FY19 Third Quarter Quarterly Business Review

Participants: Elliot Mainzer, Chris Dunning
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ELLIOT MAINZER: Good afternoon, everyone, and welcome to the third quarterly business review of 2019. I'm Elliot Mainzer, BPA Administrator. I appreciate you taking the time to join me this afternoon. I apologize for the technical problems we had this morning. Still trying to get to the bottom of exactly what happened, but we decided to terminate the call, not to waste any more of your valuable time, and figured this was probably the best methodology to get our information out this afternoon, because we do want to communicate with you, make sure you're getting that high-level overview of our financial condition and performance against our Strategic Plan.

So, thanks for joining me. I want to start by saying that we do continue to try to improve the Quarterly Business Review, not just make sure that we don't have any technical snafus, but you will notice some changes today. First of all, we did some benchmarking of earnings calls among other organizations and found that it is actually common to have a smaller number of speakers than our traditional approach. So, going forward, our QBR call will only involve myself and our Chief Financial Officer, Michelle Manary. For this particular call and recording today, our Deputy CFO, Chris Dunning, will be sitting in for Michelle, who is on summer break.

We've also received some feedback from customers that we haven't quite hit the mark on the level of detail that we've been providing. On the one hand, there's an appetite for summary-level updates on our financial condition and Strategic Plan execution, but others would like more detail around the key drivers of our performance as an agency.

We've developed an approach that attempts to address both needs. During the QBR webinar, we'll deliver a high-level overview of the agency's performance. I'll start off with the reporting status of our key performance indicators and then provide a high-level update on progress on the four major goals of our Strategic Plan, which as you know is the central organizing principle of everything we're doing here at Bonneville, and then today Chris will provide an overview of our financial performance.

To meet the need for those of you who are looking for more detail, each quarter, the QBR will be followed by a finance workshop, where you can get a significantly more detailed look into the status and key drivers of BPA's financial performance. We had that session this morning, and hopefully it satisfied that need for additional detail, looking for the feedback. And I think this approach is designed to provide both accountability and transparency. We'll try it, see how it works, and continue to adapt as necessary, I'd like to thank you for your feedback along the way.

So, with that said, let's get started. Today, because we're not live, we will still, however, take questions. If you'd like to submit those to our Communications Group, we'll make sure at the end of the call and with the push that we've got a formal channel for you to get any questions, and we'll try to be as responsive to those as possible.

So, first of all, I'd like to take a look at our KPI dashboard. I'm not going to get into every element of that, but as you know; our KPIs are the key measures of performance embedded in our Strategic Plan. They track our safety, reliability, and financial performance. These KPIs are embedded in the performance contracts of our executives and employees, and they are the primary focus of regular internal and external performance reporting.

As you can see from this high-level overview of our KPIs, we are generally making significant progress on several of them. We're in the yellow zone of several of our KPIs, including total expense, net revenues, federal hydropower forced outage factor, and days cash on hand. And we're actually red on percent of capital work plan completed.

For today's call, I'm going to focus my comments just on two of these. I'd like to start by addressing our safety metric, the incident frequency rate, which currently stands at 0.8. That's below our ceiling of 1.1, and of course in this case, lower is better.

We are definitely performing significantly better on safety in 2019 than we did in 2018, and the severity of injuries at BPA continues to decline. I would note that while it's been five years since we elevated safety to our top core value, our commitment to safety is unwavering. We've made significant progress, but at the end of the day, too many people are still getting injured, and we are currently in the process of updating our safety strategy using feedback from our workforce to define a set of actions and programs that will take our safety performance to the next level and help us make sure we send everyone home safely at the end of every shift and carry safety with them 24 x 7.

As I noted, our KPI related to percent of capital work plan completed is not on track. This KPI is an indication of how well we are executing on our capital programs. Transmission is forecast to be under rate case for capital expenditures, but actually on track for capital project execution, generally a good thing. On the other hand, power is also forecast to be under rate case for capital expenditures, but has experienced some delays in project work within the Federal Hydropower Program.

This is an area of concern for me and something that I also recognize is on the minds of customers, given the magnitude of our capital program and the importance of investing effectively in the FCRPS. We're going to continue to work with our partners at the Bureau of Reclamation, the Corps of Engineers, to explore the underlying causes and resource constraints impacting capital program delivery. We'll be sharing our findings and seeking your input on how to improve performance in the months ahead.

