Comments of the M-S-R Public Power Agency Regarding BPA's Proposed Leverage Policy Workshop

The M-S-R Public Power Agency ("M-S-R") is a joint powers agency formed by the Modesto Irrigation District, and the Cities of Santa Clara and Redding, California, each of which is a consumer owned utility. Beginning with a 2005 contract, M-S-R obtained contractual rights to the output from some of the first large scale wind resources developed in Washington State. M-S-R and its members currently have rights to 350 MW of wind generation in Washington and Oregon, which its members use to serve their customers and meet California's Renewable Portfolio Standards. Those customers ultimately bear the cost of the Bonneville Power Administration ("BPA") Transmission and ancillary services rates and charges.

<u>Comments</u>: M-S-R values the opportunity to comment on the March 20, 2018, workshop presentation on Leverage Policy. M-S-R supports BPA's initiative to strengthen its financial health, sustain its AA credit rating, and assure access to the capital markets for essential capital investments. M-S-R has concerns and questions about some of BPA's assumptions and suggested options, and the relative burdens projected to be imposed on the business lines.

The Financial Reserves Policy implementation, Leverage policy, and access to capital are interrelated issues affecting BPA's long-term financial strength. M-S-R understands that BPA decided a leverage ratio of no higher than 75%-85% is needed to maintain BPA's credit rating, and that this leverage target is consistent with industry standards. M-S-R is not convinced immediate imposition of the Leverage Policy is necessary, as historically, BPA's leverage has been 150% without any resulting negative impact on credit ratings. Instead, it appears that the more immediate problem is access to federal borrowing. Addressing access to federal borrowing through a Leverage Policy based on projections of the business lines' leverage trajectory, without considering the current leverage values, without considering different needs for capital, and without considering factors such as Power tying up $750 million in borrowing capacity for liquidity will result in placing an inequitable burden on Transmission customers to resolve the Agency's limited access to federal borrowing. M-S-R is very concerned about this potential inequity, particularly when Transmission rates continue to over-collect, resulting in continued growth of Transmission's reserves, while Power rates continue to under-collect, resulting in continued degradation of Power's reserves.

Moreover, the Leverage Policy is a significant change from established ratemaking metrics. It is essential that this significant shift from existing policy be implemented with equity and fundamental fairness in mind, in light of the entire financial position of the Agency and its two business lines.

<u>Rate Impacts</u>: The potential rate impacts of the Leverage Policy are unclear, but appear to be substantial. Some of the materials provided to date could be interpreted as the Leverage policy imposing a 40% Transmission rate increase, and a potential Power rate increase of 15%. Specifically, BPA's response to comment #28 states: "*Full revenue financing of sustain investments in BP-20 equate to roughly $312 million for Power and $394 million for Transmission.*" The CIR sustain versus Expand worksheet indicates those amounts are for 2020 alone (subject to requested clarification, below). Using a ballpark revenue requirement of $1 billion for Transmission and $2.3 billion for Power, that appears to result in a 40% rate increase for Transmission and a 15% increase for Power. BPA's March 20 presentation indicated that, depending on which tool is applied, the rate increase would be either 14% or 7% for the first two years, followed by a 2-3% rate increase (Slide 10). It is not clear if these increases are independent of any other cost increases that would result in increased Transmission rates. M-S-R is interested in further clarification of the potential rate impact of the various proposals.

<u>Calculating Leverage</u>: M-S-R understands that BPA is calculating leverage based on total outstanding debt divided by the book value of revenue producing assets, reduced by depreciation. M-S-R suggests three modifications to the calculation:

First, as is done for the Funds Available for Debt Service (FADS) metric, BPA should reduce debt by the amount of financial reserves held for risk. This change would help avoid the inequity of Transmission funding excess reserves while being required to revenue finance assets for future generations, discussed further below.

Second, the debt for Power should include the portion of the $750 line of credit that is encumbered by Power's use of the line of credit to meet liquidity tests in the rate case. That line of credit is not available for other uses, and its dedication to Power should be reflected as outstanding debt.

Third, the asset value should not be reduced by depreciation. While M-S-R understands BPA does not want to use market value due to uncertainty and value fluctuations, reducing the value by depreciation likely undervalues BPA's long-life assets. As such, eliminating the depreciation deduction from value may be a better means to better approximate the useful value of the revenue producing assets.

<u>Options for Managing Leverage/Access to Capital</u>: BPA indicated its options for reducing leverage include: (1) reducing capital spending; (2) revenue financing capital projects; (3) revenue financing debt pre-payment; (4) pursuing alternative third-party financing; and (5) use of excess reserves to pre-pay debt or fund capital (subject to the Financial Reserves Policy). In an environment where capital spending is continuing, M-S-R views the second and third options as being essentially the same. Current rates would be based off a revenue requirement that includes current dollars used to fund long-term capital spending. Debt pre-payment at a time when additional debt is issued to fund capital is essentially the same as revenue financing capital projects.

