cuts* *for the FY 2004-2006 period, stating that BPA's costs, after Financial Choices, exceed the revenue recovery levels set in the 2001 rate case by $830 million. Faddis, et al., SN-03-E-CC-01, at 20. The Coalition Customers argue that BPA is in denial and BPA's pronouncement of cost cuts is accounting sleight of hand and pales in comparison to its customers' cost cuts. Id. at 21. Please respond.*

A. BPA strongly disagrees with the assertion that BPA has made no actual overall cost cuts for the FY 2004-2006 period. On the contrary, BPA has made substantial reductions in expenses. BPA has scrutinized all of its expenses. BPA has gone to its employees, to its federal partners, to IOUs, to ENW, to the Northwest Power Planning Council, and to others to seek more expense savings. BPA consulted with its customers and others through the Financial Choices process in 2002. In Financial Choices BPA identified about $292 million in expense savings and deferrals. Much of that effort – about $140 million of the savings – was focused on BPA's internal operations costs. BPA expected these costs to increase from actual 2001 levels. In Financial Choices, BPA brought 2003-2006 costs back down to 2001 actual levels, accounting for offsetting revenues, with no allowance for inflation. To do this, BPA is bringing many cost categories down below 2001 actual levels. Categories that are being cut to below 2001 actual levels include: travel, training, monetary awards, retention allowances for critical employees, materials and equipment, association memberships, market research analysis, communications and community outreach programs, research and development (fuel cell program terminated). Absolute reductions were previously made in Energy Efficiency and Conservation programs, including Market Development, Technology Leadership/Energy Web, Legacy Conservation contracts and Market Transformation, rate staff, load forecasting staff and power account executives and nuclear oversight staff.

Additionally, directly related to the Agency's Strategic Business Objective 3: "[b]e a low-cost provider of power and transmission services in the region," BPA has set an Agency FY2003 cost management target to "secure additional cost reductions this year amounting to $35 to $70 million." BPA is expected to incur about $700 million in O&M expense for this year. This represents the forecasted expense levels for the PBL, TBL, Shared Services, and Corporate. The cost savings target was developed so that BPA must do better than expected to meet the target. The low end of the target is a five percent reduction from the original expectation and the high end of the target is a 10 percent reduction.

Furthermore, BPA is seeking greater efficiencies (while still complying with Standards of Conduct) in a number of functions that were dispersed across the organization when separate Transmission and Power Business Lines were created. The Agency has developed extensive parameters and principles for expenses related to travel, training, attendance at conferences, professional memberships and dues, outside hiring, overtime and compensation, time-off, retention pay and other administrative costs. The PBL has cancelled or deferred major information technology development projects such as the new Generation Management System, RODS Migration project, and System Backup and Recovery project. The PBL also removed dollars from its spending estimates that would have been used to develop a scheduling coordinator for a regional transmission organization, assuming that if parties want this service they will pay separately for it.

As previously noted, despite the decreases in many areas, there have been offsetting increases (or lack of decreases) in other areas driven by the fact that BPA's power business volume increased greatly by the 3,300 aMW of additional load added in Subscription, which in turn increased the number and diversity of contracts to administer, added dozens of power purchase agreements and greatly increased the effort required to manage an extremely complex rate structure. The split of power and transmission business lines and compliance with FERC standards of conduct and other requirements has increased costs and staff demands. The increasing risks and revenue opportunities in the power market have dictated increases in staff to manage those risks and maximize surplus revenues, and increases in spending on automated systems to manage business and operational functions. Conservation and renewable resource development was required in the face of West Coast supply deficits revealed during the 2000-2001 drought and energy crisis. A constant flow of regional policy issues has required ongoing staffing, as has RTO development and administration of the Asset Management Strategy with the Corps and Reclamation. Despite these increasing demands, PBL staffing in 2003 is only two percent higher than it was in 1999, and will decline.

Regarding the assertion that BPA's cost cuts are "accounting sleight of hand," BPA strictly adheres to all required accounting standards, including Generally Accepted Accounting Principles. The Coalition Customers' *ad hominem* attack is incorrect and inappropriate. If the Coalition Customers are referring to the inclusion of "offsetting revenues" that BPA describes when it evaluates its expense levels, this argument is also flawed. It is rational to evaluate increases in expenses when the expense increase produces revenue in excess of the expense, given that the overall concern is how increases in expenses put pressure on power rates. Clearly, if the revenue generated is greater than or equal to the expense, there is no negative impact on power rates. In fact, the Cost Review contemplated the notion of revenue increases which offset expense increases it its final recommendations, stating that "[t]he Management Committee recommends that the Corps increase its operating margins by $40 million, of which $30 million is assumed to be obtained from operation and maintenance expense reductions and *the remainder from improved revenues as a result of increased project availability*." *See* Cost Review of the Federal Columbia River Power System, March 1998 (emphasis added). This logic applies to other areas, such as Renewable Resources (which produce generation and an offsetting revenue) and the PBL

Efficiencies Projects (which are computer software systems that provide the optimum base points and river basin optimization and deliver more megawatts given total river flow). Additionally, some expenses, such as Market Development and Slice, are reimbursed to BPA or are paid for by other parties. This can hardly be characterized as "accounting sleight of hand."

The Coalition Customers also stated that FERC has approved BPA budgets on an interim basis. FERC, however, does not approve BPA's budgets, only BPA's rates.

Q *The Coalition Customers argue that partially because of mismanagement, BPA's financial reserves have fallen from over $800 million to a projected $51.7 million at the end of FY 2003, and BPA is now asking ratepayers for a 30 percent rate increase to rebuild its reserves so that BPA can be, in contrast to its customers, financially healthy for the next rate period, and BPA has lost its customers' trust. Faddis, et al., SN-03-E-CC-01, at 20. Please respond.*

A. As outlined in this section, BPA has not been mismanaged. BPA has managed its costs in an appropriate and timely manner, and adopted a rate structure to keep rates as low as possible while allowing them to adjust as risks materialized. However, BPA acknowledges that some customers may have a low level of trust with BPA. To address this, BPA is taking a multi-faceted approach to address this issue. First, BPA has established internal cost controls and internal cost management plans to ensure that internal expense levels will be managed to levels established as a result of the General Managers' meetings on cost control (barring force majeure-type circumstances). Second, BPA is actively working with its generating partners to ensure that their budget levels reflected in the rate case are appropriate and will not be exceeded. Third, BPA has established workgroups with customers and constituents to get input on, evaluate, track and report spending levels. Finally, BPA is engaging in a Regional Dialogue effort to position BPA's power rates and contracts to be as attractive as possible for the post-2006 period given stakeholder and mission requirements.

Q. The Joint Customers argue that when the BPA program costs included in BPA's May 2000 rates are compared to BPA's current program cost forecasts, even after Financial Choices reductions, there is an average 29 percent increase in costs, or $183 million per year on average, when FY 2003-06 program costs of $624 million in the May 2000 rates are compared to the now forecasted program costs of $807 million for the same period. Bliven, et al., SN-03-E-JC-01, at 7. The Joint Customers argue that the key areas of these more controllable costs are CGS costs, Corps and Reclamation costs, PBL Operations expense, and Shared Services and Corporate General and Administrative expense, and that over four years from FY 2003-2006, forecasted costs in these categories are $685 million higher than assumed for these categories when the rates were established in May 2000 and reaffirmed in June 2001. Bliven, et al., SN-03-E-JC-01, at 8. The Joint Customers note that the implications of these cost increases are that a $183 million average increase in BPA's FY 2003-2006 more controllable costs compared to May 2000 base rates leads to upward pressure on the SN CRAC of 3.6 mills/kWh on the PF rate, or a 16.5 percent increase, or more than half the estimated average SN CRAC proposal. Id. at 8-9. Please respond.

A. The conclusions drawn by the Joint Customers' expense comparisons are faulty in four respects.

First, identifying certain costs as "more controllable" is flawed when compared to the May 2000 forecast. For instance, as previously and extensively noted, internal operations costs (costs associated with the Power Business Line, Corporate G&A and Shared Services) are a direct result of the dramatic change in the fundamental relationship between BPA and its customers when compared with the assumptions made when developing the May 2000 forecast (*e.g.*, today BPA has complex contracts, a rate mechanism that changes every 6 months, customer service requirements, etc.). Further, the increased complexity of the electricity market due to deregulation requiring increases in staffing and operations expenses was not embedded as a fundamental assumption in the May 2000 forecasts. Another example is the increase in security costs associated with BPA's internal operations, the Corp, Reclamation and ENW due to September 11, 2001. Finally, the increased costs associated with maintaining a safe, reliable and aging hydro system and nuclear plant, increased regulatory requirements, the reallocation of project purposes at Grand Coulee dam by Reclamation, and the embedded expenses associated with implementing the Biological Opinion (in the Corps, Reclamation and internal operations line expense items) were not contemplated in the May 2000 forecast.

Second, the comparison above ignores the risk analysis for non-operating costs (called NORM), included the May 2000 and June 2001 rate filings which included an expected value of increased operations costs that was about $121 million more than the base case costs in the revenue requirement study. In essence, this risk analysis had the consequence of ensuring that rates were set high enough to cover the risk of certain expenses increasing. The risk analysis was done to recognize the difficulty of meeting those aggressive cost targets in light of the risks associated with the future that the Cost Review had assumed when making its recommendations.

Further, the Cost Review identified substantial risks associated with its recommendations (which are associated with expenses forecast levels in the May 2000 forecast). For instance, regarding internal operations costs, the Cost Review notes "a greatly reduced staff may not be able to respond to the many upcoming changes in the power business such as new market flexibilities, scheduling protocols, and new independent system operators (ISOs). Complex and highly tailored products and support services would not be offered." *See* Cost Review of the Federal Columbia River Power System, March 1998. It also notes that "some market analysis, particularly for purposes of managing river operations in relation to both fish and excess power, may need to increase, not decrease, depending on how overall industry restructuring affects operations of the FCRPS. It is anticipated that fewer analysts will be required in the future for this function, but this is very tentative." *Id.* Regarding ENW, the Cost Review notes "[t]here is some risk that WNP-2 will face significant unplanned costs, either from failure of major pieces of equipment or from increased regulatory requirements." *Id.*

Third, the analysis done by the Joint Customers does not appropriately recognize the increases in revenue associated with several of the expense categories. For instance, in the PBL Internal Operations category, several expenses are paid for by other parties (such as Market Development and Slice) or have offsetting revenues due to increases in generation or more efficient use of the hydro system (such as PBL Efficiencies Projects). Similarly, generation output from ENW and the hydro projects is greater than it otherwise would have been, which offsets some of the expense increases.

Finally, the actual SN CRAC increase is based on three factors, closing the net revenue gap, an adjusted TPP standard and a new TRP standard. *See* Keep, *et al*., SN-03-E-BPA-04, at 13-15. The net revenue standard incorporates both revenues and expenses. Therefore, the increase in expenses that the Joint Customers describe would overstate the SN CRAC because the SN CRAC calculation takes into account revenues.

Q. NWEC argues that BPA's financial condition is the result of the absence of a long-term strategy to achieve its goals and reduce risk from volatile power markets, variable precipitation, jeopardy for failure to meet fish obligations, and exposure to future CO2 mandates or taxes. Weiss, SN-03-E-SA-01, at 4. NWEC supports adequate funding for projects that reduce risk instead of crisis management. Id. Please respond.

A. BPA's long-term strategy is based on BPA's 1993 10-Year Financial Plan. *See* Administrator's Record of Decision, 1993 Final Rate Proposal, WP-93-A-02, at 68. This strategy is based on analysis of risk exposures and mitigation strategies consistent with numerous potential risk factors including, but not limited to, volatile power markets and variable hydro conditions. In assessing whether BPA has a high probability that the remainder of Treasury payments will be made, BPA explicitly uses a wide range of projected operational and market combinations. These risks are reflected in the results of the analysis and contribute significantly in assessing the adequacy of rates. For purposes of rate-setting, BPA has determined that jeopardy for failure to meet fish obligations and exposure to future CO2 mandates or taxes pose little risk on an expected value basis, and, therefore, BPA has not included those variables in the risk analysis. BPA has not found reason to deviate from its long-standing, long-term strategy of setting rates to recover costs while meeting its statutory requirements. No one could have predicted the extreme volatility of the wholesale power market or the extreme drought that recently gripped the region. During all of it, BPA's direction has been steady and BPA has taken appropriate turns to avoid or minimize impacts to the region's economy and environment. One measure of the adequacy of BPA's long-term strategy is its demonstrated ability to meet its Treasury payment on time and in full for 19 consecutive years. BPA supports funding projects that reduce risk if the expected cost of the investment exceeds the expected risk exposure on a present value basis.

Section 3. Current Economic Conditions

Q. PPC argues that Washington and Oregon have the highest unemployment rates in the country and regional utilities have taken many measures to reduce their costs, so BPA should do everything possible to avoid another rate increase. See Crinklaw, et al., SN-03-E-PP-01, at 3. Please respond.

A. BPA agrees that it should try to control its costs and avoid another rate increase. To that end, as stated in BPA's direct case: "BPA has requested, and ENW has implemented, a program to purchase surety bonds to release bond reserve funds to pay for some near-term debt service costs at ENW. Also, ENW pursued and won a $23 million settlement with the Bank of America for the Bank's role as paying agent on certain BPA-backed bearer bonds. ENW plans to provide the settlement proceeds to BPA." *See* Keep, *et al*., SN-03-E-BPA-04, at 9.

Since that time, BPA and Enron have reached a settlement of power purchase augmentation contracts. This settlement will reduce BPA's overall SN CRAC. Under the settlement BPA agreed to pay $99 million to terminate a series of contracts with Enron. The $99 million settlement to Enron will be paid from the U.S. Treasury Judgment Fund. BPA will repay the Judgment Fund. BPA considers the $99 million settlement to be an augmentation cost recovered by the LB CRAC. The details of its treatment will be an issue for the LB CRAC workshops.

BPA continues to actively participate with the Public Agency customers and IOUs to reach a settlement of the IOU Residential Exchange Program settlement contracts, which will result in overall cost savings and will help lower BPA's overall power rates. Finally, as extensively noted in PBA's direct case and in this testimony, and in other non-rate case forums, BPA continues to work to control and cut costs.

Q. WPAG argues that the Northwest is currently in a recession, with Washington and Oregon struggling with large budget deficits, a decrease in economic activity, high unemployment in Oregon and Washington. Saleba, et al., SN-03-E-WA-01, at 3-4. WPAG also notes that retail customers have been affected, citing a 50 percent increase in Lewis County's write-offs for uncollectible accounts; a 92 percent increase in notices for service disconnections in Benton REA; a 9.3 percent unemployment rate in Clark County. Id. at 5. WPAG argues that BPA's proposed increase would make matters worse. Id. Please respond.

