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

Tiered Rate Methodology Rate Case

DIRECT TESTIMONY

May 2008

RISK MITIGATION:
Lovell, Johnson, Lee

TRM-12-E-BPA-08

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BYRNE E. LOVELL, JANICE A. JOHNSON, and CARIE E. LEE

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Witnesses for Bonneville Power Administration

SUBJECT: RISK MITIGATION

Section 1: Introduction

Q. Please state your names and qualifications.

A. My name is Byrne Lovell, and my qualifications are contained in TRM-12-Q-BPA-12.

A. My name is Janice A. Johnson, and my qualifications are contained in TRM-12-Q-BPA-10.

A. My name is Carie E. Lee, and my qualifications are contained in TRM-12-Q-BPA-11.

Q. What is the purpose of your testimony?

A. Our testimony describes the risk mitigation approach for Tier 1, Tier 2, and the Slice product proposed in the Tiered Rate Methodology (TRM), TRM-12-E-BPA-01. This testimony makes use of defined terms in the TRM; *see* TRM pages v-xvii.

Q. How is your testimony organized?

A. Our testimony has five sections. First is this introduction. Section 2 contains an overview of how risk issues are treated in the TRM and what would be left for later rate cases. Section 3 covers Tier 2 risk mitigation. Section 4 deals with Tier 1 risk mitigation. Section 5 describes risk mitigation in the Slice product.

Section 2: Overview of Risk Mitigation in the TRM

Q. Please discuss your proposed approach to risk mitigation.

A. In the TRM, we propose broad principles to guide the risk analysis and mitigation in future rate cases that would be performed during the term of the CHWM Contracts.

Conducting the actual risk analysis and mitigation would be part of each rate case and would be conducted consistent with the TRM.

Q. *Why are you not proposing a specific approach for risk analysis and mitigation?*

A. The TRM would be in place for many years. During that time it is likely that the major risks in the Power function will change, and therefore the set of mitigation tools available for dealing with those risks would need to change also. BPA would need to be able to match the types of risk analysis and the application of risk treatments to the circumstances of each rate case. This is the only way to ensure that BPA can deal with risk to meet its statutory and customer service objectives over time. Therefore, BPA needs to maintain the flexibility in each rate case to propose risk mitigation measures that are appropriate for the risks BPA faces at that time.

Q. *Would BPA treat Tier 1 and Tier 2 costs and risks separately in its risk approach?*

A. Yes. BPA would do everything it can to keep the costs and risks of Tier 2 from affecting the costs and risks of Tier 1, and vice versa. BPA would propose risk mitigation measures within each tier that would mitigate the risks associated with that tier up to BPA's financial risk standards.

Q. *How do you define "BPA's financial risk standards"?*

A. BPA's financial risk standard(s) is set in BPA's 10-Year Financial Plan or its successor(s) and then is reviewed in a section 7(i) proceeding if necessary. Currently, the 10-Year Financial Plan calls for BPA to set rates to achieve a 95 percent probability of making all required Treasury payments in each two-year Rate Period (i.e., the 95 percent Treasury Payment Probability (TPP) standard). This standard is to be applied separately to the Power function and the Transmission function. BPA is confirming that standard in a FY 2008 update to the Financial Plan.

Q. Might there be other financial risk standards in the future?

A. Yes. For example, the Financial Plan update will also describe a potential companion to the TPP standard. The TPP standard currently looks only at financial results at the ends of Fiscal Years and therefore does not measure how well financial risk within a Fiscal Year has been mitigated. One idea BPA is investigating has been termed Vendor Payment Probability (VPP), the probability that all of BPA's financial obligations during each month (whether these obligations are technically to "vendors" or not) can be paid. If BPA were to adopt this or another financial risk standard, then the risk mitigations in Tier 1 and Tier 2 Rates and contracts would have to satisfy the new financial risk standard(s) as well as TPP.

Section 3: Risk Mitigation in Tier 2

Q. In general, how would the risks in Tier 2 be mitigated?

A. The majority of the risk mitigation in Tier 2 would comprise contract terms and conditions, such as take-or-pay requirements for service at Tier 2 Rates. Further details of Tier 2 risk mitigation would be developed in successive rate cases as BPA develops and proposes Tier 2 Rate Alternatives, assesses the risks facing the Tier 2 Cost Pools at that time, and proposes appropriate mitigation measures.

Q. Can you be certain that providing service under Tier 2 Rates would not add costs to the Tier 1 Cost Pool or require additional risk mitigation in Tier 1?

A. Yes. Under our proposal, BPA would limit its Tier 2 offerings to those that do not pose unmitigated risks that would increase Tier 1 Costs or require enhancement of Tier 1 risk protection. *See* TRM section 9.2.

