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The Honorable John T. Doolittle
Chairman, Subcommittee on Water
and Power Resources
Committee on Resources
House of Representatives

The Honorable George Miller
Ranking Minority Member
Committee on Resources
House of Representatives

As requested, we are providing our evaluation of the comments submitted to the Subcommittee by the American Public Power Association (APPA) on our recently issued report on three power marketing administrations (PMAs): Southeastern Power Administration (Southeastern), Southwestern Power Administration (Southwestern), and Western Area Power Administration (Western).[1] APPA is the national service organization representing municipal and other state or local government-owned electric utilities throughout the United States. APPA member utilities are the primary recipients of the PMAs' low-cost power.

We reported that unrecovered power-related costs and financing subsidies for Southeastern, Southwestern, and Western amounted to about $300 million in fiscal year 1995 and several billion dollars over the last 30 years. These unrecovered costs, financing subsidies, and inherent cost advantages, compared to nonfederal utilities, have allowed PMAs to be low cost marketers of wholesale electric power. In addition, our report noted that the PMAs are generally following applicable laws and regulations regarding recovery of power-related costs and financing of capital projects.

[1]Power Marketing Administrations: Cost Recovery, Financing, and Comparison to Nonfederal Utilities (GAO/AIMD-96-145, September 19, 1996).

APPA declined an invitation to participate in the Subcommittee hearing held on September 19, 1996, to discuss our report. However, subsequent to the hearing, APPA submitted written comments on our report to be included in the record of the hearing. Because APPA's comments were highly critical of our report and received wide distribution, your offices asked that we respond to them.

APPA's comments seek to bolster the message provided by its Deputy Executive Director at the Subcommittee's May 18, 1995, oversight hearing at which he told the Subcommittee that PMAs are self-supporting and are not subsidized. This view on the cost recovery practices of the PMAs is not supported by the findings in our report. Following is a summary of the key points in APPA's letter and our evaluation of each point. Other, more specific APPA comments are analyzed in the enclosure.

SUMMARY OF APPA's COMMENTS AND OUR EVALUATION

Unrecovered Power-Related Costs

APPA stated that our report seriously misrepresents the financial status of the PMAs by blending currently unrecovered power-related costs with financing subsidies to produce annual and cumulative estimates of uncollected costs related to the PMAs' operations. APPA suggests that the presentation of data in this fashion blurs the distinction between these two different types of costs and leaves readers with the inaccurate impression that the unrecovered costs identified in our report are subsidies. The primary objective of our congressionally requested review was to determine whether PMAs' power rates recovered all power-related costs as of September 30, 1995, and to what extent, if any, the financing for power-related capital projects is subsidized by the federal government. We reported that unrecovered power-related costs and financing subsidies for Southeastern, Southwestern, and Western amounted to about $300 million in fiscal year 1995, and several billion dollars over the last 30 years. Combining unrecovered power-related costs and the financing subsidies helps give the Congress an idea of the magnitude of federal expenditures for the three PMAs that are not currently being recovered through power charges.

APPA stated that in determining power-related costs, we substituted our judgment for that of the Congress. APPA further stated that we based a large portion of our estimates on ". . . pure speculation regarding potential future scenarios--much of which conflicts with available facts and information, and contradicts sworn testimony of the federal agencies with responsibility in these areas." APPA stated that our report did not distinguish between unrecovered and unrecoverable costs. Finally, APPA implies that because our report identifies

unrecovered power-related costs and financing subsidies, we were ". . . intent on finding ways for this power [power sold by the PMAs] to be marketed at the highest possible rates."

We disagree. The Reclamation Project Act of 1939 and the Flood Control Act of 1944 generally require the recovery through power rates of the costs of producing and marketing federal hydropower. However, these acts and the DOE Order implementing the cost recovery requirement of these acts do not specify which costs are to be recovered. To define the full costs associated with producing and marketing federal hydropower, we referred to criteria in (1) Office of Management and Budget (OMB) Circular A-25, "User Fees," (2) federal accounting standards recommended by the Federal Accounting Standards Advisory Board, and (3) accounting and cost recovery practices of investor-owned and publicly-owned utilities. Applying these criteria, the full cost of electricity sold by the PMAs would include all direct and indirect costs incurred by the operating agencies to produce the power, the PMAs to market and transmit the power, and any other agencies to support the operating agencies and PMAs. We see nothing in APPA's letter that refutes the reasonableness of these criteria.