A. BPA shares WPAG's concerns regarding the state of the Pacific Northwest economy. These are very important concerns. In response, BPA is taking steps to reduce or eliminate the proposed SN CRAC, and is seeking to set rates as low as possible sufficient to recover its costs in accordance with sound business principles. To that end, BPA has lowered the TPP standard as low as BPA feels it can, to accommodate the concerns raised by BPA's power customers. BPA appreciates the concern raised in data response WA/BPA:021, that WPAG utility members may not be able to absorb another increase without a retail rate adjustment. *See* Attachment B.

Q. The PPC argues that BPA should limit the size of the increase to the minimum necessary, keeping overall rates stable between FY2003 and FY2004, by limiting the size of the SN CRAC to be no greater than the size of the current forecasted decrease in the average LB CRAC in October of this year. Crinklaw, et al., SN-03-E-PP-01, at 4. Similarly, NRU argues that the size of the SN CRAC should be limited such that, when considered in conjunction with the size of the LB CRAC for FY 2004, rates are no higher than 2003 rates. Saven, et al., SN-03-E-NR-01, at 7. Please respond.

A. While BPA appreciates the suggested limitations on BPA rates, BPA must review such suggestions in the context of BPA's obligation to recover its costs. As stated in BPA's direct testimony, "BPA is concerned about the impact of any rate increase on the economy of the Pacific Northwest, so direction was given to staff that the rate design should mitigate the level of any rate increase, to the extent possible." Keep, *et al.*, SN-03-E-BPA-04, at 13. In addition, BPA continues to look for ways to limit the size of any rate increase by controlling and cutting costs, as discussed above. If possible within the bounds of setting rates to recover costs *Id*. BPA is attempting to meet the goal suggested in the question. However, as BPA also states in its direct case, BPA must set rates to recover its costs. *Id*. Without such a determination, BPA cannot set an arbitrary limit such as no total rate increase compared to FY 2003 total rate levels, as suggested above, to establish the level of the SN CRAC.

Q. NRU argues that its members signed 10-year contracts consistent with BPA's assurance that the PF-02 level would closely parallel the PF 96 rate, but that current rates are significantly higher. Saven, et al., SN-03-E-NR-01, at 3. NRU wants stable rates that *reflect BPA actions to ensure that BPA's power prices are competitive. Id. In addition, NRU argues that BPA should follow through with its previous emphasis on competitiveness and rate stability, citing the previous testimony of Burns and Elizalde. Saven, et al., Id. at 4. Please respond.*

A. BPA understands NRU's desire to have stable and competitive rates. BPA has those same goals. In BPA's direct case, and elsewhere in this testimony, BPA has identified the steps being taken to help ensure that BPA's costs lead toward stable and competitive rates for the long term. However, BPA must have the flexibility to deal with the wide range of uncertainties that BPA cannot control.

In a data response BPA-NR-003, NRU provided its analysis in support of its statement that " . . . BPA energy can re-emerge as a valuable cost based resource compared to alternative suppliers." *See* Attachment C. NRU's analysis fails to support its statement in two important ways. First, NRU compared an estimate of the price of raw power BPA would expect to get in a short-term surplus market, with a PF product. The PF product is not raw power but rather it is a long-term firm, load-following product providing complete service to meet the full characteristics of the utility customer's load. Second, NRU fails to provide any comparison to any alternative suppliers providing identical or similar service to BPA. BPA believes that much of the reaction to BPA's current rates is not as much rooted in whether BPA is a competitive supplier, but rather in rates that are higher than historically assessed against its customers. Hence, NRU's testimony alludes to BPA energy in terms of "valuable cost based resource" rather than, for example, "competitive supplier." Finally, while BPA is committed to controlling its costs, BPA has not made a commitment for flat rates over the full 10-year term of the Subscription contract. Though BPA believes its rates continue to extend value to the region when compared to other wholesale power suppliers providing equivalent products and services to those offered by BPA, BPA recognizes the significant economic distress caused by much-higher BPA rates and is making every prudent effort to keep rates as low as possible in view of that distress.

Q. *NRU opposes moving a disproportionate amount of costs into a future period and opposes leaving BPA where it cannot pay the Treasury or other creditors. Saven, et al., SN-03-E-NR-01, at 4. NRU wants a responsible and aggressive plan to manage costs to agreed levels and to apply financial tools that can mitigate rate increases without undermining fiscal integrity in later years. Id. Please respond.*

A. BPA agrees with NRU, and is following a strategy that aggressively manages costs. As described previously, BPA has put in place extensive management plans to manage all internal costs. Further, BPA has worked with its generating partners and other constituents on the forecasted levels of expenses included in this rate proceeding. BPA expects to continue working with these entities to manage expense levels over time. Additionally, BPA is concerned about moving expenses into the next rate period and ensuring financial integrity in later years. BPA has proposed a set of standards (net revenue, TPP and TRP) to achieve a high probability that the remainder of Treasury repayments will be made in full while minimizing expenses that are moved into the next rate period.

Q. *NRU argues that the current Northwest economic situation is very bad, citing key industries facing closing or curtailments because of poor economic conditions and, for a number of businesses, higher production costs associated with electric power prices. Saven, et al., SN-03-E-NR-01, at 5. NRU cites the 58 aMW Georgia Pacific pulp and paper mill in Toledo, Oregon, facing possible closure with 480 direct jobs, and in Northeastern Washington where Ferry County PUD's service area has seen seeing losses in mining and wood products operations, and a 2,800 MWh /mo. reduction in a gold mine and a 400 MWh/mo. reduction in a sawmill. Id. The Coalition Customers cite unemployment increases, small businesses facing increasing costs, threats to irrigators* *and food processors, cost disadvantages to Northwest manufacturing facilities, higher risk of closure for non-competitive facilities, and resulting loss of jobs and state tax contributions. Faddis, et al., SN-03-E-CC-01, 3-4. Please respond.*

A. BPA is very concerned about the financial situation that these parties describe. That is why BPA's proposal lowered the TPP standard for this rate case. *See* Keep *et.al*., SN-03-E-BPA-04 at 14, lines 3-12. However, as restated in this testimony, BPA must set rates to recover its costs.

Q. The Coalition Customers argue that BPA's SN CRAC proposal does not seriously consider the impact the rate increase will have on the Northwest economy. Faddis, et al., SN-03-E-CC-01, at 11. The Coalition Customers argue that some utilities' increased rates may not increase revenues, and that others may be politically unsustainable because of the loss in local jobs. Faddis, et al., SN-03-E-CC-01, at 16. They argue that by deliberately ignoring the impact of the proposed rate increase on utility and direct service customers and the communities they serve, BPA has neglected its duty to consider the total regional impacts of its action. Id. Please respond.

A. BPA disagrees that BPA's proposal "does not seriously consider the impact the rate increase will have on the Northwest economy." Though there is no such formal duty in law, BPA feels and is acting on a strong sense of duty to the regional economy. *See* Attachment D. In other parts of BPA's direct case, and this testimony, BPA has indicated the actions it has taken to respond to its concern about the impact BPA's rates might have on the economy. *See generally* Section 2 of this testimony and Keep, *et al*., SN-03-E-BPA-04, at 13. However, as BPA stated in its direct case, BPA is obligated to set rates to recover it total system costs. *See* Keep, *et al*., SN-03-E-BPA-04.

Q. The Coalition Customers argue that when BPA changed its TPP criteria because the rate increase necessary to allow BPA to meet its original TPP would not be sustainable in the current economy, this serves primarily to ensure that BPA does not collect more than the

$920 million revenue loss, and that BPA relaxed the TPP standard because it would have produced an embarrassment of riches to BPA. Faddis, et al., SN-03-E-CC-01, at 11-12. Please respond.

A. BPA did not relax its TPP standard because it would have produced an "embarrassment of riches." BPA reduced its TPP standard out of concern for the economic health of the region. As stated in direct testimony, "BPA is concerned that a rate increase of the magnitude necessary to achieve the 80-88 percent 5-year TPP standard used to develop BPA's proposed 2002 power rate is not sustainable in the current economy." Keep, *et al*., SN-03-E-BPA-04.

Q. The Coalition Customers argue that BPA's testimony and studies do not show that BPA analyzed whether its SN CRAC proposal was sustainable in the current economy, although it acknowledges that BPA provided reasons why a proposal based on its original TPP standard would not have been sustainable. Faddis, et al., SN-03-E-CC-01, at 12. The Coalition Customers argue that relying on the same factors that led BPA to conclude that the original SN CRAC increase was not sustainable should also lead BPA to conclude that its current SN CRAC proposal is also not sustainable, because the Northwest economy is getting worse, the Northwest has the worst recession in the nation, Oregon and Washington have the highest unemployment rates in the nation, and many manufacturing jobs have been lost. Id. at 12-13. Please respond.

A. BPA shares the Coalition Customers' concerns regarding the state of the Pacific Northwest economy. However, BPA is obligated to set rates sufficient to recover its costs. Given the current economic situation in the Pacific Northwest, BPA has been flexible and willing to adjust its TPP standard lower for this rate proceeding; however, BPA cannot ignore its obligations in order to accommodate the concerns addressed by the customers. Dropping the TPP standard to below 50 percent would not demonstrate that BPA is setting rates sufficient to recover its costs.

Q. The Coalition Customers argue that BPA's SN CRAC proposal does not reflect the economic concerns of BPA's customers, as reflected by BPA's criterion of "zero net revenue or better" over the entire rate period. Faddis, et al., SN-03-E-CC-01, at 12. Please respond.

A. The Coalition Customers' assertion is flawed. BPA's proposal does reflect the economic concerns of BPA customers and the economic condition of the Northwest. As delineated in BPA's initial proposal, management instructed staff to meet three standards in the design of the SN CRAC: the SN CRAC should produce PBL net revenues that are at least zero over the rate period; a reduced TPP standard for this rate period to a 50 percent probability that BPA can make all of its Treasury payments in the FY 2004-2006 3-year rate period; and a new Treasury repayment standard, which is the probability that BPA will be able to make all of its FY 2006 payments to the U.S. Treasury, including repayment of any amounts it might miss in fiscal years 2003-2005. *See* Keep, *et al.,* SN-03-E-BPA-04, at 13-15. Additionally, BPA is using agency reserves to calculate the TPP and TRP, temporarily departing from BPA's standard of a PBL-only TPP. Using agency reserves allows BPA to set the SN CRAC to minimize the effect on ratepayers overall while ensuring an adequate probability of making all payments, including Treasury payments, for the entire agency. The three standards taken together, in addition to the modification of using BPA agency reserves to calculate TPP, addresses BPA's obligation to set rates to recover costs as well as minimize, to the extent possible, the impact of a BPA rate increase on the Northwest economy and BPA's customers.

Q. The Coalition Customers argue that BPA's senior management stated that BPA would reduce internal costs to 2001 levels and below, while apparently intending to do nothing of the sort, because forecasted offsetting revenues will be used to conceal planned increases in internal costs during the remainder of the rate period. Faddis, et al., SN-03-E-CC-01, at 13-14. The Coalition Customers characterize this as accounting *gymnastics, which undermine BPA's credibility with its customers. Id. at 14. Please respond.*

A. The assertion that BPA's forecast of offsetting revenue is "accounting gymnastics" is flawed. BPA strictly adheres to all required accounting standards including Generally Accepted Accounting Principles. Furthermore, it is appropriate and financially prudent to recognize the increases in revenue associated with several of the expense categories. For instance, in the PBL Internal Operations category, several expenses are paid for by other parties (such as Market Development and Slice) or have offsetting revenues due to increases in generation or more efficient use of the hydro system (such as PBL Efficiencies Projects), which results in no negative impact on rates or on BPA's ability to pay Treasury.

Q. The Coalition Customers and WPAG argue that BPA's rates are not competitive for many industries, citing an 82 percent increase in electricity rates over the last 28 months for Kimberly-Clark's Everett mill, which is not competitive because of its electric rates; only one Northwest utility among the 10 utilities having the lowest industrial power rates and the loss of manufacturing jobs. Faddis, et al., SN-03-E-CC-01, at 15; Saleba, et al., SN-03-E-WA-01, at 4-5. Please respond.

A. BPA does not dispute the parties' contentions about the state of the Pacific Northwest economy and the loss of manufacturing jobs, nor the Kimberly-Clark rates as shown in Faddis, *et al*., SN-03-E-CC-01, Attachment 01T. However, utilities often design rates towards certain desired outcomes. For example, BPA has designed rates with time-of-day and seasonal shapes to encourage customers to shape their purchases from BPA away from periods of high cost (for BPA). Retail utilities can set rates to the advantage of industrial users. Without any supporting documentation, BPA has no way of knowing whether the industrial power rates of the other Kimberly-Clark mills benefit from such retail rate designs. It may be that Snohomish PUD, because its rates were so low in the past, did not need to develop beneficial industrial rates, and so does not have those types of industrial rates. In addition, the Coalition Customers were not responsive to BPA's data requests BPA-CC-005 and BPA-CC-008, which sought information pertaining to the 82 percent rate increase experienced at the Kimberly-Clark mill. BPA notes that Snohomish PUD is not supplied solely with Federal power marketed by BPA. BPA understands that Snohomish PUD executed several power purchase contracts with various suppliers during the height of the energy crisis that far exceed the cost at which it pays for power marketed to it by BPA. BPA also is aware that Snohomish is currently in legal proceedings to seek relief from those contracts. Therefore, BPA believes the rate increases noted in the Coalition Customers' testimony are likely a result of independent decisions that Snohomish PUD made with respect to meetings its own loads, in addition to cost increases from BPA.

Q. *The Coalition Customers argue that BPA's rates are not competitive for the primary aluminum industry, with no known aluminum smelter operating at power rates above $40 per MWh. Faddis, et al., SN-03-E-CC-01, at 16. Please respond.*

A. The price of power is only one of an aluminum smelter's costs. At any given time, the competitiveness of an aluminum smelter depends on its overall cost structure and the world aluminum price. The cost structure is driven by an individual smelter's production efficiency and its cost components. For Pacific Northwest smelters the cost of power is one of three major cost components. The other two are labor and raw materials (alumina, carbon, and miscellaneous materials). If a smelter is able to sufficiently lower all other costs then it can operate economically with higher power costs.

Q. *The Coalition Customers argue that BPA has not considered the cost of changes in BPA's bond ratings and that BPA has not provided an estimate of the cost of a rating downgrade. Faddis, et al., SN-03-E-CC-01, at 17. The Coalition Customers argue that in the BPA Journal, an ENW financial advisor estimated the cost of degradation of*

BPA's financial position as $637,000 in a $730 million bond sale, or less than one tenth of one percent. Id. Please respond.

