Comments of the
M-S-R Public Power Agency
Transmission Loss Capacity Charges
Financial Issues – Capital Availability

The M-S-R Public Power Agency[1] (M-S-R) appreciates the opportunity to comment on two topics covered during BPA's September 29th Customer meeting. The two topics addressed are: (1) BPA's proposed inclusion of capacity charges for financial settlement of transmission losses; and (2) BPA's assessment of its financial situation with respect to capital availability, and its proposed solution of adding substantial revenue financing in the next two rate periods (and beyond).

1. **Financial Settlement of Transmission Losses Does Not Justify a Capacity Charge**

M-S-R understands BPA intends to include a capacity charge on loss returns, with a smaller capacity charge applied to in-kind losses returned after a 168-hour period, and a substantially higher capacity charge added to an hourly index price for financial loss returns. M-S-R's prior comments on losses encouraged BPA to defer these changes until customers have more time to explore the changes, and BPA has time to develop a concurrent in-kind loss mechanism. M-S-R renews its request for deferral of these changes.

In these comments M-S-R focuses on BPA proposal to impose a substantial capacity charge ($6.65/MWh) as an adder to the market price BPA will charge for financial settlement of transmission losses. BPA's presentations

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[1] 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.

on capacity indicate they are necessary for the delayed in-kind loss returns, but would not apply to concurrent in-kind loss returns. For the same reasons there should be no capacity charge applicable to financial losses. Financial losses are charged concurrent with the transmission schedule, and M-S-R understands BPA intends to charge customers the applicable hourly rate for the period when the schedule occurs. There is no need for BPA to hold capacity when it is charging an hourly price. BPA can purchase the financial losses for the same price it intends to charge its customers. Arguments that energy may not be available are unavailing. The scarcity will be reflected in the market price that BPA intends to impose on its customers.

M-S-R does not understand why it is appropriate to impose a capacity charge on concurrent financial settlement of losses when BPA has indicated that it does not intend to impose a similar charge on concurrent physical settlement of losses.

M-S-R encourages BPA to reconsider its proposal and delete the imposition of capacity charges on the financial settlement of transmission losses.

2. BPA's Financial Situation Needs to be Explored Without Assuming Customer Financing is the Answer

M-S-R understands from the September 29th meeting that BPA is concerned about its ability to access capital in the future given the existing restrictions on its federal borrowing authority. M-S-R further understands that BPA previously assumed that the Leverage Policy it adopted in 2018 would have the practical consequence of imposing revenue financing charges in transmission customer rates sufficiently to close the gap in the anticipated borrowing needs of the agency. While M-S-R does not recall that being the expressed rational for the Leverage Policy when it was adopted, M-S-R now understands that was BPA's view and intent for the Leverage Policy.

M-S-R understands that as a result of certain accounting changes recently initiated by BPA, BPA now believes that transmission revenue financing under BPA's Leverage Policy likely will result in insufficient formation of capital to meet BPA's forecasted capital expenditures. M-S-R also heard BPA Staff indicate on September 29th that it was inappropriate for customers to rely on 100% debt financing, and in BPA Staff's words, overextend the "BPA credit card."

The data posted by BPA as a response to data requests from the September 29th workshop raises more questions than it answers. Those questions include: How has the base case evolved since the 2018 financial policy review workshops? How is the assumption that the $3.5 billion of Energy Northwest bonds being extended taken into account in the repayment run? How is the underspending of capital by Transmission over the past few years reflected in the forecasts? How was the borrowing in excess of repayment for Power addressed in 2020?

As a solution BPA indicated that it would be evaluating alternative forms of revenue-based financing in BP-22. Specifically, BPA Staff proposed to add a total of $644 million to Transmission rates between BP-22 and BP-24, raising Transmission rates by 18.8%. In contrast, BPA Staff would consider adding some revenue financing to Power's rates, subject to an overall 1% rate pressure cap.

