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REBUTTAL TESTIMONY OF

ALEXANDER LENNOX AND WILLIAM W. HENDRICKS

Witnesses for Bonneville Power Administration

SUBJECT: POWER AND TRANSMISSION REVENUE REQUIREMENTS **Page**

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Section 1: Introduction and Purpose of Testimony

Q. Please state your names and qualifications.

A. My name is Alexander Lennox, and my qualifications are contained in BP-20-Q-BPA-23.

A. My name is William W. Hendricks, and my qualifications are contained in BP-20-Q-BPA-14.

Q. Please state the purpose of your testimony.

A. The purpose of this testimony is to respond to issues regarding revenue requirements presented by the Alliance of Western Energy Consumers (AWEC) in its direct testimony, Mullins and Hellman, BP-20-E-AW-01, and to respond to comments by AWEC, the Western Public Agencies Group (WPAG), Northwest Requirements Utilities (NRU), and the Public Power Council (PPC) regarding an error in the way BPA has attributed financial reserves available for risk between the Power Services and Transmission Services business lines. *Id.*; Andersen *et al.*, BP-20-E-WG-01, at 9; Stratman, BP-20-E-NR-01, at 5–6; Deen and Bush, BP-20-E-PP-01, at 11–12.

Section 2: Accelerated Amortization of Regulatory Assets

Q. Please describe AWEC's proposal.

A. AWEC proposes that BPA accelerate the amortization of the Conservation Acquisition and fish and wildlife regulatory assets. Mullins and Hellman, BP-20-E-AW-01, at 3. AWEC argues that the Conservation Acquisition regulatory asset could be completely amortized in the BP-20 rate period and still have some capacity to increase amortization of the fish and wildlife regulatory asset. *Id.* at 4-5

Q. How do you think AWEC is using the term "amortization"?

A. The term "amortization" can be used two ways. First, amortization is a common reference to the paying down of outstanding debt. Second, it is used in reference to amortization expense. This is a depreciation-like expense that BPA uses to reduce a regulatory asset over a specific period of time. It is the latter use of amortization that BPA believes AWEC references.

Q. Why does AWEC propose this change to the amortization of the Conservation Acquisition regulatory asset?

A. AWEC states it expects two effects from changing the amortization of the Conservation Acquisition regulatory asset. AWEC argues that amortization could be accelerated in the short term without raising costs in the FY 2020–2021 rate period because the increase in cost will be offset by reductions to minimum required net revenue (MRNR). Mullins and Hellman, BP-20-E-AW-01, at 3, 5–6. AWEC argues that accelerating amortization will reduce future costs in the long term as BPA approaches the end of the Regional Dialogue contract period. *Id.* at 3, 6–9.

Q. What is MRNR?

A. MRNR is included in the Power revenue requirement to ensure that rates are set at levels sufficient to generate the cash flows necessary to ensure repayment of the Federal investment. MRNR represents a net revenue target that is added to the revenue requirement when the forecast of cash from operations, which is equal to the sum of the non-cash elements of the income statement (*e.g.*, depreciation, amortization expense, capitalization adjustment), is less than the scheduled debt payments. Without MRNR, BPA would not generate sufficient cash to make its debt payments.

Q. Would accelerating amortization of regulatory assets reduce MRNR?

A. Yes. The total revenue requirement would remain the same, but the composition would change. Accelerating amortization would increase the amortization expense in the year it is accelerated. This would result in a dollar-for-dollar reduction to MRNR so long as the increase in amortization is not greater than the amount of MRNR forecast for the period. In this sense, MRNR provides headroom to change the amount of non-cash expenses without affecting the total revenue requirement. Increasing amortization expense by more than the available MRNR would result in a dollar-for-dollar increase in the revenue requirement in an amount equal to the difference between the accelerated amortization and the MRNR.

Q. Would accelerating amortization reduce expenses in the future?

A. Yes. If we assume that the entire Conservation Acquisition regulatory asset is fully amortized by the end of FY 2021 as proposed by AWEC, it would eliminate the amortization expense currently expected in FY 2022 through the remainder of the Regional Dialogue contract period.

