



Memorandum

To: ISO Board of Governors

From: Ryan Seghesio, Chief Financial Officer & Treasurer

Date: December 10, 2015

Re: **Decision on budget for fiscal year 2016**

This memorandum requires Board action.

This memorandum summarizes the 2016 budget proposal that the Board is requested to approve and which will become effective January 1, 2016. The draft budget was posted to the ISO's website for stakeholder review following the September Board meeting and discussed at a stakeholder meeting held on October 8, 2015.

The proposed revenue requirement¹ of \$195.3 million remains within the tight range that the ISO has maintained over the past ten years. The ISO is forecasting upward cost pressures in the operations and maintenance (O&M) expenses of \$4.2 million, however these expenses are offset by a decrease in the other costs and revenue component of \$1.4 million and a decrease of \$6.0 million in the cash funded capital component resulting in an overall revenue requirement decrease of \$3.2 million compared to 2015.

Management recommends the following motion:

Moved, that the ISO Board of Governors approves the 2016 revenue requirement and capital/project budgets as set forth in Attachment A to this memorandum dated December 10, 2015; and

Moved, the ISO Board of Governors authorizes Management to take all necessary and appropriate actions to implement the 2016 grid management charge rates reflected in the 2016 budget.

¹ In this memorandum, the terms budget and revenue requirement are synonymous.

DISCUSSION AND ANALYSIS

The annual revenue requirement is an integral component of the planning process and reflects the priorities and commitments made in the ISO's strategic vision.

The 2016 revenue requirement, at \$195.3 million, is approximately \$7 million less than the FERC-approved \$202 million cap (discussed below in the 'Grid management charges' section). This amount is \$3.2 million lower than the 2015 revenue requirement and represents an average annual growth rate of 0.3% since 2007. Our bundled grid management charge (GMC) is derived by dividing the revenue requirement by the forecasted transmission volume. The 2016 projected volumes of 242.7 terawatt-hours (TWh), are 5.8 TWh less than the 2015 budgeted volumes. The 2016 projected volumes are based on a slight growth of 0.5% over the 2014 actual volumes. To help offset the impact of lowered volumes on the bundled GMC, the 2016 cash funded capital component is budgeted at \$24.0 million. The anticipated decrease in volume combined with a decrease in the revenue requirement results in a bundled GMC for 2016 of \$0.805 per megawatt-hour (MWh), an increase of \$0.006 per MWh, or a .08% increase, over the 2015 bundled GMC.

The revenue requirement has five components:

- Operations and maintenance (O&M) budget;
- Debt service;
- Cash funded capital budget;
- Other costs and revenues; and
- Operating cost reserve adjustment from prior year.

A summary of the 2016 revenue requirement compared to 2015 is as follows:

Revenue Requirement (\$ in millions)	2016 Budget	2015 Budget	\$ Change
O&M Budget	\$169.3	\$165.1	\$4.2
Other Costs and Revenues	(10.8)	(9.4)	(1.4)
Subtotal net O&M	158.5	155.7	2.8
Debt Service including 25% Reserve	16.9	16.9	-
Cash Funded Capital	24.0	30.0	(6.0)
Subtotal before reserve adjustment	199.4	202.6	(3.2)
Operating Cost Reserve Adjustment	(4.1)	(4.1)	-
Total Revenue Requirement	\$195.3	\$198.5	\$(3.2)

Operations and maintenance budget

The largest component of the revenue requirement is the O&M budget, which for 2016 is proposed to be \$169.3 million, representing a \$4.2 million, or 3%, increase from 2015. The 2016 Budget and Grid Management Charge Rates book, included as *Attachment A*, presents the O&M budget in three different perspectives: delivery of services (objectives and processes), utilization of resources, and divisional costs. ISO activities have been broken down into nine end-to-end core processes, which are measured through activity-based costing.

A summary of the 2016 O&M budget by resource compared to 2015 is as follows.