A. BPA's overview testimony was not intended to provide an exhaustive list of all potential effects of bond ratings downgrades on BPA. *See* Keep, *et al*., SN-03-E-BPA-04, at 7. However, BPA specifically considered the cost of changes in its bond ratings and indicated in the referenced testimony that such changes would likely affect the expected interest savings of ENW April refinancings and future refinancings of ENW and other BPA-backed bonds. This statement was made based upon a general and rough estimate provided by its Financial Advisor, Public Financial Management (PFM), during a February 2003 phone conversation. In data response PP-BPA:007, BPA provided this February 2003 estimate as well an April 2003 update to this estimate. *See* Attachment E.

The referenced April BPA Journal article referred to a $682 million bond sale, not $730 million as stated in the Coalition Customers' testimony. Not mentioned in the article is the fact that the sale was broken down into two parts, a tax-exempt pricing (2003A) and a taxable pricing (2003B), both fixed rate issues. Sale 2003A was in the amount of $637,860,000 and 2003B was for $44,315,000. This represented only a portion of the bond transactions closed in April. Subsequent tax-exempt variable rate bond sales (2003C, D, and E) in the cumulative amount of $499,575,000 were priced and closed in April 2003.

The estimated cost of the downgrade on expected interest rate savings of $637,000 referenced in the BPA Journal article was an estimate covering 2004-2017. The estimated amount for 2004-2006 is about $191,358. Although the actual effect for the April 2003A transaction appears minimal, another downgrade would most likely have a more severe impact as noted in the data response referenced above.

What was not estimated in the BPA Journal article was the potential impact of the ratings downgrade on the 2003C, D, and E variable rate bonds or other outstanding variable rate debt that has been issued by ENW and backed by BPA. These bonds carry interest rates that change on a weekly or monthly basis, and future bond rating changes will affect those interest rates.

BPA's power marketing can also be affected by counterparties' views of BPA's creditworthiness. Ratings downgrades can impact BPA's ability to purchase power. Counterparties may reduce trading limits on transaction levels and downgrades increase the likelihood for requests for credit support. The effects of ratings downgrades can be far-reaching and are not necessarily limited to the effects mentioned by the Coalition Customers.

Q. The Coalition Customers argue that BPA has ignored the impact that the proposed rate increase would have on the bond ratings of its utility customers and their consumers. Faddis, et al., SN-03-E-CC-01, at 17. Please respond.

A. Bond rating agencies consider a number of factors when evaluating an entity for creditworthiness. Among the factors are quality and expertise of management, adequacy of financial and risk management policies, operating performance as measured by financial ratios, the local economic situation, and, in the case of distribution utilities, cost of wholesale power. BPA has virtually no control over most of those factors as they relate to its customer utilities and, as is the case of many of its rated customers, has only partial responsibility for the cost of wholesale power. In addition, each utility customer manages the impact of BPA's rates uniquely. Since BPA influences so few of the rating factors and no formula seems to exist for isolating and evaluating the effects of BPA's actions on all customers, BPA does not specifically include impacts of the bond ratings of its utility customers and consumers in ratesetting.

Section 4. Financial Policies

Q. NRU argues that it does not support the new policy of an 80 percent Treasury Recovery Probability or the measure of total net revenues for the FY 2002 – FY 2006 period of at *least zero because the policies are unnecessary and give BPA too much flexibility to either (1) fully recover losses already experienced during the rate period and (2) build in too much of a cushion of reserves to partially mitigate deferrals during the remainder of the current period. Saven, et al., SN-03-E-NR-01, at 16. Additionally, NRU argues that BPA's proposed revenue recovery of $920 million appears excessive since BPA only needs $339 million to cover losses through FY 2006, and NRU would only support an ending level of reserves closer to $150-200 million. Saven, et al., SN-03-E-NR-01, at 17. SUB also argues that BPA's TPP standard, TRP standard, and zero net revenue standard increase the SN CRAC threshold levels each year, producing a possibility of BPA having over $400 million in reserves in 2006. Nelson, SN-03-E-SP-01, at 13. Additionally, SUB argues this is inappropriate because (1) customers subject to all three CRACs are paying unintended costs and this impact should be mitigated, and (2) the regional economy is fragile and significant rate increases could cause further economic harm. Id. Please respond.*

A. The three standards in BPA's proposal, taken together, reflect BPA's concern for the economic condition of the Northwest, reflect BPA's mitigation of overall rate increases, and also provide a high level of assurance that BPA's obligations to the U.S. Treasury will be satisfied by the end of FY 2006. This is consistent with the original intent of the SN CRAC to restore a high probability that Treasury payments during the remainder of the rate period will be made in full to the extent market and other risk factors allow. The three standards represent a compromise, but appropriate, balance of financial objectives. Consistent with traditional financial disclosure requirements, no single financial measure can adequately assure financial disclosure or health. BPA also needs measures of current and future liquidity (TPP and TRP), period cost recovery (zero net revenue), and long-term viability (multi-year repayment studies set to recover future costs) in setting rates for the remainder of a multi-year period. Additionally, BPA traditionally sets rates to recover the higher of depreciation or amortization, which is explicitly a standard of the higher of accrual results and cash results. As an alternative to this multi-faceted approach, BPA could have chosen to maintain its traditional TPP standard of setting rates to ensure an equivalent 80-88 percent probability that BPA can make all of its Treasury payments in the FY 2004-2006 three-year rate period. Had BPA taken the traditional approach, this would have resulted in rates and ending reserve levels far in excess of those resulting from the combination of the three standards.

NRU indicates that it would only support an ending level of reserves closer to $150-200 million. BPA did not establish a desired ending reserve level in FY 2006. Instead, BPA proposed rates based on the three standards that resulted in a certain level of ending reserves.

Q. GPU argues that BPA's third financial standard should be rejected because the GRSPs limit the SN CRAC to "achiev[ing] a high probability that the remainder of Treasury payments during the FY 2002-2006 rate period will be made in full", and the purpose of the SN CRAC was to ensure high TPP, not necessarily recover prior PBL net losses. Lovely, SN-03-E-GP-01, at 7 (emphasis in testimony). Similarly, GPU argues that BPA has triggered the SN CRAC in order to recover from the consequences of past decisions. Lovely, et al., SN-03-E-GP-01, at 5. The Coalition Customers also argue that BPA's SN CRAC proposal is inconsistent with the purpose of the SN CRAC because the SN CRAC is intended to be forward looking and to address only future Treasury payment, while BPA's standard of zero net revenues over the five-year rate period and reliance on Accumulated Net Revenue is backward-looking, arguing that BPA's goal is to recover $920 million is driven largely by cost overruns that occurred before the SN CRAC rate period from losses in FY 2001-02 and a projected loss for FY 2003. They argue BPA only needs $340 million. Faddis, et al., SN-03-E-CC-01, at 9-10. The Coalition Customers also argue that BPA has designed its SN CRAC proposal to recover an *additional $920 million from its customers in three years to build reserves for the next rate period. Faddis, et al., SN-03-E-CC-01, at 10. Please respond.*

A. As previously noted in this testimony, the three standards in BPA's proposal, taken together, represent a compromise and multi-faceted approach which mitigated the impact of BPA's traditional TPP standard of setting rates to ensure an equivalent 80-88 percent probability that BPA can make all of its Treasury payments in the FY 2004-2006 three-year rate period. Had BPA taken this traditional approach, the result would have been higher rates and ending reserve levels far in excess of those resulting from the combination of the three standards. The parties' assertion that BPA is establishing an SN CRAC to make up for past decisions is flawed. The SN CRAC rate levels are the result of the proposed set of standards (net revenue, TPP and TRP) to assure a high probability of making the remainder of Treasury payments over the remainder of the rate period in full.

The SN CRAC had to be designed to recover from bad financial results because of the triggering potential based on actually *missing* a payment to Treasury or other creditor. This circumstance would necessitate recovery from the consequences of past decisions.

Q. CRITFC argues that BPA should not use the effects of the economy as a rationale to increase the risk of failing to make its Treasury payments or to set rates that do not meet its costs because BPA has not done an analysis of the economic impacts of raising rates, BPA has not seen a reduction in electricity purchases as a result of rate increases implemented to date, and BPA has not analyzed the economic impacts of reducing fish and wildlife recovery activities on local communities and economies. Sheets, et al., SN-03-E-CR/YA-01, at 7-8. Please respond.

A. BPA is obligated to set rates to recover its costs consistent with sound business principles. Meeting this obligation entails the consideration of many factors, including impacts to end use consumers of BPA's utility customers. BPA assumes that such end-use consumers include the local communities and economies referenced in CRITFC's testimony. While BPA considers potential impacts of rate increases on load, it does not necessarily follow that BPA would need to consider the impacts on communities and economies as they relate to fish and wildlife activities. BPA's 2002 GRSPs specifically provide that "BPA will propose changes to the FB CRAC parameters that will, <u>to the extent market and other risk factors allow</u>, achieve a high probability that the remainder of Treasury payments during the FY 2002-2006 rate period will be made in full." 2002 GRSPs, section II.F.3 (emphasis added). BPA has, with its proposal, tried to balance its concern with the current state of the Pacific Northwest economy with the need to set rates sufficient to recover its costs.

Q. *CRITFC argues that BPA should raise TPP estimates to 88 percent to provide the certainty needed to meet Fish and Wildlife Principles 3 and 4 and the assurance of making Treasury payments on time and in full. Sheets, et al., SN-03-E-CR/YA-01, at 42. Please respond.*

A. The TPP standard in the Fish and Wildlife Funding Principles was 80-88 percent. This standard was met with the conclusion of the 2000 rate proceeding. The rates set in that proceeding include the three CRACs to deal with additional uncertainty not covered in base rates. The availability of the CRACs led, in part, to the WP-02 rates meeting Principles 3 and 4. The GRSPs do not require any of the individual CRACs to independently meet the Fish Funding Principles. Therefore, the availability, and now implementation of, the CRACs allows BPA's rates to meet the Fish Funding Principles. The Fish Funding Principles do not dictate the specific level of the CRACs, in particular the SN CRAC.

Q. *CRITFC argues that BPA faces unprecedented volatility and planning for uncertainty requires a more risk averse portfolio, not a less risk averse portfolio. Sheets, et al.,* *SN-03-E-CR/YA-01, at 42. Please respond.*

A. BPA's financial situation is as it has been stated in BPA's direct case and in this testimony. BPA is setting the SN CRAC at a level, given market and other risk factors, to achieve a high probability of making the remainder of the Treasury payments in full. Implementing the SN CRAC is creating a more risk averse portfolio.

Q. CRITFC argues that a 50% TPP is too low because increases the risk of a Treasury deferral and risk to fish and wildlife funding. Sheets, et al. SN-03-E-CR/YA-1, at 41. How do you respond?

A. Under the GRSP's BPA must consider market and other risk factors in establishing the TPP. Given the current economic circumstance in the Pacific Northwest, BPA believes the 50 percent TPP in conjunction with the 80 percent TRP and zero net revenue standards is appropriate and gives sufficient security that BPA will meet its Treasury payment and payments for its fish and wildlife obligations. *See* McNary, *et al.,* SN-03-E-BPA-18 for discussion of the appropriateness of the current fish and wildlife expense levels.

Q. CRITFC argues that it has additional concerns about a lower TPP, including the need to adjust BPA's risk management structure to ensure that it can fund all obligations, including fish and wildlife, and not just its power sales contracts, keeping rates below market, providing contracted water, and flood control, as was the case in the 2001 drought. Sheets, et al., SN-03-E-CR/YA-01, at 42. Please respond.

A. BPA is setting its rates sufficient to cover all of its obligations, including fish and wildlife. In addition, as described throughout this testimony, BPA is taking steps to ensure this is the case. These include controlling and cutting costs, rate designs, the development of the three repayment standards and the variable, contingent design, and addressing risk management.

Q. CRITFC argues that Treasury payment is not the true measure of BPA's exposure to risk, *because Treasury payments can be deferred. Sheets, et al., SN-03-E-CR/YA-01, at 42. CRITFC calls for the establishment of a standard based on BPA's obligations to pay other creditors, or a Creditor Payment Probability (CPP). Id. CRITFC argues that because the 4(h)(10)(C), FCCF, and MOA monies cannot be used to pay creditors, such funds must be taken out of the calculations to determine CPP. Id. Please respond.*

A. All payments to Treasury are the lowest in BPA's priority of payments. By definition, then, if BPA has made any portion of its Treasury payment at year-end, all other creditors have been satisfied. Section 4(h)(10)(C) credits and, under specified conditions, the FCCF, are applied toward the Treasury payments. However, it is highly unlikely, if not impossible, that they would be substantial enough to fully cover the power portion of the Treasury payment at the expense of other creditors, especially with the diminished balance in the FCCF. In addition, BPA wants to clarify that there are no specifically identified "MOA monies" at this time. BPA is not proposing changing any of the three standards for meeting cost recovery obligations as discussed in Keep, *et al*., SN-03-E-BPA-04, at 13-15.

Q. CRITFC argues, citing data responses, that "net revenues to zero" does not adequately address the Fish and Wildlife Funding Principles because this goal will not position BPA to be financially healthy in the future. Sheets, et al., SN-03-E-CR/YA-01, at 52. Please respond.

A. BPA does not expect that the zero net revenues standard alone will position BPA to be financially healthy. Rather it is the combination of the three standards upon which BPA is relying. As previously noted in this testimony, the three standards in BPA's proposal, taken together, reflect the concern BPA has for the economic condition of the Northwest, reflect BPA's concern regarding the rate impact on customers, as well as provide a high level of assurance that BPA's obligations to the U.S. Treasury will be satisfied by the end of FY 2006, consistent with the original intent of the SN CRAC to restore a high probability that Treasury payments during the remainder of the rate period will be made on time, if and to the extent market and other risk factors allow. The three standards represent a compromise, but an appropriate balance of financial objectives that positions BPA to be financially healthy in the future.

Q. *CRITFC argues that BPA underestimated in the WP-02 rate case its internal costs and the costs of the Corps, Reclamation and ENW by $570 million compared to the cost projections revealed during Financial Choices. Based upon this fact, they contend that it does not appear reasonable for BPA to assume that there will be no uncertainty associated with these costs through 2006. Therefore, CRITFC argues that BPA should use the NORM model to incorporate the financial uncertainties identified in their testimony. Sheets, et al., SN-03-E-CR/YA-01, at 49-50. Similarly, NWEC argues that BPA's calculation of its TPP ignores many risks that could impact the agency's finances and, by not incorporating such risks in the Non-Operating Risk Model (NORM), BPA is overstating its TPP. In particular, NWEC cites BPA's assumption that there are no cost increase risks associated with ENW, the Corps, Reclamation, and BPA's internal costs. Weiss, SN-03-E-SA-01, at 5, 10-11, and 23. Please respond.*

A. BPA disagrees with CRITFC's assertion that because BPA underestimated its internal costs and the costs of Reclamation, Corps, and ENW in the WP-02 rate case that BPA should use the NORM model to incorporate the financial uncertainties identified in its testimony.

