

Why BPA Does Not Need To Collect an SN CRAC
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Introduction

This document is marked “draft” because this is a complex issue, and various people continue to work on refining estimates of BPA’s likely financial performance over the next few years. Yet we are confident that the broad picture of BPA finances that we outline here is accurate. To the extent we can provide additional detail in the future, we will do so.

BPA’s 80% Treasury Payment Probability

BPA has established a target of an 80% Treasury payment probability (or TPP). What this means is that BPA uses a probabilistic model designed to capture a variety of risks that BPA faces. BPA concludes that it has enough revenues when it calculates that it has an 80% chance of making all Treasury payments throughout the rate period.

Customers have made several criticisms of BPA’s approach. The key point regarding BPA’s approach is that it focuses on bad outcomes, inasmuch as the decision point that the analysis focuses on is the lowest 20% of the distribution of possible outcomes.

This means, for example, that the current state of the Northwest snowpack has improved the TPP, even though the snowpack is currently estimated to be slightly less than normal. This is because droughts are far more likely than slightly bad water years to contribute to a failure to pay Treasury. The chance of a drought this year is now less than at the beginning of the year, because there is less variability in the estimate of the final snowpack once one has gotten through much of the winter.

What Problem Is The SN CRAC Supposed To Solve?

BPA determined that it would not be able to meet its target 80% TPP without an SN CRAC. This determination was chiefly based on a forecast that BPA’s finances would not do well in FY05 and FY06, due in large part to a forecast decline in BPA’s nonfirm revenues, driven by a decline in forecast natural gas prices.

BPA therefore determined that it would need to collect on average \$357 million in FY04-06 in SN CRAC monies to reach its 80% TPP goal. But only \$302 million of that amount would be available to BPA, for \$55 million of the SN CRAC charged to investor-owned utilities would be offset by the investor-owned utilities reducing the deferral of their benefits from BPA, a deferral that they had agreed to earlier.

The Curious Outcome Of FY03 – BPA Added Hundreds Of Millions To Its Financial Reserves, Yet Claimed Only \$37 Million In “Net Revenues”

BPA’s claims that it needs several hundred million dollars in additional revenues is rendered more curious by BPA’s actual performance in FY03, under the new rates, but without an SN CRAC. BPA began FY03 with \$188 million in financial reserves, and concluded the year with \$511 million in financial reserves – a net improvement of \$322 million in its financial reserves.

Despite having what most enterprises would characterize as a stellar financial performance for the year, BPA went to great lengths to downplay how well it had done. BPA’s 2003 annual report cited \$555 million in net revenues, but then claimed that BPA’s net revenues, once adjusted for BPA’s debt optimization program with Energy Northwest and SFAS 133 (which adjusts for derivative values), were only \$37 million. Indeed, a senior BPA official recently claimed that BPA had actually *lost* \$40 million last year, despite the \$322 million improvement in BPA’s financial reserves. (Clearing Up newsletter, January 26, 2004, Page 12).

The difference is that while BPA acknowledges the cash inflow, it claims that it incurred various additional liabilities that offset the cash inflow – such as a \$122 million difference in “Depreciation in Excess of Planned Federal Debt Amortization”, where BPA is apparently depreciating its system for accounting purposes faster than it has to repay its Federal debt.

On the other hand, BPA’s ability to repay Treasury (the claimed justification for the SN CRAC) is a function of the financial reserves that BPA has on hand, not the accounting boxes into which BPA puts those reserves. From the standpoint of repaying Treasury, the level of BPA financial reserves is what matters.

In attempting to minimize the improvement in BPA’s financial reserve position, BPA does raise one valid point. BPA took a number of actions in FY03 that were one-time improvements in the level of its financial reserves, which improvements cannot be replicated in the future. To look at BPA’s sustained ability to generate additional financial reserves, one should exclude these actions. In a workshop in August, BPA enumerated five things that it did to improve its cash reserve

position on a one-time basis. These five items were Energy Northwest reserve fund free-ups; the IOU deferral of residential exchange benefits; the settlement with the Bank of America over Energy Northwest bearer bonds; the Slice true-up; and a payment as a result of BPA's settlement with Enron. These items together total \$199 million. When subtracted from the \$322 million improvement in BPA's financial reserves, \$123 million remains in sustainable increases in financial reserve levels. It is important to note that the \$199 million does in fact represent an improvement in the level of BPA financial reserves – it's just that one could not expect this to be replicated in the future, unlike the remaining \$123 million improvement.

In trying to evaluate BPA's ability to generate additional financial reserves in the future, given current rates, one must also consider that FY03 was a below-normal water year, which had an impact on BPA's revenues. The Columbia River flows were 83% of normal, or about 17 MAF (million acre-feet) less than normal. Using a standard rule of thumb that each additional MAF is worth about \$10 million in additional revenues to BPA, BPA would have been expected to have roughly \$170 million in additional revenues in a normal water year. Added to the \$123 million in sustainable increases in BPA's financial reserve levels, this implies that BPA could be expected to add nearly \$300 million to its financial reserves given current rates, normal water and conditions otherwise like FY03 – without an SN CRAC.