O&M Budget by Resource (\$ in millions)	2016 Budget	2015 Budget	\$ Change
Salaries and Benefits	\$121.6	\$117.8	\$3.8
Occupancy Costs and Equipment Leases	3.7	3.7	-
Telecommunication and Hardware and Software Maintenance Costs	14.1	14.0	0.1
Consultants and Contract Staff	11.8	11.5	0.3
Outsourced Contracts and Professional Fees	9.7	10.4	(0.7)
Training, Travel and Other Costs	8.4	7.7	0.7
Total O&M Budget by Resource	\$169.3	\$165.1	\$4.2

- Salaries and benefits grew primarily due to merit increases.
- Telecommunications and hardware and software maintenance costs increased due to industry-driven increases in hardware and software maintenance expenses offset by a reduction in telecommunication costs.
- Consultant and contract staff costs increased primarily due to an increase in resource adequacy studies, process assessments, regional coordination and integration initiatives, and the need for subject matter experts in fields such as meteorology and renewable integration.
- Outsourced contracts and professional fees decreased primarily due to anticipated savings in outside legal costs.
- Training, travel and other costs increased primarily due to additional expenses for insurance premiums and travel related to regional activities.

A summary of the 2016 O&M budget by division compared to 2015 is as follows:

O&M Budget by Division (\$ in millions)	2016 Budget	2015 Budget	\$ Change
Chief Executive Officer	\$18.2	\$17.1	\$1.1
Market and Infrastructure Development	14.9	14.5	0.4
Technology	61.4	60.1	1.3
Operations	43.7	42.5	1.2
General Counsel and Chief Compliance Officer	12.5	12.8	(0.3)
Market Quality and Renewable Integration	7.9	7.7	0.2
Policy and Client Services	10.7	10.4	0.3
Total O&M Budget by Division	\$169.3	\$165.1	\$4.2

- The 2016 division budgets include a 3% merit growth in the salaries and benefits category.
- In addition to the merit growth there is minor growth in the non-personnel categories:
 - Chief Executive Officer Division includes increases in consultants and contract staff in support of short-term process efficiency projects and in training, travel, and other costs primarily related to corporate training efforts as well as regional integration and coordination-related travel.
 - The General Counsel and Chief Compliance Officer Division's costs decreased due to anticipated savings in outside legal costs.

Debt service

The debt service component of the 2016 revenue requirement will be \$16.9 million, the same as in 2015. The Series 2013 bonds were issued in November 2013 to refinance the 2009 bonds. The refinancing resulted in approximately \$1.25 million in lower annual debt service payments and over \$30 million in total savings. The 2009 bonds had been issued to finance the ISO's new headquarters facility in Folsom, and to fund other capital expenditures. Debt service includes the amounts due, plus the required 25 percent reserve. A summary of debt service is as follows:

Debt Service (\$ in millions)	2016 Budget	2015 Budget	\$ Change
Principal payments	\$4.6	\$4.5	\$0.1
Interest payments	8.9	9.0	(0.1)
Subtotal	13.5	13.5	-
25% Debt Service Reserve	3.4	3.4	-
Total Debt Service	\$16.9	\$16.9	\$ -

Capital and project budget and cash funded capital

The proposed revenue requirement will allow for the collection of \$24.0 million for cash funded capital. Excess amounts collected will be used to fund future projects.

The 2016 capital/project budget is projected to be \$16.5 million. A prioritization is underway that will result in the highest priority projects being proposed. Throughout the year the projects are taken to the Corporate Management Committee for final approval. The current list of projects under consideration totals in excess of \$28.3 million and is divided into five main categories:

- Enhancement of markets and performance - covering projects such as operations enhancements and market design comprehensive review;
- Enhancement of the technology foundation - covering projects such as general hardware, software, and communications refresh;
- Evolve the market and infrastructure projects such as flexible ramping and reliability services;
- Operational excellence including the enterprise model management system and operational meter analysis and reporting systems; and
- Customer services and other costs, which includes hardware and software purchases and capital project labor.

The projects under consideration are in support of our mission to provide improvements to our grid and market management activities, as required. The capital/project budget provides for customized software enhancements, hardware purchases, and other projects considered outside of the operations and maintenance realm.