As previous testimony describes, BPA realizes that the practice of assuming significant cost cuts without a complete plan on how to achieve those cost cuts has contributed to BPA's current financial condition. *See* Keep, *et al.,* SN-03-E-BPA-04, at 9. Regarding its internal operation costs, BPA has an integrated and multi-faceted plan for controlling and managing the internal operations costs that impact power rates. Due to the serious nature of BPA's financial condition, BPA has re-emphasized its established principles, processes, and procedures such that these internal costs are scrutinized, reduced where appropriate, reported and tracked.

BPA has taken extensive steps to manage its costs such as a significant reduction of employee awards, employee retention payments, and a reduction of capital budgets. Additionally, BPA has placed a moratorium on outside hires with limited exceptions, reduced contractor expenses, and offered early retirement to reduce Federal employment levels. Additionally, BPA is seeking greater efficiencies (while still complying with Standards of Conduct) in a number of functions that were dispersed across the organization when separate Transmission and Power Business Lines were created. In addition to supporting these Agency-level efforts, the Power Business Line has increased its focus on cost management. As BPA has done historically, expense targets for PBL managers are promulgated in their individual performance contracts. The PBL has taken this a step further by establishing a spending limit for each manager that is consistent with the overall expense levels for PBL internal operations costs in the rate proceeding, which is tracked weekly and formally evaluated twice per year in mid-term and annual performance reviews.

To re-emphasize its commitment, the PBL conducted management-training sessions on cost management in December 2002 and January 2003 that outlined the new "hard" spending limits and procedures the PBL will be following. The PBL also instituted a formalized and standardized weekly and monthly reporting process that tracks individual managers' spending by general ledger account (e.g., travel, training, materials and supplies etc.). The PBL is using the Bonneville Enterprise System extensively to report and manage expense levels.

The PBL has developed extensive parameters and principles for expenses related to travel, training, attendance at conferences, professional memberships and dues, outside hiring, overtime and compensation, time-off, retention pay and other administrative costs.

The PBL has cancelled or deferred major information technology development projects such as the new Generation Management System, RODS Migration project, and System Backup and Recovery project. The PBL also removed dollars from its spending estimates that would have been used to develop a scheduling coordinator for a regional transmission organization, assuming that if parties want this service they will pay separately for it.

As a part of its overall cost management plan, the PBL has established informal monthly meetings with customers, customer representatives and constituents to review current year actual and forecast expense levels for both program and internal operations expenses charged to power rates. In these forums, the PBL also reports on changes to expense levels including reductions taken to date.

Additionally, BPA has worked extensively with ENW, Corps and Reclamation on their expense forecasts included in this rate proceeding. BPA works very closely with the Corps and Reclamation, through the Joint Operating Committee, to set and manage to budgets. Through this process, BPA is confident that the three agencies will stay within budgets, absent force majeure-type events. ENW has expressed its intent to keep its costs for CGS as low as it can, consistent with safe and reliable operation of the plant.

Therefore, BPA is not overstating its TPP by not including the Non-Operating Risk Model (NORM) in this rate proceeding.

Q. *CRITFC argues that, according to data responses, BPA's estimate of internal operating costs during Financial Choices was approximately $222 million higher than assumptions in the WP-02 rate case; $279 million higher than the forecast in the May 2000 proposal; internal costs exceeded BPA's 2002-2006 forecast by $313 million; the change between Financial Choices and the data response was $91 million and the difference between the proposal and the errata was $34 million. Sheets, et al., SN-03-E-CR/YA-01, at 45. CRITFC argues that BPA's assumption that new internal cost estimates are certain is not* *reasonable given these foregoing figures. Id. Please respond*

A. Estimates of internal operations costs that have frequently been made public over the last several months have reflected ongoing changes, cost reductions and new forecasts. Results and differences from the May 2000 proposal and Financial Choices can and will change as BPA goes through time, making decisions about cost reductions and getting better information. However, the estimates BPA is using in the SN-03 rate case are the most current and best estimates of internal operations costs. BPA has established plans to manage to these internal expense levels or below and are these costs are therefore more certain.

Section 5. Purpose of the SN CRAC

Q. NRU and the Coalition Customers argue that the SN CRAC was intended to be a mechanism of last resort available if BPA had missed a scheduled Treasury payment or forecasted a 50 percent or greater probability of missing the next Treasury payment. Saven, et al., SN-03-E-NR-01, at 6; Faddis, et al, SN-03-E-CC-01, at 4. The Coalition Customers argue that the SN CRAC is not intended to address the same concerns as the Load-Based CRAC, i.e., augmentation costs, or the Financial-Based CRAC, i.e., normal risks such as water conditions, load changes, Columbia Generating Station 2 outages, and cost overruns. Faddis, et al., SN-03-E-CC-01, at 4. The Coalition Customers argue that, as a tool of last resort, the SN CRAC is intended to cover BPA for extraordinary or catastrophic events, such as an extended outage at CGS 2, the removal of the Snake River dams, or a significant constraint to the power system due to fish mitigation measures. Id. at 7. Please respond.

A. BPA agrees that the SN CRAC was intended to be a tool of last resort. However, there are no limits as to the costs that the SN CRAC can recover. Such costs are not limited to "extraordinary or catastrophic events." Specifically, when the LB CRAC was designed during BPA's Supplemental rate case, the methodology explicitly provided for augmentation costs to be excluded from recovery using the LB CRAC when BPA had acquired more augmentation power than was needed to meet augmentation needs. *See* 2002 GRSPs, Section F(1)(d)(2)(i). When augmentation power is excluded from the LB CRAC, it is remarketed by BPA's trading floor. Revenues from this remarketing, as well as the gross cost of the excluded augmentation power, are included in BPA's overall financial results. If the remarketing revenues fall short of the costs of these excluded augmentation megawatts, the cost shortfall may be recovered by the FB or SN CRACs.

Q. The Coalition Customers argue that the SN CRAC was not intended to cover BPA's inability to control its costs or speculation in energy markets. Faddis, et al., SN-03-E-CC-01, at 7. Please respond.

A. To the extent the Coalition Customers' statement implies there are categories of costs that should be excluded from the SN CRAC, such is not the case. BPA has dealt with the cost control issue in Section 2 in this testimony. BPA does not "speculate" in energy markets. Rather, BPA must manage the risk associated with a highly uncertain hydroelectric system and volatile market prices, which requires it to take positions in the market without complete certainty. Nevertheless, there are no limits on the categories of costs that the SN CRAC can recover.

Q. The Coalition Customers argue that BPA's expected net revenue loss for the remainder of the rate period is $340 million, but the proposed SN CRAC will take an additional $920 million, thus in FY 2004-06 BPA is proposing to collect almost $600 million more from its customers than its net revenue loss in the same period. Faddis, et al., SN-03-E-CC-01, at 8. Please respond.

A. As previously noted in this testimony, BPA's proposal is consistent with the original intent of the SN CRAC to restore a high probability that Treasury payments during the remainder of the rate period will be made on time, if and to the extent market and other risk factors allow. An alternative to the proposed multi-faceted approach (using the three standards of a reduced TPP, TRP and net revenue equal to zero), BPA could have chosen to maintain its traditional TPP standard of setting rates to ensure an equivalent 80-88 percent probability that BPA can make all of its Treasury payments in the FY 2004-2006 3-year rate period. This would have resulted in rates and ending reserve levels far in excess of those resulting from the combination of the three standards. This likely would have also resulted in BPA collecting far greater net revenues over the FY 2004-2006 period than it currently expects to collect under its proposal.

Q. The Coalition Customers argue that BPA expects to do very well under the SN CRAC proposal because it will have almost $350 million in reserves, will retain the right to retrigger the SN CRAC, and therefore BPA is not bearing its share of the economic difficulties in FY 2001-2006 when it insists on a zero or better net revenue condition over the rate period, especially compared to customers who cannot afford to pay higher rates. Faddis, et al., SN-03-E-CC-01, at 8-9. Please respond.

A. The first part of the Coalition Customers' argument implies that BPA has a reserve target of $350 million. BPA, however, does not have a reserve target. The expected value of reserves are a model output, based on ToolKit runs that meet the repayment standards of TPP, TRP, and Net Revenues greater than zero. Because BPA has relaxed repayment standards for this proceeding, it is imperative that BPA keep the ability to re-trigger the SN CRAC if necessary during the reminder of this rate period.

It is unclear what the Coalition Customers mean by "BPA is not bearing its share of the economic difficulties" in FY 2001-2006 given that BPA is mandated to set rates to recover its costs. As previously noted in this testimony, the three standards in BPA's proposal, taken together, reflect BPA's concern for the economic condition of the Northwest, reflect BPA's concern regarding the rate impact on customers, and also provide a high level of assurance that BPA's obligations to the U.S. Treasury will be satisfied by the end of FY 2006, consistent with the original intent of the SN CRAC to restore a high probability that Treasury payments during the remainder of the rate period will be made on time, if and to the extent market and other risk factors allow. The three standards represent a compromise, but appropriate, balance of financial objectives that positions BPA to be financially healthy in the future.

Q. The Coalition Customers argue that BPA's SN CRAC proposal is inconsistent with the intent of the SN CRAC because BPA is not using all its financial tools in lieu of a rate increase. Faddis, et al., SN-03-E-CC-01, at 10. In particular, the Coalition Customers argue that by refusing to recognize ENW's reduced debt service costs in its calculation of TPP or TRP, BPA misstates its true cash position and ignores the SN CRAC rate schedule, such that BPA is using the SN CRAC rate increase to preserve or replenish BPA's financial tools. Id. Please respond.

A. There is no requirement that BPA must use all its financial tools in lieu of a rate increase. BPA recognizes ENW's reduced debt service costs for what they are, an extension of bond principal, which would otherwise have been paid off at maturity. That principal extension, on its own, is pushing a significant amount of debt into future years. Without planning for the corresponding payment of Treasury debt, the act of extending the ENW debt would be financially imprudent. In order to be effective and justifiable, the debt optimization program is a two-part transaction extending ENW principal and paying down Treasury debt. This is consistent with the intent of the SN CRAC.

Section 6. Trigger of the SN CRAC Process

Q. GPU and the Coalition Customers argue that BPA has not demonstrated that it is at risk of missing its upcoming payment to the U.S. Treasury or another creditor. Lovely, et al., SN-03-E-GP-01, at 5; Faddis, et al., SN-03-E-CC-01, at 5-7. Please respond.

A. Section II.F.3 of BPA's 2002 GRSPs provides that "[t]he SN CRAC will be available if the Administrator determines that, after implementation of the FB CRAC and any Augmentation True-Ups, either of the following conditions exist: BPA forecasts a

50 percent or greater probability that it will nonetheless miss its next payment to Treasury or other creditor, or BPA has missed a payment to Treasury or has satisfied its obligation to Treasury but has missed a payment to any other creditor." At the time the Administrator triggered the SN CRAC process, BPA demonstrated that it had met the GRSP requirements to start the process. As stated in Keep, *et al.*, SN-03-E-BPA-04, at 3:

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

BPA met the requirements of the GRSPs to start the SN CRAC process: BPA forecasted a 50 percent or greater probability that it would miss its next payment to Treasury; and it sent written notification of the determination to customers with the documentation used by BPA to determine that the SN CRAC process had triggered, including the amount of the forecasted shortfall, and the time and location of the SN CRAC workshop.

Q. *GPU and the Coalition Customers argue that BPA's trigger of the SN CRAC process is inappropriate because no catastrophic events have occurred that would justify triggering the SN CRAC. Lovely, et al., SN-03-E-GP-01, at 5; Faddis, et al., SN-03-E-CC-01, at 7. Please respond.*

A. As noted above, there is no requirement that a "catastrophic event" must occur to trigger the SN CRAC process. The GRSPs control the triggering of the SN CRAC, and no mention is made of a "catastrophic event". Instead, the standard is that "BPA forecasts a 50 percent or greater probability that it will nonetheless miss its next Treasury or other creditor, or BPA has missed a payment to Treasury or has satisfied its obligation to

Treasury but has missed a payment to any other creditor." *See* 2002 GRSPs, section II.F.3.

Q. *The Coalition Customers argue that, based on the Joint Customers' testimony, when BPA's costs and revenues are updated to reflect committed cost reductions, anticipated water conditions and market prices, and other factors, the TPP for FY 2003 ranges from 97 to 100 percent in the cases analyzed. Faddis, et al., SN-03-E-CC-01, at 5. Please respond.*

A. This argument has little bearing on the triggering of the SN CRAC process. The Administrator's determination to trigger the SN CRAC process must be made at a specific time. This trigger determination does not establish or require the implementation of an SN CRAC. Instead, it simply begins a process in which BPA must determine whether to implement an SN CRAC and, if so, the extent of that SN CRAC. The fact that costs, revenues, water or prices may change over time does not affect the trigger determination, but instead is considered in determining whether an SN CRAC should be implemented and, if so, the level of such a CRAC. The Joint Customers' arguments regarding costs, revenues, water and prices are addressed elsewhere in BPA's rebuttal testimony.

Q. *The Coalition Customers argue that BPA has already pre-paid Treasury and is currently $262 million ahead of scheduled payments in the rate period (not including the $315 million). Faddis, et al., SN-03-E-CC-01, at 6. GPU similarly argues that BPA's trigger of the SN CRAC process is inappropriate because BPA has already effectively prepaid its Treasury obligation for this year through advanced amortization payments. Lovely, et al., SN-03-E-GP-01, at 5. Please respond.*

A. While BPA has made extra amortization payments in recent years, largely as part of the debt optimization program, Treasury does not view payments in prior years as available to satisfy current-year obligations. At this point, BPA believes Treasury and others in the

Administration would view any attempt to claim the additional payments as having satisfied this year's payment as a deferral. BPA believes there could be serious political repercussions resulting from such an action.

Q. The Joint Customers cite BPA's GRSPs, which provide that "[i]n determining which proposal to include in its initial proposal in the SN CRAC 7(i) proceeding, BPA will give priority to prudent cost management and other options that enhance Treasury Payment Probability while minimizing changes to the FB CRAC." Bliven, et al., SN-03-E-JC-01, at 2. They argue this means that BPA must reduce its costs and use cash tools, meaning the use of borrowing for long-lived assets, where appropriate (it is not clear BPA has done this) and potentially the use of ENW refinancing proceeds to minimize rate adjustments. Id. at 2-3. Since spending forecasts are higher than 2001 actual costs, and not all cash tools at BPA's disposal have been used, they believe BPA can undertake further prudent spending reductions and cash management actions to eliminate or minimize the need for an SN CRAC rate increase. Please respond.

