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BY THE U.S. GENERAL ACCOUNTING OFFICE

**Report To The
Secretary Of Energy**

**Policies Governing The Bonneville Power
Administration's Repayment Of Federal
Investments Need Revision**

By reviewing its Federal investment repayment policies Bonneville could better meet new legislative requirements, improve rate level determination credibility, reduce inefficient use of agency staff and resources, enhance management decisionmaking tools, and provide a more reliable assessment of repayment progress.

This report recommends that the Secretary of Energy direct Bonneville to adopt a cost-based approach to repayment and rate level determination which would replace the long-term forecast-based approach now used.



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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

ENERGY AND MINERALS
DIVISION

B-203382

The Honorable James B. Edwards
The Secretary of Energy

Dear Mr. Secretary:

The Bonneville Power Administration (Bonneville) increased its wholesale electric power rate by about 90 percent in December 1979 and has proposed another rate increase of about 50 percent effective July 1, 1981. Bonneville expects to follow these large increases with annual rate hikes over the next several years. These frequent increases are of major concern to Bonneville wholesale customers and Northwest rate-payers. Since Bonneville power sales revenues are a source of funds returned to the United States Treasury, its rate levels are also of interest in the Administration's efforts to balance the Federal budget.

Because of the widespread concern over Bonneville power rates, we conducted a survey of its policies for repaying Federal investments in power generating and transmitting facilities. Bonneville's repayment policies form the basis for calculating its annual revenue requirements, which in turn determine the size of its power rate increases and also affect the amount and timing of funds returned to the Treasury. Our survey did not address rate design or related topics other than repayment.

Our survey included the Department of Energy's (Department) study of alternative amortization methods initiated in September 1979 by the Office of Power Marketing Coordination. As a result of the Department's study, the Assistant Secretary for Resource Applications 1/ recently encouraged Bonneville to explore a cost accounting amortization method as a more rational method for meeting its repayment obligations and as an efficient means of implementing the Pacific Northwest Electric Power Planning and Conservation Act (Public Law 96-501, Dec. 5, 1980). Bonneville's repayment policies have changed markedly over the

1/Bonneville reported to the Assistant Secretary for Resource Applications until the Department reorganized on February 25, 1981. Under the reorganization, Bonneville reports to the Assistant Secretary for Conservation and Renewable Energy.

years. This report outlines the major factors which Bonneville should consider in evaluating further policy changes and, on the basis of these factors, recommends that Bonneville replace its current repayment methodology with a cost-based approach. We discussed the results of our survey with Bonneville officials, obtained their oral comments on the facts presented in this report, and incorporated suggested changes where appropriate.

BACKGROUND: A HISTORY OF
CHANGING REPAYMENT POLICIES

Bonneville repayment policies have undergone major changes over the years in response to changing circumstances and administrative interpretations of statutory requirements for Federal investment repayment.

Statutory requirements

The basic cost recovery and repayment provisions were set forth first in the Bonneville Project Act of August 20, 1937 (16 U.S.C. 832f). Section 7 of the Bonneville Project Act provides that:

"Rate schedules shall be drawn having regard to the recovery * * * of the cost of producing and transmitting such electric energy, including the amortization of the capital investment over a reasonable period of years."

The phrase "amortization of the capital investment over a reasonable period of years" is not further defined in the Act. However, as Bonneville attorneys noted in a 1980 court memorandum, its legislative history is "replete with discussion of Congress' concern that the Federal debt be repaid * * *." The legislative history shows the Congress intended that debt amortization proceed on a schedule determined by the potential output of Bonneville Dam, and that amortization be delayed only if the dam's entire output could not be sold.

Additional cost recovery criteria were included in section 5 of the Flood Control Act of 1944 (16 U.S.C. 825s), which provides that power from Corps of Engineers projects be marketed " * * * at the lowest possible rates to consumers consistent with sound business principles * * *," but it does not specifically define "sound business principles." However, the Pacific Northwest Electric Power Planning and Conservation Act repeats the "sound business principles" requirement and links it with amortization of the Federal investment. We believe this reaffirms the need for Bonneville to operate under sound financial policies of debt repayment.