Supplemental Board-approved projects

The ISO entered into implementation agreements with PacifiCorp and NV Energy as the first steps in enabling them to participate in the western energy imbalance market. PacifiCorp began participating on November 1, 2014 and NV Energy began participating on December 1, 2015. Meanwhile, two other utilities, Puget Sound Energy and Arizona Public Service Company announced their intentions to enter the market in the fall of 2016. The participants

reimburse all project costs related to joining the EIM. With the new additions, the EIM will encompass eight states.

The ISO is proceeding with the construction of a new back-up control center in Lincoln, California (Lincoln Operations Center or "LOC"). The new facility will replace the current back-up control center in Alhambra, California. The planned go-live date for the LOC is the fourth quarter of 2016. The approved budget of \$30.4 million will be funded entirely from capital reserves on-hand; therefore, no additional debt financing will be required. Capital reserves come from two sources: 1) remaining bond proceeds from the 2013 bonds, and, 2) cash funded capital collected as part of the annual revenue requirement. There is no negative impact to the revenue requirement and resulting GMC rates.

Other costs and revenue

Other revenue increased by \$1.4 million to \$10.8 million; these revenue items help bring the revenue requirement below the new \$202 million cap. The primary components are energy imbalance market administrative charges of \$2.5 million, intermittent resource forecasting fees of \$2.1 million, fees to operate the California-Oregon intertie of \$2.0 million, interest income of \$2.0 million, large generator interconnection studies of \$1.8 million, and other fees and charges of \$400,000.

Operating cost reserve adjustment

The operating cost reserve adjustment is budgeted as a credit of \$4.1 million, which is flat compared to the 2015 budget. The operating cost reserve adjustment is primarily the cumulative result of the actual results versus the budgeted revenue requirement and the 25% debt service reserve collection from the prior year. As with other revenue, this credit adjustment helps bring the revenue requirement below the \$202 million cap.

Grid management charges

The ISO recovers its costs through separate GMC charges to market participants. The design, originally approved in 2011, provides for three service categories and five associated fees and charges. The rate design was updated in 2014 to be effective January 1, 2015 and included changes in two cost categories: the system operations and congestion revenue rights services charges, a change in the rate for the transmission ownership rights charge and an increase in the revenue requirement maximum to \$202 million. The update was approved by the Board in July 2014 and FERC in December 2014. The ISO derives the rate by dividing the recoverable costs for the category by the estimated billing determinants.

A comparison of the preliminary 2016 rates with 2015 rates is as follows (\$ per unit):

Service Category or Fee	2016 Rate	2015 Rate	\$ Variance	Comments
Market Service Charge	\$0.0850	\$0.0876	(\$0.0026)	3% lower costs projected for 2016
Systems Operations Charge	0.2979	0.2978	0.0001	1% lower volume projected for 2016
Congestion Revenue Rights (CRR) Services Charge	0.0049	0.0059	(0.0010)	5% lower volume and 20% lower costs projected for 2016
Bid segment fee	0.005	0.005	-	Fixed rate
Inter-SC Trade fee	1.00	1.00	-	Fixed rate
SCID monthly fee	1,000	1,000	-	Fixed rate
Transmission Ownership Rights charge	0.24	0.24	-	Fixed rate
CRR auction bid fee	1.00	1.00	-	Fixed rate
Intermittent forecast fee	0.10	0.10	-	Fixed rate

Budget process

The ISO has provided several opportunities for stakeholder review and comment on the draft budget. The stakeholder process commenced with a June budget kickoff call and an October stakeholder workshop. The ISO posted materials from the meetings as well as stakeholder comments and ISO responses on its website. Stakeholders also had the opportunity to present comments on the draft budget to the Board at its November meeting. With Board approval, the ISO will post the proposed GMC rates on its website to be effective January 1, 2016.

It should be noted that minor adjustments are sometimes required to line items within the O&M budget due to final year-end headcount and consultant numbers and cost center reorganizations. These year-end adjustments will not affect the total in the final approved budget.

Conclusion

The proposed budget will provide sufficient funding to enable the ISO to deliver on the commitments made in the ISO's strategic plan while still reducing the costs to customers. Therefore, Management recommends that the Board approve the budget attached to this memorandum.