A. While this argument has little bearing on triggering the SN CRAC process, it relates to development of BPA's SN-03 Initial Proposal. As noted previously, the Administrator's trigger determination schedules a workshop. The workshop therefore occurs after the Administrator has made the trigger determination. As provided in the GRSPs, the purpose of the SN CRAC workshop is to discuss the cause of the shortfall, and any proposed changes to the FB CRAC that will achieve a high probability that the remainder of Treasury payments for the rate period will be made timely. *See* 2002 GRSPs, section II.F.3.a. As the Joint Customers correctly note, "[i]n determining which proposal to include in its initial proposal in the SN CRAC Section 7(i) proceeding, BPA will give priority to prudent cost management and other options that enhance Treasury Payment Probability while minimizing changes to the FB CRAC." *Id*. The GRSPs therefore do not require that these actions be incorporated *before* the Administrator triggers the SN

CRAC process, but rather in the development of BPA's initial proposal.

In developing BPA's SN-03 Initial Proposal, BPA gave priority to *prudent* cost management and other options that enhance Treasury Payment Probability while minimizing changes to the FB CRAC. BPA's Initial Proposal reflected cost reductions, cash tools, including the use of borrowing for long-lived assets where appropriate, and BPA considered the potential use of ENW debt extension proceeds to minimize rate adjustments, although BPA determined this latter option was imprudent.

While BPA's Initial Proposal gave priority to prudent cost management and other options, BPA is continuing to look for additional cost cuts which, given BPA's proposed variable and contingent rate design, would decrease the size of rate increases under the SN CRAC. Furthermore, the PBL is currently borrowing for all investment that is appropriately considered capital investment. (The Transmission Business Line's recent rate proposal assumed revenue financing of some amount of capital investment in FYs 2004-2005). Also, BPA is using cash tools to minimize the level of the SN CRAC. BPA requested and ENW implemented a process to release bond reserve funds by purchasing surety bonds. In keeping with the spirit of parties' proposals to delay cash payments until later in the rate period, BPA has shaped the payments to Treasury for the Judgment Fund associated with the Enron settlement. Payments will remain within the original term of the Enron contracts, but are heavily weighted toward the end of the rate period. In FY 2002, ENW proposed, and BPA agreed, to start issuing debt for new capital investments. This change reversed historical practice and reversed the accounting and revenue financing that had occurred in prior years for the Independent Spent Fuel Storage Installation at CGS. ENW and BPA are in the process of issuing bonds for this capital project and other anticipated projects for FY2004. Contrary to ENW standard of levelized debt service, the ENW board has agreed to schedule principle payments to start in 2007. BPA intends to keep the option of using cash tools for short-term liquidity needs, but does not intend to employ them further to reduce rates. In summary, to the extent parties believe BPA's initial proposal did not give priority to prudent cost management and other options that enhance Treasury Payment Probability while minimizing changes to the FB CRAC, the parties have had the opportunity to present such options in their direct cases and the Administrator will carefully review the parties' arguments based on the record. The parties' arguments on the issues have been addressed in BPA's rebuttal testimony.

Section 7. Retrigger of SN CRAC

Q. NRU argues that the SN CRAC should be imposed on a year-by-year basis, and only one time during the year. Saven, et al., SN-03-E-NR-01, 11. Please respond.

A. NRU's statement is inconsistent with BPA's 2002 GRSPs (also cited in BPA's direct testimony, Keep, *et al*., SN-03-E-BPA-04, at 2), which provide that the SN CRAC will achieve a high probability that the remainder of Treasury payments during the FY 2002-2006 rate period will be made in full. *See* GRSPs, Section II.F.3. Once the criteria for triggering the SN CRAC process have been satisfied, BPA must set the proposed SN CRAC to achieve a high probability of Treasury payments *for the remainder of the rate period*. This is inconsistent with imposition of the SN CRAC on a year-by-year basis. With regard to the phrase "only one time during the year", BPA assumes this means only triggering the SN CRAC one time during a year, and BPA agrees that this is appropriate.

Section 8. Term of SN CRAC

Q. NRU rejects the proposition that a one-year SN CRAC has to address a net revenue problem covering both past years of the rate period and future years beyond FY 2004, and the SN CRAC should only address a net revenue problem for FY 2004. Saven, et al., SN-03-E-NR-01, at 8. Please respond.

A. The GRSPs are clear that if the SN CRAC triggers, the rate must be set to ensure repayment for the remainder of the rate period. Therefore, it cannot only address a net revenue problem for FY 2004, unless that was the only year where there is a net revenue problem. As stated in Keep, *et al.*, SN-03-E-BPA-04 at 15-16, PBL is expecting persistent negative net revenues over the remaining three years of the rate period. If PBL only needed to collect additional revenues to cover the actual losses from FY 2002 and expected losses in FY 2003, or the projected shortfall over FY 2004-2006, a one-year SN CRAC adjustment may have been sufficient. However, trying to solve the rate period net revenue problem in only one year would have required a large SN CRAC and would not have met BPA's criterion to mitigate rate impacts. In addition, the SN CRAC, as proposed in BPA's June 2001 Supplemental Proposal and as adopted in BPA's 2002 GRSPs, is intended to restore a high probability that Treasury payments during the remainder of the rate period will be made on time, if and to the extent market and other risk factors allow. The three-year rate design goes hand-in-hand with the new TRP standard. By adopting the TRP standard and establishing a three-year rate period, BPA can set a lower rate because it allows for better years later in the rate period to make up any shortfalls that preceded them.

Q. Coalition Customers argue that BPA should consider SN CRACs one year at a time because the regional economy is in a fragile state and the state of the economy should be reviewed on an annual, real time basis. Faddis, et al., SN-03-E-CC-01, at 24. Please respond.

A. As BPA has stated throughout this testimony, BPA is also very concerned with the fragile state of the Pacific Northwest economy. This concern resulted in a proposed lowering of the repayment standards, as described elsewhere in this testimony. The concern about the economy was a major contributing factor to the direction to staff to develop a multi-year and variable SN CRAC rate design. That design structure resulted in the lowest rate possible, while still allowing BPA to meet its requirement to set rates sufficient to recover its costs over the remainder of the rate period.

Q. *The Coalition Customers also argue that BPA should consider SN CRACs one year at a time because BPA has two CRACs in place today and another CRAC gives excessive flexibility to the agency and contributes to an absence of cost restraint. Faddis, et al., SN-03-E-CC-01, at 25. Please respond.*

A. In BPA's direct case, Keep, *et al.*, SN-03-E-BPA-04, BPA described the intent of the SN CRAC:

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

It was the package of rate mitigation tools, including all three CRACs, that let BPA set its base rates as low as they are, while still providing a sufficiently high TPP. BPA disagrees that this gives "excessive flexibility" to the agency. It was a necessary part of an integrated package of risk mitigation tools. As stated above, setting an SN CRAC for only one year at a time, given BPA's net revenue forecast, would not allow BPA to set rates sufficient to ensure a high probability that the remainder of Treasury payments during the FY 2002-2006 rate period would be made in full.

Q. *The Coalition Customers also argue that for the future BPA should reexamine its long-term TRP recommendation of 88 percent because it is a cause of a large accumulation of cash reserves. Faddis, et al., SN-03-E-CC-01, at 25. Please respond.*

A. When asked during clarification, the Coalition Customers' witnesses verified that the term "TRP" should be TPP, *i.e.*, they are referring to a TPP of 88 percent. While BPA appreciates the Coalition Customers' concerns about setting rates in the next general rate case, the Coalition Customers must raise such issues in that rate case and the Administrator will address and resolves such issues in that forum.

Section 9. Proposed Cost Reductions

Q. NRU argues that the SN CRAC is not necessary because runoff has improved since the Initial Proposal, issues regarding IOU benefits remain under discussion for settlement, and cost cuts and $100 million of ENW refinancing proceeds should be used, citing the Joint Customers' testimony. Saven, et al., SN-03-E-NR-01, at 6-7. Please respond.

A. BPA addresses NRU's proposed adjustments in BPA's rebuttal testimony. The effect of increased runoff is addressed in BPA's Loads and Resources testimony, Hirsch *et. a*l., SN-03-E-BPA-12, and Secondary Revenue Forecast testimony, Oliver *et al*., SN-03-E-BPA-12. Issues regarding cost cuts, the uncompleted settlement of challenges to the IOUs' Residential Exchange Program settlements, and ENW "refinancing proceeds" are addressed in the current testimony.

Q. GPU and WPAG argue that BPA should take all actions to reduce its expenses to the levels projected in the May 2000 and June 2001 decisions. Lovely, SN-03-E-GP-01, at 9; Saleba, et al, SN-03-E-WA-01, at 7. Please respond.

A. BPA continues to aggressively pursue cost reductions both internally and with its generating partners (*i.e.*, Corps, Reclamation and ENW). Nevertheless, as previously noted, because of the changes in BPA's operating environment, it is unrealistic that BPA can reduce all of its expense levels to May 2000 levels without jeopardizing mission critical programs or reliability. As previous testimony addresses, internal operations costs are essentially flat compared to actual spending in 2001, but the dramatic decreases in internal costs embedded in the May 2000 proposal have not occurred due to the increasing complexity of the market, the load obligations placed on BPA by its customers, the service-level expectation of BPA's stakeholders and the required functional split between the power and transmission business lines. Deregulation and restructuring along with the West Coast power crisis in 2000-2001 required expense increases in order to respond to increase in complexity of the electricity market, scheduling protocols, congressional and FERC enquiries, etc. Additionally, the increasing risks and revenue opportunities in the power market have dictated increases in expense to manage those risks and maximize surplus revenues, and increases in spending on automated systems to manage business and operational functions. Conservation and renewable resource development was required in the face of West Coast supply deficits revealed during the 2000-2001 drought. Further, a constant flow of regional policy issues has required ongoing staffing, as has RTO development and administration of the Asset Management Strategy with the Corps and Reclamation. The split of power and transmission business lines and compliance with FERC standards of conduct and other requirements has increased costs and staff demands. The managing and implementation of Subscription contracts, the implementation of the CRAC-rates structure, and the acquiring and managing of BPA's augmentation portfolio has placed upward pressure on costs.

As also noted previously, due to increases in security costs associated with BPA internal operations, the Corp of Engineers, the Bureau of Reclamation and ENW due to September 11, 2001, the increased costs associated with maintaining a safe and reliable, though aging hydro system and nuclear plant, the increased regulatory requirements, the reallocation of project purposes at Grand Coulee dam by the Bureau of Reclamation, and the embedded expenses associated with implementing the Biological Opinion (in the Corps, Reclamation and internal operations line expense items) all virtually prohibit reducing expenses to levels in the May 2000 forecast.

Q. The Joint Customers, WPAG, and GPU argue that the $23 million of ENW bearer bond revenues from a settlement with the Bank of America should be reflected in BPA's *revenue requirement and ToolKit runs. Bliven, et al., SN-03-E-JC-01, at 10; Saleba, et al., SN-03-E-WA-01, at 8. Lovely, et al., SN-03-E-GP-01, at 4. Please respond.*

A. BPA has received $22 million relating to the Bank of America settlement, and proposes to include it in the net revenue forecast for BPA's Final Proposal, consistent with the parties' urging. ENW retained $500,000 for support of its other business ventures. This $22 million will improve BPA's net revenue and reserve projections in FY 2003. Along with the settlement comes the responsibility to pay future bond presentments. BPA expects that those payments will be approximately $500,000 per year.

Q. The Joint Customers argue that $20 million in cost cuts identified in Financial Choices but inadvertently omitted from the SN-03 initial proposal should be incorporated, and that BPA's commitment in the Financial Choices close-out letter that BPA would reduce average FY 2003-06 internal operating expenses, G&A expense and shared services to the 2001 level of $136 million (not including revenue offsets, which were not mentioned in the letter). Bliven, et al., SN-03-E-JC-01, at 11-12. The Joint Customers also argue that a further reduction of $6 million per year, in addition to the $5 million per year BPA identified, should be made to BPA's revenue requirement in FY 2003-06 to reflect these internal operating, G&A and shared services costs. Bliven, et al., SN-03-E-JC-01, at 12. Please respond.

A. As BPA noted its direct testimony, BPA proposes to incorporate In BPA's Final Proposal the $20 million inadvertently omitted in the SN CRAC Initial Proposal. BPA also is continuing to pursue cost reductions that do not jeopardize mission critical program objectives, which BPA proposes to incorporate into BPA's final analysis. At this point BPA estimates a total reduction in internal operations costs of over $30 million, relative to the initial proposal. Additional reductions are being sought.

Q. PPC and GPU argue that BPA should more aggressively pursue cost cutting measures, citing the Joint Customers' testimony, Bliven, et al., SN-03-E-JC-01, Section 2.

Crinklaw, et al., SN-03-E-PP-01, at 4; Lovely, et al., SN-03-E-GP-01, at 4. The Joint Customers note that $580 million of savings are being pursued by BPA, but require the participation or action of other entities, including Corps and Reclamation costs, power purchase contract renegotiation, debt service reductions and reductions to fish and wildlife costs. Bliven, et al., SN-03-E-JC-01, at 12-13. They argue that BPA should incorporate these savings into its revenue requirement in this proceeding. Id. at 13. Please respond.

A. BPA is aggressively pursing cost reductions both internally and with its generating partners (*i.e.*, Corps, Reclamation and ENW). BPA will incorporate all cost reductions that have been identified with a high level of certainty by the time of development of the final proposal. Additionally, BPA is considering a contingent SN CRAC design, which would allow resetting the SN CRAC parameters in August 2003, based on cost savings found in specific categories. Specifically, to the extent relevant events occur and cost savings have been identified with some certainty for the FY 2004-2006 period, reductions in the following categories will be reflected in re-calibrated SN CRAC thresholds, caps and revenue amounts: BPA Internal Operations Costs (the sum of PBL Internal Operations and Corporate Internal Services); Corps and Reclamation O&M; CGS O&M, BPA's Fish and Wildlife Integrated Program O&M; and any IOU litigation settlement. To the extent savings are realized each year, the variable component of the proposed SN CRAC will capture those savings.

Q. The Joint Customers argue that an automatic adjustment clause mechanism does not mean that the size of the SN CRAC can be expected to decline if BPA's financial condition improves because allowing BPA such rate flexibility reduces BPA's incentives to control costs and automatic adjustment clauses only increase the risks that contributed to BPA's financial problems. Bliven, et al., SN-03-E-JC-01, at 23. The Joint Customers further argue that these, in conjunction with take-or-pay contract remove incentives to *control costs. Bliven, et al., SN-03-E-JC-01, at 23. Additionally, the Joint Customers argue that automatic adjustment clauses create the expectation of increasing rates and therefore remove cost control incentives. Bliven, et al., SN-03-E-JC-01, at 25. They further argue that a contingent approach does not remove their foregoing concerns about automatic adjustment clauses. Bliven, et al., SN-03-E-JC-01, at 27. Please respond.*

A. BPA disagrees with these contentions. An automatic adjustment clause mechanism and a contingent mechanism do not reduce BPA's incentive to control costs or increase the risks that contributed to BPA's financial problems. BPA is going through significant cost cutting efforts, both internally and with its cost partners. In addition, BPA proposed and customers agreed through the rate case settlement in the 2002 Supplemental rate case that BPA faced many large uncertainties, most of which were beyond BPA's control. Without the ability to implement the CRACs, BPA would have had to set very high base rates. The automatic nature of the CRACs allows them to rise, and fall, as the risks they are designed to cover result in greater or lesser costs to BPA. For example, the LB CRAC, designed to cover augmentation costs associated with Subscription contracts, is expected to decline as those costs decline. Had BPA implemented a fixed rate, it would have been necessary to set the rate much higher, and customers would have only seen a rate decrease if the Dividend Distribution Clause had been invoked.

