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Accounting and Information
Management Division

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November 10, 1997

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The Honorable John R. Kasich
Chairman
Committee on the Budget
House of Representatives

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

Subject: Financial Management: Briefing on Federal Electricity Activities

At the joint request of your offices, on October 20, 1997, we briefed representatives of several Members of Congress on the results of our recently completed review of federal electricity activities. This work was done at your request and resulted in our September 19, 1997, report entitled, Federal Electricity Activities: The Federal Government's Net Cost and Potential for Future Losses (GAO/AIMD-97-110 and 97-110A). The enclosed briefing slides highlight the findings in that report. The review responded to your concerns about (1) any ongoing expenses incurred by the federal government to support the electricity-related activities of the power marketing administrations (PMAs),[1] Rural Utilities Service (RUS), and Tennessee Valley Authority (TVA) and (2) potential future losses from these activities given the move toward deregulation and increased competition in the electricity industry.

The federal government incurred net costs of over a billion dollars annually for fiscal years 1992 through 1996 to support the electricity-related activities of RUS and the PMAs. We estimated that the net costs to the federal government for fiscal year 1996 totaled about \$2.5 billion--\$0.4 billion for BPA, \$0.2 billion for

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[1]We reviewed four of the five PMAs: the Bonneville Power Administration (BPA) and the Southeastern, Southwestern, and Western Area Power Administrations (which we refer to as the three PMAs). The fifth PMA, the Alaska Power Administration, was excluded from our review because legislation has been enacted to sell it to nonfederal entities.

the three PMAs, and about $1.9 billion for RUS, including about $982 million in RUS loan write-offs. Cumulatively, for fiscal years 1992 through 1996, we estimated that the net costs were about $8.6 billion in constant 1996 dollars, including over $1 billion in RUS loan write-offs. The net costs associated with TVA were minimal. Under current policies and law, the federal government will likely continue to incur many of the same types of costs; however, future RUS loan write-offs cannot be accurately predicted.

We also reported that there is risk to the federal government of future losses from each of these entities because of financial difficulties faced by RUS borrowers, BPA, TVA, and one or a few projects at each of the three PMAs. As of September 30, 1996, the federal government was exposed in varying degrees to the risk of future losses because of its more than $84 billion in direct and indirect financial involvement in the electricity-related activities of RUS, the PMAs, and TVA. The risk of future losses relates to the possibility that RUS borrowers, the PMAs, or TVA would be unable to repay the full $53 billion in debt owed to the federal government or that the federal government would incur unreimbursed costs as a result of actions it took to prevent default or breach of contract on the $31 billion in nonfederal debt owed by these entities.

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We are sending copies of this letter to the Ranking Minority Members of the House Committee on the Budget and the Subcommittee on Water and Power Resources, House Committee on Resources. Copies will also be made available to others upon request.

We appreciated the opportunity to share the results of our work. In addition to the briefing slides we presented on October 20, 1997, we have enclosed a list of the Members of Congress represented at the briefing. If you have questions or desire additional assistance on any of these matters, please contact me at (202) 512-8341.

Linda M. Calbom

Linda M. Calbom
Director, Civil Audits

Enclosures (2)

Members of Congress Represented at the Federal Electricity Activities Briefing

October 20, 1997, 10:00 a.m.
Longworth House Office Building - Room 1334
Washington, D.C.