M-S-R is quite concerned that BPA did not raise any of these concerns until the last customer meeting before publication of the BP-22 case and the imposition of *ex parte* rules. There was no mention of these concerns in the IPR process. When Leverage Policy issues were raised during a July 28, 2020 workshop, BPA Staff indicated that accounting changes meant it would be unlikely to have revenue financing added to rates in BP-22. BPA should understand that the revelation of a potential 19.8% rate increase for capital management on the last day of workshops is counterproductive.

Further, the IPR letter published shortly after the September 29th workshop reflected no cost control concerns for Transmission (while it remains the focus for Power). The IPR letter also revealed that the Vancouver Control Center ("VCC") announced as a possibility during the IPR is essentially a certainty despite broad customer comments raising concerns with the half-billion-dollar project in IPR comments. The lack of focus on transmission cost control is inconsistent with the Leverage Policy, which provides four options for addressing BPA's financial concerns, one of which is revenue financing, but another of which is reducing capital expenditures. To that end, the Leverage Policy provides: *"Actions related to reducing planned capital spending and changes to regulatory treatment of certain investments will be addressed through Bonneville's capital review process, such as the Integrated Program Review or its successor."* (Leverage Policy Section 4.4) The lack of any discussion regarding reduced capital expenses for

Transmission in the IPR is inconsistent with BPA's financial policies. Ignoring the cost control aspects of the policy and instead assuming the answer is revenue financing undermines any aspect of customer protection built into the policy.

Combining the September 29th workshop with the IPR letter, it is apparent BPA expects Transmission customers to revenue finance the VCC, plus another $100 million in capital over the next four years. As M-S-R has raised in prior comments on the financial processes, revenue financing of assets with a projected life of 40 years or more in current rates is completely inconsistent with the alignment of cost causation and alignment of benefits with costs. M-S-R strongly encourages BPA to suspend this proposal and allow for a full discussion of the real issue (discussed below) and the fundamental economic principles associated with capital expenditures.

M-S-R thinks it is important to briefly indicate where it disagrees with BPA's "theory of capital formation":

1. Revenue financing is fundamentally different than raising equity to balance debt
2. The underlying critical element in the evaluation of acceptable debt levels by rating agencies is the probability of repayment by the borrower-not the level of debt per se
3. The cost of capital of rate payer provided funds is not zero and likely has a very wide range
4. BPA does appear to have a serious access to capital issue which needs to be addressed collaboratively by both the agency and its customers

Revenue Financing vs. Equity Capital

Equity capital is a source of capital that is subordinated to debt. It typically is required when there is uncertainty regarding the adequacy of future revenues to fully repay the debt. Also, it is often used when the expected payback period for the asset is over an extended time frame. Equity capital typically commands a premium return (ROE) relative to the cost of debt.

Revenue financing is a current period charge to current customers (the market) to cover expenses, not investment. It is a charge, not a source of equity, revenue financing as a "charge" does not warrant a "return". It is not intended to have current customers (the market) subsidize future customers (the future market).

Clearly, BPA recognizes this reality in its customer financed LGIAs. The customer provides the funds upfront and earns a defined return over the life of the repayment in the form of interest and transmission credits.

Acceptable Levels of Debt

BPA has asserted in its justification of the adoption of the Leverage Policy that the rating agencies are concerned about the ratio of debt to assets. BPA indicates that it has concluded that a ratio of 75%-80% is appropriate for a ten-year target, with a ratio of 60% being its long-term goal. BPA's Leverage Policy ROD indicated these targets are consistent with "industry" standards and rating agency standards. Administrator's Record of Decision – Leverage Policy at p. 5 (2018).

It is M-S-R's view that the salient issue is the level of debt that must be serviced to avoid an event of default. Debt that can be deferred without triggering an event of default (a violation of covenants) or without other severe consequences that threaten the going concern status of the debtor is a form of deep subordination and is more like preferred stock. Thus, an appropriate ratio is debt with default provisions (excluding debt without such provisions-preferred stock like) divided by assets. M-S-R understands that currently BPA is well below the 75%-80% threshold using this methodology.