Q. If expenses are reduced, does that mean that the revenue requirement would be lower in the future?

A. Not necessarily. The revenue requirement analysis considers the expected accrued expenses, including amortization expense, and the anticipated cash needs of the business unit. At this time, the cash needs are significantly larger than the cash flows generated from operations, as is evidenced by the positive MRNR for FY 2020–2021. It is entirely possible that this condition will be present in future rate periods. As a result, a reduction in future amortization expense would simply be offset dollar for dollar by higher MRNR. Only the composition of the revenue requirement, not the total, would change.

Q. Is it possible to accelerate the amortization of a regulatory asset?

A. Yes. BPA's Administrator determines whether spending can be treated as a regulatory asset and the period over which it will be recovered. This includes accelerating the amortization of existing regulatory assets.

Q. How much could a regulatory asset be accelerated?

A. We will not know until we are preparing the Final Proposal. It will depend on how much the variables in the MRNR calculation change, including the anticipated impact of the decommissioning trust fund accounting changes. For example, some assumptions described in the Initial Proposal, such as the amortization periods for non-Federal assets, are not completely settled. While preparing this rebuttal testimony, we discovered that there are ongoing discussions between BPA Accounting and BPA's external auditor about the appropriate amortization period for the Cowlitz Falls hydro facility. The amortization period could be longer than the remaining life of the outstanding debt as described in the Initial Proposal. *See* Lennox *et al.*, BP-20-E-BPA-17, at 19. If the service life is lengthened, it would reduce amortization expense and increase MRNR.

The simplest, most straightforward approach to accelerating amortization is to shorten the amortization period of Conservation Acquisition investments. However, this could easily result in the increase in amortization exceeding the available MRNR, which would increase rates. To ensure that this does not happen, we would need to construct a customized schedule that fits the amount of acceleration within the available MRNR. The challenge is that BPA's accounting system is not designed for customized amortization schedules. It follows the norm of amortizing or depreciating an investment over a fixed period, *e.g.*, $15 million amortized over 15 years produces $1 million of annual amortization expense. We would need to explore options for making the adjustments outside of the conventional systems currently in place.

Q. Is it possible to completely amortize the Conservation Acquisition regulatory asset in the FY 2020–2021 rate period?

A. It is unlikely that it could be completely amortized in the next rate period. In addition to the uncertainties about the exact amount of MRNR anticipated in the Final Proposal, we expect accounting changes that will affect the recalculation of MRNR in the annual Slice true-up. There is also the possibility of changes to the accounting treatment of the CGS decommissioning trust fund that would be implemented in FY 2020. Mandell *et al.*, BP-20-E-BPA-20, at 4. These changes would not be incorporated in the Final Proposal, and would thus require changes to the Slice true-up during the rate period. It is highly likely that MRNR calculated in the Slice true-up would be lower than the MRNR calculated in the Initial Proposal, and probably lower than the MRNR calculated in the Final Proposal as well. The reduction in MRNR reduces the amount of accelerated amortization that would be possible without increasing the revenue requirement or the Slice true-up. Despite this concern, it is still possible to accelerate the amortization of the Conservation Acquisition regulatory asset, but it is unlikely that we would be able to fully amortize it in the FY 2020–2021 rate period. If we are unable to fully amortize the Conservation Acquisition regulatory asset, there would not be capacity to accelerate the amortization of the fish and wildlife regulatory asset in the BP-20 rate period.

Q. AWEC states that its proposal would not affect financial reserves or the leverage ratio. Mullins and Hellman, BP-20-E-AW-01, at 8. Do you agree?

A. Yes. Changing the amortization schedule should not affect the financial reserves attributed to Power. Similarly, the leverage ratio calculation for Power Services should not be affected by this proposal because regulatory assets are not included in the calculation.

Q. In light of the above, what is your position regarding the treatment of the Conservation Acquisition regulatory asset?

A. We are open to accelerating amortization of the Conservation Acquisition regulatory asset. The amount of acceleration will depend on expectations about MRNR and the ability to create an accelerated schedule that fits within the available MRNR.

Section 3: Repayment

Q. Please describe AWEC's proposal regarding BPA's repayment.

A. AWEC argues that BPA should "start thinking of ways to modernize its repayment study theory." Mullins and Hellman, BP-20-E-AW-01, at 9.