Rep. Franks (R-NJ)
Rep. Klug (R-WI)
Rep. Knollenberg (R-MI)
Sen. Mack (R-FL)
Rep. Meehan (D-MA)
Sen. Reed (D-RI)

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FEDERAL ELECTRICITY ACTIVITIES:

The Federal Government's Net Cost and Potential for Future Losses

Briefing for Congressional Staff

October 20, 1997 10:00 AM

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Background

- Requesters raised concerns about:
  - The significant ongoing expenses incurred by the federal government to support the electricity-related activities of the PMAs and RUS and
  - Potential future losses from the PMAs, RUS, and TVA given the move toward deregulation and increased competition in the electricity industry

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Overall Objectives

- For the federal government's electricity-related activities, we designed our work to
  - Estimate the fiscal year 1996 net recurring cost and, where possible, fiscal years 1992 through 1996 cumulative net recurring cost and
  - Assess the likelihood of future losses beyond the net recurring costs

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Scope

- Rural Utilities Service
- 4 Power Marketing Administrations
  - Southeastern
  - Southwestern
  - Western
  - Bonneville
- Tennessee Valley Authority

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Scope Limitations

- GAO did not:
  - Estimate the forgone revenue for federal, state, or local governments resulting from the tax-exempt status of the RUS borrowers, the PMAs, and TVA
  - Assess the reasonableness of the methodologies used by the operating agencies to allocate power-related costs to the PMAs for recovery

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Net Costs

- For fiscal year 1996, the federal government incurred net costs of about $2.5 billion for BPA, the 3 PMAs, and RUS
- For fiscal years 1992 through 1996, the federal government's net cost of operating these entities was about $8.6 billion, in constant 1996 dollars
- The net costs incurred by the federal government to operate TVA for fiscal years 1992 through 1996 were minimal

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Net Costs

- Criteria used to determine net cost
  - Federal accounting standards
  - OMB Circular A-25
  - Industry Practice

Full Cost

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Net Costs

Estimated Net Costs to the Federal Government

(Dollars in millions)

	RUS		3 PMAs		BPA		TVA		Total	Cumulative
Net Costs	1996	1992-96	1996	1992-96	1996	1992-96	1996	1992-96	1996	1992-96
Financing	$874	$3,812	$208	$1,155	$377	$1,974			$1,459	$6,941
Loan write-offs	982	1,049							982	1,049
Benefits	1	3	16	82	21	110	$1	$4	39	199
Construction			30	138		1			30	139
Other	21	112	(69)	157					(48)	269
Total	**$1,878**	**$4,976**	**$185**	**$1,532**	**$398**	**$2,085**	**$1**	**$4**	**$2,462**	**$8,597**

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Federal Financial Involvement

Dollars in billions

Entity	Direct	Indirect	Total
RUS	$32.3		**$32.3**
Three PMAs	7.0	$0.2	**7.2**
BPA	10.1	7.1	**17.2**
TVA	3.8	24.1	**27.9**
Total	**$53.2**	**$31.4**	**$84.6**

GAO Federal Financial Involvement

- The federal government would incur a future loss:
  - Direct involvement - to the extent the RUS borrowers, the PMAs, or TVA fail to make payments on federal debt
  - Indirect involvement - to the extent it incurs unreimbursed costs as a result of actions it took to prevent default or breach of contract on nonfederal debt

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Risk of Loss

- Criteria for assessing risk
  - Statement of Federal Financial Accounting Standards (SFFAS) No. 5, Accounting for Liabilities of the Federal Government
    - Probable, reasonably possible, or remote
  - Consistent with criteria used by bond rating services to assess credit risk for nonfederal utilities

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Risk of Loss

- For RUS, we reviewed the loan portfolio, assessed the production costs of key borrowers relative to their respective markets, and considered state regulatory actions
- For the PMAs and TVA, we considered the cost of electricity production and rates, key financial ratios, generating mix, competitive environment, management actions, and legislative and other factors

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Risk of Loss - RUS

- $10.5 billion owed by 13 financially stressed G&Ts
  - 4 borrowers owing $7 billion are in bankruptcy
  - 9 borrowers have invested in uneconomical plants and/or have formally requested debt forgiveness from RUS

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Risk of Loss - RUS

- Some currently viable borrowers are likely to face future financial difficulty due to
  - High production costs (27 of 33 G&Ts had average revenues per kilowatt hour higher than neighboring IOUs)
  - Competitive and/or regulatory pressures