Q. Would Tier 2 Rates include Planned Net Revenues for Risk (PNRR)?

A. Probably not, though this question could be answered only in each rate case. The function of PNRR is to generate revenue to build up financial reserves to buffer BPA against financial risk. The PNRR mechanism is not readily applicable to Tier 2 risks, because we are proposing not to attribute financial reserves to Tier 2 Cost Pools. Accordingly, because there would be no financial reserves attributed to Tier 2 Cost Pools, PNRR *per se* would not be a risk mitigation tool that could be used for Tier 2 Cost Pools or Tier 2 Rates.

Section 4: Risk Mitigation in Tier 1

Q. In general, how do you propose to mitigate Tier 1 risks?

A. At this point, we expect that BPA's risk mitigation for the Non-Slice Cost Pool would generally be a continuation of the risk mitigation for non-Slice rates that BPA has used for the last decade. Each rate case has brought changes to the non-Slice risk package, but the changes have been consistent with BPA's overall philosophy of risk mitigation. The risk packages BPA includes in its Power rates have relied in large part on financial reserves, with PNRR often but not always added to the revenue requirement to build up reserves. Cost-adjustment mechanisms generally are included in rate proposals (examples include Cost Recovery Adjustment Clauses (CRACs), including the Financial-Based CRAC, the Load-Based CRAC, and the Safety-Net CRAC; the Dividend Distribution Clause; and the Adjustment and Emergency Surcharge related to the National Marine Fisheries Service Federal Columbia River Power System Biological Opinion). BPA would probably also need to use some reserves to provide liquidity within each year (liquidity reserves, formerly called working capital). The efficacy of these measures would be determined by TPP or any successor risk standard(s) BPA adopts. BPA likely would continue to set rates to achieve a two-year 95 percent TPP, as determined in BPA's 10-Year Financial Plan or its successor(s).

Q. Are those the tools you would use for mitigating non-Slice Tier 1 risk under the TRM?

A. As with our proposed overall approach to risk in the TRM, specific plans for mitigating risk related to the Tier 1 Cost Pool would be decided in each rate case. Likewise, the actual selection of risk mitigation tools would be made in each rate case.

There may be changes in BPA's financial risk standards that require BPA to look for new risk mitigation tools. For example, if BPA were to adopt a within-year financial risk standard, perhaps a VPP standard, to accompany the annual TPP standard, BPA may need new tools to manage within-year liquidity risk. For the most part, however, we anticipate that non-Slice risk mitigation would be a continuation of current practice, and we do not currently have plans for changes.

Section 5: Risk Mitigation for the Slice Product

Q. How do you propose to mitigate risks associated with Slice?

A. We are proposing some changes to the Slice product that would further mitigate risks. As in the current Slice rate methodology, the primary mitigation mechanism for financial risks associated with the Slice product would be the use of annual cost true-up adjustments at the end of each Fiscal Year. However, if this method is shown to cause cost shifts between Slice and non-Slice customers, BPA would address this in the relevant rate case.

Q. How would the Slice product differ from other products, in terms of its risks?

A. Slice customers would assume BPA's financial risks directly rather than through other risk mitigation devices such as PNRR and financial reserves. The Slice product differs from BPA's other products in that the Slice customers would purchase a product based on the shape of the actual output of Tier 1 System Resources (with the exception of Augmentation, which would be delivered in flat annual blocks). This means that the power delivered would vary hourly, weekly, monthly, and seasonally.

Q. *How would the Slice product address BPA's financial risks?*

A. The Slice product would address BPA's financial risks by 1) transferring the power supply and market price risks directly to the Slice customers and 2) incorporating an annual True-Up Adjustment Charge for the differences between planned and actual expenses and credits in the Composite Cost Pool and Slice Cost Pool (*see* TRM Table 4.1). These risk mitigation mechanisms would ensure that the Slice customers would bear a proportionate share of the Power function's financial risks.

Q. *How would power supply and market price risks and the Power function's cost uncertainties be transferred to the Slice customer?*

A. The charges that the Slice customer pays would not include credits for secondary revenues. Instead, the Slice customer would receive a share of secondary energy directly and must realize the secondary revenues through its own marketing actions. The Slice customer would deal with the same uncertainties, variability, and costs that BPA incurs with the marketing of its secondary energy. If the supply of secondary energy decreases, the market price for secondary energy decreases, or the costs of transmitting the secondary energy increase, then the Slice customer's net revenues would decrease, just as BPA's net revenues would do in similar circumstances. The Slice customer would assume the risks that the secondary energy will be available and that the related market prices will be as forecast in BPA's ratesetting process.

Q. *What other risks would the Slice customers assume?*

A. The Slice customer would assume the risk of having to purchase power when the customer's percentage share of the generation output from Tier 1 System Resources does not produce the power expected from it. The amount, shape, and timing of the generation output are subject to actual conditions, and the Slice customer would accept the risks associated with this uncertainty and variability. The Slice customer would assume the risks associated with the uncertainty of market prices for purchasing or selling power.