Carefully applying these criteria, we estimated that the unrecovered power-related costs and financing subsidy for the three PMAs totaled about $300 million for fiscal year 1995. While we recognize the distinction between "unrecovered" and "unrecoverable," we believe that "unrecoverable" costs are essentially a subset of "unrecovered" costs. However, most of this estimate pertains to the financing subsidy and unrecovered pension and postretirement health benefits, which are not recoverable under existing PMA practices. Unless these practices change, the financing subsidy and unrecovered benefits will continue to accumulate.

We disagree with APPA's statement about the objective of our review. Based on agreements with the requesters' staff, we were asked to determine whether all power-related costs incurred through September 30, 1995, had been recovered through electricity rates, and whether the financing for power-related capital projects is subsidized by the federal government. We were not asked to and did not address whether any changes in PMA cost recovery practices or financing should be made. Whether any change is needed is a judgment for congressional decisionmakers.

Subsidized Financing

APPA stated that we selected an arbitrary method for calculating the "alleged financing subsidies." It also stated that the only accurate way to establish whether any "interest rate gap" exists would be to compare PMA interest rates and the Treasury interest rates project by project. Moreover, APPA stated that GAO agrees that this is the most accurate method, but dismissed it because records were not available for all Western projects.

We defined the financing subsidy as the difference between Treasury's borrowing cost and the interest rate paid by the three PMAs to Treasury. This interest differential is the result of explicit subsidies and the economic cost to the federal government of taking on interest rate risk in the structuring of the PMA financing. As outlined on pages 52 and 53 of our report, the interest rates the PMAs paid on outstanding appropriated debt[2] for fiscal year 1995 (2.9, 4.4, and 5.5 percent for Southwestern, Southeastern, and Western, respectively) are lower than the cost to the federal government for fiscal year 1995 (9.1 percent) of providing this financing. As a result, there is a significant difference between the interest income earned by Treasury on the appropriated debt and Treasury's related interest expense.

As stated on page 57 and again on pages 84 and 85 of our report, there are three primary components of the financing subsidy to the PMAs. One is the difference between the PMA borrowing rate and the closest match of Treasury borrowing in terms of maturity at the time of the appropriation. The second is the PMAs' ability to repay the highest interest-bearing appropriated debt first. This source of financing subsidy occurs because PMAs' debt management flexibility is not shared by Treasury, which cannot pre-pay most high interest-rate debt during periods of low interest rates. Finally, the PMAs' appropriated debt has maturities of up to 50 years, which is beyond the maximum maturity--30 years--of Treasury bonds. Thus, if PMAs do not pay off appropriated debt within 30 years, Treasury would have to refinance its corresponding debt.[3]

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[2]GAO calls this appropriated debt because PMAs are required to repay, with interest, appropriations used for capital investments. However, these reimbursable appropriations are not technically considered lending by the Treasury.

[3]Our consideration of the financing subsidy does not include the impact of other forms of subsidy, such as the difference between Treasury debt being compounded semiannually versus PMA debt being compounded annually. We

(continued...)

As discussed on page 49 of our report, in addition to these three main aspects of the subsidy, Treasury takes on risk, known as interest rate risk, with regard to PMAs' appropriated debt. Appropriated debt carries a fixed interest rate and a term of 50 years with no ability of Treasury to call[4] the debt. Although PMAs are generally required to pay off the highest interest debt first, they cannot refinance the debt. Thus, Treasury bears the risk of increases in interest rates and PMAs, to some degree, bear the risk of decreases in interest rates. Western, for example, has some appropriated debt that is at interest rates above the current Treasury 30-year bond rate. However, because Western cannot refinance this debt and does not have sufficient cash flow to pay it off, it must pay the above-market interest rates. However, as indicated above, the majority of the PMA appropriated debt is well below Treasury rates. The combination of the explicit subsidies and the federal government's interest rate risk has resulted in billions of dollars of cost to taxpayers, which we defined as the financing subsidy, over the period the appropriated debt has been outstanding.

