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Elliot Mainzer
Administrator
Bonneville Power Administration
911 NE 11th Ave
Portland, OR 97232

RE: Integrated Program Review - 2

Dear Administrator Mainzer:

Thank you for the opportunity to engage BPA and its partner agencies (the Army Corps of Engineers, the Bureau of Reclamation, and Energy Northwest) regarding BPA's proposed FY2017-2019 budgets. The IPR process is a key piece of what we hope will be a renewed public power-BPA partnership to ensure that BPA is a competitive power supplier in the near future and going forward. BPA and its core customers are at a critical juncture. The upcoming rate period ends just ten years before BPA's long-term contracts with its preference customers expire. Substantive negotiations around new contracts will have to begin well before expiration. As the most immediate opportunity to begin to turn the corner of competitiveness, PPC strongly encourages BPA to make the current IPR process a tangible demonstration by BPA and its partner agencies of their commitment to cost-reduction and long-term financial health.

BPA has articulated its commitment to changing its internal culture to lower costs and create transparency. Progress evidenced through the IPR processes in the past year was mixed. There were some specific improvements recently in the flow of information, in setting goals, in aspiring to budget process improvement, and in notable examples where the growth of budgets was slowed. But, significant areas require more work, both in substance and in process and information delivery, which are detailed below.

The Need to Further Reduce Costs

With respect to the bottom line, the helpful news is that IPR-2 may reduce the growth of planned increases by approximately $16 million on the power side and $9 million to $10 million on the transmission side. Added to the reductions achieved in IPR-1, this is a welcomed reduction from the costs that BPA proposed initially.

The bad news, of course, is that BPA's costs are still going up. Hydropower costs are going up 3.6% from the prior rate period, while costs at Columbia Generating Station are going up 2.1%. BPA proposes incremental spending as well to modernize its commercial and operational systems and processes. This underscores the need to fully develop and implement a strategic plan, and the ongoing challenge of getting three federal agencies in three different areas of government (BPA, the Corps, and the Bureau) plus Energy Northwest to work together on longer-term cost control measures to allow BPA to start actually cutting its costs, as opposed to merely slowing the growth in its costs.

PPC members are looking for BPA and its partner agencies to embrace the philosophy of doing "less with less." True long-term savings will occur only when processes are reengineered to require less labor and other resources. In that mode, it has been encouraging to hear the recent remarks of BPA and Energy Northwest executives who embrace such an approach and management style.

Overall, PPC recognizes BPA's efforts to curb spending and achieve cost reductions in some areas. BPA's efforts, however, need to be much more robust to cut low priority projects, rather than push them off to future years, and to focus on the necessary, if difficult, task of doing only what is needed so that the cost of delivering services declines. Transition to a new culture of cost-competitiveness and customer responsiveness can be advanced by taking tough actions required of the new culture. At a minimum, assuming at least the same amount of undistributed reductions in the power business that were shown in the last rate period could help create the actions needed to build that new culture.

In the week prior to the submission of these comments, BPA sent an e-mail to customers noting that its power revenues continue to be below expectations, despite relatively good water, due to low power prices. Coupled with BPA's low power financial reserves, this creates the distinct possibility that a CRAC might trigger on October 1st. BPA pledged to "step up" cost-control measures. This short-term financial issue is an opportunity to accelerate the implementation of the needed cost reductions contemplated in the IPR, and can be a way of demonstrating a commitment to cost-reduction by being able to hold the line, and thus not implement a CRAC.

Development of a Cooperative Path to Cost-Competitiveness

BPA and customers' initial intention was for IPR-2 to employ a more collaborative and rigorous approach to setting spending levels. The intent was that BPA would develop a variety of alternative spending scenarios in conjunction with customers, and have robust discussion about which scenario BPA should select. It was not envisioned that BPA would present the spending proposal the agency intended to pursue and then field questions and comments.

While IPR-2 fell short of the intended objective, there was some progress toward this end. BPA held some preliminary discussions with customers, which were quite useful in understanding the agency's proposals as well as the proposals by the Corps, Bureau, and Energy Northwest. But, ultimately, it defaulted back to something that resembled more the standard IPR process. No robust or alternative scenarios were produced, except a minor one for the Commercial Operations KSI (Comm Ops). BPA's reports centered on a single set of proposed spending reductions for public comment.

Clearly, one difficulty is that the IPR-2 process is necessarily more compressed than the IPR-1 process, since it takes place simultaneously with the BPA rate case. BPA should commit to begin to meet with customers prior to the end of 2017 to create an iterative, collaborative, and durable process to replace the current IPR. In the meantime, BPA should continue to meet with customers regarding the development of projects to be funded under the Comm Ops KSI as set out in more detail below.

