

**Irrigation & Electrical Districts Association of Arizona
Annual Meeting
January 8, 2016**

2015 Year in Review: Position and Promise

Before we get started, I want to offer my sincere appreciation and thank you to Bob Lynch for his recent work securing a FOIA exemption for our critical infrastructure. This is an important piece in the on-going challenge we face balancing security of our overall system with transparency in how we operate. Such a balance underscores the emphasis of our business principles this past year and highlights actions worth considering as we navigate the future.

We are living in amazing times in the energy business. The changes in technology, the innovation in markets and the shifting sands of electricity production present us with challenges and opportunities not seen in the last 50 years.

Together in 2015 we completed more than \$230 million in capital projects, became the first Power Marketing Administration to fully join a market, and worked with peers and partners to further the industry's fall protection effort. These feats were made possible by efficient business practices, streamlined processes, nominal increases to costs, and no additional headcount.

As we look to the New Year, I see more promise as the energy landscape continues to evolve. I look forward to maturing our business processes and moving forward with our cooperative investment of

nearly \$160 million in capital improvements, work that will further strengthen and maintain the infrastructure we all share.

The evolution of our industry brings with it a series of technical and policy considerations. Western is not as it was five years ago – external factors carve our path and drive changes to our operating model. Whether it is new NERC standards, physical security needs, cyber security requirements, replacement of our core financial system (now 17 years old), increasing asset investments, or operating challenges due to renewables, Western must adapt so we can continue to be one of the lowest cost providers of electricity and transmission in the nation. This requires creativity in our thinking and operating and agility in our planning.

I share this with you today because I want to be clear: we are well positioned to actively pursue all opportunities to be effective stewards of your money and our nation’s assets. And we are dedicated in our promise to continue delivering on our mission.

2015 Year in Review

We are in a good position. We remain one of the lowest cost providers of electricity and transmission in the nation, a feat made possible by a sharp focus on sound business principles as well as investments for the future. Our customers pay less than half the cost of transmission services than comparable providers. In each of our markets we are tracking with the rates of the lowest providers—even those for whom we make up a significant portion of their power portfolio.

To make sure we continue this record of success, last year we launched a Continuous Process Improvement Program to identify cost savings and other process improvements to help streamline operations and reduce expenses by \$2.2 million. We reorganized and evolved information technology, preventing unnecessary duplication of resources and reducing costs, providing a savings of about \$5 million. The results of Continuous Process Improvement are impressive — roughly \$6.9 million in cost avoidance in just 18 months. Our asset management program, which applies a data-driven approach to the management of the transmission system infrastructure, is expected to further reduce and avoid costs and build on our record of reliability. Cost savings and avoidance are not the only evidence of our success.

In 2015, our accomplishments ranged from technical and operational to contracting and the ever important human capital management. And we have managed this with a flat appropriated budget in the face of increasing regulation, expanding markets and stricter operational requirements. These are cooperative efforts that require our terrific staff in the regions supported by the equally amazing team working out of the Lakewood headquarters.

Yet, we have to do more while remaining focused on our three core lines of business: the provision of Federal hydropower to all of you, operating your transmission system reliably and helping the expansion of the nation’s critical infrastructure through the TIP program.

On October 1 Western “went live” in the Southwest Power Pool, becoming the first federal agency to become a full member of a

regional transmission organization. Western entered into agreements with SPP to place transmission facilities in its Pick Sloan-Missouri Basin Eastern Division project, served by its Upper Great Plains regional office, into the Southwest Power Pool. This move is important as it demonstrated our adaptability and how we can come together to resolve challenges. Together with our partners, Western met the challenge of operating next to two organized energy markets while at the same time maximizing benefits to all of its customers.

The number one concern at Western, as it is around the industry, is the safety of our employees. Since 1992, we have been proactively embracing and incorporating OSHA's new fall protection standards into our safety processes across our 17,000 miles of transmission lines, highlighting our continued drive toward business, technology and operational excellence. In October, we launched the second video in our Fall Protection series. The video has proved to be an effective way of communicating best practices across our team of linemen and as a way to share knowledge and experience with our external partners, some of whom have begun using the video as a standard communication piece in their own training.

The Electrical District 5-to-Palo Verde Hub transmission line began commercial operation January, 10, 2015, after energization of the final transformer at the Electrical District 5 substation. The project directly helps 18 communities and tribes. It is the second project to be successfully completed under the Transmission Infrastructure Program, which manages the \$3.25 billion borrowing authority authorized to Western in 2009 to facilitate the delivery of renewables in the

West. The 109-mile transmission line was completed on time and within budget. It connects a renewable-rich zone south of Phoenix, AZ, with the Palo Verde market hub, a major electrical trading hub in the western United States.

In November, we saw another TIP project moving toward completion. I signed the Final Environmental Impact Statement for the proposed Southline project, a 360-mile electric transmission line proposed to run from New Mexico to Arizona.

Last year, we published the final allocations for the post-2017 remarketing of the Boulder Canyon Project, providing for marketing and delivery of the electric generation at Hoover Dam. This will provide low-cost, renewable, reliable federal hydropower to Native American tribes and other preference customers in Arizona, California and Nevada. As a result of this Remarketing effort, 59 new customers will receive power generated at Hoover Dam, helping ensure the widespread use of this valuable resource.

And here in the Desert Southwest Region, we celebrated a five-year safety record of no lost work days, held more than 25 face-to-face meetings with our customers across the region, and capped the year with zero accountable outages in the month of December.