Early history: Bonneville adopts
annual repayment schedules

Early in its history, Bonneville adopted annual amortization schedules as a businesslike approach to measuring repayment progress. In its second annual report to the Congress (fiscal year 1939), Bonneville used an annual amortization schedule (computed like a home mortgage with annual payments) to rebut criticisms that its projects were "white elephants." Bonneville predicted that it would exceed a \$4.1-million annual amortization requirement by an average of \$3.4 million annually and pay off the full Government investment in Bonneville Dam, plus interest, in 15 years. In its fiscal year 1944 report to the Congress, Bonneville said it was adopting business principles (accounting and financing) governing repayment whereby its accounts would

"* * * reflect the application of revenues in much the same way as private industries apply revenue to meet operating expenses, including * * * repayment of the power investment through an amortization schedule."

Subsequently, in 1946 Bonneville established scheduled annual revenue allocations for power construction cost amortization through memoranda of agreement with the Corps of Engineers and the Bureau of Reclamation. The Corps agreement specified annual capital and interest repayments over a 50-year span, administratively determined to represent a "reasonable period of years" for debt amortization. According to the original Corps-Bonneville agreement, schedules could be revised annually by mutual consent to reflect actual costs incurred and to improve future cost estimates. Bonneville maintained annual repayment schedules for its projects through fiscal year 1962, after which it eliminated progress reporting altogether.

The 1960s: repayment undergoes
dramatic change

An economic crisis descended on Bonneville during the late 1950s and early 1960s, causing it to depart from what it previously considered a businesslike approach to repayment. As shown in table 1 on page 4, a \$79-million cumulative repayment surplus achieved through fiscal year 1957 was fast approaching a cumulative repayment deficit because Bonneville could not meet its scheduled annual repayment requirements.

Table 1

Repayment Results and Forecasts
Fiscal Year 1957 through Fiscal Year 1965

<u>Status</u>	<u>FY</u>	<u>Annual repayment deficiencies</u>	<u>Cumulative repayment surplus (deficit) (note a)</u>
		----- (millions) -----	
Through	1957	N/A	\$78.8
Actual	1958	\$ 2.5	76.3
do.	1959	11.7	64.6
do.	1960	11.5	53.1
do.	1961	15.3	37.8
do.	1962	17.7	20.1
Forecasted	1963	17.3	2.8
(note b)			
do.	1964	13.4	(10.6)
do.	1965	9.4	(20.0)

a/Rounded to nearest \$100,000 for ease of presentation; amounts approximate due to Bonneville's subsequent revised power cost allocations.

b/Forecasted in fiscal year 1962.

Citing the prospect for continuing revenue insufficiency, the Administrator in 1962 concluded:

"Basically, there are three ways to attack this problem: modify our financial practices and payout schedules, sell power now being wasted, and raise our rates."

Believing that a rate increase (Bonneville's first since 1939) " * * * would seriously impair economic growth of the region, and must be avoided if at all possible," the Administrator focused on the other alternatives. Characterizing scheduled repayment benchmarks as "unnecessarily severe," the Administrator, with the Department of the Interior 1/ approval, eliminated schedules and adopted a policy which used future revenue forecasts to provide conformance to repayment requirements.

1/Bonneville was a component of the Department of the Interior until October 1, 1977, when it was transferred to the Department of Energy.

Under the revised policy, repayments made in any given year were not significant, and annual repayment surpluses or deficits were neither relevant nor determinable. The Administrator said the change would level out year-to-year revenue fluctuations and provide rate stability over extended periods. The policy, supplemented by revised project cost allocations and by revised accounting practices, had the effect of removing what the Administrator considered burdensome problems created by repayment schedules. According to the Administrator, the repayment policy and other changes, in concert with efforts to market more power and improve long-range power production planning, successfully reduced a possible 30-percent rate increase to 2.4 percent in 1965.

The repayment policy revisions began in 1963 and culminated with policy presentation to the Congress during legislative hearings for authorizing the third powerhouse at Grand Coulee Dam (Public Law 89-448, June 1966). An April 1966 House committee report transmitting the proposed legislation included a description of the policy, noting that it required power revenues to pay

--all operation, maintenance, and replacement costs, and

--interest charges on unrepaid investment at project rates,

and to repay

--each increment of capital investment in power generation within 50 years of being placed in service (except one 66-year project),

--each transmission system investment increment within 40 years of being placed in service, and

--irrigation construction costs beyond the ability of irrigators to repay within various prescribed periods.

In addition, the report described the policy's repayment study concept, which uses forecasted (hypothetical) year-by-year system revenues and costs over a (then) 81-year period to test revenue and rate level sufficiency for meeting repayment requirements.

