

# Memorandum

**To:** ISO Board of Governors

**From:** Ryan Seghesio, Chief Financial Officer & Treasurer

**Date:** December 10, 2014

**Re:** Decision on budget for fiscal year 2015

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***This memorandum requires Board action.***

## EXECUTIVE SUMMARY

This memorandum summarizes the final 2015 budget proposal that the Board is requested to approve, to become effective January 1, 2015. 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 an October 9, 2014 stakeholder meeting.

The proposed revenue requirement of \$198.5 million remains within the narrow range that the ISO has maintained for the past eight years. The ISO is absorbing upward cost pressures by continuing to achieve efficiencies in non-labor costs, resulting in an increase of only \$739,000 of operating and maintenance expenses. The level of operating and maintenance (O&M) increase 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 2015 revenue requirement and Capital/Project budgets as set forth in Attachment A to the memorandum dated December 10, 2014; and***

***Moved, the ISO Board of Governors authorizes Management to take all necessary and appropriate actions to implement the 2015 grid management charge rates reflecting the 2015 budget.***

## DISCUSSION AND ANALYSIS

The annual revenue requirement is an integral component of the three-year planning process, and reflects the priorities and commitments made in the three-year strategic plan.

The proposed 2015 revenue requirement is \$198.5 million. This amount is \$500,000 higher than the 2014 revenue requirement and represents an average annual growth rate of 0.6 percent since 2007. Despite this modest increase, the bundled grid management charge will slightly decrease in 2015. This is because transmission volume is estimated to increase to 248.5 TWh, or a 0.5 percent increase from 2014. The bundled grid management charge is derived by dividing the revenue requirement by the forecasted transmission volume. The anticipated increase in volume combined with only a slight increase in the revenue requirement will yield a bundled grid management charge for 2015 of \$0.799 per MWh, slightly less than 2014. In July 2014 the Board approved an update to increase the revenue requirement cap to \$202 million, with no end date, to be effective January 1, 2015. The Federal Energy Regulatory Commission (FERC) is expected to provide their decision on the update late December 2014.

The revenue requirement has five components:

- Operating 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 2015 revenue requirement compared to 2014 is as follows:

Revenue Requirement (\$ in millions)	2015 Budget	2014 Budget	\$ Change
O&M Budget	\$165.1	\$164.4	\$0.7
Other Costs and Revenues	(9.4)	(8.3)	(1.1)
Subtotal net O&M	155.7	156.1	(0.4)
Debt Service including 25% Reserve	16.9	16.9	-
Cash Funded Capital	30.0	26.0	4.0
Subtotal before reserve adjustment	202.6	199.0	3.6
Operating Cost Reserve Adjustment	(4.1)	(1.0)	(3.1)
<b>Total Revenue Requirement</b>	<b>\$198.5</b>	<b>\$198.0</b>	<b>\$0.5</b>

**Operating and maintenance budget**

The largest component of the revenue requirement is the O&M budget, which for 2015 is proposed to be \$165.1 million, representing a \$739,000, or 0.4 percent, increase from 2014. The 2015 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 are measured through activity-based costing.

A summary of the 2015 O&M budget by resource compared to 2014 is as follows.

O&M Budget by Resource (\$ in millions)	2015 Budget	2014 Budget	\$ Change
Salaries and Benefits	\$117.8	\$114.3	\$3.5
Occupancy Costs and Equipment Leases	3.7	3.5	0.2
Telecommunication and Hardware and Software Maintenance Costs	14.2	14.6	(0.4)
Consultants and Contract Staff	11.6	13.1	(1.5)
Outsourced Contracts and Professional Fees	10.4	11.8	(1.4)
Training, Travel and Other Costs	7.4	7.1	0.3
<b>Total O&amp;M Budget by Resource</b>	<b>\$165.1</b>	<b>\$164.4</b>	<b>\$0.7</b>

- Salaries and benefits increased by \$3.5 million, or 3.1 percent, primarily related to merit increases.
- Occupancy costs increased by \$173,000, or 5.7 percent, primarily because of increasing preventative maintenance costs needed for the ISO headquarters building.
- Telecommunications and hardware and software maintenance costs decreased by \$368,000, or 2.7 percent, related primarily to savings from the new telecommunications contract.
- Consultants and contract staff costs decreased by \$1.5 million, or 11.5 percent, primarily due to initiatives to lower use of temporary staff and consultants in 2015.
- Outsourced contracts and professional fees decreased by \$1.4 million, or 11.9 percent, attributable to reduced need for outside legal services.
- Training, travel and other costs increased by \$356,000 or 4.2 percent related to increased insurance premiums, training and travel.

