

Memorandum

To: ISO Board of Governors
From: Nancy Saracino, Vice President, General Counsel & Chief Administrative Officer
Date: December 7, 2010
Re: **Decision on 2011 Budget, Revenue Requirement and GMC Rates**

EXECUTIVE SUMMARY

This memorandum summarizes the proposed 2011 budget, revenue requirement and grid management charge rates.

- *The proposed revenue requirement for 2011 is \$189.8 million, a decrease of \$5.3 million or 2.7% lower than the 2010 revenue requirement of \$195.1 million.*
- *The proposed pro-forma bundled GMC for 2011 is \$0.791 per MWh, a slight decrease from the pro-forma bundled GMC in 2010 of \$0.793. .*

The proposed revenue requirement will provide funding for the California Independent System Operator Corporation's defined business processes, evolving scope (including additional market capabilities, compliance mandates, support of environmental policy initiatives, and transmission planning) and enable the ISO to deliver on the commitments made in the *Five-Year Strategic Plan*. In this memorandum, the terms *budget* and *revenue requirement* are synonymous.

The ISO has been able to absorb increased health insurance costs and other salary adjustments, deploy improved market functionality, and manage the additional costs of transitioning between the two Folsom sites, while decreasing the overall revenue requirement.

Management recommends the following motion for the Board approval:

Moved, that the ISO Board of Governors approves the 2011 Budget and Grid Management Charge Rates as set forth in Attachment A to the memorandum dated December 7, 2010, and authorizes Management to take all necessary and appropriate actions to implement the 2011 Budget and Grid Management Charge Rates.

DISCUSSION AND ANALYSIS

The annual revenue requirement is an integral component of the five-year planning process, and reflects the priorities and commitments made in the *Five-Year Strategic Plan*.

The proposed 2011 revenue requirement is \$189.8 million. This amount is \$5.3 million lower than the 2010 revenue requirement and represents no change from the level in 2007. Transmission volume is estimated to fall to 240 TWh, or a 2.4% decline from 2010's budgeted volume, as a result of the continued economic slowdown. The reduction in the revenue requirement more than offsets the effects of an anticipated reduction in volume of system use on the resulting bundled grid management charge rate. This rate is derived by dividing the revenue requirement by the forecasted transmission volume. The bundled grid management charge for 2011 will be \$0.791 per MWh, a slight decrease from the 2010 bundled charge. The 2011 revenue requirement is below the \$197 million limit set in the 2011 rate extension which was approved by the Board in September and filed with FERC in October.

The revenue requirement has five components:

- Operating and maintenance (O&M) budget;
- Debt service;
- Capital budget;
- Miscellaneous revenue; and
- Operating reserve credit from 2010.

The operating and maintenance budget

The largest component of the revenue requirement is the O&M budget, which for 2011 is proposed to be \$162.5 million, representing a \$200,000, or 0.1%, decrease from 2010. *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 ten end-to-end core processes, which will be measured through activity-based costing. Health insurance costs increased by approximately \$600,000, but cost savings in other areas, primarily overtime, were sufficient to offset the increase.

Debt service

Debt service on the 2008 and a portion of the 2009 bonds, including the required 25% debt service reserve, will be \$43.7 million. This is a decrease of \$17.3 million from 2010. The ISO completed a \$200-million financing for the new facility project in 2009. The 2009 bonds contained an interest reserve that funded bond interest costs through July of 2011. The remaining interest is included in the revenue requirement. The facility bonds' interest rates range from 4.5% to 6.25% and are amortized over 30 years.

Capital budget

The 2011 capital budget is projected to be \$23.5 million, all of which will be paid from grid management charge funds.

Miscellaneous revenue

Miscellaneous revenue decreased by \$1.2 million from 2010 to \$6.9 million, primarily related to lower interest revenue arising from lower rates from those estimated for 2010.

Operating reserve credit from 2010

The revenue requirement includes a \$33.0 million operating reserve credit, which is \$2.5 million lower than 2010. The reserve credit arises from the collection of an additional month's grid management charge and the return of the debt service reserve collected in 2010.

Budget process

The ISO has provided several opportunities for public review and comment on the draft budget. This public input process commenced with a June 23 budget kickoff call with stakeholders, a follow-up call on August 19 and a stakeholder workshop on October 14. The ISO posted notes from the meetings on its website. Stakeholders also had the opportunity to present comments on the draft budget to the Board at the November 1-2 meeting. No stakeholders commented. By December 17, 2010, the ISO will post on its website the GMC rates that will be effective January 1, 2011.

Minor adjustments are sometimes required to line items within the operations and maintenance budget due to final year-end headcount and consultant numbers. These year-end adjustments will not affect the final total approved budget.

The proposed revenue requirement will provide funding for the ISO and enable the delivery on the commitments made in the Five-Year Strategic Plan while still reducing the costs to our customers.