CALIFORNIA ISO

California Independent
System Operator

Memorandum

To: ISO Board of Governors

From: William J. Regan, Jr., Chief Financial Officer

Philip Leiber, Director of Financial Planning and Treasurer

CC: ISO Board Assistants, ISO Officers

Date: November 20, 2001

Re: FY2002 Budget Review

This memorandum is for information only. No Board action is required.

Executive Summary

Consistent with direction received at the October 25 Board meeting, the ISO has reviewed its 2002 budget proposal in light of Executive Orders D-48-01 and D-49-01. ISO Management believes the budgets approved on October 25 are prudent, and do not contain more than the necessary resources to accomplish the tasks that the ISO is charged with fulfilling. However, the ISO believes that it will be possible to hold the 2002 O&M budget flat at $171.8 million, at an increased risk that it will not be possible to achieve the budget. Two alternatives are presented to implement this reduced spending plan-- setting more aggressive budget goals in the 2002 corporate goals, and/or implementing lower rates effective January 1, 2002 or later. Management recommends the more stringent budget goals, while deferring any rate adjustment until better information is available about 2001 full year costs and the outlook for 2002. A rate reduction could be implemented April 1, 2002 that would result in total GMC collections for 2002 consistent with a $171.8 million O&M budget, provided that it is consistent with ISO financial viability.

Background and Budget Review

Executive Orders 48 and 49 were issued by Governor Davis on October 24, 2001, in response to the developing general fund shortfalls the State of California is expected to experience as a result of the downturn in the economy, tragic events of September 11, and currently unreimbursed energy purchases. Executive Order 48 institutes a limited hiring freeze, and Executive Order 49 advises/orders reductions in non-essential contracts and purchases.

While the California ISO is not a state agency subject to these directives, it is cognizant of the need to spend limited resources prudently in these fiscally uncertain times. To that end, immediately following the last Board meeting, the ISO commenced a review process of its 2002 budget to ensure that proposed spending is indeed prudent and necessary. This was in addition to the comprehensive, deliberative budget process that resulted in the proposed 2002 budget, which included (or will include) the following measures:

- Directive by ISO President & CEO on expected budget outcome: flat GMC.
- Detailed budgeting by ISO Division, department and expense type.
- Separate consideration of proposed budgets by base (ongoing programs in 2001 budget) and incremental/decremental programs.

- Iterative budget development process between ISO department managers, directors, and Officers.
- Review by ISO Finance Committee
- Stakeholder review at special public budget meeting and presentation at Market Issues Forum
- Full Section 205 rate case at the Federal Energy Regulatory Commission commencing with the November 2, 2001 filing (the 2001 rate case has resulted in over 1,000 discovery requests related to the 2001 budget and other aspects of the rate filing.)

The review process conducted in response to the October 25, Board directive consisted of the following:

Step 1. A review all of ISO activities with a view toward identifying prudent cost saving opportunities.
Step 2. Preparation of a impact analysis documenting costs related to the ongoing investigations and other extraordinary energy crisis related issues.

For Step 1, all ISO departments listed the tasks reflecting their ongoing or special anticipated work efforts for 2002. With consideration of these work tasks, departments were requested to identify potential cost saving measures and the impact of such. ISO Officers met, presented and discussed these tasks, possible cost savings, and the impact of such cost reductions. Previously in the budget process, ISO Officers as a group reviewed all incremental/decremental programs. This latest step was performed to put up for discussion all tasks performed by the ISO. This procedure failed to identify any tasks or programs that were not considered essential and integral to overall ISO operations.

The ISO performed the exercise noted in Step 2, to highlight and the extraordinary costs associated with the energy crisis which began in the summer of 2000, and which continues today[1], and as a subset of those costs, the extraordinary costs associated with the investigations from various regulatory and governmental bodies and extraordinary litigation[2].

The results of this analysis are listed below:

	2001		2002	
	Investigations/ Extraordinary Litigation[2]	**Energy Crisis Related[1]**	**Investigations/ Extraordinary Litigation[2]**	**Energy Crisis Related[1]**
ISO Staff Time	3%, or $2.2 million	8%, or $5.9 million	3.2%, or $2.5 million	7.3%, or $5.6 million
Other Direct Costs	1.3%, or $2.3 million	3.5%, or $5.9 million	2.1%, or $3.7 million	4.4%, or $7.9 million
Total	4.3% or $4.5 million	11.5% or $11.8 million	5.3% or $6.2 million	11.7% or $13.5 million

These estimates were developed on a detailed basis, through consideration of time spent on these activities by individual ISO staff, and through consideration of all direct expenditures other than staff time.

