Memorandum

To: ISO Board of Governors

From: Ryan Seghesio, Chief Financial Officer & Treasurer

Date: December 6, 2012

Re: **Decision on 2013 Budget**

This memorandum requires Board action.

EXECUTIVE SUMMARY

This memorandum summarizes the proposed 2013 budget that the Board is requested to approve. In this memorandum, the terms *budget* and *revenue requirement* are synonymous. The draft budget was posted to the California Independent System Operator Corporation's website for stakeholder review following the September Board meeting, and discussed at a stakeholder meeting on October 10.

The preliminary revenue requirement of $196.0 million remains in the tight range that the ISO has maintained for the past five years, holding the revenue requirement growth rate to less than 1.6 percent over that same period. The total budget is unchanged from the draft budget presented at the September Board meeting but contains the follow changes to individual components: the addition of $700,000 in added legal costs in the O&M budget, reduced interest income by $300,000, a $3.0M increase in the revenue credit arising from anticipated budget savings in 2012 and offset by a $4.0 million increase in cash funded capital. The increase in cash funded capital collected helps ensure the long-term viability of the ISO.

Management recommends the following motion:

> ***Moved, that the ISO Board of Governors approves the 2013 O&M and Capital/Project budgets as set forth in Attachment A to this memorandum dated December 6, 2012; and***
>
> ***Moved, the ISO Board of Governors authorizes Management to take all necessary and appropriate actions to implement the 2013 grid management charge rates reflecting the 2013 budget.***

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 ISO's five-year strategic plan.

The 2013 revenue requirement is $196.0 million and represents a $1.2 million, or 0.6%, increase from 2012. Transmission volume is estimated to increase to 244.8 TWh, or a 1% increase from 2012. Our bundled grid management charge is derived by dividing the revenue requirement by the forecasted transmission volume. The anticipated increase in volume combined with a higher revenue requirement will lead to a bundled grid management charge for 2013 of $0.801 per MWh, a 0.4% decrease ($0.003) from 2012. The 2013 revenue requirement is below the $199.0 million limit set in the 2012 GMC rate filing approved by the Federal Energy Regulatory Commission on September 30, 2011.

The revenue requirement has five components:

- Operating and maintenance (O&M) budget;
- Debt service;
- Cash funded capital budget;
- Miscellaneous revenue; and
- Operating reserve credit from 2012.

A summary of the 2013 revenue requirement compared to 2012 is as follows:

Revenue Requirement ($ in millions)	**2013 Budget**	**2012 Budget**	**$ Change**
Operating and Maintenance Budget	$162.9	$163.0	$(0.1)
Miscellaneous revenue	(7.9)	(8.4)	0.5
Subtotal net Operating & Maintenance	155.0	154.6	(0.4)
Debt Service including 25% reserve	42.5	46.3	(3.8)
Cash funded Capital	24.0	17.0	7.0
Subtotal before revenue credit	221.5	217.9	3.6
Revenue Credit	(25.5)	(23.1)	(2.4)
Total Revenue Requirement	**$196.0**	**$194.8**	**$1.2**

Operating and maintenance budget

The largest component of the revenue requirement is the operating and maintenance (O&M) budget, which for 2013 is proposed to be $162.9 million, representing a $141,000, or 0.1%, decrease from 2012. The 2013 Budget and Grid Management Charge Rates book, included as *Attachment 1*, 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 9 end-to-end core processes, which will be measured through activity-based costing.

A summary of the 2013 O&M budget by resource compared to 2012 is below:

O&M Budget by Resource ($ in millions)	2013 Budget	2012 Budget	$ Change
Salaries and benefits	$115.0	$113.5	$1.5
Facility operating costs and equipment leases	4.0	8.1	(4.1)
Telecommunication and maintenance costs	15.6	15.2	0.4
Consultants and contract staff	11.8	10.8	1.0
Outsourced and other contracts and professional fees	9.4	8.4	1.0
Training, travel and other costs	7.1	7.0	0.1
Total O&M Budget by Resource	**$162.9**	**$163.0**	**$(0.1)**

- Salaries and benefits increased by $1.5 million primarily because of anticipated merit increases and increased healthcare costs offset by reductions in overtime and other payroll costs.
- Facility lease costs decreased by $2.9 million because of expiring leases in 2012 for the original Folsom locations. Equipment leases decreased $1.2 million because of expiring leases for data storage hardware.
- The increase in telecommunications and maintenance costs were primarily the result of increased software maintenance and telecommunications costs of $2.2 million offset by lower hardware maintenance costs of $1.8 million.
- Consultants and contract staff costs increased by $1.0 million primarily for assistance for interconnection contracting, process documentation and redesign and technical definitions documentation. This area has been reduced by over 25% over the last five years.
- Professional fees costs increased by $1.0 million primarily in support of outside legal counsel costs. The primary drivers are additional litigation and hearings at the FERC in connection with transmission planning and approvals and market investigations.
- Training, travel and other costs increased slightly because of a small increase in anticipated travel and training for 2013.