The development of a robust and rigorous program review is one part of the new partnership with BPA that PPC seeks. Another part of that partnership is oriented toward the long-term. BPA is implementing its strategic planning process, a large component of which should be devoted to establishing long-term cost controls. BPA's customers should be intimately involved in the development of the strategic plan and should help determine the objectives, which should hold a key role in assuring BPA takes the actions necessary on a specific timeline to move toward being cost-competitive versus other resource options.

Comments Regarding BPA IPR-2 Proposals

Workforce

PPC recognizes and appreciates that BPA made important gains in workforce savings including $7.9 million on the power side, $5.7 million in transmission expense savings, and $1.7 million in transmission capital savings. (An additional $3.8 million in transmission expense workforce savings was used to help meet the $11.8 million in transmission undistributed reductions promised in IPR-1.)

While a significant fraction of the savings reflects the Office of Personnel Management's updating of BPA's retirement health costs, it was encouraging to see that BPA also proactively achieved about a million dollars a year in savings in retirement costs by getting more accurate workforce cost numbers from the Corps and Bureau. These numbers replaced the estimated numbers that the Corps and Bureau had provided previously.

Longer-term, workforce management is a key part of the strategic plan that BPA will be developing. BPA made progress in limiting the agency workforce numbers below the initial IPR levels. PPC supports the initial goal to keep BPA employment limited, rather than expanding back to the 3,100 positions that BPA is allowed under Federal policy. BPA needs to focus, however, on significantly reducing its use of hundreds of contractors.

Energy Northwest

In another area showing notable progress during IPR-2, Energy Northwest reduced the proposed budget for Columbia Generating Station (CGS) by an additional $6.3 million. A couple of things stood out about Energy Northwest's presentation. First, notable was the emphasis given to reengineering processes, i.e. the mantra of doing "less with less". To achieve long-term cost savings, you need to rethink what needs to be done and what is superfluous, and reengineer processes, to reduce the amount of labor and resources used. Clearly, this type of thinking, not just by ENW, but if really applied by BPA and its other partner agencies, will be a step in the right direction.

Second, it is notable that Energy Northwest's savings are embedded within a longer-term effort to control costs. For example, staffing at CGS has been reduced by about 12% since 2010, and the current plan is to reduce staffing by another 8% by 2020. To accomplish this, Energy Northwest has formed a central hiring panel that has to approve hiring decisions. Budgetary controls are also in place so that personnel reductions are not offset by the increased use of contractors and overtime. More generally, Energy Northwest outlined its objective of being within 5% of the forecasted BPA PF rate in FY26. This mirrors larger efforts within the nuclear industry of reducing costs, in response to continued low power prices nationally.

As far as IPR-2 goes, Energy Northwest is reducing costs further by lowering the O&M risk reserve it carries, reducing the length of the planned refueling outage in FY19 from 40 to 35 days, and optimizing certain non-critical preventive maintenance tasks.

Hydro O&M

It was both hope-inducing and frustrating that the concluding slide for the hydro O&M presentation stated: "[The] majority of the potential reductions for FY 18-19 are considered short-term and temporary. Achievable long-term reductions will need to be identified through our efforts in Operational Excellence."

That statement was a concise summary of the IPR-2 proposal by the hydro agencies. It will prove to be a step in the right direction if the agencies are truly committed to achieving and implementing a system of enforceable operational excellence for the long term. There are encouraging indications in the realm of asset management that show that the agencies are beginning to work together toward that end.

But, while we appreciate the work and time put into these processes, the short-term proposed IPR-2 reductions were fairly modest ($2.5 million for the Bureau, and $2.0 million for the Corps). And, the hydro agencies' IPR-1 and -2 reductions mostly reflect the deferral of work, not an improvement in efficiency. Indeed, rather than identifying a new prioritization or offsetting reduction, the Bureau even indicated that the modest IPR-2 reduction might delay its ability to implement the longer-term World Class Hydro efficiency improvement program.

Prior IPR presentations by the Corps and the Bureau indicate that they, along with other parts of the FCRPS and BPA's transmission system, are grappling with the challenges of maintaining aging infrastructure. The response of the hydro agencies has been to expand the size of its workforce, which has also been subject to considerable wage inflation. Since most of the hydro agencies' O&M costs are labor-related, that has had a significant effect on the costs of maintaining the hydro system.

