



April 10, 2014

Nancy Mitman
Bonneville Power Administration
P.O. Box 3621 – F-2
Portland, OR 97208-3621

RE: BPA’s Capital Investment Review

Dear Ms. Mitman:

We appreciate the opportunity to comment on BPA’s Capital Investment Review. And, since BPA’s finances are a unified whole with respect to impact to consumers, we look forward to many more discussions with you in the months ahead regarding the expenditure side as well and the interaction and total impact of these various pieces on BPA’s power and transmission rates. As you are well aware, PPC and its members have serious concerns about the prospects, as previewed in BPA’s presentations in February, of significant rate increases for the third rate case in a row.

Introduction

After relatively stable loads and debt for decades, BPA has embarked upon a path of significantly increasing its capital spending and resultant debt. Much of the capital spending is necessitated by aging generation and transmission infrastructure, but there is an ongoing question whether the demand for BPA’s services will increase fast enough to accommodate the additional capital burden. To its credit, BPA has acknowledged that additional debt and costs are a serious concern to customers, and has proposed an “affordability cap” to try to limit the continued upward pressure on capital spending. While the concept of an affordability cap still needs to be further refined, it is an important first step in trying to keep BPA’s increasing capital obligations proportionate to increasing demand for BPA’s services.

We appreciate that BPA senior executives took some time to hear directly from consumer-owned utility managers about the continued poor economy in much of the Northwest, and the critical importance that electrical costs have for both people and employment in Northwest communities. Your record of that meeting will reflect some very striking presentations about the human element involved with rising electricity costs

across our region. It is for this reason that BPA's upward trend in capital expenditures is so concerning. In the end, rising capital expenditures need to be repaid. The effect is to lock BPA into a stream of fixed long-term expenditures to repay capital and interest, which puts upward pressure on both power and transmission rates.

Reducing this upward rate pressure is particularly critical, given the size of the power rate increases in the last two rate cases, and the substantial forecasted power and transmission rate increases in the upcoming rate case. For example, one utility manager noted that BPA's costs are growing much faster than the utility's other costs.

In addition, the customers would value a better articulation of how the long-term strategic plan and priorities of BPA are tied to the capital investment proposal.

Prioritization

PPC acknowledges that BPA has taken a substantial step forward by developing a way of prioritizing capital expenditures on an agency-wide basis, which provides a mechanism for agency-wide management of BPA's prioritization costs. By acknowledging the need for prioritization, and beginning the implementation of prioritization, BPA has taken an important first step in getting its capital expenditures under control. However, there are significant deficiencies in BPA's initial prioritization proposal, which need to be addressed.

One challenge that BPA faces is how to implement prioritization. For understandable reasons BPA is taking a phased-in approach to prioritization. But, phasing in prioritization creates its own difficulties. The problem with initially exempting certain categories from prioritization is that it exacerbates BPA's existing problem that its capital budget is "front loaded" – that capital expenditures are higher in the near term, necessitating lower capital expenditures in later years.

For example, BPA is choosing not to initially prioritize prioritization capital expenditures under \$3 million. However, next year BPA is spending about \$100 million on capital expenditures under \$3 million. One way of reducing the burden of front-loading is to flip the default assumption, BPA could decide that all capital expenditures under \$3 million will be deferred absent a demonstration that the project has to be done immediately, rather than assuming that all capital expenditures under \$3 million will be automatically grandfathered into BPA's capital spending plans.

Another thing that BPA should do is to look at what level of capital spending BPA could make, without requiring a rate increase. Both on the capital and the expenditure side, it would be very useful to see a presentation showing a base case with a level of expenditure that would result in a zero percent rate increase, and then show an explicit case made for any capital or expenditure spending greater than that level. The point is

not to forbid BPA from spending money above the zero rate increase level, but that the agency would be reoriented towards budgeting from an initial default that does not presume high single-digit power rate increases in each rate case.

Complementing BPA’s prioritization efforts is the “affordability cap”, which sets the overall limit for BPA capital expenditures. One real strength of the affordability cap is that the affordability cap covers almost all BPA capital expenditures, even those capital expenditures not subject to prioritization. So, even though BPA is not prioritizing energy efficiency and fish and wildlife expenditures (due to the dependence of those expenditures on outside processes), those capital expenditures still count towards the overall limit.