Q. Does AWEC identify areas of concern?

A. Yes. AWEC identifies two broad areas of concern. First, AWEC is concerned about whether the total revenue requirement is driven by accrued expenses or cash needs. *Id.* at 10. Second, AWEC believes the repayment modeling should take into account actual debt management practices. *Id.* at 10–11.

Q. Please describe AWEC's first concern.

A. AWEC refers to BPA's practice of rates being set to recover both the forecast of accrued expenses and the cash needs of the business unit. *Id.* at 10. In practice, this is commonly referred to as the "higher of" test in that the revenue requirement can be driven by either the forecast of accrued expenses or the cash needs, depending on which is higher. AWEC believes that either approach would result in full cost recovery on its own, but that in combination they could lead to recovering more than 100 percent of an investment. *Id.*

Q. How do you respond?

A. We do not agree with the perspective that over-collection will occur. We expect that the Power revenue requirement will be driven by cash needs. A significant influence is the change in non-Federal debt accounting. All non-Federal principal will appear in the statement of cash flows beginning in FY 2020 instead of on the income statement as it is today. Lennox *et al.*, BP-20-E-BPA-17, at 19-20. It is highly likely that MRNR will be positive for the foreseeable future, which would mean that cash requirements will drive the revenue requirement.

Q. *Please describe AWEC's second concern.*

A. AWEC argues that the repayment study should take into consideration BPA's actual debt management practices. Mullins and Hellman, BP-20-E-AW-01, at 10-11. Specifically, AWEC argues that BPA should assume future refinancings of Energy Northwest (EN) debt. *Id.* at 11.

Q. *How do you respond?*

A. Generally, we agree with AWEC. BPA attempts to mirror actual practice in its repayment modeling. For example, projected debt issuances are based on actual borrowing practices and forecasts instead of simply assuming maximum maturities for all debt.

Q. *Please describe the EN refinancings referenced by AWEC.*

A. For over a decade, BPA has worked with EN to refinance EN debt as it comes due. This reduces EN debt payments, which allows BPA to instead repay a like amount of Federal debt. The Debt Optimization program, which ran from FY 2002–2009, allowed BPA to refinance Treasury bonds to extend access to BPA's limited U.S. Treasury borrowing authority. The most recent effort, the Regional Cooperation Debt (RCD) program, which began in FY 2014, allowed BPA to repay higher interest rate appropriations to reduce interest expense for Power Services.

Q. *Did the rate case repayment modeling differ from actual practice?*

A. Yes. BPA did not model Debt Optimization refinancings in the rate cases affected by that program. The RCD program was indirectly modeled to produce the desired rate effects. Instead of assuming refinancings would occur, BPA estimated the impact of such refinancings and included the effect, called the RCD Effect, as an adjustment to the revenue requirement. Lennox *et al.*, BP-20-E-BPA-17, at 5.

Q. Why was the repayment modeling different than actual practice?

A. The most significant concern was that we would commit to significantly higher Treasury payments based on EN debt refinancings that BPA did not directly control. In the event the refinancing did not occur, BPA would be responsible for the original EN debt payment and the higher Treasury payment based on the assumed EN refinancing while only having the funds for one of the two payments. *Id.* at 5–6.

Q. How is BPA modeling EN refinancings in this rate proceeding?

A. Refinancings of EN debt will be included once the EN Executive Board has issued a motion of support. The Initial Proposal includes a planned refinancing of EN debt in FY 2020. We expect to include a refinancing for FY 2021 in the Final Proposal. BPA received support from the EN Executive Board for the FY 2021 refinancing after the completion of the Initial Proposal. While it was not included in the Initial Proposal, it will be included in the Final Proposal. While there are always risks to the completion of the EN bond deal, BPA is comfortable that they are negligible and plans to include the FY 2021 refinancing in the final proposal.

Q. How does AWEC characterize the forecast FY 2020 EN refinancing?

A. AWEC argues that MRNR is increased by $23 million because of the refinancing, which reduces the benefits of the refinancing. Mullins and Hellman, BP-20-E-AW-01, at 11.