It is unclear to BPA whether an incentive to increase costs has been created by variable rate mechanisms. However, as demonstrated by the following history, if there were incentives they did not materialize in activating these variable rate mechanisms. In the past, BPA's rate structure has had both a Cost Recovery Adjustment Clause (CRAC) (*See* 1987 and 1989 Wholesale Power and Transmission Rate Schedules) and an Interim Rate Adjustment (IRA) (*See* 1993 Wholesale Power and Transmission Rate Schedules), which were variable rate structures. BPA did not need to activate either of these clauses while under the 1981 Power Sales Contracts. Therefore, it is not necessarily true that having variable rate mechanisms lead to a lack of cost control.

The current automatic adjustment mechanisms were not established to create an incentive to relax cost controls; rather they were established to deal with risks of all types, including cost uncertainties. The fact that these risks have proved real and BPA now needs to raise its rates to deal with these materialized risks is not a function of the rate design or lack of control effort on BPA's part relative to the demands and expectations placed on it. The rate design allowed BPA to set a lower base rate initially and only raise rates if the need arose. The ability to raise rates did not drive the rate increase. The risks the variable rate was designed to cover drove the rate increase. *See* Keep, *et al*., SN-03-E-BPA-04, at 5-6.

Q. The Joint Customers summarize BPA's cost-cutting efforts in the mid-1990s and argue they are more extensive than BPA's current efforts. Bliven, et al., SN-03-E-JC-01, at 24-25. Please respond.

A. BPA's current cost-cutting efforts have been extensive and have been thoroughly described in previous parts of this testimony. BPA must note, however, that the comparison between today's cost-reduction efforts and those in the mid-1990s is flawed. BPA's relationship with its customers has evolved since the mid 1990s and the electricity market is very different as well. BPA's overall expense structure reflects the load obligations placed on BPA by its customers, the service-level expectation of BPA's stakeholders and the required functional split between the power and transmission business lines. Additionally, the managing and implementation of Subscription contracts, the implementation of the CRAC-rates structure, and the acquiring and managing of BPA's augmentation portfolio has placed upward pressure on costs. Further, deregulation and restructuring along with the West Coast power crisis in 2000-2001 required expense increases in order to respond to increase in complexity of the electricity market, scheduling protocols, congressional and FERC enquiries, etc. Additionally, the increasing risks and revenue opportunities in the power market have dictated increases in expense to manage those risks and maximize surplus revenues, and increases in spending on automated systems to manage business and operational functions. Conservation and renewable resource development was required in the face of West Coast supply deficits revealed during the 2000-2001 drought. Further, a constant flow of regional policy issues has required ongoing staffing, as has RTO development and administration of the Asset Management Strategy with the Corps and Reclamation. The split of power and transmission business lines and compliance with FERC standards of conduct and other requirements has increased costs and staff demands. All of these factors differentiate the cost-cutting environment of the mid-1990s and today.

Q. The Joint Customers use BPA employee positions as an example, stating that BPA reduced headcount by 1,017 positions for FY 1994-1999, but BPA added 518 positions for FY 2001-03 and proposes adding eight positions for FY 2004. Bliven, et al., SN-03-E-JC-01, at 25. Please respond.

A. BPA has added staff in the last three years, 63 percent of whom were in Transmission, 29 percent in Corporate and eight percent in Power. In the last three years BPA has gone to a 24/7 basis for real-time generation scheduling as well as to a 24/7 power trading function, neither of which existed on a 24/7 basis prior to 2000. In addition, PBL has had to add eighteen staff for the Slice product, primarily for scheduling, with costs 100 percent reimbursed by the Slice customers.

Section 10. Debt Extension Proceeds and Other Financial Tools

Q. Several parties argue that BPA should use portions or all of the proceeds from extending ENW debt for something other than repaying higher-interest Federal debt. Specifically, the Coalition Customers note that BPA has $315 million available for its next scheduled payment from reduced ENW debt service made available from a refinancing of bonds. Faddis, et al., SN-03-E-CC-01, at 5. They argue that, as acknowledged by the

Administrator and reflected in the Official Statements of the bond issues, BPA can (and if necessary, intends to) use these funds to make up any shortfall in its Treasury payment, which would produce a 100 percent TPP for 2003. Id, at 5-6. Please respond.

A. BPA will have $315 million from extending ENW principal due this year into the 2013–2018 period. BPA intends to make payments on higher-interest Treasury debt with these funds, consistent with the Debt Optimization Program. BPA acknowledges that these funds could be applied in other ways. Just as the Administrator stated in the letter cited in the Coalition Customers testimony, "extraordinary cash tools, such as use of ENW refinancing proceeds or the Treasury note, are BPA's last line of financial defense." The Administrator also noted that "[e]ven with an SN CRAC in FY04, there is high probability that BPA will need these last-defense tools to meet obligations both in the fall of 2003 and the fall of 2004. Using $100 million of ENW debt extension proceeds to avoid an SN CRAC means that the last line of defense is that much smaller." *Id*. at 5. In other words, using these proceeds to decrease rates (or avoid increasing them) means they are unavailable for other purposes. BPA recognizes that these funds may be necessary for short-term liquidity purposes, such as making the scheduled year-end Treasury payment, or for cash flow in October or November. Because of this, and because other actions and factors are acting to decrease the proposed expected rate increase, BPA does not plan to use these tools in rate setting.

Q. NRU argues that BPA should use up to $100 million of ENW refinancing proceeds as a reserve to assure a high TPP in 2003 through 2005, with any use of the reserve being paid back during 2006, with BPA holding the funds rather than making a prepayment to Treasury as part of BPA's debt optimization plan, and that such use would only occur after all customer-proposed cost cuts. Saven, et al., SN-03-E-NR-01, at 12, 14. They support this use of up to $100 million of the ENW refinancing proceeds, particularly if the SN CRAC is over a year in duration. Id. at 12. PPC argues that BPA should set aside

$150 million of ENW refinancing proceeds in a reserve of last resort, for use if BPA cannot achieve its cost cuts. Crinklaw, et al., SN-03-E-PP-01, at 4. The Joint Customers argue that BPA has $315 million of income available for other purposes than accelerating amortization of existing Treasury debt in cases of extreme financial pressure. Bliven, et al., SN-03-E-JC-01, at 16. The Joint Customers also argue that BPA is currently under extreme financial pressure and a portion of these proceeds should be held as a reserve of last resort to make scheduled amortization payments, with this restricted usage only for the current rate period and repaid in full by the end of the rate period. Id; Saleba, et al., SN-03-E-WA-01, at 7. The Joint Customers acknowledge that such use of the ENW refinancing program would require the concurrence of the ENW board in order not to imperil future ENW refinancings. Bliven, et al., SN-03-E-JC-01, at 16. Please respond.

A. As indicated above, BPA will not plan on holding ENW debt extension proceeds to lower the SN CRAC rate. If needed, at the end of this year, BPA may need to hold some proceeds "as a reserve of last resort." The following are reasons for continuing the debt optimization program as originally intended:

- BPA has already employed several financial tools that it considers prudent as described elsewhere in this testimony;
- Use of the proceeds as proposed by the customers will jeopardize the future of the program, which BPA believes provides value to the region. The understanding with ENW does not envision a long-term use of these funds, even under serious financial conditions;
- Use of the proceeds as proposed will jeopardize bond ratings on BPA-backed bonds, the impacts of which are described more fully elsewhere in this testimony;
- Recently issued bond Official Statements state that "[t]he possible financial tools Bonneville may rely on to meet cash flow needs in early fiscal year 2004 include

among other items: (i) deferring all or a portion of planned early repayments and amortization of about $315 million in bonds issued by Bonneville to the United States Treasury and appropriations repayment obligations by Bonneville to the United States Treasury at the end of fiscal year 2003 in great part under the Debt Optimization Proposal, (ii) seeking access to short-term borrowing with the United States Treasury under Bonneville's existing borrowing authority, or (iii) deferring scheduled interest and/or principal payments to the United States Treasury, meaning planned payments to the United States Treasury as scheduled under applicable repayment criteria in contrast to the advance amortization payments described in clause (i)." BPA does not interpret this statement as giving BPA the ability to expand that interpretation to include using debt extension proceeds to reduce rates. BPA believes that the Official Statements give BPA some flexibility with regard to use of the proceeds, but they do not permit the type of use parties have advocated.

Q. NWEC argues that BPA should use some of its financial tools to defer some of its temporarily high costs into the next rate period. Weiss, SN-03-E-SA-01, at 29-30. Please respond.

A. BPA is very concerned about moving costs into the next rate period. Using the ENW debt extension proceeds as a reserve fund in FY 2004 or FY 2005 would require a larger SN CRAC in FY 2006 or a higher rate in post-2006 period. While it could be preferable for short-term impacts to move these repayment costs beyond the current rate period, such actions will be difficult to defend to the financial community and with ENW and may have a material adverse impact on BPA's debt optimization program. BPA's debt optimization program and the rating agencies' perception of BPA's creditworthiness both provide value to BPA's customers and the region.

Q. NWEC contends that adding $111.5 million/year in additional costs for fish and wildlife *and low-income conservation expenses should be met with financial tools to the extent the costs are not covered by rates. SN-03-E-SA-01 at 29. How do you respond?*

A. Decisions about BPA budgets for fish and wildlife and low-income conservation expense are not subject to this rate proceeding. The purpose of this rate proceeding is to ensure that rates recover costs for the existing rate period. Nevertheless, BPA does not believe that it is prudent business practice to pay for expenses with long-term financing arrangements.

Q. NRU argues that use of the reserve fund in FY2004 or FY 2005 would require a larger SN CRAC in FY2006, but while it would be preferable for short-term impacts to move these repayment costs beyond the current rate period, such actions may be difficult to defend to the financial community and ENW and may have a material adverse consequence on BPA's debt optimization program. Saven, et al., SN-03-E-NR-01, at 13. Please respond.

A. BPA agrees with NRU that such actions may be difficult to defend to the financial community and ENW and may have a material adverse consequence on BPA's debt optimization program.

Q. NRU argues that the use of $100 million of ENW refinancing proceeds as a reserve would not have a significant enough impact on BPA's creditworthiness or capital program because the rating agencies should recognize that, without the potentially large rate increase in the SN CRAC proposal, customers in the Northwest would be able to buy power from BPA at rates that would not contribute to additional regional economic curtailment and that would provide a more stable market for the firm power of the federal system. Saven, et al., SN-03-E-NR-01, at 13. Do you agree?

A. No. Standard and Poor's has said in the SN-03 Study, SN-03-E-BPA-01 Attachment 1-1: "Rating concerns that could prompt a downgrade include: the use of any debt restructuring savings to offset current operating expenses which would constitute a deferral of the cost recovery needed into future years." BPA interprets this statement to mean *any* level of deferral, not simply the entire $315 million. BPA may be able to make a reasonable case to the rating agencies, but BPA cannot assume that they will agree that it does not merit a downgrade.

Q. If BPA is unable to use the ENW refinancing proceeds, NRU argues that BPA should use other financial tools to improve liquidity, including using some of BPA's $250 million Treasury note in lieu of all or any portion of ENW refinancing proceeds, noting that Standard and Poor's already assumes that BPA will use liquidity tools such as this $250 million line of credit, and that BPA should reimburse the Treasury by the end of the rate period. Saven, et al., SN-03-E-NR-01, at 14. GPU argues that BPA should use the existing $250 million Treasury note to help avoid an SN CRAC. Lovely, et al., SN-03-E-GP-01, at 4. Please respond.

A. BPA views use of the Treasury note similar to use of the ENW debt extension proceeds. That is, it is a tool that is available for short-term liquidity purposes if necessary. However, planning to use it, and lowering rates with the expectation that it will be used, is not a position BPA is willing to take, given that it exacerbates longer-term financial impacts and would be viewed negatively by rating agencies.

Q. GPU and WPAG argue that BPA should renew efforts to obtain credit from the Treasury for accelerated repayments made during this and prior rate periods. Lovely, et al., SN-03-E-GP-01, at 4; Saleba, et al., SN-03-E-WA-01, at 7. Please respond.

A. Although BPA is continuing discussions with Treasury on this issue, there is no basis on which to assume that BPA would obtain Treasury concurrence.

Q. GPU argues that the contingent SN CRAC should incorporate strict spending controls and prohibitions on using cash for capital investments or early payment of Treasury bond principal and appropriations, so that any excess spending or other uses of cash in the remaining years of the rate period do not increase the SN CRAC over a maximum level.

Lovely, et al., SN-03-E-GP-01, at 6. Please respond.

A. As is described in the SN CRAC Design testimony, McCoy, *et al.*, SN-03-E-BPA-17, BPA is proposing to restrict any increase under the SN CRAC for internal operation costs (PBL Internal Operations and Corporate Internal Services) beyond those forecasted in this rate case. For items included in PBL Internal Operations and Corporate Internal Services, *see* Attachment F. As described in the Revenue Recovery rebuttal testimony, Lefler, *et al.*, SN-03-E-BPA-13, PBL is not proposing to finance any capital investments from revenues, and in the past has not revenue-financed without including such assumption in setting rates (with the exception of the short-term financing prior to issuing long-term bonds). Therefore it is not necessary to prohibit this practice. Because BPA's Debt Optimization Program calls for repaying Treasury bond principal and Federal appropriations with the proceeds from ENW debt extension, BPA will not prohibit that practice in the SN CRAC rate design. However, under the variable rate design, the practice should have little or no impact on rates, since increases in Treasury principal payments would be offset by an equal decrease in ENW principal payments.

Q. GPU argues that BPA should calculate ANR by adding back (1) any operating revenues used to finance new capital investments, and (2) any early payment of principal (a) in excess of that which is due or was scheduled to be paid in the May 2000 rate case 50-year repayment study or (b) that was funded from reduced ENW debt service pursuant to BPA's Debt Optimization Plan. Lovely, et al., SN-03-E-GP-01, at 9. Please respond.