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Mitigating Factor - RUS

- "All-requirements" wholesale power contracts between G&Ts and their member distribution cooperatives
    - Long-term contracts obligate the distribution cooperatives to purchase all of their power needs from the G&Ts
    - Short-term shield against competition

Risk of Loss -- RUS

- Despite the mitigating factor, it is probable that
  - the federal government will continue to incur losses on loans to financially stressed borrowers
  - additional losses will be incurred on borrowers that are not currently troubled, but will likely become troubled in the future

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Risk of Loss - Three PMAs

- Three PMAs competitively sound overall
  - Production costs average more than 40 percent below IOUs and POGs in the primary NERC regions in which they operate
- If required to recover all power-related costs, ability to remain competitive might be impaired

Risk of Loss - Three PMAs

- All three PMAs have at least one project or rate-setting system with problems that, taken as a whole, make risk of some loss to the federal government probable
- In aggregate, these problem projects or rate-setting systems represent 19 percent (about $1.4 billion) of the federal government's involvement in the three PMAs

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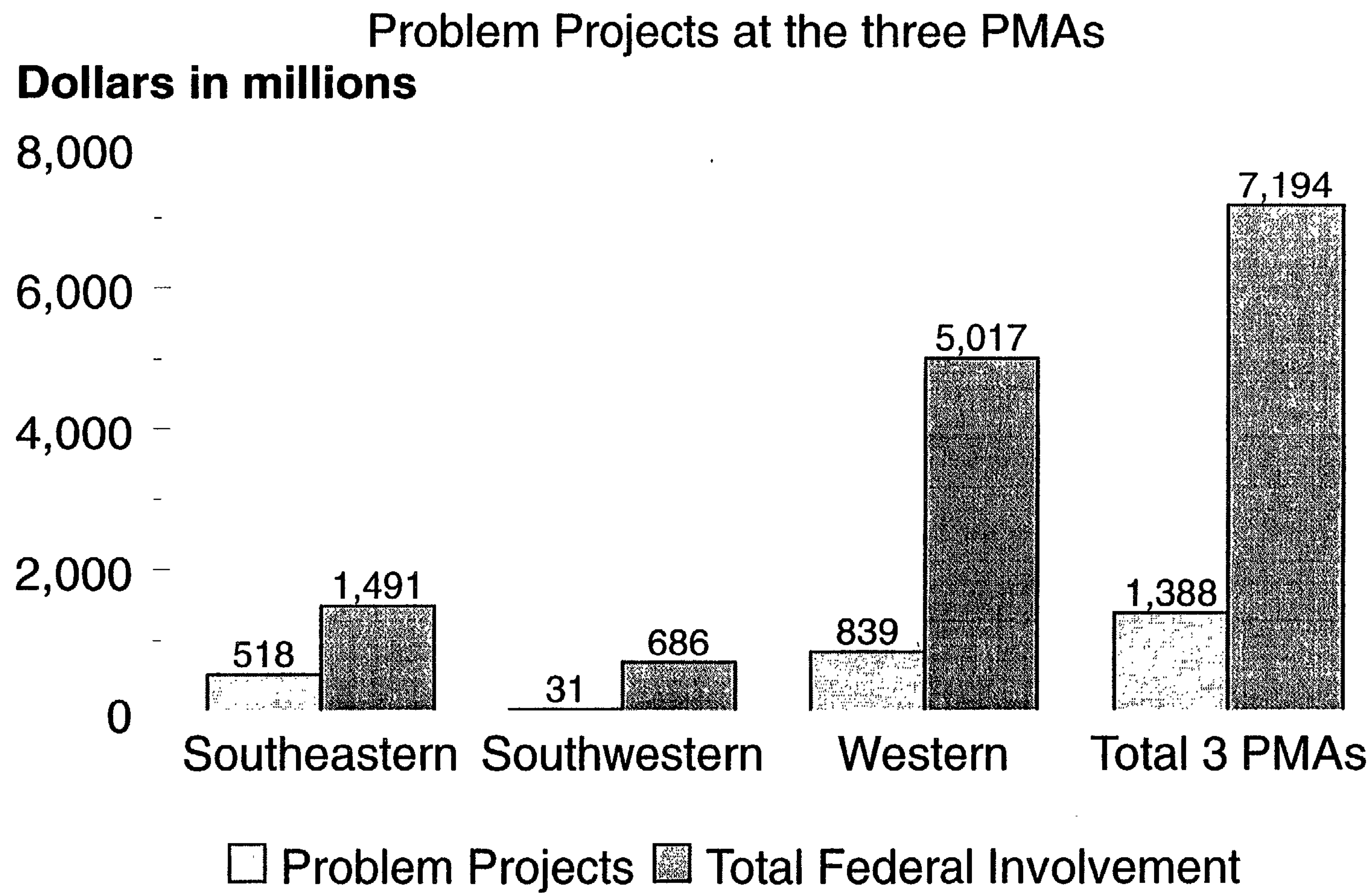
Risk of Loss - Three PMAs