Since 1966: continuing policy change

Although the repayment study concept outlined in the 1966 House committee report has remained the test for revenue and repayment sufficiency, the Department, the Department of the Interior, and Bonneville have continued to change repayment policies. Among the many policy changes made during the period the following appear most significant:

- Wherever possible, highest interest bearing capital obligations will be amortized first (1972).
- Irrigation repayment, capital power repayment, interest on unrepaid investment, operations costs, and maintenance costs may be deferred, on a short-term basis, in the order shown when annual revenues are insufficient (1974).
- Hypothetical forecasted interest, operations, or maintenance cost deferrals may be treated as "unpaid annual expenses" in repayment studies so long as they are capitalized and amortized with interest prior to repaying any other obligation (1974).
- Bonneville's cumulative repayments have been allowed to decrease between fiscal years 1973 and 1974, 1976 and 1977, 1977 and 1978, and 1978 and 1979 (see table 2, page 8).

FACTORS TO CONSIDER IN
EVALUATING REPAYMENT POLICIES

The Department has encouraged Bonneville to explore a cost accounting amortization approach as an alternative to current repayment study methodology. Bonneville officials told us that they have decided to retain existing repayment methodology in the near term but for the future are willing to consider a range of cost-based alternatives. Officials said Bonneville has neither identified a preferred alternative nor established a schedule for doing so. As discussed below, we believe a change to cost-based approach is appropriate and should be implemented as soon as possible. We identified a number of factors which Bonneville should consider in evaluating its current policies and alternatives. These considerations fall into two categories involving (1) requirements of the Pacific Northwest Electric Power Planning and Conservation Act and (2) principles of good Government.

Requirements of the Pacific Northwest
Electric Power Planning and Conservation Act

Two requirements of the act should be major considerations in evaluating repayment policies.

Repaying on a current basis

Section 2 of the act includes among its stated purposes that Bonneville customers and their consumers pay all costs of meeting the region's electric power requirements, "including the amortization on a current basis of the Federal investment * * *." Earlier statutes did not specifically mention repayment currency, and

under existing policies, there is no repayment schedule against which currency can be measured. Ability to assure the repayment is on schedule should be a prime consideration for Bonneville.

Bonneville's lack of repayment progress over the last decade (see table 2, page 8) and the lack of a direct way to determine whether it is "ahead" or "behind" in repaying its debt, raise the question: "Is Bonneville's repayment current?" Bonneville officials told us that repayment study forecasts prove that debts will be repaid on time, and also said that no other measures are needed to assess repayment currency. Since we found Bonneville's repayment study forecasts to be highly variable, we wanted to examine repayment status from alternative perspectives: (1) comparing current performance with repayment expectations had schedules been maintained and (2) contrasting Bonneville's modern repayment performance with its performance through fiscal year 1965. As discussed below, Bonneville's repayments have fallen far behind levels which would have been expected had annual schedules been maintained, and the agency has assigned proportionally less resources to repaying Federal debt since new policies were adopted.

To compare Bonneville's actual repayment progress with what could have been expected if Bonneville had followed repayment schedules throughout history, we asserted repayment schedule expectations through fiscal year 1979 based on annual amortization of each investment. We selected Bonneville Dam, one of Bonneville's oldest projects, to illustrate the application of our repayment schedule expectations to a single project. Repayment of this project's \$91.3 million initial investment, coming in service from fiscal year 1938 through fiscal year 1944, falls due during the fiscal year 1988 through fiscal year 1994 period. Using asserted repayment schedule expectations, \$58.6 million in repayments could have been expected. Instead, Bonneville has repaid only \$33.9 million which is 37.1 percent of the initial investment and only 57.8 percent of asserted repayment schedule expectations through fiscal year 1979. For the entire Bonneville system, our asserted repayment schedules anticipated \$1,093 million in repayments through fiscal year 1979, but Bonneville had only repaid \$620 million, or 56.7 percent of asserted repayment schedule expectations. Had Bonneville made regularly scheduled repayments, substantially more investment would have been repaid as of fiscal year 1979.

Table 2

Cumulative Repayment Progress Since FY 1970
(from repayment studies for fiscal years shown)

<u>Fiscal year</u>	Increase (decrease) in amount repaid (note a)	<u>Cumulative repayments</u>
------(millions)-----		
Through FY 1970	N/A	\$620
1971	\$ 39	659
1972	29	688
1973	6	694
1974	(2)	692
1975	40	732
1976	82	814
1977	(48)	766
1978	(34)	732
1979	(112)	620
1980	<u>31</u>	651

Net progress FY
1971 - FY 1980 \$ 31

a/Increases or decreases computed from previously rounded cumulative repayments for ease of presentation.