Q. How do you respond?

A. We believe this is a misinterpretation of the Initial Proposal. The $23 million in question is the conditional Federal payment that will be made in FY 2020 because of the EN refinancing. If the refinancing does not occur, BPA will instead pay $23 million to EN for its bond payment currently due to mature in FY 2020. In either event, $23 million will be spent on debt. The refinancing simply determines which type of debt is repaid. Customers of Power Services will receive significant benefits from the RCD transactions through lower overall interest expense. This conditional payment is a part of the RCD program rather than an artifact that erases the benefit of it.

Q. How was this conditional payment of $23 million derived?

A. The total amount of EN debt scheduled to be refinanced for the RCD program in FY 2020 is roughly $250 million. This would allow for the repayment of $250 million of Federal debt. However, BPA and EN have been working together to accelerate the savings of the RCD program with the use of short-term lines of credit (LOC). In FY 2019, we anticipate the use of an LOC to cover the cash needs of EN's operations and maintenance costs. The FY 2020 refinancing of EN debt will free up $250 million, which will be used to repay the $227 million LOC from FY 2019, leaving $23 million to be used for repayment of Federal debt. Since this additional Federal payment depends on the refinancing of EN debt, it is classified as the conditional payment rather than part of the base payment for FY 2020.

The positive MRNR value in FY 2020 indicates that the principal payments, both Federal and non-Federal, will be larger than the cash generated by operations. It is influenced by the total amount of debt scheduled for repayment in a given year. The total amount of debt repaid in FY 2020 is not determined by the RCD transaction. This transaction only determines whether funds will be spent to repay Federal or non-Federal debt. In other words, a refinancing determines how the money is spent but not the total amount that will be spent.

Q. Do BPA and Energy Northwest plan on refinancing EN debt beyond FY 2020?

A. Yes. The EN Executive Board recently issued a motion of support to extend the Regional Cooperation Debt initiative past FY 2020. This motion was not present at the time that

BPA modeled the Initial Proposal, so it could not be included. We refer to this new effort as RCD2.

Q. Will the RCD2 program be modeled in the Final Proposal?

A. Yes. In addition to the FY 2020 refinancing that was modeled in the Initial Proposal, we plan on modeling the FY 2021 refinancing that will be part of RCD2.

Q. What do you expect to model?

A. We expect to model the refinancing of all EN bonds that come due in FY 2021. Simultaneously, we will increase Federal repayment in an amount equal to the bonds being refinanced. The refinancings will include EN bonds associated with Debt Service Reassignment (DSR), which will allow the funds coming from Transmission to Power for the bond payments to be used instead to repay a like amount of Federal debt. The debt service on these bonds will be functionalized to Power. Finally, we will assume that EN sells bonds for the premiums, currently embedded in non-Federal interest expense, on the original debt issuances. This will reduce non-Federal interest expense, which will allow Federal repayment to increase by a like amount.

Q. How will the FY 2021 RCD2 transaction affect the Final Proposal?

A. The mix of debt payments will be different in the Final Proposal. Non-Federal debt payments will be much smaller, while Federal repayment will be correspondingly higher. Interest expense will also change. We expect non-Federal interest expense to be lower. Federal interest expense will be unaffected in the year of the refinancing because the Federal debt payment will be made at the end of the fiscal year.

Q. Does AWEC raise other issues?

A. Yes. AWEC believes that BPA could reduce its revenue requirement if repayment modeling considered the maturities of debt when scheduling debt repayment for Power Services rather than only scheduling repayment based on the highest interest rate first. Mullins and Hellman, BP-20-E-AW-01, at 12. AWEC also argues that Order RA 6120.2

has slightly different language regarding power and transmission, and that these differences mean that the Power repayment study is not required to consider whether each annual increment of Federal investment is repaid in the repayment period. *Id.* AWEC recognizes that these would be shifts from BPA's existing methodology, but recommends that BPA consider opportunities to modernize the repayment study methodology in the future. *Id.*

Q. What is your reaction to these ideas?

A. We recognize that AWEC is not proposing that BPA modernize the repayment study methodology in this rate proceeding. We understand AWEC to suggest that we ignore, at least occasionally, the highest-interest-rate-first requirement of the Order because, in practice, it may reduce the overall repayment obligation to retire certain debt obligations early. *Id.* at 12. We believe that we can, and do, accomplish the results that AWEC seeks without abandoning or relaxing the requirements of Order RA 6120.2. For example, the rollover feature of the repayment model, which allows the operator to simulate the refinancing of an existing Federal bond, was created to enable the operator to mitigate a critical year. If the critical year is a result of a projected bond, the operator can shorten or lengthen the maturity. The operator is also free to place projected debt as needed to minimize these peaks.

