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B-125042

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AUG 1 1974

The Honorable Henry S. Reuss
Chairman, Conservation and Natural Resources Subcommittee
Committee on Government Operations
House of Representatives

H1502

Dear Mr. Chairman:

As your office requested on May 28, 1974, we reviewed an excerpt "Financial Position of the Central Valley Project" from Mr. Herbert C. Westfall's May 20, 1974, testimony before the Water and Power Resources Subcommittee of the House Interior Committee (hearings on H.R. 14221). H1907

We examined the excerpt to ascertain

--its accuracy;

--the validity of Mr. Westfall's contention that "A rate increase is justified only if the projected unpaid balance exceeds the allowable unpaid balance"; and

--the effect such contention would have had on the November 1, 1973, electric power rate increase for the Central Valley Project (CVP).

ACCURACY OF THE EXCERPT

The factual data Mr. Westfall presented is accurate. His assumptions, however, concerning the method used by the Bureau of Reclamation, Department of the Interior, to compute interest expense is not entirely accurate and the basis for his conclusion on CVP's financial condition does not recognize all the necessary factors. These matters are discussed below.

Interest expense computation

Mr. Westfall testified as follows concerning the Bureau's interest expense computation:

"The calculation of a $1.3 billion deficit with rates existing prior to April 1, 1974 appears on page 20 of the June CVP Study and is described as the 'accumulated results of a repayment study ending in 2031 based on the current rate.' The

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> reference to a deficiency of $1.3 billion within the 50-year repayment period is in error under the conditions of the June CVP Study and is grossly misleading insofar as the financial position of the CVP is concerned. Interest charges of $1.1 billion can only be obtained by compounding interest upon interest and by disregarding investment already repaid. In this regard, it is noted that the unpaid electric investment of $436,194,000 supporting its claim of $1.3 billion deficit represents the total plant investment over the full 87-year period of the June CVP Study and is added as part of the computed deficit; however, this figure is meaningless since $204,909,710 of the total investment has already been paid, leaving an unpaid balance of only $31,920,290 in 1973."

The calculation which Mr. Westfall refers to is in a summary of a Bureau computer study. The summary creates the erroneous impression that the Bureau computed the interest expense on the estimated total electric investment in CVP ($436,194,000) without considering the amount of that investment repaid as of June 30, 1973 ($204,909,710). However, the Bureau did give proper consideration to the amount of investment repaid in computing the interest expense.

The following schedule shows the summary appearing on page 20 of the June CVP study representing the estimated results of a repayment study ending in fiscal year 2031 without a power rate increase.

	Amount (000 omitted)
Operating income:	
Net firm sales	$1,492,277
Project use	251,846
Peaking capacity	185,484
Other	214,360
Total	2,143,967
Operating expenses:	
Operation and maintenance	385,784
Purchased power	751,166
Replacements	79,157
Other	378,889
Interest	1,109,683
Total	2,704,679
Deficit in operating revenues	560,712
Unpaid electric investment	436,194
Required aid	337,561
Total deficit	$1,334,467

The net operating deficit of $560,712,000 was determined by netting the estimated operating deficit after 1973 ($765,622,000) against the net operating revenue before that date ($204,910,000).

Because the Bureau deducted the net operating revenues before June 30, 1973, from the operating deficits estimated after that date, the summary leaves the erroneous impression that the net operating revenues were not used to repay part of the electric investment. After the operating revenues and deficits were netted in this manner, however, it would not have been proper to show the net operating revenues as repaying the electric investment. To do so would have resulted in double counting the net operating revenues in the Bureau's summary. Thus, the unpaid electric investment is shown as not having been reduced by the repayments made as of June 30, 1973, which leaves the impression obtained by Mr. Westfall that those repayments were not considered in the Bureau's summary.

Our review of the repayment study which the Bureau summarized, however, shows that the total deficit of $1,334,467,000 comprised the following amounts.

	Amount (000 omitted)
Power investment (1944-73)	$ 236,830
Power investment (1974-2031)	199,364
Total power investment	436,194
Less repayments (1944-73)	204,910
Unpaid power investment	231,284
Capitalization of operating deficit (1974-2031)	765,622
Balance of power investment and deficit to be repaid as of 2031	996,906
Required aid to irrigation and waterfowl conservation costs	337,561
Total balance to be repaid as of 2031	$1,334,467

The above schedule shows that the Bureau did reduce the power investment for repayments made before June 30, 1973, and our test check of the interest computations showed that the Bureau properly considered such repayments in computing the estimated interest costs of $1.1 billion.

CVP's financial condition

Mr. Westfall testified as follows concerning CVP's financial condition:

"The unpaid balance of the CVP at the end of fiscal year 1973, was $31,920,290 on the total federal investment charged to commercial power of $236,830,000 (as shown in columns 30 and 31, respectively, on the payout schedule in the June CVP Study), which clearly demonstrates that the CVP is in good financial condition. This federal investment has been paid off much more rapidly than is required under established payback procedures for federal projects. Almost 87% of the current investment has been paid and the remaining balance is not required to be paid until the year 2023."

These facts are accurate and show that cumulatively CVP was in good financial condition as of June 30, 1973. The adequacy of power rates for CVP, however, is not determined entirely on the basis of the project's cumulative financial condition at that date.