As our report indicated, new projects, additions, and equipment replacements made after September 30, 1983, are financed at Treasury market interest rates.[5] Thus, the initial below market interest rate aspect of the subsidy was generally eliminated for post-1983 appropriated debt. However, the PMAs' ability to repay the highest interest rate appropriated debt first has resulted in much of the pre-1983 below market rate debt remaining on the PMAs' books. This factor will continue to contribute to the interest rate differential over the next several decades until all pre-1983 appropriated debt is repaid.

We agree with APPA and the PMAs that the most accurate way to assess the first component of the financing subsidy (the initial below market financing) would be to compare the PMAs' and Treasury's interest rates on a project-by-project basis

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[3](...continued)
also exclude the impact that the risk of hydropower projects might have had on the PMAs' interest rates if they had been financed in the private market rather than through Treasury.

[4]Call refers to the ability of the lender to require the borrower to pay back the debt before its maturity date.

[5]Post-1983 capital projects are financed at interest rates equal to the average yield during the preceding year on interest-bearing marketable securities of the United States, which, at the time the computation is made, have terms of 15 years or more remaining to maturity. Our report shows that these rates approximate Treasury's 30-year rates for bonds issued from 1983 to 1995.

in the year the project was placed in service. We disagree that the calculation proposed by APPA and the PMAs would accurately capture the full subsidy cost. As we clearly state on page 57 of our report, such a calculation would only show a portion of the subsidy--that portion related to the initial below market financing--and would not recognize the other factors described above. In addition, data were not available to calculate the first component of the financing subsidy on a project-by-project basis. Thus, we chose an alternative approach. Specifically, we calculated the difference between the PMAs' weighted average interest rate on appropriated debt outstanding as of the end of fiscal year 1995 and the Treasury's average interest rate on its entire bond portfolio for the same period. This approach reasonably captures all facets of the financing subsidy.

Comparison of PMAs to Nonfederal Utilities

APPA stated that we engaged in selective and misleading comparisons of the PMAs and nonfederal utilities.[6] APPA also stated that it was inappropriate to compare the cost of federal power produced with hydropower assets to the cost of nonfederal power produced from a variety of sources, including coal and nuclear. Our requesters asked us to compare the three PMAs to nonfederal utilities and to determine the impact of these differences on power production costs. Since the PMAs compete against all utilities, not just those that are primarily hydro-based, a comparison of power produced from hydroelectric facilities would generally be irrelevant to the overall competitive position of the PMAs. Further, as our report states, we believe power customers are primarily concerned with production costs and resultant electricity rates, not with whether the utility is an IOU, POG, or PMA, or whether the utility generates its power using coal, nuclear, or hydroelectric sources.

As noted in chapter 4 and on page 76 of our report, the PMAs are different from other utilities in various ways, including cost of production, types of generating facilities, payment of taxes, accounting and rate-setting, and financing. In chapter 4 we also discuss the different missions and responsibilities of PMAs, IOUs, and POGs. Because increasing competition in the electric utility industry is expected to drive down future power rates, the current competitive position of the PMAs, in terms of production costs, is important information for the Congress to consider as it deliberates the future of the PMAs. We noted in our report that some projects and systems were already facing serious competitive pressures. PMAs that do not remain low-cost suppliers may not be able to

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[6]The nonfederal utilities we refer to are investor-owned utilities (IOUs) and publicly-owned generating utilities (POGs).

market their power at rates sufficient to recover costs, and thus, the federal government may not be able to recover its investment in power-related assets, including irrigation debt where applicable.

APPA stated that our report fails to balance PMA advantages and disadvantages. APPA suggests that our report gives greater attention to advantages enjoyed by the PMAs without giving equal attention to other costs that the PMAs' customers must repay that would not normally be charged to nonfederal utility customers. We disagree. Our report provides an appropriate discussion of the relative advantages and disadvantages the PMAs have compared to nonfederal utilities. We did conclude that the advantages outweigh the disadvantages. The PMAs' use of hydropower plants built 30 to 60 years ago, and the fact that as federal agencies they generally do not pay taxes, the unrecovered costs, and the financing subsidy, in aggregate, provide the PMAs with a substantial cost advantage compared to nonfederal utilities. This large difference is reflected in the average revenue per kilowatthour (kWh) comparisons shown in chapter 4 and appendix V of our report. We agree that the PMAs have certain disadvantages compared to nonfederal utilities, such as the cost of the Hoover Dam Visitor Center and certain irrigation debt which Western must recover through power rates and which we acknowledged in our report.