AWEC suggests that Order RA 6120.2's language requires differing treatments of Power and Transmission revenue requirements. We agree that the language is different, but the difference has little practical significance. AWEC is correct in noting that the "each annual increment" language of the Order specifically references Transmission. DOE Order RA 6120.2 at § 12b(2). However, AWEC leaves out the previous section of the Order, which requires the repayment study to demonstrate recovery of "[e]ach dollar of power investment." *Id.* at § 12b(1). Power investment is done incrementally, just like Transmission investment. The repayment of each dollar of appropriations or Treasury bonds for Power is a demonstration of the repayment of each increment of Power investment. The wording of the repayment requirements may differ, but for all practical purposes the requirements are the same.

Q. Would there be complications with changing the application of the highest-interest-rate-first provision of DOE Order RA 6120.2?

A. Yes. This is a Department of Energy Order that is generally applied to all Power Marketing Administrations (PMA), which include BPA. It is used by the Federal Energy Regulatory Commission (FERC) when evaluating PMA rate filings. It is not obvious how BPA could choose not to follow the highest-interest-rate provision of the Order. It may require a comprehensive review of the Order by DOE and the other PMAs. Furthermore, AWEC acknowledges that BPA has decades of precedent that guides how it acts. Mullins and Hellman, BP-20-E-AW-01, at 12. Changing course is not easy and often cannot be accomplished quickly. BPA will continue to seek ways to manage its repayment obligations and minimize costs within the requirements of existing authorities.

Section 4: Financial Reserves Error

Q. AWEC, WPAG, NRU, and PPC note that during a publicly noticed conference call on February 19, 2019, BPA shared preliminary findings regarding an error in the way it has attributed financial reserves available for risk between the Power Services and Transmission Services. Mullins and Hellman, BP-20-E-AW-01, at 24–25; Andersen et al., BP-20-E-WG-01, at 9; Stratman, BP-20-E-NR-01, at 5–6; Deen and Bush, BP-20-E-PP-01, at 11–12. Does this error affect the revenue requirement?

A. Typically, we use the most recent public forecast of end-of-year reserves as the starting reserves balance for the first year of the rate period. In this case, the second quarter FY 2019 forecast would be the starting FY 2020 reserves balance. If that forecast includes an assumption about a reallocation of business unit financial reserves for risk, the reallocation will be included in the analysis for the Final Proposal. The only impact on the revenue requirement would be in the calculation of interest income, which is treated as a reduction to the revenue requirement. A rebalancing of reserves could result in an increase in Power interest income and a reduction in Transmission interest income. The actual impact will depend on the amount of reserves that is reallocated and the interest rates used in the calculation.

Q. Will this error affect the calculation of MRNR?

A. No. As noted earlier, the calculation of MRNR is a comparison of the expected cash from operations and the expected debt payments for each year of the rate period. The reserves balance is not a factor in this calculus. Interest income is also not a factor in this equation.

Q. Will this error affect the debt-to-asset ratios calculated in the revenue requirements?

A. No. The debt-to-asset ratio, also referred to as the leverage ratio, is not affected by the error. The ratio compares revenue-generating assets to outstanding debt by business unit. While financial reserves are an asset, they are not classified as a revenue-generating asset for the purposes of the leverage ratio calculation. This issue was addressed in the Leverage Policy Record of Decision, September 2018, at 26 (available at https://www.bpa.gov/Finance/FinancialPublicProcesses/Financial-Reserves-Leverage/Pages/Financial-Reserves-Leverage-Policies.aspx). Changing the amount of reserves for risk attributed to Power and Transmission will not affect the leverage ratio of either business unit.

Q. Does this conclude your testimony?

A. Yes.

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