Both options 2 and 3 would result in significant rate increases and both suffer from inequities of having current rate payers completely fund a long-term asset that will be enjoyed by future ratepayers. Future ratepayers would receive benefits they do not pay for, violating the basic rate making principles of intergenerational equity and cost causation/cost benefit. That is, revenue-financed capital violates a fundamental accounting principal to match the term of debt with the expected useful life of the asset. Transmission assets with a 40 year useful life should be financed over a 40 year term and should not be funded with current revenues. A policy requiring current customers to finance 40 year assets using current revenues is neither a sound business practice nor equitable between generations. Furthermore, BPA's reliance on revenue financing being an industry standard to justify its use is questionable. BPA's response to comments indicates this is more of an assumption on BPA's part than a verified industry standard procedure. Ratemaking principles requiring intergenerational equity and requiring costs to flow to beneficiaries conflict with that assumed industry practice.

The first option, spending less on capital projects, is the least cost solution from a rates perspective, and it is effective at avoiding growth in leverage. M-S-R disagrees with what it understands to be BPA's view that avoiding spending is 10% as effective as revenue financing (See March 20 presentation at Slide 10). Presuming revenue financing is more effective than avoided spending ignores the cost to ratepayers. That is, revenue financing may be more effective to manage BPA's leverage, but revenue financing merely shifts the burden of capitalizing long-life projects from BPA to current customers, who do not receive any equity in the project in return for funding the long-life project. BPA's view regarding the relative leverage benefits appears to assume that forgone capital projects would be financed with debt if they are pursued. However, M-S-R submits that in light of the proposed use of revenue financing, the better comparison is between revenue financing a project and not investing a project. In that case, forgoing the project will have a 100% beneficial impact on rates, while also not causing any growth in leverage, compared with revenue financing causing severe and inequitable rate increases to reach similar leverage benefits.

To the extent capital spending is unavoidable, M-S-R submits that the best option, until Power's reserves meet their threshold, is option 4, aggressively pursuing third party debt. While this option will not improve Transmission's leverage, it will address the underlying concern of access to federal borrowing. One concern raised with the lease-financing is that it is more labor intensive than other forms of financing. While that may be true, it seems that labor for implementing third-party leasing is still less expensive to ratepayers than revenue financing long-term assets.

For the above reasons, M-S-R submits that the order of preference for implementing the options should be: (1) avoid capital spending; (2) use excess financial reserves; (3) utilize third-party financing; and (4) only as a last resort, utilize revenue financing options (2 and 3), subject to allocating the costs to the beneficiaries.

Charge the Modernization Costs to the Beneficiaries: M-S-R understands that a significant portion of the capital spending projected for Transmission is for automation of Transmission facilities to provide access to new markets for the power generated by the FRCPS. While the modernization goal may be valid, BPA should treat the automation of the Transmission system similar to any other request for expansion and subject the request to the same process as any request for additional Transmission. M-S-R understands the automation is not necessary for the current uses of the Transmission system under existing Transmission contracts. M-S-R is aware that BPA anticipates that new demands on the Transmission system may require system upgrades. These new uses are not likely to raise new revenues to offset their costs, resulting in rate pressures even if the projects are fully debt financed. M-S-R understands BPA has a process in place for evaluating Transmission upgrade requests, including a formal request for the enhanced service, some type of cluster study analysis, an Environmental Impact Analysis, a cost/benefit study, and eventually a rate analysis. BPA should follow its existing system for evaluating upgrade requests with regard to the automation projects, and it should allocate the costs to the customers seeking to use automated systems to access new markets. It is inequitable to force the costs of the upgrades on customers that do not need them for their existing contracts.

Furthermore, decisions about maximizing value of assets through replacements need to take into account the source of funding. A project that is capitalized will have a far different cost profile for customers than one that is revenue financed.

Surcharge vs Rate Increase: M-S-R opposes revenue financing, but if it is pursued to any degree it seems it should be done on a surcharge basis, and not built into rates perpetually. The surcharge should be imposed on the class of customers that benefits from the investment, and not on all Transmission customers.

<u>Phase-In</u>: During the March 20 workshop, BPA indicated it will consider mechanisms to phase-in the Leverage Policy. M-S-R has three suggestions that should be implemented to equitably phase-in the Leverage Policy in light of surrounding circumstances.