A summary of the 2015 O&M budget by division compared to 2014 is as follows:

<b>O&amp;M Budget by Division (\$ in millions)</b>	<b>2015 Budget</b>	<b>2014 Budget</b>	<b>\$ Change</b>
Chief Executive Officer	\$16.8	\$16.8	\$ -
Market and Infrastructure Development	14.6	14.4	0.2
Technology	60.2	58.8	1.4
Operations	42.9	43.1	(0.2)
General Counsel and Chief Compliance Officer	12.9	14.2	(1.3)
Market Quality and Renewable Integration	7.6	7.1	0.5
Policy and Client Services	10.1	10.0	0.1
<b>Total O&amp;M Budget by Division</b>	<b>\$165.1</b>	<b>\$164.4</b>	<b>\$0.7</b>

- The Operations Division's costs decreased due to the transfer of forecasting costs to Market Quality and Renewables Integration Division
- The General Counsel and Chief Compliance Officer Division's costs decreased due to a reduction in need for outside legal services.
- 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 2015 revenue requirement will be \$16.9 million – the same as in 2014. The Series 2013 bonds were issued in November 2013 for the purpose of refinancing the 2009 bonds. The refinancing resulted in approximately \$1.25 million in lower annual debt service payments beginning in 2014, and over \$30 million in total savings. The 2009 bonds had been issued to finance the ISO's new headquarters facility in Folsom, California 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:

<b>Debt Service (\$ in millions)</b>	<b>2015 Budget</b>	<b>2014 Budget</b>	<b>\$ Change</b>
Principle Payments	\$4.4	\$4.4	\$ -
Interest Payments	9.1	9.1	-
<b>Subtotal</b>	<b>13.5</b>	<b>13.5</b>	<b>-</b>
25% Debt Service Reserve	3.4	3.4	-
<b>Total Debt Service</b>	<b>\$16.9</b>	<b>\$16.9</b>	<b>\$ -</b>

### ***Capital and project budget and cash funded capital***

The proposed revenue requirement will allow for the collection of \$30.0 million for cash-funded capital. Excess amounts collected will be used to fund future projects.

The 2015 capital/project budget is projected to be \$20.0 million. A prioritization 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 \$43.6 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 replacement of the energy management system and the existing transmission contract calculator system;
- 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 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 NV Energy to enable NV Energy to participate in the energy imbalance market. FERC approved the agreement on June 13, 2014. The agreement provides that NV Energy will reimburse the ISO \$1.1 million for implementation costs based on achieving specified milestones. It is anticipated NV Energy will commence participation in October 2015.

### ***Other costs and revenue***

Other revenue increased by \$1.1 million to \$9.4 million; these revenue items help bring the revenue requirement below the new \$202 million cap. 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 \$2.0 million, large generator interconnection studies of \$1.4 million, energy imbalance market administrative charges of \$1.6 million and other fees and charges of \$300,000. FERC approved the energy imbalance market tariff on June 19, 2014. The ISO began parallel non-binding operations on 10/1/2014 and full implementation on 11/1/2014.

**Operating cost reserve adjustment from 2014**

The operating cost reserve adjustment is budgeted at a credit of \$4.1 million, which is an a \$3.1 million credit over 2014. The operating cost reserve adjustment is primarily the cumulative result of the actual results versus the budgeted revenue requirement and the 25 percent debt service reserve collection from the prior year. As with other revenue, this credit adjustment helps bring the revenue requirement below the new \$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 consists of changes in two cost categories: the system operations and CRR services charges, a change in the rate for the TOR charge and an increase in the revenue requirement maximum to \$202 million. The update was approved by the Board in July and is awaiting approval at FERC. The ISO derives the rate by dividing the recoverable costs for the category by the estimated billing determinants.

A comparison of the preliminary 2015 rates with 2014 rates is as follows (\$ per unit):

Service Category or Fee	2015 Rate	2014 Rate	\$ Variance	Comments
Market Service Charge	\$0.0876	\$0.0867	\$0.0009	2% lower volumes projected for 2015
Systems Operations Charge	0.2978	0.2890	0.0088	1% increase in cost allocation
Congestion Revenue Rights (CRR) Services Charge	0.0059	0.0112	(0.0053)	1% decrease in cost allocation
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 (TOR) Charge	0.24	0.27	(0.03)	Updated cost of service study
CRR Auction Bid Fee	1.00	1.00	-	Fixed rate
Intermittent Forecast Fee	0.10	0.10	-	Fixed rate

**Budget process**

The ISO provided several opportunities for public review and comment on the draft budget. This public input process commenced with a June budget kickoff call with stakeholders and included a stakeholder workshop in October. 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. Upon Board approval of the proposed budget, the ISO will post the GMC rates on its website to be effective on January 1, 2015.

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 customer costs. Therefore, Management recommends that the Board approve the 2015 budget attached to this memorandum.