A summary of the 2012 O&M budget by division compared to 2011 is as follows:

O&M Budget by Division ($ in millions)	2013 Budget	2012 Budget	$ Change
Chief Executive Officer	$4.8	$4.8	$ -
Human Resources	5.7	5.5	0.2
Market and Infrastructure Development	16.7	15.9	0.8
Technology	58.8	61.7	(2.9)
Operations	44.7	44.7	-
Legal and Administrative	22.8	21.9	0.8
Policy and Client Services	9.4	8.5	0.9
Total O&M Budget by Division	**$162.9**	**$163.0**	**$(0.1)**

The changes in divisional costs are largely driven by internal and external personnel and staffing costs.

In November, the ISO formed a new division known as the Market Quality and Renewable Integration Division. It will consolidate market performance review functions previously split across the Technology and Operations divisions within the organization and sharpen the ISO's focus on price analysis while increasing transparency and confidence in market results. As this Division is in the initial stages of being organized, the budget discussed herein remains unchanged. The overall O&M budget will not be affected because the costs will be shifted from the Technology and Operations divisions.

Debt service

The debt service component of the 2012 revenue requirement will be $42.5 million, which represents a $3.8 million decrease over 2012. The amount includes the net debt service amounts due, plus the required 25% reserve on the ISO's 2008 and 2009 bond issues.

- *2008 Bonds*: $197 million issued to refinance existing variable rate debt and to fund the development of the new market software. The collection for payments of the remaining 2008 bonds will be spread evenly over the 2012 and 2013 budgets. The 2008 bonds will be retired in 2014.

- *2009 Bonds*: $200 million issued to construct the Iron Point facility and other capital projects. The 30-year bond issue has level debt service payments due through 2039.

A summary of debt service is below:

Debt Service ($ in millions)	2013 Budget	2012 Budget	$ Change
Principle payments on 2008A and 2009A bonds	$27.0	$39.6	$(12.6)
Interest payments	12.3	14.2	(1.9)
Less amounts from debt service and capitalized interest reserves	(20.9)	(1.2)	(19.7)
Debt service collection leveling adjustment	15.6	(15.6)	31.2
Subtotal	**34.0**	**37.0**	**(3.0)**
25% Debt Service Reserve	8.5	9.3	(0.8)
Total Debt Service	**$42.5**	**$46.3**	**$(3.8)**

Capital/Project budget

The 2013 capital/project budget is projected to be $19.5 million. The proposed revenue requirement will allow for the collection of $24.0 million for these capital projects. Unused amounts collected will be used to fund future projects. The ISO engages in a process to prioritize these resources towards the highest-priority projects. The projects under consideration include implementation of systems and tools, such as phase 3 of the outage management system and enhancements to the resources interconnection management system; enhancement of markets and performance, covering projects such as flexible ramping and intertie pricing and settlement; and various technology projects.

These capital projects 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 operating and maintenance realm.

Miscellaneous revenue

Miscellaneous revenue will decrease by $500,000 to a total of $7.9 million. The primary components of miscellaneous revenue are interest income, generator interconnection studies, fees to operate the California-Oregon intertie, and intermittent resource forecasting fees.

Operating reserve credit from 2012

The reserve credit is primarily the cumulative result of the actual results versus the budgeted revenue requirement for the prior year. The revenue requirement includes a $25.5 million operating reserve credit, which is $2.4 million higher than 2012.

Grid management charges

The ISO recovers its costs through separate grid management charges to market participants. A new rate design for 2012 was developed with stakeholders, approved by the Board at its May 2011 meeting, and then filed with FERC. FERC approved the new design on September 30, 2011 without change. The new design provides for three service categories and five associated fees and charges. The rate is derived by dividing the recoverable costs for the category by the estimated billing determinants. A comparison of the 2013 rates with 2012 is as follows ($ per unit):

Service Category or Fee	2013 Rate	2012 Rate	$ Variance	Comments
Market Service Charge	$0.0931	$0.0851	$0.0080	8% lower volumes projected for 2013
Systems Operations Charge	0.2872	0.2845	0.0027	Increase of less than 1% for 2013
Congestion Revenue Rights (CRR) Services Charge	0.0135	0.0170	(0.0035)	27% higher volumes projected for 2013
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	0.27	0.27	-	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 public review and comment on the draft budget. This public input process commenced with a June 21 budget kickoff call with stakeholders and a stakeholder workshop on October 10. 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. The ISO will subsequently post the GMC rates on its website to be effective on January 1, 2013.

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 final total approved budget.

Conclusion

The proposed budget will provide sufficient funding to enable the ISO to deliver on the commitments made in the *Five-Year Strategic Plan* while still reducing the costs to customers. Therefore, Management recommends that the Board approve the budget attached to this memorandum.