First, the Leverage Policy is being proposed at a time when Transmission's leverage is 20% lower than Power, but projections show Power's leverage will decrease while Transmission's leverage will increase. Because Power is projected to decrease its leverage, BPA indicates the proposed policy will not impose any costs on Power (March 20 Presentation at Slide 6). However, Transmission's leverage has been lower than Power's for a considerable time, and Transmission's leverage is projected to remain lower than Power's leverage for the next 6 or 7 years. It is inequitable to impose severe rate increases on Transmission to reduce its leverage while its leverage is still lower than Power's leverage, based solely on projections of the trajectory of leverage. To avoid this inequity, the Policy should be implemented in a manner that avoids imposing costs on Transmission customers until such time as Power's leverage is less than or equal to Transmission's leverage.

Second, Transmission's inability to use its excess reserves to fund the Leverage Policy tools is due to Power's lack of reserves and the way the Reserves Policy intertwines the business lines' reserves into an Agency target. BPA indicated it does not intend to make an exception to the Reserves Policy to enable Transmission to utilize its excess reserves to fund capital projects or pre-pay debt to assist with the Leverage Policy implementation. Although projected to shrink in BP-18, Transmission's reserves for risk are now projected to grow 10% by year end. It would be inequitable to have Transmission customers continue to fund growing reserves far beyond their target while also imposing the costs of future generations' capital needs through revenue financing. To avoid this inequity, no revenue financing should be imposed on Transmission customers until its excess reserves have first been applied to debt reduction/capital funding. While the

Reserves Policy may prevent transmission from accessing its excess reserves for a number of years, this phase-in is necessary to equitably implement the Leverage Policy.

Third, a cap should be imposed on combined rate impacts of the Leverage Policy and other rate pressures, similar to the proposed phase-in of the Reserves Policy.

Fourth, while the Financial Reserves Policy is being phased-in, Transmission should be able to access the incremental growth in its excess reserves above the level projected in BP-18 for the end of FY2017. In the BP-18 proceeding, Transmission's reserves were projected to be $352 million at the end of FY2017, $346 million at the end of FY2018, and $299 million at the end of FY 2019. The January 2018 Quarterly Business Review Financial Reports show Transmission is now expected to end FY2018 with $452 million in reserves for risk, about $106 million higher than projected in the BP-18 rate proceeding in which the FRP was adopted. Permitting the use of the excess reserves above the projection from BP-18 will not place BPA in a worse position than projected, and it will provide a means to mitigate the cost of the Leverage Policy. It will also serve to offset, to a degree, the inequity of Transmission not being able to access its reserves due to Power having used up $700 million in reserves over the past 10 years.

<u>Follow-Up Questions</u>: M-S-R appreciates BPA Staff's written summary of comments, and the written information provided in response to the comments. Due to the written comments becoming available shortly before the March 20 workshop, the following portion of M-S-R's comments are follow up questions it had not formulated at the time of the workshop.

1. BPA's responses to several of the questions in comments point to the 2016 IPR as the basis for assumptions. The link included in the comments goes to the general IPR page. Can BPA point to where in those materials one can locate the assumptions on Transmission and Power capital spending, and the major projects that make up those assumptions? Also, the 2016 IPR close out documents indicate that a study of EIM benefits would be performed. Has that study been completed, and if so are the results available?

2. In response to Comment #13 BPA describes a number of categories of debt. What is meant by NIFC, NIFCSW COI, and Debt Service Reassignment?

3. In response to Comment #22 BPA includes Corporate Assets as "revenue producing assets." How are corporate assets allocated to the business lines' leverage calculations?

4. In response to Comment #22 BPA indicates spacer dampers are regulatory assets. Why does BPA treat spacer dampers as regulatory assets, and what is the book value of the BPA space dampers?

5. In response to Comment #27 BPA discusses the costs of third-party leasing vs Regional Cooperation Debt. Has BPA quantified the cost of implementing the Lease-Finance program in comparison with other finance mechanisms? How do the costs of the lease-Finance program compare with the rate impact of revenue financing?

6. In response to comment #28, BPA references the 2016 sustain versus expand worksheet, and states: "*Full revenue financing of sustain investments in BP-20 equate to roughly $312 million for Power and $394 million for Transmission. These levels of revenue financing would have a significant downward impact on both Power and Transmissions leverage*."

-Comparing the statement with the worksheet, it appears the values stated for BP-20 are the values listed on the worksheet for just 2020. Is it correct that the total cost for BP-20 would be the sum of the amounts listed for 2020-2021? If so, is it correct that the total cost in BP-20 would be $650 million for Power, and $775 million for Transmission?

-While the response references a significant downward impact on leverage, has BPA analyzed the upward impact on rates?

7. In response to Comments #28 and 29 BPA indicates EWEB, Cowlitz County PUD and Grant County PUD revenue finance a portion of their capital programs. What is the portion of capital programs those entities finance with current revenues? Can BPA provide links to the reports where that revenue financing is referenced?