Our Position

Even with all of these accomplishments, throughout 2015 and over the past five years, our net budget authority has remained flat. This so called “flat budget” is specific to our federal allocation. The Omnibus bill that recently passed reflected the same 8% federal allocation we

have received for the past several years. It is one we have maintained despite increasing costs of infrastructure replacement, environmental regulations, varying hydrology conditions, physical and cyber security enhancements, new operational requirements, as well as pressure to live with reduced appropriations.

Western welcomes the new legislative language in the current Omnibus bill which will allow us to continue our policy of transparency and openness. We will provide you and Congress with additional information about our budget, as divided by regional and Lakewood offices.

We are committed to keeping our operational costs low—both indirect and direct. Costs rising in one part of Western have to be balanced by decreases in another. We work diligently to ensure overheads are kept in check and we see results. It is important to understand that Western overheads are the smallest slices of the cost pie, being dwarfed by all other categories. Westernwide, overheads represent around 10 percent of the costs found in rates. Here in the Desert Southwest Region, Boulder Canyon, Intertie, and Parker-Davis overheads are \$15.4 million out of \$207.7 million in total cost components.

But it is rates that are our scorecard. After safety and reliability, I believe Western should be judged on the rate impacts for those things within its control. In order to minimize the impacts to rates, Western is working hard to become even more efficient and improve processes across the organization. We are creating headroom in some areas in order to be able to afford needed human and other capital in another.

In Fiscal Year 2017, we will use the headroom to hire some new positions.

A significant portion of these new hires will be real-time engineers, necessary for meeting new reliability standards approved by FERC in November. The purpose of the real-time engineering positions is to prevent instability and uncontrolled separation or cascading outages that adversely impact reliability. Following the 2011 Southwest Outage, industry reports indicated that further use of Advanced Network Applications to run Real-Time Contingency Analysis of the power system would improve system reliability and help prevent similar events in the future. As a result, Western will add nine new positions in the Colorado River Storage Project, Rocky Mountain and Desert Southwest regions, six in Upper Great Plains region and four in the Sierra Nevada region.

The threat from cyber and physical attack remains a paramount concern for the nation. The electric industry has seen an unprecedented surge in cyberattacks targeting sensitive cyber assets that are responsible for keeping the grid running. We provide transmission services 24-hours a day, seven days a week, 365 days a year. Similarly, open market trading requires us to have access to our facilities at all times. For Western to continue protecting these assets and keep them continually operational, it is imperative we comply with growing standards set forth in North American Electric Reliability Corporation standards for physical security for critical infrastructure, cyber security, and transmission operations. That compliance is just part of the robust state-of-the-art protective measures we employ for

cyber and physical security. We manage risk by prioritizing protection of the most critical grid components against the most likely threats, a practice consistent with the electric industry.

We need to maintain our focus on providing a reliable and efficient system, ensuring the value it brings for years to come.

Our Promise to Customers

Our promise to our customers is to expand our transparency and continue evolving to meet your needs. We remain committed to collaborating with you. Our goal is to be inclusive of our customers and stakeholders in our operational choices and capital planning efforts.

As we look to the future, we continue to expand our engagement with customers, becoming ever-more agile in our planning. Keying off of the very successful 10-year planning process put in place in 2013, this year we celebrated our third cycle of Western-wide capital plan formulation. Internally, in 2014 we put in place a revised budgeting process for Fiscal Year 2016 that saved nearly \$1.5 million by incorporating a 360-degree review. We will take this one step further in the New Year as we look to FY 2019 budget building in time for preference customer engagement and understanding.

Understanding our assets is critical because the future is bringing change. To make good on our promise to our customers to fulfill our mission, we must be able to position ourselves to respond to the growing demands of a rapidly changing industry.

For example, Western's decision to participate in the Southwest Power Pool market rose from the challenge of operating next to two different

regional transmission organizations. To determine the most beneficial solution for all of our customers, we developed a detailed analytical and collaborative process. Two years ago, we deployed a similar methodology that resulted in our decision to *not* participate in the CallSO Energy Imbalance Market.

That said we are continuing to follow developments with our customers and to analyze the situation in regards to the EIM. We are also looking at the development of the Mountain West Tariff aimed at reducing pancaked transmission in the West. Seven utilities are involved in this process with the main ones being Tri-State, Xcel and Western. Our goal is to get 80% of the market benefit at 20% of the cost. This is an active process and we anticipate a decision whether or not to move forward in the next 60 days.

I want Western to be ready for the future so you, our customers, can continue receiving the benefits of our federal mission. I recognize, as does my staff, that the changes being brought about as we move into the future of the energy frontier will not always be comfortable. Whether it is the reinvestment in our 17-year-old financial system—necessitated by the lack of support from the supplier and more costly due to work arounds—or the need to invest more than 40,000 person hours in order to meet our critical infrastructure, costs may rise in the short term to provide longer term benefits, we at Western are dedicated to fulfilling our promise to our customers: to continue delivering reliable, low cost federal hydroelectric power and related services.

Conclusion

We have grown much over our 38 year history. While our positions adjust to meet the changing industry around us, we remain true to our promises. We must remain organizationally excellent, open to the benefits of partnership, and willing to evolve to meet the changing times. We can only accomplish these things by continuing to work directly with you.

We simply cannot afford to skimp on needed or required investments or to artificially keep the costs low. We need to make sure Western is robust in this era of change, work to keep costs low while recognizing sound business practices.

I ask that we focus on the real drivers of costs, for your support in improving all of our processes and understanding that the entire organization is aimed at maintaining your resources and the low rates you enjoy today so we can enjoy them affordably in the future.

That is how we will continue to collaboratively power the energy frontier.