The rating agencies seem to recognize this concept in their evaluation of BPA debt. They express concern about the agencies willingness to impose rates sufficient to cover costs; they express concern when elements of BPA's business fail to maintain sufficient reserves to serve as a shock absorber against uncertainty (volatility) in certain revenue sources. Based on M-S-R's review of more recent rating agency filings it does not appear that the agencies are particularly concerned about the current level of debt held by creditors other than the federal treasury, nor do they appear to be concerned about the level of debt held by the federal treasury.

It also is M-S-R's understanding that historically BPA has "missed" one or more repayments to the federal treasury. It also is M-S-R's understanding that historically BPA's ratio of debt to assets has been well above 100% with a significant investment in “regulatory assets” that never have had any prospect of producing any revenue to offset the associated financing costs. M-S-R is not aware of any concern expressed by a rating agency or BPA during this historic period.

Customer (ratepayer) Cost of Capital

It is M-S-R’s understanding that BPA assumes the cost of capital associated with revenue financing is zero. It also is M-S-R’s understanding that BPA does not acknowledge that its transmission customers may incur significant financing costs associated with currently providing BPA with potentially hundreds of millions of dollars to finance transmission that will serve future customers for the next 40-50 years.

To assume that transmission customers do not have a cost of capital is inaccurate. Investor Owned Utilities have a publicly available filing indicating their utility commission approved cost of capital. Publicly owned transmission utilities like the Transmission Agency of Northern California have a cost of capital imputed in their tariff rates posted on their OATT. The retail customers of BPA’s transmission customers have a cost of capital that may range from a low of current mortgage rates to a high of credit card rates or paycheck advance services. Despite the current policy of the Federal Reserve, capital always has a cost.

To assume that capital raised from transmission customers does not have a cost is to create a massive distortion in the efficient allocation of resources. If that were correct in reality all capital expenditures should be financed with “free” capital-revenue financing should cover all capital investment.

BPA Appears to Have a Serious Access to Capital Issue

M-S-R understands from the September 29th workshop materials that BPA’s Base Case forecast indicates BPA could exhaust its borrowing authority on or around 2027, while exceeding its self-imposed limit of maintaining a $1.5 billion buffer around 2024. However, the follow-up information posted by BPA indicates BPA’s forecast indicates the existing authority would be exhausted around 2032. It is not apparent, however, if the Base Case is the same data set used in the Leverage Policy. Subsequent to the adoption of the Leverage Policy BPA’s spending has been at least $300 million less than projected for Transmission, raising questions about the reliability of the forecasts. M-S-R acknowledges that BPA has expressed a focus on improving its ability to spend on capital projects, but that remains to be seen.

M-S-R acknowledges there may be significant capital needs on the horizon for Transmission, particularly related to deferred maintenance, and improvements that may be necessary for BPA and the region's increased participation in organized markets relying upon security constrained economic dispatches. However, in contrast to the focus of the Power business, there have been no discussions of how those potential costs can be offset by "bending curves" elsewhere in Transmission's budget. Assuming that customer revenue financing is the solution appears to be the most expedient answer, but it does not reflect consideration of customer's costs and needs. As noted above, it is also inconsistent with BPA's own financial policies.

M-S-R encourages BPA to recognize this fundamental issue-the need for new sources of cost-competitive capital- and collaborate with its regional transmission customers to identify new sources and possibly new structures to assure the region does have the necessary access to capital to participate in the energy markets of the future. Asking current customers to finance the region's transmission needs for the next 30-40 years is not the answer.

M-S-R encourages BPA to recognize the strategic significance of this issue. In partnership with regional transmission customers, BPA should set aside sufficient time now to facilitate an in-depth inquiry and analysis of several financing options. BPA should then partner with the region and select the most acceptable option to assure the regions has sustainable access to required capital to finance its participation in the future transmission world.