In summary, after thoroughly considering APPA's comments, we continue to support our report's primary message: The PMAs' power rates do not recover all relevant power-related and financing costs.

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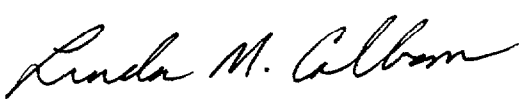
As agreed, unless you publicly announce its contents earlier, we plan no further distribution of this letter until 7 days from its date. At that time, we will send copies to appropriate House and Senate committees, interested Members of the Congress, the PMAs, the Secretary of Energy, the Secretary of the Interior, the Secretary of Defense, the Director of the Office of Management and Budget, the American Public Power Association, and other interested parties.

Please contact me at (202) 512-8341 if you or your staff have any questions concerning this letter.



Linda M. Calbom
Director, Civil Audits

GAO'S EVALUATION OF APPA'S COMMENTS

The following are additional GAO comments on APPA's letter dated October 9, 1996.

UNRECOVERED COSTS

- APPA noted and our report made clear that, as is the case with all federal agencies, the PMAs do not have authorization to make direct contributions into the Civil Service Retirement and Disability Fund (CSRD Fund). APPA, however, incorrectly stated that our report seems to recommend that the PMAs find a way of avoiding what appears to be a direct prohibition that applies to all federal agencies regarding contributions to the CSRD Fund to cover postretirement benefits. APPA's comments also suggest that the PMAs should not pay the full costs associated with postretirement benefits into the Treasury's General Fund (General Fund) since this will not ". . . provide adequate assurances that funding will then be allocated [to the CSRD Fund] for stated purposes."

  We did not recommend in our report that PMAs recover postretirement benefits and deposit amounts recovered into the CSRD Fund. We identified pension and postretirement health benefits as costs related to power that were not being recovered through power rates. In their comments on our draft report, the PMAs agreed. As we stated in our report: "Our objective was not to address whether PMAs should or should not recover these costs; our objective was to determine whether these costs were unrecovered."

  The PMAs raised an augmentation concern in their comments. They stated that they could not deposit power revenues into the CSRD Fund to cover unfunded retirement benefits because doing so would violate federal appropriations law by augmenting the annual appropriation made to the CSRD Fund. In the agency comments section of our final report, we agreed with the PMAs, and stated that ". . . should the Congress decide that the PMAs should deposit directly into the Fund [CSRD Fund] an amount to cover these costs, the Congress should enact legislation permitting a transfer of that amount into the Fund [CSRD Fund]." We then noted that "alternatively, the augmentation issue could be avoided by depositing amounts recovered, like many other PMA ratepayer collections, into the General Fund of the Treasury. . . ."

  This method of recovering the full cost of Civil Service Retirement System pension and postretirement health benefits would be consistent with the way certain power-related costs incurred by the Bureau of Reclamation (Bureau) and Corps of Engineers (Corps) are currently recovered and returned to the Treasury. A large portion of the power revenues collected by the PMAs and returned to the Treasury are for power-related costs incurred by the Bureau and the Corps. At the September 19, 1996,

hearing of the Subcommittee on Water and Power Resources, the PMAs agreed to work with the Congress to identify a way to include the full cost of pension and postretirement health benefits in power rates.

The APPA is correct in noting that upon deposit into the General Fund, there is no assurance ". . . that funding will then be allocated [to the CSRD Fund] for stated purposes." This should not deter PMAs from recovering these costs. It is clear that the cost recovery provisions of the Reclamation Project Act of 1939 and the Flood Control Act of 1944 are intended to defray the costs incurred by the federal government in producing and marketing electric power to the end-user. Depositing amounts in the General Fund collected from end-users will accomplish that goal.

- APPA took exception to GAO questioning the ultimate recoverability of construction costs related to the Russell Project at Southeastern and the Truman Project at Southwestern. APPA also took exception to our characterization of deferred payments (operations and maintenance and interest) at Western as being unrecovered.