You're going to hear more details about several of our other financial KPIs during the presentation today from Chris. Overall, I'm feeling generally positive about the progress Bonneville has made this year in delivering on the four major goals of our strategic plan. And as we look forward to our next QBR at the end of the fiscal year, we'll probably be updating this slide to provide a little bit more detail on the specific metrics and give you just a little bit more high-level insight into how we're actually doing against the specific targets themselves. This is sort of a transitional phase for us on this slide.

Okay, I'd like to advance to our Strategic Goals slide. I think by now, hopefully all of you are familiar with these big four at the heart and soul of our Strategic Plan. I'd like to start by discussing our efforts to strengthen Bonneville's competitiveness and financial health -- our Strategic Objective #1. As you've hopefully by now heard, we released our final rates for Fiscal Years 2020 and 2021 last week. I was pleased to announce that we're not increasing the average base power rate. And I think as you recognize, keeping the base power rate at BP18 levels was definitely a significant accomplishment for Bonneville, considering the upward rate pressures we faced. It took a lot of work to cut our program costs, which we were able to reduce by $66 million per year.

We were also able to offer a lower transmission rate increase than what we originally anticipated. The weighted averaged transmission rate increase of 3.6% was set through a settlement as part of an effort to reach agreement with customers on the terms and conditions of a new transmission tariff. And without settlement, the transmission rate increase was initially estimated to be 9.5%.

Chris will provide some additional information about our current financial reserve situation and the high likelihood that we will trigger the financial reserve surcharge of 1.5% for power later this fall. This was also the subject of the financial reserves workshop that's actually still going on at this particular moment this afternoon.

I wanted just to let folks know that I certainly understand and acknowledge the concerns expressed by some customers about this approach, but I see implementation of the financial reserves policy as essential to improving BPA's long-term financial resiliency, and I am committed to this path.

I wanted to talk a little bit more about some of the infrastructure that we're putting in place to sustain our progress. You know, certainly, bending our cost curves and stabilizing rates has been a big lift for Bonneville and our partners, and we are taking a moment internally to celebrate and reflect on our progress. But unequivocally, there is no room for complacency. At the end of the day, I'd say we're actually acutely aware that we need to stay focused on sustaining the improved business discipline we've established over the past several years and continue delivering on the core objectives of our Strategic Plan.

To that end, we've been developing operating plans, program plans, and asset strategies to improve how we measure and manage performance, create more cost transparency and accountability, and make well-informed decisions about cost management, infrastructure investments, and human resource deployment.

We've also developed an integrated financial planning model to organize and simplify BPA's financial information and the interrelationships of BPA's business lines. The financial planning model produces a 10-year forecast of key financial and rate information for both Power and Transmission. The model has several advantages: First of all, it allows us to evaluate key agency decisions and their long-term impact on the business. It also allows us to constantly monitor our progress and trajectory towards meeting strategic and financial plan goals.

We're going to be using the 10-year model to develop scenarios and test sensitivities for the next integrated program review process, where we will set expense and capital spending levels for the BP22 rate period. We plan to share some of the important output from this planning tool with customers to add depth and strategic context to the IPR process.

Moving on to our next strategic goal of modernizing assets and system operations, a key part of this goal is our grid modernization initiative. On that front, we're closing in on the date when we will decide whether to sign an implementation agreement with the California Independent System Operator to take the next step in the process of potentially participating in the Western EIM. We've received public comments on our letter to the region, which laid out the business case for joining the EIM, and now we're using those comments to help develop a final record of decision, which I expect to sign in the second half of September.

If BPA signs the implementation agreement, we will work towards a go-live date of March 1st, 2022. We will continue to administer a robust stakeholder process in our EIM engagement, and look forward to staying very connected with customers and others as we proceed into the next phase of issues and decisions.

In other news, I'm happy to report that all items in the Coordinated Transmission Agreement with the CISO have been completed. We started this effort when the CISO launched its energy imbalance market because we wanted to develop controls and gain more visibility into how EIM flows might affect the federal transmission system. We now have improved operational controls and better sharing of real-time

data. The CTA implementation represents a significant step forward in our grid modernization efforts, providing additional tools to mitigate congestion on our transmission system.