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Mitigating Factors - Three PMAs

- Management Actions
  - Staffing
  - Benchmarking
- Cost-based contracts

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Risk of Loss - BPA

- Risk of loss through fiscal year 2001 is remote
  - Contracts through FY2001 with preference and industrial customers provide for stable revenues
  - Fish cost funding responsibility capped through FY2001
  - Current substantial financial reserve balance provides flexibility

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Risk of Loss - BPA

- Risk of loss after fiscal year 2001 is reasonably possible
  - Expiration of customer contracts
  - Risks from market uncertainties
  - High fixed costs
  - Substantial upward pressure on operating expenses

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Mitigating Factors - BPA

- Mitigating factors reduce risk of loss
  - Inherent cost advantages
  - Management actions to reduce operating costs
  - Extensive transmission system
  - Scheduled paydown of nonfederal debt beginning in 2013

GAO Mitigating Factors - BPA

While the mitigating factors reduce the risk of loss, we believe the risk of loss is still reasonably possible.

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Risk of Loss -- TVA

- Under current monopoly-type structure, risk of loss to the federal government from its involvement in TVA is remote
  - Long-term contracts provide stability and ensured cash flow
  - Exemption from the "wheeling" provisions of the Energy Policy Act of 1992 protects against outside competition
  - TVA can set rates with minimum oversight

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Risk of Loss -- TVA

- Risk of loss is <u>reasonably possible absent protection from competition</u>
  - TVA has chosen to defer costs related to its substantial nuclear investment to future years rather than including them in current or prior year costs being recovered from ratepayers
  - This cost deferral has resulted in a high level of fixed costs and deferred assets which leaves TVA vulnerable to future competition

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Risk of Loss -- TVA

- TVA's vulnerability to wholesale competition without protections was recently demonstrated when the Bristol Virginia Utilities Board announced that it is going to leave the TVA system for Cinergy, Inc
  - Cinergy offered firm wholesale power at 2.59 cents per kWh for 7 years, 40 percent lower than TVA's comparable wholesale rate of 4.3 cents per kWh

GAO Mitigating Factors -- TVA

- Mitigating factors reduce risk of loss
  - Inherent cost advantages
  - Management actions to increase revenues, cut operating expenses, and reduce debt
  - Extensive transmission system

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Mitigating Factors -- TVA

- TVA recently released a 10-year business plan that calls for:
  - Increasing power rates enough to increase annual revenues by about 5.5 percent ($325 million)
  - Limiting annual capital expenditures to $595 million
  - Reducing debt by about 50 percent from $27.9 billion as of 9/30/96, to $13.8 billion by FY 2007
  - Reducing its total cost of power by about 16 percent by FY 2007

Mitigating Factors - TVA

While the mitigating factors reduce the risk of loss, we believe the risk of loss is still reasonably possible.

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