  Our report correctly stated that there are substantial power-related costs associated with the Russell and Truman Projects that were not being recovered by the PMAs at the time of our review. We pointed out that if the currently nonoperational pumping units at these projects are never allowed to operate commercially, it is unclear whether the costs associated with their construction will be recovered through rates. The circumstances surrounding these projects, as discussed on pages 32 through 35 and on page 45 of our report, do not offer any assurance that the nonoperational components of these two projects will become operational and that the costs will be included in future rates. Regarding the Russell Project, our report points out that the ultimate operation of the nonoperational pumping units is questionable because these units have been in construction-work-in-progress (CWIP) for 20 years and litigation preventing operation of the units has been ongoing since 1988. Even if the nonoperational components do come on line, no certainty exists that Southeastern will be able to recover the related power costs--about $514 million as of the end of fiscal year 1996.

  The Russell Project is part of Southeastern's Georgia-Alabama-South Carolina system, which reported total revenues and total expenses for fiscal year 1995 of about $106 million and $99 million, respectively. If the nonoperational components do eventually come on-line, as Southeastern officials believe, interest will have to be paid annually on the federal investment rather than being capitalized, as is now done. Paying this interest expense, which totaled almost $26 million in fiscal year 1995, would increase the system's total expenses by about 25 percent. Because interest continues to be capitalized, each year that the components remain nonoperational, the outstanding principal and the associated annual interest payments required if the components

come on-line continue to grow. Although revenues would also increase if the project becomes fully operational, it is unclear whether the Georgia-Alabama-South Carolina system would be able to absorb these additional costs. This is especially true given that the system's power rates are approaching the rates of nonfederal utilities at a time when increasing competition in the electric utility industry is expected to drive down costs further, as we discussed in chapter 4 and appendix V of our report.

Regarding deferred payments at Western, our report does not suggest that these payments will never be recovered. On page 41 of our report, we stated that the balance of outstanding deferred payments at Western decreased from $250 million to $196 million during fiscal year 1995, and that Southeastern and Southwestern had repaid their deferred payments, with interest, prior to September 30, 1995. In addition, on page 42, we state that "Western plans to recover the majority of these costs [deferred payments] over time." Our report correctly stated that as of September 30, 1995, the deferred payments (operations and maintenance and interest) had not been fully recovered.

- APPA stated that our report failed to explore the reasons that the Washoe Project has not been able to generate sufficient revenues to cover its expenses. APPA stated that if we had done so we would have ". . . discovered that the situation arose as the result of anticompetitive activities of an investor-owned utility."

The purpose of our review was not to explore all of the reasons Western believes the Washoe Project is unlikely to recover the federal investment. However, on pages 35 and 36 of our report, we did note that, according to Western, the Washoe project has not been able to recover the costs of producing power because the project: (1) has construction costs that are high in relation to other utilities, (2) has not been able to find customers to purchase the power at a rate that would recover the full cost of producing the power, (3) began producing power in the first year of a 7-year drought, and (4) prior to 1992, lacked the transmission service to wheel power to customers interested in buying the power. We also noted in our report that the primary reason the Washoe Project has not been able to generate sufficient revenue to cover its costs is because its cost of producing power is significantly higher than other utilities. On page 36 of our report we noted that, in January 1996, Western projected that the Washoe Project would have to sell its power at 11 cents per kWh in order to recover its annual operating and maintenance expenses (less depreciation), interest charges, and debt repayments on the federal investment; however, in fiscal year 1995, the project was selling its power for about 2 cents per kWh. Western's fiscal year 1995 annual report also stated that "Based on current conditions, it is unlikely the project [Washoe] will be able to generate sufficient revenues to repay the Federal investment." As noted in chapter 4 and appendix V of our report, in 1994, the average revenue per kWh for wholesale power sold by IOUs and POGs in the area served by the Washoe

Project ranged from a low of 3.49 cents per kWh for IOUs to a high of 3.73 cents per kWh for POGs. Even if Washoe could sell its power at these rates, Washoe would still be losing over 7 cents per kWh on power sold. Clearly, high costs are the most significant reason for Washoe's financial problems.

- APPA incorrectly stated that our report ignores the fact that Congress must approve changes to cost allocations of multipurpose water projects. On page 39 of our report, we stated that the Congress must approve any change in the cost allocation methodology used to distribute costs to the various program purposes at the Pick-Sloan Program. Our report did not recommend any changes to the cost allocations. Rather, as requested, we identified the unrecovered power-related costs of the three PMAs as of September 30, 1995.