A. BPA intends to use the ANR calculation used in the FB CRAC determination. PBL does not intend to revenue-finance capital investments, as explained in the testimony of Lefler, *et al.*, SN-03-E-BPA-13, so no adjustment for this is necessary. The ANR calculation does not reflect principal payments to Treasury, but rather reflects the non-cash annual write-down (depreciation/amortization) associated with capital investments. For this reason, and the fact that the ENW debt service is treated as an accrued expense in the

ANR calculation, BPA does not believe an adjustment to "back out" the Treasury payment side of the debt optimization program in ANR is appropriate. To do so would reflect only one side of the debt optimization program – the extension of ENW debt – and not the payment of an equal amount of Federal debt.

Q. The Coalition Customers argue that BPA's SN CRAC proposal is inconsistent with the intent of the SN CRAC because BPA is not using all its financial tools in lieu of a rate increase. Faddis, et al., SN-03-E-CC-01, at 10. In particular, the Coalition Customers argue that by refusing to recognize ENW's reduced debt service costs in its calculation of TPP or TRP, BPA misstates its true cash position and ignores the SN CRAC rate schedule, such that BPA is using the SN CRAC rate increase to preserve or replenish BPA's financial tools. Id. The Coalition Customers argue that the full effect of all actual and expected ENW financings during the rate period must be included in the TPP calculations. SN-03-E-CC-01, at 10. Please respond.

A. As explained above, BPA's intention on a planning basis is to conform to the Debt Optimization Program. This entails repaying the same amount of combined Federal and non-Federal debt that was planned in the May 2000 proposal, using proceeds from extending ENW debt to repay an equivalent amount of higher-interest Federal debt. Given this plan, BPA is not misstating its cash position. The GRSPs do not require BPA to use all cash tools to lower rates. Rather, the GRSPs state that, in developing BPA's initial proposal, BPA will give priority to *prudent* cost management and other options that enhance TPP while minimizing rate increases. BPA believes that planning to use ENW proceeds or all available cash tools to lower rates is not a prudent business plan. Rather, BPA assumes it will have some cash tools available to cover short-term liquidity needs. In terms of using "other options" to minimize rate increases, BPA has done a number of reserve fund free-ups, used the Judgment Fund to structure payments related to the Enron settlement, agreed to back ENW issued bonds for CGS capital improvements, and has accepted a combination of criteria other than just a high TPP for this rate process.

Q. *The Coalition Customers argue that the recognition of reduced ENW debt service costs in the TPP calculations is not using credit to pay current operating costs, but that recognizing reduced ENW debt service costs in the TPP calculation is appropriate and prudent, particularly in the context of the current Northwest economy, because it balances the extreme scenarios that occur in the 3000 games of the TPP calculation. Faddis, et al., SN-03-E-CC-01, at 11. Please respond.*

A. The Debt Optimization Program was never intended to mitigate forecasted risks in the manner described by the Coalition Customers. BPA should not use the proceeds from debt extension to mitigate risks of potential extreme scenarios when forecasting TPP.

Q. *The Joint Customers argue that BPA has estimated the financial impact of bond downgrades by citing a statement from the BPA Journal by an employee who said that recent bond downgrades had reduced BPA's $37 million of savings of an ENW debt refinancing by $637,000, and further downgrades could be as much as half of a percent, which implies that the benefit from the ENW refinancing to be done of $600 million later this year would be reduced by as much as $3 million. Bliven, et al., SN-03-E-JC-01, at 28. The Joint Customers conclude that the estimated financial losses from rating downgrades appear to be an insufficient justification for BPA's potential billion-dollar rate increase. Id. at 29. Please respond.*

A. The statement in the BPA Journal indicating that the effects of further downgrades could be as much as half of a percent was intended as a general remark to make the point that downgrades affect savings, without providing significant detailed background. The supporting information to make such a statement was provided to BPA by its Financial Advisor, Public Financial Management (PFM) in March 2003 and updated in April 2003 (*See* Data Response PP-BPA-007, Attachment 5). Specifically, PFM advised BPA that a downgrade to A- could cost about 30 basis points and a downgrade to BBB could be

80-90 basis points.

If one assumes a downgrade creating a 50 basis point (half of a percent) additional interest cost on a $600 million bond sale, the additional cost would be $3 million per year, for the life of the bonds (2017 in this case), or about $42 million, not simply $3 million as stated by the Joint Customers. Additionally, such a downgrade could be expected to also affect the variable rate debt outstanding or to be issued in the future, whose interest rates change on a weekly or monthly basis. The downgrade also would affect any future refinancings, perhaps making them uneconomic.

BPA's power marketing also can be affected by counterparties' view of BPA's creditworthiness. Ratings downgrades can impact BPA's ability to purchase power. Counterparties may reduce trading limits on transaction levels and downgrades increase the likelihood for requests for credit support. The effects of ratings downgrades can be far-reaching and not necessarily limited to those effects mentioned by the Joint Customers.

Q. The Joint Customers argue that BPA made no reference to the concern about the impact of a 30 percent rate increase on the credit worthiness of BPA-backed bonds, by reducing the ability of customers to pay their bills. Bliven, et al., SN-03-E-JC-01, at 28. Please respond.

A. Standard and Poor's (S&P), as stated in their report on ENW/BPA, is concerned about the opposite effect. In the SN-03 Study, SN-03-E-BPA-01, Attachment 1-1, S&P states: "Rating concerns that could prompt a downgrade include: Failure to implement an adequate SN CRAC, which is needed at 16 percent absent any additional cost cuts, to keep cash reserves at a minimum operating level." BPA believes that S&P is familiar with the regional economic environment when it makes that statement.

Section 11. Alternative Rate Design: Contingent and Capped

Q. WPAG argues that the creation of spending categories in addition to those listed on

Table B of Attachment A would not be permitted in determining compliance with the subtotal categories that WPAG argues should be subject to spending limits. Saleba and Piliaris, SN-03-E-WA-01, at 18.

A. BPA disagrees that the creation of spending categories in addition to those listed on Table B of Attachment A (*See* Saleba and Piliaris, SN-03-E-WA-01) should not be permitted. In fact, the table in BPA's direct Revenue Recovery testimony, Lefler, *et al.*, SN-03-E-BPA-06, needs to be modified per the PBL Pro Forma Revenue and Expense Summary (*See* Attachment F). The category of PBL Internal Operations should be modified by removing the conservation initiatives (line items labeled Energy Efficiency Development, Energy Web, Legacy Conservation and Low Income Weatherization, Market Transformation and Sponsored Energy Initiatives). A new category named Conservation Initiatives should be formed consisting of the following line items: Energy Efficiency Development, Energy Web, Legacy Conservation and Low Income Weatherization, Market Transformation and Sponsored Energy Initiatives. These line items associated with conservation spending are largely contract services and are not expenses related to traditional internal operations expenses such as compensation, travel, training, materials and supplies, etc. Additionally, some of these items are fully reimbursable to BPA and therefore do not have a net impact on rates.

Notwithstanding the foregoing and subsequent testimony on placing spending limits (capping costs) on certain expenses, BPA agrees that the creation of additional categories in addition to those in Attachment F should not be permitted in determining compliance with spending limits.

Q. WPAG recommends specific spending levels that will be recognized in any SN CRAC adjustment. They believe this recommendation is necessary to impose discipline on BPA's spending and the absence of limits provides a mechanism to fund future programs. Saleba and Piliaris, SN-03-E-WA-01, at 15-18. Further, WPAG's proposal on spending *does not include any offsetting adjustments for overspending in one area for under spending in another. Id. at 18. Similarly, the Joint Customers contend that BPA should cap cost increases to prevent future triggering of the CRACs. They argue that automatic adjustment clauses will recover all expense increases and there would be insufficient motivation to hold down costs. The Joint Customers argue that a cap on the ability of BPA to collect spending over-runs will provide a constant signal to the agency that costs must be kept under control and that caps should be implemented for BPA and non-BPA controllable costs. Bliven et al., SN-03-E-JC-01 at 21. Please respond.*

A. The specific spending levels that WPAG recommends to be capped for purposes of the SN CRAC calculation for the FY 2003–2006 period are as follows: PBL Internal Operations, Corporate G&A and Shared Services, Residential Exchange Monetary Payments, Power Generation, Renewable Projects, Transmission Acquisition, Civil Service Retirement Payments, Terminated Projects, Fish and Wildlife and Non-Federal Debt Service S*ee* Saleba and Piliaris, SN-03-E-WA-01A, at 5.

BPA generally agrees that annual spending limits should be placed on internal operations expenses. However, several modifications need to be addressed. First, PBL Internal Operations should be modified as stated in previous testimony and as reflected in Attachment F. Additionally, the annual spending limits should apply to the sum of PBL Internal Operations and Corporate Internal Services (*See* Attachment F, "PBL Pro Forma Revenue and Expense Summary"). BPA disagrees with the parties that spending limits should be placed on these two categories separately. The PBL Internal Operations and Corporate Internal Services categories are similar in nature in that they both support the internal operations of the PBL. Additionally, in order to advance efficient internal operations and create more transparent management and accountability of these costs, it may be necessary to move expenses between these two categories over time.

In addition to the foregoing, there are four areas of concern to BPA related to placing annual spending limits on internal operations expenses now defined as the sum of PBL Internal Operations and Corporate Internal Services. First, the annual spending limits must allow for force majeure-type conditions that may require an increase to internal operations expenses, such as court rulings, litigation settlements, changes in legal requirements, changes in security requirements, mandated regulatory requirements, and natural or man-made disasters. Second, in order to fully allocate costs associated with a project or program, some corporate internal operations expenses (also called "direct charges") are currently reflected in categories other than one of the two internal operations categories. Therefore, if these "direct charges" are moved to either PBL Internal Operations or Corporate Internal Services, it may appear like an increase, but actually, there will be no net increase in expenses charged to power rates. In other words, the change would be a result of simply moving expenses from one category outside of internal operations expenses into either PBL Internal Operations or Corporate Internal Services. Therefore, if these "direct charges" are determined to support a different project or are combined with existing projects to gain efficiencies and management accountability and therefore move out of one category into the internal operating expenses, the annual spending limits should increase by the amount of the expense, which has been moved. Third, the line item labeled "Slice" in PBL Internal Operations category should not be capped given that it is reimbursable to BPA and may increase at the specific request of Slice customers. Finally, expenses related to RTO development and implementation have not been forecast in any expense category. Therefore, increases in expenses related to RTO must not be considered as a breach of the annual spending limits and should simply increase the limits.

Therefore, in conjunction with the foregoing, the annual spending limits for internal operations expenses should be the sum of the "PBL Internal Operations" and "Corporate Internal Services" in Attachment A as forecast in the Final Proposal.

BPA agrees that the $20 million in omitted cost reductions and any recent additional cost reductions in the "PBL Internal Operations" and "Corporate Internal Services" should be reflected in the annual spending limit in the Final Proposal.

BPA disagrees with creating annual spending limits for all other categories that WPAG lists, specifically Residential Exchange Monetary Payments, Power Generation, Renewable Projects, Transmission Acquisition, Civil Service Retirement Payments, Terminated Projects, Fish and Wildlife and Non-Federal Debt Service and the new category of "Conservation Initiatives". These costs are not controllable or variable in the near-term by BPA without potentially violating BPA's ability to complete its mission and legal responsibilities.

Q. CRITFC argues that it would oppose any mechanism in the SN CRAC rate design that would fix BPA's internal operating costs for purposes of calculating the SN CRAC adjustment if the result would limit BPA's fish and wildlife funding or alternatively if internal costs were higher BPA needed to draw down reserves to meet these additional expenses. Sheets, et al., SN-03-E-CR/YA-01, at 50. Please respond.

A. BPA is not proposing to limit fish and wildlife funding as a part of its proposal to limit internal operations expenses. Further, BPA has established management plans to reduce the risk of its internal operations expenses exceeding those forecast in this rate proceeding.

~~*Q. NWEC proposes that BPA offer approximately 600 MWs of power to the DSIs under a variable rate design to ensure a presence on BPA's system as "swing" load. Weiss, SN-03-E-SA-01, at 28. Please respond.*~~

~~A. This portion of NWEC's testimony appears to have been copied from NWEC's comments on the Regional Dialogue, a separate public process where BPA and interested parties are discussing BPA's service to customers after 2006. BPA, however, is only implementing the SN CRAC in this rate proceeding, and is not establishing BPA's future~~

~~power sales to its customers. BPA also is not revisiting the rate design of BPA's base rates, such as the IP rate. BPA, however, will include NWEC's comments in the public record regarding the Regional Dialogue.~~

Section 12. IOU Settlement Benefits

Q. NRU states that the IOUs have offered to defer $55 million of their Residential Exchange Program settlement benefits and that benefit reductions are the subject of current negotiations, which NRU believes will be successful. Saven, et al., SN-03-E-NR-01, at 15. NRU argues that BPA should take all actions necessary to include the results of these negotiations into the setting the SN CRAC as soon as possible. Id. The Joint Customers argues that BPA's SN CRAC analysis, and determination of LB CRAC, could reflect removal of the litigation payment premium due the IOUs, assuming the settlement of litigation with the IOUs. SN-03-E-JC-01, at 10. Please respond.

A. BPA views an agreement over benefits paid to IOUs as an essential part of the overall effort to control potential rate increases, and is working actively with other parties to bring such an agreement about. Building such an agreement into the SN CRAC analysis before it actually is reached would not be financially prudent. However, the contingent and variable rate design would allow an agreement to be reflected in rates if it is reach before the final rate calculation later this year.