[1] Including investigations & extraordinary litigation (see list below), market defaults, CERS/CDWR relationship/interface, Internal review of energy transactions from 11/01/2000 to 5/15/2001, FERC Emergency Orders (Dec 2000, April 2001, June 2001) and ISO response, extraordinary Department of Market Analysis efforts, generator maintenance program, settlement statement re-runs related to the energy crisis.

[2] Including responding to discovery/data requests, testimony, appearances, etc, related to: California Senate-Dunn Investigation, Electricity Oversight Board actions, Attorney General investigations, PG&E Bankruptcy, Refund case, Reliant vs. ISO (case related to the CERS relationship)

While we believe this spending is necessary to properly respond to these circumstances, absent these special circumstances, ISO costs could be reduced, and/or ISO staff and resources could be more effectively channeled to meet other ISO responsibilities.

Conclusion

The recently approved 2002 budgets (O&M and capital) are responsible, reasonable spending plans to meet the challenges the ISO anticipates in 2002. These budgets were developed with an 80-90% confidence factor that spending would not exceed budgeted amounts--this is consistent with the assumptions underlying the 2001 budget. As approved, spending in the combined O&M and capital budgets decreases from $209.5 million to $199 million from 2001 to 2002, with a substantial reduction in the capital budget, and a 3% increase in the O&M budget.

Various mechanisms exist to ensure that ISO spending is prudent and no higher than necessary. The Board can monitor ISO spending as 2002 unfolds, and direct changes as necessary. The ISO tariff has been revised effective for 2002 to permit quarterly rate reductions due to lower forecasted spending. Should the budgets be higher than is actually necessary in 2002, rate reductions can be implemented. Additionally, ISO corporate goals have since 1998 included budget related goals to encourage responsible spending, and can and should for 2002.

The ISO faces risk in the current environment that would otherwise argue against arbitrarily reducing the budgeted amounts. The ISO's Operating Reserve has already been significantly stressed by the events of 2001, and risks being over-taxed given the significant risks that face the ISO currently, including continued deterioration of 2001 volumes upon which the GMC is assessed, inability of the ISO to obtain a bank line of credit, other credit difficulties, and continued uncertainty about the scope of significant legal matters.

However, despite these considerations, we recognize that there are significant concerns about overall ISO spending for 2002. Accordingly, ISO Management is willing to commit to holding the 2002 O&M budget flat at the 2001 level of $171.8 million versus the $177.5 million in the approved budget, through the implementation of the following forced reductions:

Dollar Value	Reduction
$ (2,327,123)	**Salary & benefit** related savings achieved through delayed hiring, assumed headcount vacancies, reduced overtime, salary & benefit adjustments and controls.
$(1,790,000)	**Consulting**: 10% reduction in consulting related costs to be identified and managed over the next year. Reduction distributed to all ISO Divisions on a pro-rata basis in proportion to budgeted spending on Consulting, Consulting Expenses, and Temporary & Contract Staffing.
$(750,000)	**Legal Expenses**: Represents reduction of budgeted external legal fees--specific cost saving measures to be developed.
$(800,000)	**Hardware, software maintenance and equipment leases**. Represents 4% reduction in budgeted costs of $19 million. Specific cost saving measures to be developed.
$(5,667,123)	Total

As a result, total ISO spending in the combined O&M & capital budgets would fall from a 2001 budgeted amount $209.5 million to $194 million, a decrease of 7.5%.

Two options (which are not mutually exclusive) are available to implement this reduced spending plan:

1. Set the budget related corporate goal for 2002 to require O&M spending to be at or below $171.8 million. Keep the rates as filed on November 2 for now, with a rate adjustment targeted for early 2002.

   PRO:
   - Reduces risk that ISO revenues will fall short of necessary spending. Could make a quarterly rate adjustment later in 2002, as it becomes clear that the reduced revenue will not adversely impact the financial viability of the ISO.

   CON:
   - Does not provide the immediate rate reduction that GMC ratepayers would prefer.

2. Implement lower rates effective January 1, 2002either through the use of the newly available quarterly rate adjustment provision[3], or re-file a new Section 205 rate case replacing the November 2, 2002 rate filing. The ISO is currently discussing the relative merits of these approaches with regulatory counsel.

   PRO:
   - GMC ratepayers would prefer immediately lower rates.

   CON:
   - Greater stress on ISO Operating Reserve.

ISO Management recommends option 1, but is prepared to discuss the merits of these alternatives on November 29. By deferring the rate decrease until April 1, 2002, greater assurance can be provided that the reduction will not further compromise the ISO's operating reserve. A rate reduction effective April 1, 2002 would be calculated to result in total O&M budget collections in 2002 of $171.8 million, so that deferring the adjustment until that time will not result in ISO "over-collection".