However, the process that BPA went through to develop the “affordability cap” seems inadequate. BPA’s affordability cap seems to be determined largely by taking the level of BPA’s capital spending over the last few years, and limiting BPA’s level of capital spending over the following ten years to that level. It’s not clear that BPA determined that this level of capital spending was financially sustainable for the agency in the long-run or how it was specifically tied to the overall strategic plan. Rather, it appears to be approximated with recent capital spending patterns, and with what would leave some remaining Treasury borrowing authority in 2023.

Since the forecast level of capital spending is higher than the affordability cap in the next few years, this means that BPA will have to constrain its spending later, in order to fit under the affordability cap. Unfortunately, this resembles the well-known budgetary practice of “front-loading” – concentrating expenditures in the early years of a forecast period, while asserting that expenditures will decrease in the later “out-years” of the forecast period. Obviously, this budgetary pattern is risky, since near-term expenditures are much more predictable than later expenditures, so there is little chance that near-term expenditures will fall, but a much greater chance that later expenditures will rise. Not all departments of BPA submitted a front-loaded budget, but enough did to create an agency-wide front-loading effect. It would be useful if BPA revisited the overall level of the affordability cap to provide a more rigorous justification that BPA can sustainably make capital expenditures at levels permitted by the affordability cap, and to determine if there are available steps to take to mitigate the current front-loading of BPA’s capital budget.

Transmission

BPA’s presentation on October 23rd included two graphs showing capital spending trends on the power and transmission sides of BPA, as well as planned principal repayment (pages 37 and 38 of the presentation). What is striking about the graphs is that they show that on the power side of BPA’s business, principal repayment is almost as great as new capital spending through 2025, while on the transmission side, capital spending far exceeds principal repayment. In other words, it is currently transmission system

investment that is driving the growth in BPA's capital program.

As BPA has documented in this CIR process as well as in numerous other forums, this pressure for growth in net transmission investment is driven by a number of factors. On a basic level, much of BPA's transmission facilities are simply old, as over half of the extant facilities were constructed over fifty years ago. As presented in BPA's Transmission Asset Strategy for "sustain" investments, a significant portion of transmission equipment is already beyond its initially projected economic life, with a number of "asset walls" approaching in future years when high volumes of devices will exceed their planned lifecycle.

PPC recognizes the need to replace these aging assets that form the core of BPA's transmission network. Generally speaking PPC is supportive of the asset strategy presented by BPA for sustaining the existing transmission infrastructure to meet reliability and availability requirements. PPC does encourage BPA to continue to refine its asset management practices to ensure that the sustain program is executed in the most efficient, reliable, and cost effective manner possible.

In addition to the core sustain capital investment program, the majority of BPA's projected capital program over the next ten years in transmission is categorized as expansion. As described, investments categorized as "expand" enhance the capacity and flexibility of the transmission system beyond its current capabilities. Expansion investments are further broken down into the three categories of compliance, policy investments, and discretionary.

As noted above, BPA's general capital program under the prioritization and affordability cap framework is highly front-loaded in the early years of the ten-year planning horizon. A driving factor in this situation is the large number of "policy" investments that are already in progress. In this context, policy investments refers to build commitments made through the Network Open Season (NOS) as well as other contracts or processes prior the current CIR.

Through previous NOS processes and other commitments, BPA has created an unsustainable level of transmission expansion investment. Further, in the current process, customers have extremely limited ability to influence transmission expansion investments for the period under consideration. This situation is unfortunate. If BPA is to achieve a sustainable capital program in the future, the agency must more carefully and globally consider the commitments and terms of build obligations it takes on under NOS or other commitments going forward.

Another area of concern for PPC in the area of transmission investment prioritization is the treatment of expansion and "non-core" sustain investments made primarily for preference customer load service. Although a substantial conflict did not arise in this

CIR, PPC is concerned that a situation may arise in the future where preference load service investments may be competing under the prioritization process with discretionary or commercially based expansion projects. PPC would like to work closely with BPA staff in future CIR processes to more explicitly consider how load service-related transmission investments are treated under prioritization.

Lastly regarding transmission investments, PPC would like to comment regarding BPA's "Net Economic Benefit" ratio analysis. Although the concept represents a strong start, aspects of the incremental benefits analysis for the "green lighted" prioritization portfolio raise some concerns with the implementation of the methodology. Specifically, although BPA shows a benefits-to-costs ratio of nearly 8 to 1 for the portfolio, 69% of those benefits take the form of "added capacity and increased reliability."