Toward our next strategic goal, providing competitive power products and services, we're going to begin engaging with customers on new long-term wholesale power contracts later this year. Power account executives will begin meeting with their customers individually to gain insight into contract issues starting in December of 2019. This information will be assembled into an initial findings report that we will share with customers next spring. Based on the findings of this report, we will then begin a series of work streams to better define and address issues. Our Power leadership team is currently working from an assumption that we will offer new contracts no later that 2025. There's much more work to come on this front in the months and years ahead.

I'd like to turn my attention now to the Columbia River System Operations Review Environmental Impact Statement process. We're making significant progress on the draft Environmental Impact Statement for the CRSO, which is expected in February 2020, followed by the final EIS in June of 2020. Records of decision from the three co-lead agencies would follow at the end of September 2020.

At the moment, we're ramping up outreach and responding to requests from stakeholder groups for updates on our process. We're working to help build understanding of the options under analysis in the financial, biological, operational, reliability, and socioeconomic tradeoffs associated with the different options. The more the public and our stakeholders know and understand the issues and choices at play, the easier it will be for them to provide substantive and useful input on the draft EIS.

I strongly encourage you to stay actively involved and informed in this process as it will be a major determinant of the operational characteristics and financial competitiveness of the federal systems as well as a driver of the key actions and investments related to the survival of salmon and other species in the Columbia River Basin.

On to our last strategic goal, meeting transmission customer needs efficiently and responsively. Later this fall, we will begin taking reliability coordinator services from RC West, the California Independent System Operator's RC Service, which started offering these services to California and northern Mexico in July. BPA will begin shadow operations with the RC after Labor Day and go live November 1st. Our current focus in this transition is on our data sharing and modeling in preparation for the launch.

The implementation of our new transmission tariff is also well underway. The new tariff's terms and conditions will be foundational for the achievement of Bonneville's strategic objective to operate a highly responsive and modernized transmission business. One of the hottest topics in this area involves the changes we've been making to our hourly firm transmission service. We've been engaging with customers on the hourly firm data collection and evaluation, and my understanding is that the process is proceeding well, and we've begun to see a market response that's consistent with our expectations.

We'll be hosting a customer call in August to provide more information and work through this transition as efficiently as possible.

As you're aware, another key topic right now is wildfire mitigation. There's an elevated fire threat across our service territory through the remainder of the summer and fall, particularly along the Coastal Range. We've reviewed our transmission assets, operations, vegetation management, and training programs to minimize the risk that a fire might ignite from a piece of BPA equipment or as a result of an action by a BPA employee.

Transmission is prioritizing the repair or replacement of any components they've identified as high risk. In addition, Bonneville has changed its protocols for testing lines remotely. In certain locations or in certain conditions, transmission will ensure crews are on the ground before attempting to reenergize the faulted line. This may extend the length of some outages, but we believe the benefits of this practice far outweigh its costs.

Bonneville also continues to look for ways to improve the customer experience for all of our power and transmission customers. We're currently reviewing the organizations within BPA that most directly provide customer services to determine if we can streamline processes, lower costs, and improve customer satisfaction. And in September, we'll launch the customer satisfaction survey for the first time since 2016. We're looking forward to collecting your feedback and using it to make tangible improvements in the service you receive from Bonneville.

Before I hand it over to Chris, I wanted to acknowledge two important personnel changes at Bonneville. At the end of the fiscal year in September, Janet Herrin, our Chief Operating Officer, is going to be leaving Bonneville. She's going to be heading off into another attempt at retirement. As you know, Janet has just been a terrific partner and a major factor in our progress here in the last couple of years, and we're going to really miss her and we are actively developing a succession plan behind Janet.

And as I think many of you know, this week is the last week for Scott Simms here at Bonneville. Scott has also just been a tremendous partner and a wonderful contributor to our success and progress the last couple of years, and I'm really looking forward to working with him in a strong partnership as he takes the helm over at the Public Power Council. So, to both Janet and Scott, we're going to miss them and look forward to them succeeding in their next adventures.

So, that does it for my update. I'm now going to hand it over to our Deputy CFO, Chris Dunning, to go over our third quarter financials. Chris? All you.