For Purposes Of The SN CRAC, How Does BPA Weather-Normalized Results In FY03 Compare To What BPA Is Forecasting In FY04, FY05 And FY06?

BPA forecasts much worse results for its financial reserves in FY04, FY05 and FY06 than it actually achieved in FY03. In the last workshop in November on the SN CRAC, BPA provided model runs forecasting that its level of financial reserves would fall by about \$35 million in FY04, by about \$85 million in FY05, and by about \$35 million in FY06, despite the fact that BPA modeled net inflows of money from the SN CRAC of about \$40 million in FY04 (\$95 million less the \$55 million in reduced IOU deferrals), about \$135 million in FY05, and about \$125 million in FY06. Thus without the cash infusions provided by the SN CRAC, BPA forecasts that its financial reserves would fall by about \$75 million in FY04, by about \$220 million in FY05, and by about \$160 million in FY06 (adding together BPA's forecast reserve loss and net SN CRAC revenues). Quite a contrast to the FY03 weather-normalized improvement in BPA's financial reserves (excluding one-time improvements) of nearly \$300 million.

Are There Indications That BPA's Financial Position This Year (FY04) Is Better Than Forecast?

Yes. Ray Bliven, a consultant working for Alcoa, has been updating the numbers BPA used in the rate case by using current estimates of monthly market prices in FY04 to estimate BPA nonfirm revenues, and using current BPA estimates of BPA operating expenses. Bliven's conservative estimate is that if BPA sells 95% of the secondary power that it forecasted in the rate case, and realizes 80% of the West Coast market price from these secondary sales, BPA's FY04 secondary revenues will be \$176 million higher than was forecast in the SN CRAC rate case. (The 5% reduction in the assumed amount of secondary sales reflects that current streamflow estimates for this year are about 95% of normal.) Bliven's optimistic estimate is that if BPA sells 100% of the secondary amounts that it forecast in the rate case, and realizes 90% of market price, BPA's FY04 secondary revenues will be \$344 million higher than was forecast in the SN CRAC rate case. Bliven also notes that BPA's operating expenses are forecast to be \$20 million less than was in the rate case (excluding \$65 million additional savings from non-Federal debt refinancing).

Thus a conservative estimate of the improvement in BPA's finances is about \$196 million, and the optimistic estimate is \$364 million – or, overall, an improvement in BPA's reserve position from FY04 to FY05 from BPA's estimate of about minus \$35 million to about plus \$160 million (conservatively) or \$330 million (optimistically) *without collecting the SN CRAC*. In light of the fact that the SN CRAC is forecasted to net \$302 million over a 3-year period, the pessimistic estimate indicates that BPA's finances have improved enough just in FY04 to cover more than half of the total forecasted SN CRAC collections, while the optimistic estimate indicates that all the money BPA says that it needs for the SN CRAC would be collected in FY04, without any need for an SN CRAC in the 3-year period.

Senior BPA officials have apparently been trying to justify the continuation of the SN CRAC by stating that current revenues, costs and net revenues since the fiscal year began in October are tracking fairly closely to the estimates made in the SN CRAC rate case, and stating that therefore there is no improvement in BPA's financial situation justifying removal of the SN CRAC. Because we do not yet have first quarter BPA financial data, Bliven's analysis showing the improvement in BPA's FY04 status *assumed* that BPA's SN CRAC rate case numbers were, in fact, accurate through the end of December. However, West Coast forward prices for the rest of FY04 are higher than what BPA forecast it would get for its nonfirm power in the rate case. To cite the most extreme example, BPA forecasts that it will have the most nonfirm power to sell in July (4,619 aMW). In the SN CRAC rate case, BPA assumed that it would sell this power for 21.91 mills. The current

on-peak mid-C forward price for the third quarter of CY04 (including July) is 41.50 mills, and the current on-peak California forward price is 59.38 mills (average monthly prices are 90-95% of these amounts).

Why Are BPA's Forecasts In FY05-06 So Much Gloomier Than BPA's Results In FY03?

One thing we discovered in the rate case, by looking at BPA's estimates of the Slice true-up, is that BPA does not assume that the cost-cuts it has implemented persist through the rate period, and thus its finances are forecast to deteriorate over time. Obviously, having rate increases based in part on an assumption that BPA will fail to maintain its cost cutting activities will increase the likelihood that BPA will fail in these activities. Related to this, we can find no evidence that BPA's promised \$100 million of additional cost cuts/revenue savings is included in the SN CRAC analysis, and we have been told that BPA has assumed no reduction in summer spill in the SN CRAC analysis.

