Memorandum

To: ISO Board of Governors

From: Ryan Seghesio, Chief Financial Officer & Treasurer

Date: December 11, 2013

Re: **Decision on 2014 budget**

This memorandum requires Board action.

EXECUTIVE SUMMARY

This memorandum summarizes the proposed 2014 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 8, 2013.

The proposed revenue requirement of $198 million remains within the tight range that the ISO has maintained for the past eight years. The ISO is absorbing upward cost pressures, including the increased cost of healthcare, which are offset by a reduction in staff (by eight) and continual efficiency achievements in non-labor costs, resulting in a decrease of $615,000 of operating and maintenance expenses after netting out the effects of revenue collected from forecasting fees. The level of O&M decrease allows the ISO to increase the cash-funded capital collected which helps ensure the long-term viability of the ISO.

Management recommends the following motion:

> ***Moved, that the ISO Board of Governors approves the 2014 revenue requirement and Capital/Project budgets as set forth in Attachment A to this memorandum dated December 11, 2013; and***
>
> ***Moved, the ISO Board of Governors authorizes Management to take all necessary and appropriate actions to implement the 2014 grid management charge rates reflecting the 2014 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 proposed 2014 revenue requirement is $198 million. This amount is $2 million higher than the 2013 revenue requirement and represents an average annual increase of approximately 0.6% over the past 8 years. Transmission volume is estimated to increase to 247.2 TWh, or a 1% increase from 2013. Our bundled grid management charge is derived by dividing the revenue requirement by the forecasted transmission volume.

The anticipated increase in transmission volume, combined with a higher revenue requirement, will lead to a bundled grid management charge for 2014 of $0.801 per MWh, the same as in 2013. The 2014 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;
- Miscellaneous revenue; and
- Operating reserve credit from 2013.

A summary of the 2014 revenue requirement compared to 2013 is as follows:

Revenue Requirement ($ in millions)	**2014 Budget**	**2013 Budget**	**$ Change**
Operating and maintenance budget	$164.4	$162.9	$1.5
Miscellaneous revenue	(8.3)	(7.9)	(0.4)
Subtotal net operating & maintenance	156.1	155.0	1.1
Debt service including 25% reserve	16.9	42.5	(25.6)
Cash funded capital	26.0	24.0	2.0
Subtotal before revenue credit	199.0	221.5	(22.5)
Revenue credit	(1.0)	(25.5)	24.5
Total Revenue Requirement	**$198.0**	**$196.0**	**$2.0**

Operating and maintenance budget

The largest component of the revenue requirement is the operating and maintenance (O&M) budget, which for 2014 is proposed to be $164.4 million. This represents a $1.5 million, or less than one percent, increase from 2013. The 2014 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 nine end-to-end core processes, which will be measured through activity-based costing.

A summary of the 2014 O&M budget by resource compared to 2013 is as follows:

O&M Budget by Resource ($ in millions)	**2014 Budget**	**2013 Budget**	**$ Change**
Salaries and benefits	$114.3	$113.9	$0.4
Occupancy costs and equipment leases	3.5	3.8	(0.3)
Telecommunication and hardware and software maintenance costs	14.7	14.9	(0.2)
Consultants and contract staff	13.2	13.4	(0.2)
Outsourced contracts and professional fees	11.6	9.8	1.8
Training, travel and other costs	7.1	7.1	-
Total O&M Budget by Resource	**$164.4**	**$162.9**	**$1.5**

- Salaries and benefits increased by $409,000 or less than 0.5 percent. Merit and other increases were mitigated by a staff reduction of eight and lower benefits burden arising from modifications in the retiree medical plan offset merit increases.

- Occupancy costs decreased by $351,000, or 8 percent, primarily because of increased efficiencies at the new headquarters building.

- Telecommunications and hardware and software maintenance costs decreased by $165,000, or 1 percent, primarily related to contract consolidation.

- Consultants and contract staff costs decreased by $212,000, or 1 percent, primarily due to lower planned utilization in 2014.

- Outsourced contracts and professional fees increased by $1.8 million, or 18%. The increase was due to increased legal costs to support litigation at FERC and forecasting costs for intermittent resources. The increase in forecasting costs results from the almost doubling of resources projected to come on stream in 2014. The intermittent resources pay a ten cent per megawatt forecasting fee to offset the forecasting costs. The forecasting fee is included in miscellaneous revenue at $2.1 million for 2014.

- Training, travel and other costs remained at the same level as 2013.

A summary of the 2014 O&M budget by division compared to 2013 is as follows:

O&M Budget by Division ($ in millions)	2014 Budget	2013 Budget	$ Change
Chief Executive Officer	$4.4	$4.7	$(0.3)
Market and Infrastructure Development	14.2	13.8	0.4
Technology	58.9	57.6	1.3
Operations	41.5	43.6	(2.1)
General Counsel and Administrative Services	28.5	28.4	0.1
Market Quality and Renewable Integration	7.1	5.0	2.1
Policy and Client Services	9.8	9.8	-
Total O&M Budget by Division	**$164.4**	**$162.9**	**$1.5**

- The Operations Division's costs decreased due to a reduction in five staff and the transfer of forecasting costs to the Market Quality and Renewables Integration Division.