The Slice customer also would share in the variability of the Power function's expenses and revenue credits through the proposed annual Slice True-Up Adjustment.

Q. Is this why the Slice product purchases would have an annual true-up adjustment and other product purchasers would not?

A. The current annual Slice True-Up Adjustment Charge was determined to be one of the appropriate financial risk mitigation methods applied to the Slice product in prior rate cases, and we propose to continue it for the Slice customers who would purchase under Regional Dialogue Contracts. The proposed rate design for products sold at Tier 1 Rates allows for the application of a variety of risk mitigation mechanisms to deal with the financial variability of the costs in the Composite Cost Pool. As stated in section 4 of this testimony, specific risk mitigation related to non-Slice customers purchasing power at Tier 1 Rates would be decided in each rate case. Likewise, the actual selection of risk mitigation tools would be made in each rate case.

Q. Do you believe that the proposed annual Slice True-Up Adjustment is acceptable to Slice customers?

A. Yes. The Slice customers have experience with a True-Up adjustment process based on their existing Slice product purchase. Over time, they have gained more knowledge about BPA expenses and credits. In addition, BPA's transparency with respect to the Power function's financial reports further helped them understand and track changes in expenses and revenues. The current True-Up Adjustment Charges for the existing Slice product have become less volatile, due to improved accuracy of BPA's financial forecasting and reporting. Less volatility in the True-Up has resulted in fewer unanticipated large changes than was the case in the early years of implementing the Slice True-Up.

Q. What is your proposal for determining the cost allocation to the Slice product for unanticipated expenses that are incurred during a Rate Period?

A. The proposed cost allocation principles in the TRM would guide the allocation of new expenses or revenue credits to the various Cost Pools. *See* TRM section 2.1. Once the expense or revenue has been accrued, BPA would allocate the amount to the appropriate Cost Pool, according to the cost allocation principles in the TRM. If BPA allocates the expense or revenue to a Cost Pool that applies to the Slice product, BPA would include that expense or revenue in the Slice True-Up calculation for that year.

Q. How do you propose to handle disputes related to Slice true-up issues?

A. We propose to address disputes related to Slice True-Up issues in rate cases subsequent to the True-Up calculation. Slice True-Up issues are rate issues and should be addressed in a rates forum to be discussed by all customers—these are issues related to cost allocation, and the resolution of these disputes will affect all customers. As such, parties may challenge BPA's allocation of a new expense or revenue credit through the Slice true-up in the rate case following that allocation (*see* TRM section 5.4.2).

Q. Addressing disputes related to True-Up issues in rate cases may not allow for timely adjustment of cost resulting from resolution of the issues. What are you proposing to address the time lag?

A. We recognize that the resolution of issues through rate cases can result in lags for which compensation will be required. Thus, we propose to compensate all customers for the time value of money through interest credits or charges to Slice customers for the lag period.

Section 5.1: Verification Process for Slice True-Up

Q. What is the proposed Slice cost verification process for the annual Slice True-Up?

A. The proposed verification of financial data in the Slice True-Up report would allow customers to submit information requests to validate whether BPA correctly calculated the amount of each cost on which the Slice True-Up calculation would be based. TRM section 9.4.2; *see also* Cherry *et al.*, TRM-12-E-BPA-02. The scope of the verification process would be limited to review of cost assignment and identifying errors in calculation and application of those costs. Customers would not be able to question BPA's accounting policies, standards, management decisions, application of other policies, or other similar issues.

Q. Who would participate in this verification process?

A. All customers would be allowed to participate.

Q. How would the verification process be developed?

A. The details of the verification process would be developed in relevant rate cases. BPA intends to include the protocols for the verification process in the General Rate Schedule Provisions. This would allow for periodic modification to the process over the life of the Regional Dialogue Contracts. The protocols for the verification process would be developed in consultation with customers to ensure specific customer concerns are identified and addressed in a collaborative manner.

Q. What would be the schedule for the verification process?

A. The verification process would occur in the second quarter of a Fiscal Year following the Fiscal Year to which the Slice True-Up Adjustment applies. In addition, the verification process could commence only after BPA has closed its financial records for the Fiscal Year and after they have been audited.

We anticipate that it may be possible to facilitate a smoother, faster verification process by using other, existing forums to discuss costs and their allocation during the year. For example, we expect BPA will start periodic Quarterly Business Review (QBR) meetings in November 2008. The February QBRs could be the starting points for the

Slice cost verification process for the annual Slice True-Up. The QBR is intended to be an ongoing forum for reviewing BPA's finances that would also allow customers to inquire about specific costs. At the QBR meetings or other similar BPA public forums related to cost reviews, customers could request specific information about certain accounts to ensure that the contents of those accounts comport with the costs specifically excluded from Slice. As new costs arise, the QBR could be a forum for discussing BPA's expected allocation between Slice and non-Slice customers.

Q. Does this conclude your testimony?

A. Yes.