As we pointed out in our report to you entitled, "California's Central Valley Project--Proposed Power Rate Increase" (B-125042, Nov. 19, 1973), the adequacy of power rates in Federal power projects is determined by rate and repayment studies that show actual costs and revenues through the current fiscal year and projected estimated costs and revenues through the rest of the repayment period. The repayment period extends to 50 years after the estimated date that the last authorized facility will be placed in service. This period extends through fiscal year 2031 for CVP.

For the existing power rate to be considered adequate, the rate and repayment study must show that the power rate will result in sufficient estimated revenues to pay all operating costs--including interest--through fiscal year 2031; repay each increment of existing and authorized investment in a facility within 50 years after its in-service date; and provide financial assistance to help repay the cost of other reimbursable project functions, such as irrigation.

Although CVP's cumulative financial condition as of June 30, 1973, was good, the Bureau's rate and repayment study showed the power rate on that date to be inadequate to cover estimated operating costs and repayment requirements through the repayment period. When a rate and repayment study shows this condition, the existing power rate is considered inadequate, regardless of the project's present financial condition. This ratemaking concept for Federal power sold by the Department of the Interior is consistent with criteria set forth in House Report 1409, 89th Congress, 2d session.

VALIDITY OF THE CONTENTION THAT "A RATE INCREASE IS JUSTIFIED ONLY IF THE PROJECTED UNPAID BALANCE EXCEEDS THE ALLOWABLE UNPAID BALANCE"

We believe that the basis cited by Mr. Westfall for establishing power rates on Federal projects is valid and is consistent with the repayment policy established by the Secretary of the Interior in 1963. This repayment policy was set forth in House Report 1409, 89th Congress, 2d session, in order to have a clear, concise statement of that policy.

As Mr. Westfall indicated, the Bureau, in preparing the rate and repayment study included in its June 1973 study, established an additional criterion that the power rate be adequate to provide revenues in each year of the remaining repayment period (1974-2031) to pay all operation and maintenance expenses, the interest expense, the purchased power cost, and the replacement cost. This additional criterion has been referred to as either the "no-deficit-year concept" or the "pinch-point criterion."

The Bureau prepared a revised rate and repayment study for CVP in November 1973 in which it modified the no-deficit-year concept to allow deficits in 2 years--1974 and 1976.

We believe that the no-deficit-year concept is inconsistent with the averaging concept inherent in rate and repayment studies and is inconsistent with the 1963 repayment policy statement issued by the Secretary of the Interior and subsequently set forth in House Report 1409, 89th Congress, 2d session.

In our opinion, the sole basis for testing the adequacy of the power rate is clearly stated in that report as follows:

> "As long as the unamortized investment is less than the allowable unamortized investment, this demonstrates that each generating project, and each increment of investment in the transmission system, is being repaid within the allowable period."

Existing laws establish broad criteria indicating that the recovery of cost and amortization of the Federal investment shall form the basis for establishing power rates. They do not, in our opinion, specifically provide that power rates be established so as to avoid a deficit in any single year of the repayment period. We believe, however, that under existing law, Interior could legally change its criteria for establishing power rates to provide for the no-deficit-year concept.

EFFECT THE CONTENTION WOULD HAVE HAD ON THE NOVEMBER 1, 1973, ELECTRIC POWER RATE INCREASE

On November 1, 1973, Interior announced a two-step power rate increase for CVP as follows:

--Effective April 1, 1974, a capacity charge of $1.15 per kilowatt-month and an energy charge of 3 mills per kilowatt-hour.

--Effective January 1, 1977, a capacity charge of $1.65 per kilowatt-month and an energy charge of 3 mills per kilowatt-hour.

This two-step increase resulted in projecting an estimated deficit in 2 years (1974 and 1976) of the remaining repayment period (1974-2031) and an estimated surplus of about $579.4 million by the end of fiscal year 2031. A surplus of about $78.4 million is needed to repay deferred costs, such as those for (1) excess capacity in, or authorized for, the Folsom South and Tehama-Colusa Canals and (2) facilities being constructed at Auburn Dam for installing generators which have not yet been authorized by the Congress.

The Bureau has not, to our knowledge, made a computer analysis showing what the effect on power rates would have been if Mr. Westfall's contention had been followed in preparing the November 1973 rate and repayment study. The Bureau did, however, make a computer analysis showing what the effect would be on the November 1973 rate and repayment study if--instead of the two-step rate increase--only the first increase cited above was used through the remaining repayment period ending June 30, 2031.

The one-step rate increase starting April 1, 1974--providing for a capacity charge of $1.15 per kilowatt-month and an energy charge of 3 mills per kilowatt-hour--shows that the actual unpaid investment would not exceed the allowable unpaid investment in any year of the repayment period and that there would be an estimated surplus of about $10.3 million at the end of fiscal year 2031. The study estimates that there would be 19 deficit years for the period 1974-93.

Therefore, if the Bureau had followed Mr. Westfall's contention in preparing its November 1973 rate and repayment study for CVP, the first increase announced by Interior as effective April 1, 1974, would be approximately adequate without the necessity for the second increase, although the first increase would have to be increased slightly to show sufficient revenues at the end of the repayment period to cover the deferred costs previously discussed.

We discussed our observations and conclusions with Mr. Westfall and with Bureau officials but, as your office requested, we did not obtain their written comments on this report.

We do not plan to distribute this report further unless you agree or publicly announce its contents.

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States