In contrast to the asserted repayment performance comparison through fiscal year 1979 above, through fiscal year 1965 Bonneville's repayments exceeded scheduled expectations. Even though Bonneville has earned nearly three-fourths of all system revenues since fiscal year 1965 (\$3,291 million), it has only applied \$233 million or 7.1 percent of those revenues to repayment. Through fiscal year 1965, it had applied \$418 million or 36.3 percent of its revenues (\$1,151 million) to repayment. Bonneville officials told us that the decline in repayments was primarily the result of circumstances beyond the agency's control (such as rapid cost acceleration, low water years) and that, based on existing repayment policies and repayment study forecasts, repayments are current. Our intention is not to imply that Bonneville repayments are not current when measured under existing repayment policies, but that past policies imposed more strict repayment requirements than those currently used.

Allocating costs among pools

Another requirement of the Pacific Northwest Electric Power Planning and Conservation Act which Bonneville should consider in evaluating repayment policies involves the need to establish cost pools as a basis for various rates. Section 7 requires that total costs be divided into cost pools to identify the cost of serving (1) the general requirements of preference customers and residential loads of investor-owned utilities, (2) direct-service industries, and (3) all other firm power sales. Bonneville must identify the costs of the existing Federal base system, as well as the costs of all other resources added to meet future loads, and allocate them to the proper cost pools for establishing rates. Complicating the process is the need to account for and allocate the costs of several new programs Bonneville is initiating in areas such as energy conservation, assistance to State and local governments, and fish and wildlife mitigation. Based on the experience in preparing the 1981 rate proposal, Bonneville staff told us that including the act's requirements in existing repayment study methodology has been difficult.

Principles of good Government

A second set of considerations which should guide Bonneville in evaluating repayment policies involves principles of good Government. There are many such principles which derive from Bonneville's responsibilities to ratepayers, taxpayers, and the Congress. Of these, we have identified four which are particularly relevant to Bonneville's repayment policies.

Establish credible and reliable processes

First, because of its leadership role in Northwest energy matters and its major influence on consumers' energy costs, Bonneville's rate setting methodology should be as understandable, reliable, and defensible as possible. This is particularly true of the repayment study methodology which determines Bonneville's overall revenue requirement, and thus, the size of its rate increases.

Bonneville staff note that several aspects of the repayment study cause confusion among customers, and that it is extremely difficult to use the methodology to explain the factors behind a rate increase. They also recognize the inherent difficulty of projecting revenues and costs

more than 80 years in the future, and concede that the methodology can produce inaccurate results. They believe these problems have contributed to a decline in Bonneville's credibility in the eyes of its customers and the public.

Their conclusions are supported by our review of Bonneville's 1979 wholesale rate filing which showed considerable lack of confidence in the repayment study methodology among wholesale customers and others. For example, in August 1979 a group of six investor-owned utilities served by Bonneville demonstrated their lack of confidence in the repayment study methodology in a letter to the Department. They said that repayment studies

"* * * are simply a conglomeration of marketing agency assumptions on cost and really offer nothing for determining the reasonableness of a proposed rate level * * *"

and concluded that Bonneville and other marketing agencies

"* * * can justify almost any rate level and devise a repayment study to support it * * *."

Coopers and Lybrand, an independent accounting firm hired to review Bonneville's December 1979 rate increase proposal, in a December 1978 progress report expressed reservations about Bonneville's repayment study methodology. The auditors noted, "* * * Even accounting and power management specialists are often unable to understand - or be able to adequately critique - the present repayment studies * * *." They also expressed concern that Bonneville's reliance on long-run cost and revenue forecasts could diminish customer confidence in the fairness of forecast-based rates. They told Bonneville that repayment studies were "not suitable as the principal means of communicating BPA revenue requirements * * *," and suggested that Bonneville adopt a different format. Bonneville rejected the Coopers and Lybrand suggestion and continues to use repayment studies as a basis for rate level determinations.

Facilitate management decisionmaking

Bonneville's repayment policies should facilitate (rather than inhibit) informed, timely management decisionmaking, particularly in view of new program requirements imposed by the Pacific Northwest Electric Power Planning and Conservation Act. Although the act became law in early December 1980, Bonneville was unable to incorporate the act's new program requirements into its repayment study process in time for the March 1981 public rate hearings concerning its proposed July 1981 rate hike.