8. In response to Comment #40 BPA indicates that the value of CGS is reduced when its debt is paid down. Why is that?

9. In response to Comment #40 BPA discusses "discontinuing regulatory treatment." What is meant by "discontinuing regulatory treatment"?

10. M-S-R understood BPA to indicate during the workshop that Transmission's leverage is expected grow, despite Transmission paying more debt than it collects in depreciation, due to the way the prepayment methodology works. A remedial explanation of on how the repayment methodology affects leverage would be helpful for customers to understand why leverage is growing.

11. The 2016 sustain versus expand worksheet breaks the 2016 IPR capital spending amounts out between sustain projects and expand projects. How does BPA determine if a project is a sustain project or an expansion project?

Conclusion: M-S-R appreciates the opportunity to comment on BPA's presentation of its proposed Leverage Policy framework. M-S-R seeks additional information, as requested above, and looks forward to working with BPA to develop a fair and equitable Leverage Policy, with the entirety of BPA's financial position in mind. M-S-R understands that BPA has financial constraints and a desire to expand the capabilities of its Transmission system. M-S-R emphasizes that these concerns do not warrant an abandonment of existing sources of capital, nor does it justify a departure from maintaining equity between intergenerational customer groups, nor disregard for BPA's current process for accepting customer Transmission requests, evaluating those requests, and assigning financial responsibility to those who benefit.

Comments of the M-S-R Public Power Agency Regarding Proposed Financial Reserves Policy Implementation Workshop

The M-S-R Public Power Agency ("M-S-R") is a joint powers agency formed by the Modesto Irrigation District, and the Cities of Santa Clara and Redding, California, each of which is a consumer owned utility. Beginning with a 2005 contract, M-S-R obtained contractual rights to the output from some of the first large scale wind resources developed in Washington State. M-S-R and its members currently have rights to 350 MW of wind generation in Washington and Oregon, which its members use to serve their customers and meet California's Renewable Portfolio Standards. Those customers ultimately bear the cost of the Bonneville Power Administration ("BPA") Transmission and ancillary services rates and charges.

Comments: M-S-R values the opportunity to comment on the March 20, 2018, workshop presentation on BPA's proposed implementation of the Financial Reserves Policy. BPA's presentation provided analysis as to how likely various phase-in mechanisms are to reach BPA's strategic goal of increasing Power Services financial reserves to its lower threshold of 60 days on hand, roughly $300 million, by 2027. While M-S-R's primary interests involve BPA's Transmission and Ancillary Services rates, the Financial Reserves Policy makes Transmission's ability to access its excess reserves contingent on Power reaching its reserves thresholds. Until Power meets its reserves targets, there is no relief valve to balance Transmission rates that have consistently over-collected BPA's costs. That was the problem at hand in the BP-18 rate proceeding. The new leverage policy adds another layer of potential inequity for Transmission customers.

In the Leverage policy workshops BPA stated that Transmission will not be able to access its growing excess reserves to assist with leverage until Power meets its thresholds. That is, despite the Strategic Plan referencing reserves as a tool available to address leverage, that tool is not available to Transmission until Power meets its reserves target. Therefore, it is essential that whatever phase-in mechanism BPA adopts will be the one best designed to reach the goal of Power meeting its threshold. Otherwise, Transmission customers are exposed to the dual problem of rates that over-collect and build reserves above what is necessary for liquidity and rate stability, along with the potential for even higher rates to revenue finance long-term capital projects.

As the Administrator's Preface to the BP-18 Record of Decision noted "The use of more than $700 million in Power's financial reserves over the last 10 years provided significant rate relief for the region's power customers." Power's depletion of its reserves, coupled with the new Financial Reserves policy, will now prohibit Transmission from accessing any of Transmission's excess reserves so Transmission customers can enjoy similar rate relief, without depleting its reserves below targeted levels. That rate relief is critical in light of proposals to impose revenue financing of long-term assets under the Leverage Policy. Depending on how that policy is applied, it could increase Transmission rates by as much as 40%. As such, unless BPA reconsiders its decision to not allow any use of Transmission reserves as a Leverage tool until Power meets its thresholds, it is imperative that BPA adopt a phase-in mechanism that will have the highest probability of getting Power to its threshold in the shortest amount of time.

M-S-R acknowledges there are significant challenges with regard to maintaining BPA's financial health both with respect to liquidity and access to capital. M-S-R continues to support the principles of customer equity and financial accountability for costs incurred for services provided. M-S-R encourages BPA to apply these principles in the formulation of its Financial Reserves Policy implementation and leverage/access to capital policies.

M-S-R appreciates the opportunity to comment on BPA's presentation of its proposed Financial Reserves Policy implementation mechanism, and looks forward to working with BPA as it develops an implementation mechanism that takes into account not only the rate pressures that result for Power, but also those being imposed on Transmission customers.