It is our understanding that these modeled benefits vary by project, but in many cases may be driven heavily by assumptions regarding reductions in unplanned outages and other factors that do not actually benefit BPA or the majority of its customers. Further, these types of avoided costs can be heavily driven by assumptions and may accrue to very specific parties. PPC would encourage BPA in future CIR processes to present financial justification for discretionary expansion investments that more narrowly considers financial impacts to the agency.

Hydro

The hydro program is one of the main consumers of BPA capital dollars, given the aging infrastructure of the FCRPS. BPA's hydro program has traditionally provided the most rigorous analysis of its capital needs of any of the parts of BPA, and notably, hydro's budget is not front-loaded; hydro's expected capital budget shows an increase over the ten-year forecast period. It is important that BPA's prioritization procedures and the affordability cap not damage the successes that the hydro program has already achieved in capital budgeting.

One thing that did stand out in hydro's presentation, however, was that BPA is assuming a high price of power – 72 mills – as the benchmark for evaluating hydro capital investments. A portion of that price can legitimately be ascribed as an implicit carbon credit for the carbon-free nature of hydro, but the overall number still seems high, given the state of the current power market. BPA provided an analysis that we requested that showed that at a 12% discount rate, the optimal level of investment in BPA's hydro system did in fact decline at lower power prices (the optimal level of investment in BPA's hydro system did not change at an 8% discount rate).

Given that the cost-effectiveness of some hydro investments are affected by the assumed market price, it would be desirable if hydro could introduce more flexibility into its budgeting process by deferring some of the lower-value hydro investments (to the extent

possible), while keeping the flexibility to increase the amount of hydro investments if the market price of power increases substantially. Prioritizing between higher-valued and lower-valued hydro investments would also be a way of adjusting hydro investments to conform to the affordability cap.

The larger challenge that BPA faces is that although the capital budget for Federal hydro in the upcoming rate period appears adequate, PPC is concerned that the future implementation of the affordability cap could result in competition between core “sustain” maintenance of generation assets and discretionary transmission expansions. Managing the expansion part of the transmission system is the key challenge BPA faces under prioritization, and a key part of that is keeping those discretionary transmission expansions from impacting BPA’s hydro investments.

Information Technology

BPA’s IT expenditures have increased at a rapid rate in terms of both expense and capital over the past several rate periods. Furthermore, IT expenditures are very front-loaded: proposed capital spending on IT is \$173.1 million over the ten year period from FY14 to FY23, but 25% of planned IT capital spending occurs in FY13, 43% in FY13-14, and 62% in FY13-15. Just 18% of planned IT capital spending occurs over the last five years of the ten-year forecast period.

Given the fact that BPA’s IT expenditures have increased at a rapid rate in terms of both expense and capital over the last several rate periods, the front-loading of IT capital expenses creates a significant risk that IT capital expenditures will end up considerably higher than currently forecast.

In order to control the potential escalation in IT capital costs, particularly for IT expansion capital investments, BPA should carefully quantify and assess how assumed “efficiency” gains will be realized in terms of expense offsets in other parts of the IT budget or expense reductions in other parts of the IT budget or expense reductions to other business lines.

Energy Efficiency

Although energy efficiency decisions are largely going to be made outside this process, energy efficiency still constitutes a significant part of BPA’s capital budget. Given BPA’s forecasted power rate increase in the next rate case, there is little appetite for revenue financing of energy efficiency at this time. BPA needs to devise a mechanism for bringing energy efficiency into the prioritization process. The fact that some of the decisions regarding energy efficiency are being made externally to BPA does not change the fact that energy efficiency capital expenditures are part of BPA’s budget, and should be subject to the same prioritization procedures as other parts of BPA’s capital budget.

Conclusion

In implementing prioritization and the “affordability cap”, BPA has taken an important first step towards developing the control mechanisms necessary to address the challenges posed by BPA’s expanding capital spending programs. In light of our serious concerns about the trajectory of rates in recent years and the impact that is having to citizens served by our members, we appreciate the time and work that BPA staff have dedicated to putting together these public processes, and to providing the opportunity for us to be heard and work collaboratively with BPA to address these concerns.

Thank you for the opportunity to submit these comments. BPA’s capital programs are of crucial importance to BPA’s preference customers, and PPC looks forward to working closely with BPA staff on these issues going forward.

Sincerely,

A handwritten signature in black ink that reads "Scott Corwin". The signature is written in a cursive style with a large, sweeping initial 'S'.

Scott Corwin
Executive Director