- APPA stated that we substituted our judgment for that of the Congress in regard to the irrigation costs at Pick-Sloan and environmental costs at Western. APPA stated that the unrecovered power-related cost estimates in our report inaccurately included $454 million in unpaid irrigation-related costs, and $13.5 million in estimated interest costs related to the Pick-Sloan system. APPA suggested that by referring to the $454 million as unrecovered power-related costs we were ". . . second-guessing . . . existing laws in an effort to inflate bottom-line estimates of unrecovered costs . . . ." In addition, APPA stated that our report inaccurately describes the purposes for, and funding of, certain environmental enhancement projects at the Shasta and Glen Canyon Dams. We disagree. Our report did not state or suggest that PMAs should be recovering certain costs that they currently are not required to recover. We were asked to report on power-related costs that are not being recovered and are therefore not included in rates charged to the PMAs' customers. Our report factually states that power-related costs at Pick-Sloan and certain environmental mitigation costs at the Shasta and Glen Canyon Dams are not being recovered. Whether or not these costs should be recovered is a matter for congressional decisionmakers.

- APPA incorrectly stated that our report suggested that the entire $454 million in "unrecovered power-related costs" at Pick-Sloan would be allocated to power for recovery. On page 38 of our report, we used the word "primarily" to indicate that most, but not all, of the $454 million would have been allocated to power if the federal investment in hydropower facilities and water storage reservoirs at Pick-Sloan had been allocated based on how the facilities are actually being used. As noted by APPA, a large portion of the $454 million represents power costs that were originally allocated to power, but were then suballocated for irrigation pumping power costs. The remaining portion of the $454 million represents joint costs that were also allocated to the incomplete and infeasible irrigation projects. A significant portion of these joint costs would also have been allocated to power if the allocation had been

based on how the hydropower facilities and water storage reservoirs are actually being used.

APPA also incorrectly implied that our report referred to the $454 million as a financial liability of the PMAs. Our report stated that most of the $454 million represents power-related costs that have not been recovered. Changing the terms of repayment to recover any of the $454 million investment would require congressional action.

- APPA stated that we fail to credit the PMAs for subsidizing many unanticipated nonpower related public uses of the Pick-Sloan system such as recreation, flood control, and environmental benefits. Whether the PMAs subsidize nonpower purposes such as recreation, flood control, and environmental benefits was beyond the scope of this review.

- With regard to environmental mitigation costs incurred at the Shasta and Glen Canyon Dams, APPA stated that the description of the purposes for these environmental enhancement projects and the explanation of how the environmental activities have been funded included in our report are "inaccurate." The information in our report about the Shasta and Glen Canyon Dams was either taken from Western's fiscal year 1995 annual report, or provided by Western officials. Our report included sufficient information to point out that certain environmental mitigation costs associated with the Shasta and Glen Canyon Dams have been legislatively excluded from Western's power rates. Moreover, the PMAs' written comments on our report specifically stated that they agreed with our discussion of these unrecovered costs.

  APPA incorrectly stated that our report does not acknowledge that certain of the unrecovered costs identified for the Glen Canyon Dam could be included in future power rates. On pages 40 and 41 of our report, we state that the Grand Canyon Protection Act of 1992 includes a provision that the ". . . costs [of environmental impact studies related to Glen Canyon Dam] could become the responsibility of the power customers under certain circumstances." Our report further states that "According to Western, sufficient data does not exist to determine whether the overall provisions of the act would result in a future obligation by the power customers."

- APPA stated that our conclusions regarding unrecovered costs are merely speculative because we did not examine the specific allocation formulas of the operating agencies on a project-by-project basis. APPA further states that an examination of these cost allocation formulas could have led to the conclusion that costs are in fact being overrecovered. Our report clearly recognizes that we did not assess the reasonableness of the methodologies used in developing the operating agency cost allocation formulas that are established for each project. We do not know whether an

examination of the specific cost allocations on a project-by-project basis would have revealed that power-related costs are actually being overrecovered or were underrecovered. However, the fact that we did not review operating agency cost allocations does not eliminate or reduce the significance of the unrecovered costs that were identified by our report.