CHRIS DUNNING: All right, thank you, Elliot, and good afternoon everyone. I'm very excited to be with you today. I have a lot of interesting content to share.

I'm going to start with a bottom-line, upfront look at our agency net revenues by taking you through a comparison between what we expected in terms of net revenues and rate case and what we're now seeing in our forecast. So, we're now on slide six. And this is a new slide that we're rolling out for the first time this quarter.

As you can see, it's a bridge-type presentation with our rate case expectations on the left-hand side, our current net revenue forecast on the right-hand side, and significant drivers forming the bridge.

Before diving into the drivers, I want to step back for just a second and just align on the fact that we've adjusted the rate case amount on the left-hand side for the $154-million expense reduction associated with our regional cooperation debt refinancing. And, in fact, we've made that adjustment throughout this presentation because in our view, it's a better representation of our economic performance.

Just one detailed note on that, the actual amount of the adjustment will differ depending on if you're looking at a power slide or an FCRPS slide, that's to do with the effect of consolidation.

And as we've said in prior quarters, we're going to be making some changes to both our revenue requirement and our accounting that will go into effect in Fiscal Year '20 that will eliminate the need for this adjustment.

Starting with the first driver on the left, you know, we're seeing some real gains from our cost management efforts around our program costs. Our IPR program costs are projected to be $76 million less than what we expected in rate case. These savings are part of our overall strategy to improve our cost management discipline and we're going to continue it right into BP20, where IPR costs, as Elliot said, will be $66 million lower than the BP18 rate period.

Bending the cost curve in this way has required really hard work for everyone across the agency, but some areas of significant savings that I'll call out are the Fish and Wildlife Program, our internal operating costs across the board, and also our generating partners.

Right now, we're in the middle of our Fiscal Year '20 budgeting process, and we're working through some of those harder tradeoff conversations that are required to ensure we meet our IPR commitments. As we're having these conversations, we're 100% aligned to our financial plan, which was designed to ensure our financial sustainability out to 2028 and beyond.

Moving right across the graph, the next significant driver in our performance against rate case is net interest expense. So, through careful management of our debt and investment portfolios, we're projecting to come in $61 million below rate case for the year. A good amount of these savings have come from the Regional Cooperation Debt Program, where we've strategically refinanced higher-interest debt. Other contributing factors that have lowered our net interest expense have been careful management of the timing of our cash borrowing, and also lower than expected capital spending from power and transmission, which Elliot has touched on, and I'll go into in a bit more detail later.

Moving on to the next column, which is revenues, we're expecting to over perform rate case, principally due to strong revenue output from Transmission, which I'll touch on here in a second.

So, all of our progress thus far in controlling our IPR costs and our interest costs has offset most, but not all of the projected overrun in the purchase power expense, which you can see here in the red column. The market, weather conditions, and hydro fuel supply have all really provided headwinds to us this year, which has caused this significant increase in purchase power expense. The majority of these additional power purchase costs occurred in February and March this year, where market prices hit record highs due to natural gas constraints. We saw low hydro generation, and we also had high energy demand due to cold weather.

So, moving on to slide seven, we're now going to take a look at our agency financial performance on a gross basis. As you can see here, FCRPS IPR expenses are down, which as I previously mentioned is due to our improved cost management discipline. Non-IPR expenses, however, are higher, and again, this is due to our high purchase power expense. This chart really shows how our continued efforts at IPR program cost management is critical to soften the blow of volatility we're seeing in our non-IPR costs, which are primarily influenced by market conditions.

Moving on to the next slide, slide eight, we're now going to disaggregate our agency performance into our two business lines, and we'll start with power. Power's expense forecast is $65 million greater than rate case. And as I've said before and again in this case, the primary driver is significantly the higher purchase power costs, which we've offset somewhat by our cost management actions and our IPR programs.

On the revenue side of the ledger, Power's revenue projection is $18 million higher than rate case. These higher revenues are also driven by the higher power prices we've seen periodically throughout the year, which have increased our secondary sales and also our U.S. Treasury credits for fish. When this picture is taken together, Power's higher expenses and higher revenues yield a current net revenue forecast of $243

million, which is $46 million lower than our rate case expectations. So, clearly, this is the big story in our agency net revenue picture for the quarter.