Section 13. Conservation and Renewables

~~*Q. NWEC contends that BPA is required by the Northwest Power Act to assure the Northwest of an adequate, efficient, economical and reliable power supply. Weiss, SN-03-E-SA-01, at 17. NWEC states "the fact that we are in this SN CRAC process is evidence that the agency has far to go in this respect." Id. NWEC contends that BPA has relied too heavily on extremely variable hydro-generation and the extremely volatile gas-price driven power market, which has caused BPA's power supply to be much less adequate, efficient, economical and reliable then should be the case and may subject*~~

~~*BPA and the region to a large future carbon mitigation risk. Id. Please respond.*~~

~~A. In meeting its obligations, BPA relies on a diverse set of resources to complement the FCRPS system, including conservation and renewable resources. BPA's total program has resulted in 53 aMW of conservation in FY 2002 compared to 19 aMW in 2001. In addition, BPA has purchased power, produced by renewable resources, with a total output of 67 aMW. This generation has been on line since December 2001. BPA has contractual commitments to increase this amount to 117 aMW during the current rate period. *See* SN CRAC Documentation, SN-03-E-BPA-02, at 2-90, 2-91. While the current process to implement the SN CRAC is not conducive to the establishment of agency policies regarding alternative resources, BPA is cognizant of its responsibilities regarding conservation and renewable resources and the Regional Power Plans adopted by the Northwest Power Planning Council. Such plans support and help to assure an adequate, efficient, economical, and reliable power supply for the Pacific Northwest.~~

~~*Q. NWEC contends that acquisition of all cost-effective conservation and the development of cost-competitive renewables are the "long-term path" out of BPA's problems. Weiss, SN-03-E-SA-01, at 27. NWEC proposed such a long-term strategy in the Regional Dialogue. Id. There is no need to wait until that process is concluded to make these investments since these programs save money and have short payback periods. Id. Please respond.*~~

~~A. The current process to implement the SN CRAC is not conducive to the establishment of long-term agency policies regarding conservation and renewable resources. BPA will address NWEC's strategy regarding such policies in the Regional Dialogue. BPA also is not establishing program levels for conservation and renewables in this proceeding. However, BPA's existing conservation and renewable programs are producing savings at expected levels. Existing programs are consistent with BPA's commitment to meet conservation and renewable targets contained in the current regional power plan and the~~

~~policy goals set out in testimony during the 2002 rate process.~~

~~BPA is acquiring and facilitating conservation and renewable investment sufficient to meet the goals of the current regional Power Plan. BPA's program resulted in 53 aMW of conservation in FY 2002 compared to 19 aMW in 2001. BPA's Conservation Augmentation program contributed 12.4 aMW during FY 2002. The Conservation Augmentation contribution directly offset market purchases.~~

~~In addition, BPA has purchased operating renewable resources with a total output of 67 aMW. This generation has been on line since December 2001. BPA has contractual commitments to increase this amount to 117 aMW during the current rate period. *See* SN CRAC Documentation, SN-03-E-BPA-02, at 2-90, 2-91.~~

~~*Q. NWEC refers to "background meetings" leading up to the SN CRAC process and that BPA conservation staff "indicated" there is a disparity between programs: some achieving conservation at half the cost of others. Weiss, SN-03-E-SA-01, at 27. NWEC urges BPA, if it must make cuts, to "direct its knife" to those programs that are most expensive and/or low accountability, i.e., the Conservation and Renewables Discount (C&RD) program. Id. Please respond.*~~

~~A. BPA promotes cost effective regional conservation through a variety of programs including the C&RD. The C&RD is a rate mechanism that allows BPA and the region to direct customer investment to cost-effective measures through the guidance of the regional technical forum. Implementation of the C&RD is based on the principle that the customers' own initiatives and actions will best capture the benefits and values of conservation and renewable resources.~~

~~*Q. NWEC argues that BPA is not providing an economical power supply because BPA's current power portfolio relies too heavily on hydro generation and power market purchases. Weiss, SN-03-E-SA-01, at 18, 28. NWEC states that customer and end users have provided evidence in public forums that BPA's prices are so high they threaten the*~~

~~*customers' economic well-being. Id. NWEC argues that low income consumers have been particularly hard hit and need immediate help, recommending that BPA double its current funding of low income weatherization to $7 million a year and rescind the projected $250,000 cut to this program. Id. NWEC also advocates allowing the agencies that provide these services more flexibility to install base load measures. Id. at 28. Please respond.*~~

~~A. BPA continues to plan for resource supplies sufficient to meet BPA's Subscription power sale contract obligations and statutory requirements. BPA manages conservation program as required by statute and meets program targets established by the current power plan.~~

~~BPA's low-income weatherization funding floor for the current rate period is $4 million per year. Spending in FY 2001 totaled $2.1 Million. In FY 2002, BPA total funding for state agency low income weatherization was $3.1 million with an additional $1.3 million invested in low income weatherization measures by utilities through the C&RD. Total low-income weatherization outlays amounted to $4.4 million during FY 2002. This represents a net increase in low-income weatherization activity during this rate period. BPA expects customers to continue C&RD-eligible investments in low-income weatherization measures, consistent with local priorities, sufficient to meet or exceed the program annual funding floor.~~

~~*Q. NWEC argues that BPA must make the long-term commitment to provide sustained funding for conservation and renewables and not be overly influenced by each crisis, and must analyze its cost and revenues drivers and risks in order to design rates with the right price signals to move its customers to make decisions that will reduce risk. Weiss, SN-03-E-SA-01, at 17. Please respond.*~~

~~A. We agree in principle that these are important programs, however, any commitments BPA makes for funding for conservation and renewables are made outside of BPA's rate~~

~~setting processes. BPA is obligated to set rates to recover its costs. BPA is not obligated to set rates to send price signals that will reduce risk, although BPA can consider such design in BPA's general rate case.~~

Q. *CRITFC argues that BPA's estimate of costs associated with the Corps, Reclamation and ENW in the WP-02 rate case were too low by $349 million. Sheets, et al., SN-03-E-CR/YA-01, at 45. CRITFC argues that BPA's cost assurances from these parties, as noted in data responses, are not reasonable given the previous $349 million underestimate. Id. Please respond.*

A. CRITFC misunderstands the difference between the nature of the expense estimates in the WP-02 rate case and the current expense levels in this SN-03 rate case. In the WP-02 rate case, the Corps, Reclamation, and ENW did not commit to manage to the Cost Review estimates that were embedded in that rate case. They viewed the expense forecasts as optimistic and the costs were not backed by firm plans and agreements to manage to those levels. Further, estimates of the cost of producing energy on the system (from the dams and the nuclear plant) did not reflect the costs of properly maintaining an aging system.

The estimates BPA is using in the SN-03 rate case are the most current and best estimates provided to BPA by our generating partners and have a much higher degree of reliability.

Section 14. Settlement Discussions

Q. *GPU argues that BPA should take whatever procedural steps are necessary to permit a settlement agreement. Lovely et al., SN-03-E-GP-01 at 5-6. They believe that BPA should consider the aspects of the WPAG settlement discussion. Id. How do you respond?*

A. Settlement discussions can be initiated through direct procedural communications between litigants. BPA is always willing to discuss possible settlements with rate case parties.

Section 15. Section 7(b)(2) Rate Test

Q. SUB argues that BPA should conduct a new section 7(b)(2) rate test to assess, among other factors, the decline in DSI loads. Nelson, SN-03-E-SP-01, at 9. Do you agree?

A. No. The section 7(b)(2) rate test was performed in BPA's May 2000 rate proceeding. That rate proceeding determined the level of the current posted base rates. These base rates remain in effect for the entire rate period, FY 2002-2006, and do not change with the implementation of the SN CRAC. Therefore, the section 7(b)(2) rate test is not applicable to the current SN-03 rate proceeding.

Q. SUB describes the section 7(b)(2) rate test, stating "…Congress established the 7(b)(2) "rate ceiling" which is intended to ensure that preference customers do not pay more for power under the legislation than they would have paid without the Act." Nelson, SN-03-E-SP-01, at 7. Do you agree with SUB's assertion?

A. No. SUB, however, did include a quote from BPA's Documentation for Section 7(b)(2) Rate Test Study, WP-02-FS-BPA-06A, which correctly states the purpose of the section 7(b)(2) rate test: "The effect of this rate test is to protect BPA's preference and Federal agency customers' wholesale firm power rates from certain specified costs resulting from provisions of the Northwest Power Act." Nelson, SN-03-E-SP-01, at 7-8 (emphasis added).

Q. SUB argues that the WP-02 Record of Decision (ROD) does not prohibit a 7(b)(2) rate test from being conducted for any section 7(i) process associated with an SN CRAC. Nelson, SN-03-E-SP-01, at 8. Do you agree with the implication in SUB's argument that BPA is required to conduct a new section 7(b)(2) rate test because there is no specific prohibition on doing so in the WP-02 ROD?

A. No. First, the absence of a specific prohibition of an action does not mean a particular action is appropriate, and is not a sufficient reason to take that action. For example, the

ROD also does not prohibit BPA from developing new base rates when implementing the SN CRAC, but doing so would be absurd. Furthermore, while there is no language in the ROD that specifically prohibits BPA from conducting the section 7(b)(2) rate test during the SN CRAC section 7(i) proceeding, it was BPA's intent that BPA would not conduct the section 7(b)(2) rate test in the SN CRAC process. This intent is confirmed by specific language that precludes BPA, as a practical matter, from performing such a test.

BPA's GRSPs specify that a 40-day SN CRAC section 7(i) proceeding will be used to make changes to the FB CRAC parameters. *See* 2002 GRSPs, WP-02-A-09, Appendix at 26. The section 7(b)(2) rate test is the result of a complex analysis that essentially forecasts BPA's power rates under two very different worlds. The rate test involves the projection and comparison of two sets of wholesale power rates for the general requirements loads of BPA's public body, cooperative, and Federal agency customers (7(b)(2) Customers). The two sets of rates are: (1) a set for the test period and the ensuing four years assuming that section 7(b)(2) is not in effect (Program Case rates); and (2) a set for the same period taking into account the five assumptions listed in section 7(b)(2) (7(b)(2) Case rates). *See* Section 7(b)(2) Rate Test Study, WP-02-FS-BPA-06, at 1. In BPA's general rate cases, it may require several months to conduct the section 7(b)(2) rate test. Even assuming for the sake of argument that BPA could have prepared a section 7(b)(2) rate test before the SN CRAC initial proposal, the time needed by parties to adequately review and respond to such a proposal, in BPA's experience, would not be available in an expedited section 7(i) hearing. The Administrator would not have specified a 40-day SN CRAC section 7(i) proceeding if that proceeding were to include performing a new section 7(b)(2) rate test.

Q. SUB argues that conditions used to determine the results of the section 7(b)(2) rate test, including increased BPA program costs and decreased DSI loads, have changed since the WP-02 rate case, and therefore BPA should conduct a new section 7(b)(2) rate test *for the SN-03 section 7(i) proceeding. Nelson, SN-03-E-SP-01, at 9. Do you agree?*

A. No. The DSIs and SUB made a similar argument in BPA's 2002 Supplemental Power Rate Proposal proceeding, that is, that changes in loads and costs require BPA to perform a new section 7(b)(2) rate test. *See* DSI Brief, WP-02-B-DS/AL-02, at 36-37; DSI Ex. Brief, WP-02-R-DS/AL-02, at 2-4; SUB Brief, WP-02-B-SP-02, at 7; SUB Ex. Brief, WP-02-R-SP-02, at 5-7. In BPA's 2002 Supplemental Power Rate Proposal ROD, BPA concluded that all of BPA's rate directives, including section 7(b)(2), were followed in developing BPA's May 2000 base rates. In BPA's 2002 Supplemental Power Rate Proposal, as in the current SN-03 rate proceeding, BPA's base rates developed in its May Proposal are not changing and are not higher than they were when proposed in May. Therefore, the studies conducted in the development of BPA's base rates, including the section 7(b)(2) rate test study, are still applicable.

Furthermore, costs and loads, among other data, change virtually every day. It is impractical to conduct a section 7(b)(2) rate test whenever such changes occur, for BPA would constantly be conducting the rate test. Similarly, as noted previously, the section 7(b)(2) rate test is conducted in developing BPA's base rates, not in implementing adjustment clauses. Conducting the section 7(b)(2) rate test in the SN-03 rate proceeding would be contrary to the whole point of an adjustment clause, that is, to be able to adjust for specific costs without having to undertake the tremendous requirements of redeveloping base rates.

Q. SUB argues that running the section 7(b)(2) rate test in the SN-03 rate proceeding is consistent with "BPA's historic application of the 7(b)(2) test." Nelson, SN-03-E-SP-01, at 9. Do you agree?

A. No. BPA's historical application of the 7(b)(2) test has been confined to general rate cases where base rates such as the PF, IP, and NR rates are calculated for the rate period. BPA does not conduct, and has not conducted, a new section 7(b)(2) rate test in rate proceedings where there is no adjustment to base rates. For example, the Supplemental Power Rate Proposal proceeding of June 2001, which established adjustment clauses, did not include a new section 7(b)(2) rate test.

Q. Is the current SN-03 rate proceeding similar to the June 2001 Supplemental Power Rate proceeding?

A. Yes. In both processes BPA faced increased costs and the need to adjust base rates though CRACs. In both processes, the scope of the process was limited to the development of these risk mitigation tools. In both processes, no changes to the levels of the currently posted base rates were proposed. And, finally, in both processes, BPA did not conduct a new section 7(b)(2) rate test.

Q. SUB argues that a reduction in DSI loads increases the likelihood that the section 7(b)(2) rate test will trigger and that BPA has historically recalculated changes in DSI loads as part of a 7(b)(2) study. Nelson, SN-03-E-SP-01, at 9-10. Please respond.

A. First, one cannot say that a reduction in DSI load would result in a rate test trigger absent actually performing the rate test. Furthermore, while BPA reflects any changes in DSI loads since the last general rate case forecast when conducting the rate test (or changes identified during a general rate case), this is true of all other factors used in the rate test. This, however, does not mean that each time the DSI load forecast changes between general rate cases, BPA performs a new section 7(b)(2) rate test.

Q. SUB argues that BPA should modify only a portion of the model from the 7(b)(2) test conducted in the WP-02 proceeding. Nelson, SN-03-E-SP-01, at 10. Do you agree?

A. No. By suggesting that BPA should modify only a portion of the model used to conduct the May 2000 section 7(b)(2) rate test, SUB implicitly acknowledges that there is insufficient time in the 40-day SN CRAC section 7(i) proceeding to conduct a complete section 7(b)(2) rate test. Furthermore, there are hundreds of inputs to the section 7(b)(2) rate test, all of which must be based on the best information available and all of which may affect the results of the rate test. It would be inappropriate to allow specific customers to pick and choose which parameters of the test to update and which to ignore.

Q. *SUB argues that it would be harmed if BPA does not perform the section 7(b)(2) rate test in the SN CRAC proceeding because "… the 7(b)(2) test compares the allocation of BPA costs with and without the Northwest Power Act. This information is valuable to SUB because it reveals whether or not allocation of benefits among customer groups is reasonable and is consistent with the Northwest Power Act." Nelson, SN-03-E-SP-01, at 11. SUB also argues it should be protected from cost shifts. Id. Do you agree?*

A. No. In addition to SUB's misstatement of the purpose of the section 7(b)(2) rate test, the base rates that are in place from FY 2002 to 2006 were based on a section 7(b)(2) rate test and those base rates are not changing. Because the SN CRAC is simply an adjustment to base rates, the underlying section 7(b)(2) rate test in the base rates ensures preference customers a proper allocation of costs and protection from cost shifts.

Q. *SUB argues that it believes the rate test will trigger at a higher level and therefore decrease benefits to the IOUs. Nelson, SN-03-E-SP-01, at 11. Do you agree?*

A. No. SUB's belief that a new rate test would trigger, and that a trigger would be higher than in May 2000, is highly speculative. BPA would have to conduct an entirely new section 7(b)(2) rate test in order to make such a determination. As noted in this testimony, this would be inappropriate for the purposes of this SN CRAC rate proceeding. Furthermore, SUB had the opportunity to conduct a section 7(b)(2) rate test study and present it with its direct case, but chose not to do so. SUB therefore has not supported its assertion.

Q. *Does this conclude your testimony?*

A. Yes.