- APPA stated that our report "speculates" about the potential for loss on the $94.1 million federal investment in Western's Mead-Phoenix Transmission Line. APPA also states that our report did not acknowledge the contributions of the Mead-Phoenix line to overall system reliability during the recent electrical outages in the West. Our report explained that because of reduced demand for power from the line, the project had not generated sufficient revenues to cover all operating and maintenance (O&M) and interest expense during its first few months of operation. As a result of this fact, our report appropriately questioned the future financial viability of this line. Our report did not address system performance and reliability because it was beyond the scope of this review. In addition, nothing came to our attention during the review to lead us to believe that the contributions of the Mead-Phoenix line during the recent power outage in the West would increase the line's chances of recovering all O&M and interest expense or the government's investment.

- APPA stated that our report fails to point out that the Bureau of Reclamation makes annual contributions in lieu of taxes to the states or counties where the federal water resource projects are located. This point was raised by the PMAs during our review, but when asked to provide specifics or to identify the extent to which the operating agencies make payments in lieu of taxes, they were unable to provide any support. It is not clear what portion of these contributions, if any, actually pertain to the operating agencies, and what portion of any amounts contributed by the operating agencies was allocated to power. In the absence of supportable factual information, we chose not to include this point in our report.

- APPA stated that our report does not mention that when some federal power projects came on line decades ago, the cost of power produced exceeded the cost of power available from other sources. Whether the cost of the PMAs' power in the early years of the water projects exceeded the cost of power available from other sources has no bearing on our calculation of unrecovered costs and financing subsidies or on the future competitiveness of the PMAs.

SUBSIDIZED FINANCING

- APPA states that our conclusion about the amount of the fiscal year 1995 financing subsidy for the three PMAs identified in our report ". . . could only have been reached through the assumption that the PMAs *should have* been setting power rates through

application of current Treasury interest rates to all of the PMAs' outstanding debt." APPA concludes that if the PMAs had followed this practice, they would have ". . . dramatically increased electric rates, and conflicted with the congressional directive to sell federal power at the lowest possible rates in accordance with sound business principles." APPA suggests that the problems with such a practice can be demonstrated through ". . . the frequently-used analogy of a fixed-rate home mortgage."

First, as clearly stated in the report and previously in this letter, we did not address whether any changes in financing practices of the PMAs should be made. We were asked to and did report on the amount of the financing subsidy. It is up to the Congress, given this information, to decide whether any changes in financing practices should be made. Second, PMAs' financing is not analogous to a mortgage lending situation for the following reasons:

(1) In a mortgage-type lending arrangement, the lender, if it wants to remain in business, establishes a spread between the rate it charges the borrower and the rate it must pay for the capital it lends. However, in the case of the PMAs' appropriated debt, the PMAs do not pay higher interest rates than the interest rates that Treasury pays on its bonds (or any transaction fees, which private sector companies pay). In fact, the highest rate the PMAs are subjected to for new financing is based on the rates on Treasury securities issued the previous year that have terms of 15 years or more to maturity, even though the repayment periods for appropriated debt are up to 50 years. No attempt is made to charge a differential or take into account the much greater risk of having appropriated debt outstanding for 50 years, which is in contrast to a mortgage lending situation. In addition, financing using Treasury rates gives PMAs advantages because Treasury debt is considered "risk-free." In the private sector, PMAs would likely pay higher interest rates to reflect the risks associated with hydroelectric power operations.

(2) A mortgage lender typically requires that borrowers repay their loans on a fixed schedule (principal and interest). The PMAs, in contrast, are not required to make fixed payments. Instead, the PMAs' appropriated debt is similar to a balloon loan that is due in full at the end of the term, generally 50 years. The PMAs' policy is to repay the highest interest debt first in order to minimize interest expense. In many cases, low interest rate appropriated debt has been outstanding for decades while higher rate debt has been repaid. Unlike a typical mortgage situation, PMAs can also defer interest payments if sufficient revenue is not available to make these annual payments.

(3) The oversight and monitoring of PMA appropriated debt, and principal and interest amounts to be recovered annually, is different from any situation that

we know of in mortgage lending. Mortgage lenders monitor debt balances and repayments for appropriateness. In contrast, the PMAs are responsible for keeping track of their own balances and ensuring that principal and interest payments are appropriate.

In summary, the PMAs' appropriated debt is not analogous to a fixed-rate home mortgage.

- APPA suggested that data needed to compute the "interest rate gap" (by comparing the PMAs' interest rates and the Treasury's interest rates at the time the PMA's debt is incurred) are available for the "vast majority" of Western facilities. This statement is contrary to what Western officials told us during our review.