We are supportive of the hydro agencies' conclusion that they need long-term processes to achieve **sustainable long-term cost-savings**, which will involve considerable cultural change. We discuss the need for long-term changes at the end of these comments, but note it now because it is absolutely critical to the overall goal of achieving a sustainable and competitive future for BPA. The hydro agencies need to look at new ways of doing things, whether it is using contractors more effectively in doing hydro O&M, using technology to reduce the need for staffing at certain locations, or relying more on multi-craft trades people to have a more flexible workforce.

A specific issue in the shorter term posing a challenge is that of the estimated costs for the upcoming Columbia River Systems Operations Environmental Impact Statement (CRSO). Estimated FY18-19 costs for the power-related, non-appropriated costs for the Bureau are given as $3.0 million, for the Corps as $7.2 million, and for BPA as $9.5 million, for an overall cost of $19.7 million over two years. BPA laudably is going to absorb the cost of the CRSO within its existing budget, but both the Corps and the Bureau are treating this as an incremental cost, which more than offsets their planned IPR-2 cost reductions.

No documentation was provided for these CRSO costs, and it will be important to better understand why the costs are so high, and why the Corps and Bureau consider these costs to be incremental. One of the reasons why BPA thinks that it can absorb these costs is that a lot of the work on the CRSO involves reassigning existing personnel and resources from other tasks to the CRSO. It is unclear why the Corps and the Bureau think that all these costs are going to be incremental, since at least some of those costs will involve repurposing existing resources and personnel. We are very interested to hear more about how these costs are viewed at the Corps and Bureau in relation to other costs not mostly reimbursed by federal power customers.

Hydro Capital

The IPR-2 process included some discussion of hydro capital expenditures, and whether hydro capital spending should be ramped up from about $200 million a year to $300 million a year over a period of some years. With many questions outstanding, it was helpful that BPA had delayed the ramp-up of the hydro capital spending by a year.

Given the time-frame, PPC appreciates the opportunity after the IPR-2 process concludes to further examine the justifications for doing the capital ramp-up. And, we will follow up with agency staff regarding their helpful offer to discuss their models and analysis. One thing that we would like to continue to discuss with the hydro agencies is whether it is possible to make the proposed capital program more flexible and more responsive to market prices. The hydro agencies' plan, as currently proposed, appears to include a traditional assumption that power prices will increase over time, although it was stated that the ramp-up would still provide modest benefits if hydro capital prices remained at low levels.

One thing that we heard, both at the very informative *asset management summit* BPA organized a few months ago, as well as from regional hydro utilities, is that, by comparison, other utilities are flexible in their planning. Other utilities tend to limit investments now with power prices are low, while planning on increasing the level of investments later if power prices increase. While perhaps challenging in implementation, this is an approach that the Federal hydro agencies would do well to consider.

Commercial Operations Key Strategic Initiative

BPA's initial budget for upgrading and modernizing its commercial operations was approximately $60 million to be spent over the FY 2017-19 period. We appreciate BPA's efforts to better define its proposed project list and sharpen its project cost estimates and estimates of how much work can actually be accomplished in the FY

2017-19 period. BPA now plans to spend $8 million in FY 2017 and $11.5 to 12.5 million in each of FY 2018 and 2019. As we understand the budget proposal, BPA has approved three projects for completion in the FY 2017-19 period: program management; replacement of the marketing and settlements system; and development of a generation outage tracking system. These projects account for approximately $6 to 12 million of the total $31 to 33 million for the three-year period. How the remaining $25 to 27 million is to be spent in that time period, however, is undefined. We understand that the budget is based on the assumption that BPA would spend a little bit on each of the proposed, but not yet approved, projects.

While we have more confidence in the tighter overall budget, the current proposal should be improved for a number of reasons.

- First, BPA has not attempted to capitalize as much of the project costs as it could. Although BPA removed the meter upgrade project from the KSI list and moved it to another budget as a capital item, all of the remaining projects listed in the workshop materials are expense. We believe BPA should revisit this decision. Other utilities capitalize the costs of modernizing their commercial systems. For example, Puget Sound Energy proposes in its WUTC rate case to capitalize approximately $16 million for system upgrades related to its EIM participation, and PacifiCorp has claimed capital expenses in roughly the same amount for the same purpose. BPA should continue to work with customers on this issue as the projects are better defined and should commit in this process to look for opportunities to reduce its overall cost by capitalizing project costs.
- Second, BPA should make further efforts to reduce budgets for other, lower priority programs to fund the expenditures in the proposed Comm Ops budget, rather than incrementally increase the agency's budget to pay for the proposed projects. BPA's ability to lower its overall costs is critical to BPA's competitiveness now and in the future. We understand the need to modernize some systems in order to reach this goal. That said, this does not mean that BPA should default to incremental expenses to achieve it when it can and should look for reductions elsewhere in its budget.
- Third, we are concerned about the proposal to partially fund all or a significant number of the unapproved projects. These projects have not yet been evaluated based on their costs and benefits and are not supported by rigorous analysis and prioritization.[1] Expenditures on broad array of projects, for the purpose of nudging them all forward, create sunk costs. This in turn could result in wasted investment in projects that are not needed or useful and therefore abandoned in the future. Sunk costs also create a