- The Market Quality and Renewable Integration Division's costs increased due to the transfer of forecasting costs from Operations as well as an increase in the forecasting costs resulting from the almost doubling of resources projected to come on stream in 2014. Intermittent resources pay forecasting fees to the ISO, which are included in miscellaneous revenues to offset the related forecasting costs.

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

Debt service

The debt service component of the 2014 revenue requirement will be $16.9 million, which represents a $25.6 million decrease over 2013 primarily due to the collection of the payoff of the ISO's 2008 bonds which will be retired in early 2014 and the lower debt service from the 2013 bonds which paid off the 2009 bonds. The 2014 budget will only include collections for the debt service due on the 2013 bonds. The 2013 bonds were issued in November 2013 and retired the 2009 bonds. Principal and interest on the 2013 bonds are $1.25 million lower than the 2009 bonds. The 2009 bonds were issued primarily for the construction of the Iron Point facility. Debt service includes the net debt service amounts due, plus the required 25% reserve.

A summary of debt service is as follows:

Debt Service ($ in millions)	2014 Budget	2013 Budget	$ Change
Principal payments on 2008 and 2009 bonds (2013 only) and 2013 bonds (2014 only)	$4.4	$27.0	$(22.6)
Interest payments on 2008 and 2009 bonds (2013 only), and 2013 bonds (2014 only)	9.1	12.3	(3.2)
Less amounts from debt service reserve funds	-	(20.9)	20.9
2008 bonds debt service collection leveling adjustment	-	15.6	(15.6)
Subtotal	**13.5**	**34.0**	**(20.5)**
25% Debt Service Reserve	3.4	8.5	(5.1)
Total Debt Service	**$16.9**	**$42.5**	**$(25.6)**

Cash funded capital and capital/project budget

The proposed revenue requirement will allow for the collection of $26.0 million for capital projects. Excess amounts collected will be used to fund future projects.

The 2014 capital/project budget is projected to be $24.0 million. A prioritization process is underway that will result in the highest priority projects being proposed. Throughout the year, the projects are then taken to the Corporate Management Committee for final approval. The current list of projects under consideration totals in excess of $36 million and is divided into seven main categories:

- Enhancement of markets and performance-covering projects such as FERC Order No. 764 – 15-minute market, operations enhancements, ex-post pricing, changes to incorporate the baseline energy imbalance market and market design comprehensive review;

- Enhancement of the technology foundation-covering projects comprising a new metering system;

- Evolve the market and infrastructure projects such as flexible ramping;

- Grid evolution readiness comprising several smaller projects such as the synchrophasor project;

- Operational excellence including the enterprise model management systems;

- Information technology which includes hardware and software purchases; and

- Other costs which includes capitalized project management costs.

The aforementioned 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.

The ISO has entered into an implementation agreement with PacifiCorp to enable PacifiCorp to participate in the energy imbalance market. FERC approved the agreement on July 1. The agreement provides that PacifiCorp will reimburse the ISO $2.1 million for implementation costs based on achieving specified milestones. The energy imbalance market is scheduled to go live in October 2014.

Miscellaneous revenue

Miscellaneous revenue increased $400,000 to $8.3 million. The primary components were intermittent resource forecasting fees of $2.1 million, fees to operate the California-Oregon intertie of $2.0 million, interest income of $1.9 million, large generator interconnection studies of $1.8 million and other fees and charges of $500,000. Included in other fees are fees associated with energy imbalance market activity for the last quarter of 2014, which have yet to be filed with FERC.

Operating reserve credit from 2013

The reserve credit is primarily the cumulative result of the actual results versus the budgeted revenue requirement for the prior year. The 2014 revenue requirement includes a $1.0 million operating reserve credit, which is $24.5 million lower than 2013. The decrease is attributable to collections of GMC from accelerated payments in 2013 and the reversal in 2014 of the amortization of bond premium in prior years.

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 proposed 2014 rates with 2013 rates is as follows ($ per unit):

Service Category or Fee	2014 Rate	2013 Rate	$ Variance	Comments
Market Service Charge	$0.0867	$0.0931	$(0.0064)	9% higher volumes projected for 2014
Systems Operations Charge	0.2890	0.2872	0.0018	Volume flat from 2013
Congestion Revenue Rights (CRR) Services Charge	0.0112	0.0135	(0.0023)	20% higher volumes projected for 2014
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 18 budget kickoff call with stakeholders and a stakeholder workshop on October 8. 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, although no comments were received. The ISO will subsequently post the GMC rates on its website to be effective on January 1, 2014.

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 ISO's strategic plan while still reducing the costs to customers. Therefore, Management recommends that the Board approve the budget attached to this memorandum.