Moving on to slide nine with Transmission, we can see that their expense forecast is $13 million less than rate case expectations. And, again, this is due to factors I've already discussed, principally, reduced interest expense, which is mainly due to lower capital expenditures, and also very diligent IPR cost management efforts.

On the revenue side, Transmission's revenue projection is approximately $10 million less than our rate case. The main driver behind this is lower short-term sales due to lower hydro conditions, coupled with a reduction in megawatts purchased, as customers have renewed contracts. These reductions have been partially offset by additional conditional firm sales that have exceeded our rate case expectations. These additional conditional firm sales were a result of changes to how we are modeling and awarding the product.

All told, Transmission's lower expenses and lower revenues result in a current net revenue forecast of -$4 million for the fiscal year, which is $3 million better than our rate case projection for the second year of the rate period of -$7 million.

So, moving on to the next slide, we're leaving the income statement view of our agency performance and moving to the capital view with our capital expenditures. This chart shows our forecast capital expenditures compared to rate case projections broken down by business line.

As you can see, we're expecting to spend well less than rate case expectations on our capital program across both business lines. Some of this underspend was anticipated in our start-of-year 2019 budget, but some of it was not.

As Elliot mentioned, we're seeing underruns in both Transmission, which is expecting to underrun by $67 million, and Power, which is expecting to underrun by $78 million. And on the Transmission side, we're seeing execution that we expected, whereas on the hydro side, we're not seeing the execution we had expected at the beginning of the year. And we're continuing to improve on our capital execution via implementing strategic asset planning best practices and conversations with our generating partners.

Moving on to the financial reserves slide, on slide 11, this slide is going to wrap up our discussion of third quarter financial results. But before I get into the details on the forecast, I want to step back for a second and just talk about how the third quarter forecast incorporates our initial proposal to address the financial reserves errors that we've discovered in our financial reserves review.

We had a workshop earlier today to go through our initial proposal in detail, and the materials for that workshop have been posted to our financial reserves review website. In those materials, you'll see that we're proposing to transfer $182 million in reserves from Transmission to Power to correct the past reserves misallocations that we've found. That transfer has been baked into this forecast that you're seeing on this slide. So, those of you who joined us at the workshop this afternoon, we appreciate that and I think we had a very robust and productive dialogue.

So, with all that being said, just starting with the agency reserves, I want to make it really clear that the agency-level reserves, which we show here being forecast at $544 million for the end of the year, were unaffected by the reserves misallocations. Those were really all to do with how we functionalize reserves between the power and transmission business units.

So, turning to the business units, starting first with Transmission, Transmission's reserve levels, although well into reserves distribution cost territory, as you can see here, likely won't trigger a reserves distribution clause because doing so would require meeting a two-step test, where first we have to be in RDC territory for the business unit, in this case Transmission, and also for the agency. And as you can see here, we are not in RDC territory for the agency at this point and we don't expect to be by the end of the year.

Turning to Power. Power reserve levels shows that a surcharge is nearly certain to trigger for the full $30 million mainly due to, again, the high power purchase expenses that we incurred this year. The cash effect of those power purchase expenses was somewhat offset by the reserves that we proposed to transfer in from Transmission due to the financial reserves review.

So, just stepping back for a second, one really important thing to bear in mind as we talk about the triggers for these various mechanisms -- the CRAC, surcharge, and RDC -- is that our approach to triggering those has changed from prior years. Instead of triggering off the Q3 forecast, as we've done previously, we're now triggering these mechanisms based on our actual financial results after we've closed the books at the end of the fiscal year.

So, again, for those of you who joined us for our finance workshop this morning, we covered the financial reserves outlook in more detail, so thank you for those of you that joined us, and I enjoyed that conversation.

And I believe that wraps up our prepared package. And for those of you that have questions, we'd invite you to submit those via the e-mail address that we have on the website where the QBR is posted. So, please direct any questions you have to that e-mail address and we'll field them as they come in.

ELLIOT MAINZER: Thanks, Chris. Thank you all, again, for working with us today on this alternative delivery mechanism. I apologize again for the technical problems this morning. Hope you found this at least a reasonable substitute for today. We'll make sure that next time we've got all of our links set up appropriately and we'll look forward to speaking with you again in November, when we'll have a readout on the end-of-year performance. So, thanks for joining us and all the best. Take care.

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