- APPA stated that the 9.1 percent interest rate we used in our report to calculate the PMAs' financing subsidy in fiscal year 1995 represents the very recent interest rate paid on Treasury's outstanding bonds in fiscal year 1995. The 9.1 percent we used in calculating the PMAs' fiscal year 1995 financing subsidy represents the Treasury's average interest rate on its entire bond portfolio outstanding for fiscal year 1995, not just those bonds issued in fiscal year 1995. We used the 9.1 percent interest rate on Treasury's outstanding bond portfolio, which has maturities up to 30 years, because it most closely matches the PMAs' outstanding debt, which has maturities up to 50 years.

COMPARISON OF PMAS TO NONFEDERAL UTILITIES

- APPA stated that our use of average revenue per kWh to compare the power production costs of the PMAs to nonfederal utilities was "simplistic" and an "apples to oranges" comparison. We disagree. While we agree that average revenue per kWh should not be used as a substitute for price, it is a strong indicator of power production costs. For PMAs and POGs, average revenue per kWh should equal cost over time because each operates as a nonprofit organization that recovers costs through revenues. For IOUs, average revenue per kWh should represent cost plus the regulated rate of return. Given that about 80 percent of IOUs' rate of return (net income) is used to pay common stock dividends, which is a financing cost, average revenue per kWh also approximates power production costs for IOUs.

- APPA stated that our calculation of the average annual revenue per kWh for Southwestern's Willis system was incorrect because we did not consider that this project was financed by a nonfederal entity. Our report does not mention that the Willis system was financed by a nonfederal entity, because all three PMAs have ratesetting systems/projects with unique characteristics that we factored into our analysis but did not discuss since they were not the main focus of our analysis. APPA stated that the average revenue per kWh for the Willis project was 50 cents, not 66

cents, as cited in our report. Southwestern officials who read and commented on a draft of our report did not take exception to our calculation of the average revenue per kWh for the Willis project.

- APPA stated that the PMAs' power rates ". . . overtly subsidize irrigation assistance . . ." but did not provide any specifics. As noted in our report, Western is required to use its power revenues to recover capital costs of irrigation facilities that are beyond the ability of irrigation customers to repay (irrigation assistance). Our review did not find that irrigation assistance is a large subsidy currently being paid by Western's customers. Our report stated that as of September 30, 1995, according to Western, about $32 million of the $1.5 billion of total irrigation debt (construction costs incurred and assigned to power) had been recovered through electricity rates. To the extent that Western's ratepayers actually repay this irrigation debt, the power users are subsidizing irrigators. In addition to the existing irrigation debt, billions of dollars of additional irrigation construction costs are planned. These future irrigation investments have not been incurred, and it is questionable whether they ever will be. Until these future irrigation costs are incurred and repaid to Treasury, or funds are set aside for their future repayment, they do not represent a disadvantage to Western.

- APPA states that "close political oversight" is a common characteristic of public power but is "lacking" with respect to investor-owned utilities (IOUs). Our report did not focus on the "political oversight" of the IOUs; however, we do not agree that oversight of the IOUs is "lacking." IOUs, to varying degrees, are subject to oversight and/or monitoring by public utility commissions; the Securities and Exchange Commission; the Federal Energy Regulatory Commission (FERC); boards of directors; local, state, and federal governments; independent external auditors; customers; stockholders; bond rating agencies; bondholders; and various public interest groups. Based on our review, FERC's oversight of the PMAs is more limited than its oversight of IOUs.

OTHER

- APPA incorrectly states that our report did not mention that PMAs are required to transmit and dispose of their power and energy in such a manner as to encourage the most widespread use thereof at the lowest possible rate to consumers consistent with sound business principles. On page 16, our report states that ". . . PMAs sell electricity primarily on a wholesale basis with the legislated goal of encouraging widespread use of power at the lowest possible cost to consumers consistent with sound business principles."

- APPA suggests that our description of the rate review process in appendix VI of our report is incomplete because it does not address the public's involvement in the rate-setting process. APPA states that by excluding this information, our report will lead

readers to conclude that FERC's oversight of the PMAs' rate-setting process is "unduly limited." As agreed to with the requesters' staff, our report was to provide a brief description of FERC's oversight of the PMAs. We included a brief, page and a half description of this process in appendix VI.

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