Another key factor driving BPA's pessimistic forecast is the assumption that its nonfirm revenues will be markedly lower in FY05 and FY06 than they realized in FY03. BPA forecast in the SN CRAC rate case that natural gas prices would fall sharply over the rate period. Since natural gas fired plants are normally the resource on the margin in the West Coast power market and thus determine the market price of power, BPA then assumed that the price it would get for its nonfirm power would also decline. In the SN CRAC rate case, BPA forecast that the benchmark Henry Hub price of natural gas would fall from \$5.75/MMbtu in 2003, to \$4.25/MMbtu in 2004, to \$3.25 in 2005, to \$3.50 in 2006. Natural gas price forecasts have generally rebounded strongly since BPA's estimate. For example, the Short-Term Energy Outlook, published in January 2004 by the Energy Information Administration of the Department of Energy, stated: "[i]n 2004, natural gas prices are expected to average just under \$5/MMBtu, falling somewhat along with oil prices. In 2005, natural gas spot prices are projected to fall again to average \$4.83/MMbtu under the assumption that domestic and imported supply can continue to grow at about 1-1.5 percent per year." EIA's 2005 natural gas price forecast is therefore about 50% higher than BPA's forecast in the SN CRAC rate case.

NYMEX publishes daily forward prices for natural gas. On 1/29/04, the average settling price for 2004 futures trading was \$5.39/MMbtu; for trades in 2005 \$5.18/MMbtu; and although there was a limited number of trades for 2006, prices remained above \$5.

Ray Bliven also forecast BPA's secondary revenues for FY05 and FY06 based on current forward West Coast electrical prices. Because these prices are farther out

in the future than the FY04 forward prices, Bliven used more conservative assumptions – he assumed that BPA would get only 70% of the current West Coast forward price in FY05, and only 65% of the current West Coast forward price in FY06. Even so, Bliven estimated that likely BPA nonfirm revenues in FY05 were \$190 million above BPA’s SN CRAC forecast, and \$125 million above BPA’s forecast in FY06. Together, this increases BPA’s likely revenues in FY05 and FY06 by \$315 million – more than the total amount BPA proposes to net from the SN CRAC.

Doesn’t The SN CRAC Go Away If BPA’s Finances Improve, And Doesn’t BPA Need The Flexibility Associated With The SN CRAC?

BPA will likely respond to the arguments presented in this paper by arguing that our claims are all very well and good, but that the SN CRAC is not a fixed amount – if BPA’s accumulated net revenues rise to a high enough level, then the current SN CRAC mechanism will lead to a reduction in the SN CRAC (perhaps to zero), and indeed, might lead to partial refunds of SN CRAC monies already paid.

BPA has argued that it needs “flexibility” in setting rates to address future uncertainty, and that the variability of the SN CRAC provides BPA with that necessary “flexibility”. The problem is that giving BPA this “flexibility” fundamentally weakens BPA’s incentives to control its costs. When BPA first acquired flexible rates in 2001, the result was a rapid escalation of BPA costs in numerous areas. BPA’s cost cutting goals now largely consist of returning BPA’s costs to 2001 levels, before BPA acquired flexibility in its rates.

BPA has devoted more attention to cost-control as customers have grown increasingly vocal regarding the perpetration of BPA rates far above historic levels. But as long as BPA has the option of raising rates, there will be a temptation to avoid making difficult decisions to hold costs down. Customers have also observed that giving BPA “flexibility” weakens its ability to negotiate cost reductions with other groups. As BPA has noted, many of its costs cannot be reduced unilaterally, but require negotiations with other Federal agencies and constituencies. When these other agencies and constituencies know that BPA has the ability simply to raise rates if cost control targets are not met, it sharply reduces BPA’s leverage in these negotiations.

The experience of 2003 illustrates another fundamental problem with the SN CRAC. Accumulated Net Revenues, and the corresponding level of SN CRAC, is tied to BPA’s calculation of “net revenues”, not to the actual BPA financial reserve levels needed to pay Treasury. If 2003 is any guide, BPA’s reserve levels can rapidly increase, while BPA simultaneously insists that “net revenues” are low

(or even negative), thereby ensuring that the SN CRAC continues to be charged at a high level, despite large (and increasing) levels of BPA financial reserves.

BPA is also likely to claim that the improvements that we cite are only improvements in forecasts – and that forecasts are inherently unreliable and subject to change. This is of course true. But BPA chose to impose the SN CRAC based primarily on a forecast of poor financial performance in FY05 and FY06, driven by a forecast of low natural gas prices, leading to a forecast of low nonfirm BPA revenues. BPA's forecast is now out of date.

Given the crushing 45%+ rate increases that BPA has imposed in the last several years (increases that are hidden when FY04 BPA rates are only compared to FY03 BPA rates), BPA should be finding ways of mitigating these rate increases, not perpetuating them.