[1] In response to a question at the February 16 workshop, BPA related that there are no business cases for the projects that are candidates but not yet approved.

future impetus to continue to expend money on projects that unneeded, not cost-effective, or incorrectly scoped.

PPC supports BPA investment in modernization of its commercial and operational systems provided that each project is cost-effective and the cost of each project is allocated to and recovered from the customers that benefit from it. In our comments in the 2016 Integrated Program Review process, PPC asked that the IPR-2 process focus on cost-effectiveness of projects and not creating incremental spending. We understand that BPA staff is still developing these projects and the program as a whole. We are sympathetic to the level of effort and time that this development takes. PPC asked BPA to provide the information currently available to it regarding the projects, including that the information that BPA relied on in approving the three projects noted above that BPA will fund in the FY 2017-19 period. BPA provided some of the requested information, which we appreciate, and we look forward to discussing the projects and receiving the remaining information in a follow-on process.

Lastly, given the IPR-2 and KSI development timelines, BPA expects that it will not complete its gap analysis to identify commercial systems needs and possible projects, nor can it develop business cases or prioritize projects, before the close of the IPR-2 process. This is somewhat problematic. From a rate case perspective, the purpose of the IPR process is to review, discuss and comment on BPA's proposed budgets such that the costs and benefits of proposed expenses and capital investments can be understood and evaluated. This process has allowed BPA to remove its budgets from the scope of the rate case and so not litigate them there. We are encouraged that BPA has proposed effectively to extend IPR-2 for this KSI with a process in which customers will be informed of BPA's decision-making on projects funded through its proposed budget but not yet defined in it. Given that IPR-2 will close without the opportunity for customer comment on the particulars of the KSI budget, as those have not been decided, we encourage BPA to provide opportunities for customers and BPA to discuss proposed projects, including their costs, benefits, scope and prioritization, prior to BPA's decision to fund them and for customers to provide feedback and comment to BPA on those matters. PPC is not suggesting the customers micro-manage BPA's budget process, but we strongly believe that BPA should view public power as its business power in this and other budget matters.

Overall, PPC requests that BPA's IPR-2 decision incorporate the following actions such that BPA will:

- seek out and use reductions in other, lower priority programs to fund the KSI budget for the FY 2017-19 period;

- capitalize project costs where that is consistent with the practices of other utilities and reduces BPA's overall costs and contributes to lower rate levels;
- revise the proposal for funding candidate projects only if the projects are cost-effective and are appropriately prioritized, consistent with PPC's recommendations on competitiveness;
- establish a follow-on process to IPR-2 for the Commercial Operations KSI budget that will provide opportunities for customers to meet with and comment on BPA's proposed project funding under this KSI prior to BPA making decisions on funding; and
- commit to provide additional information in this and the follow-on process as soon as it becomes available, regardless of whether the IPR-2 process has been closed out.

The Longer-Term Challenge

As noted in the introduction to these comments, the IPR process is one important component of a critical, longer-term process to control BPA costs that must be a collaboration between BPA, its customers, and its partner agencies.

BPA is working with the other Federal hydro agencies to improve how O&M dollars are spent, and the hydro agencies themselves are working on initiatives such as the World Class Hydro program and hydro excellence models to improve the efficiency of hydro O&M spending. But progress in this area needs to be made, starting now, with an explicit timeline and explicit objectives. The initiation of reforms cannot be pushed off into an indeterminate future.

Key to longer-term cost control is BPA's upcoming strategic plan. Developing firm, longer-term spending plans within an ambit of an overall strategic direction, and managing spending (by BPA, the Corps, the Bureau, and Energy Northwest) within the limits set by the strategic plan will be crucial for long-term competitiveness. An important consideration will be how to move beyond a two-year focus in developing longer-term cost controls that are effective while maintaining the value of this system.

We look forward to working with BPA and its partners in continuing to improve both the long term and short term budget and cost management processes. While this will mean difficult choices, the long-term competitiveness of this clean portfolio of power is well worth the effort.

Sincerely,

Scott Corwin
Executive Director