Bonneville staff has expressed doubt that some of the act's requirements can be appropriately accommodated using the current repayment study methodology.

During the December 1979 rate increase public hearing period, customer groups hired outside consultants to analyze impacts of including or excluding certain projected repayment study costs. Bonneville had difficulties with assessments of this type because its computerized repayment study programs were just too cumbersome and costly to use in evaluating numerous alternatives. Bonneville has since improved computerized repayment study support. However, because of time-consuming data preparation required, we doubt that the current repayment methodology will help Bonneville managers assess critical contemporary issues with any more dispatch or accuracy than in the past. Such difficult contemporary issues include the rate and repayment impact of alternative electric power use forecasts, various conservation measures, or scheduling and cost changes in construction of power generating facilities.

Encourage economy and efficiency

Bonneville has a basic responsibility to maximize its economy and efficiency, and therefore, should assure that its repayment policies do not result in unnecessary use of resources. The current repayment study methodology is extremely complex and time consuming. While we did not attempt to quantify staff time involved, it appears that hundreds of staff-hours are spent in preparing future cost and revenue estimates, maintaining and using computerized support, and modifying estimates when assumed future conditions change. Bonneville staff believes that additional time and expense may be incurred compared to alternative cost-based approaches for determining the overall revenue requirement.

Avoid unsanctioned burdens on taxpayers

A final principle of good Government which Bonneville should consider is that the Nation's taxpayers should carry only those Bonneville-related cost burdens expressly sanctioned by the Congress. We believe that current repayment policies could violate this principle in two areas: (1) repaying highest-interest debt first and (2) allowing cumulative repayment decreases (see page 6).

The policy of amortizing highest-interest bearing investment first allows Bonneville to defer payment of older debts (bearing interest rates of 2.5 percent to 3 percent) until the end of their repayment periods, while accelerating payment of recent, higher cost debts. In this case, the Treasury must absorb the higher costs. A Price Waterhouse report reviewing Bonneville's repayment policy impact on a

Corps of Engineers project expressed agreement with the Corps that under Bonneville's highest-first amortization policy

"* * * the U.S. Treasury is not relieved of the higher financing costs of newer money as it must redeem the older and lower interest bearing bonds and notes first as they become due. The difference between the higher U.S. Treasury financing costs and the lower financing costs repaid by power users is made up by general tax revenues."

Other reviewers, including staff from the Treasury, the Office of Management and Budget, the Corps of Engineers, the Federal Energy Regulatory Commission, and the Department of Energy Inspector General's Office, have expressed similar sentiments. In Bonneville's case, because of recent cumulative repayment decreases, the past impact of this highest-first policy may be largely hypothetical, but it remains a key repayment study feature and as such has a material impact on forecasted interest costs, repayments, and today's rate levels.

The recent decreases in cumulative repayments (see table 2, p. 8) could represent an additional unsanctioned burden on taxpayers. The Department policy recognizes the potential for "unpaid annual expenses" to occur occasionally, and directs that they be capitalized and repaid at relatively current interest rates before any other amortizations. Bonneville officials told us that the cumulative repayment decreases are not due to unpaid annual costs but could not explain why they occurred. Most of the cumulative repayment decreases occurring between fiscal year 1978 and fiscal year 1979 carried 2.5-percent project interest rates, far below any current rates. In that case, using this practice, Bonneville could have reduced its cumulative repayments by as much as \$551 million, leaving only \$69 million repaid on about \$5.8 billion in capital investments. While we do not believe Bonneville would consider carrying this practice to its extreme, any cumulative repayment decrease at low interest rates appears additionally burdensome for the Nation's taxpayers.

CONCLUSIONS

In view of the above considerations, we believe the option of preserving Bonneville's current repayment policies intact is unacceptable. In our view, the current repayment study methodology makes it virtually impossible for Bonneville to adequately meet the requirements of new legislation and conform to principles of good Government. We believe a cost-based approach would offer many advantages over the current methodology because it could be designed to

- provide detailed, supportive evidence of repayment progress and a better basis for the Congress and others to judge whether Bonneville is meeting its repayment obligations;
- improve defensibility and credibility of rate level determinations through use of financial statement principles;
- reduce costs incurred in repayment study preparation; and
- enable Bonneville to develop more timely, responsive, and reliable management tools.

Bonneville staff note that, in implementing a cost accounting approach, they must resolve an issue involving depreciation service lives. Among possible approaches, they mentioned (1) calculate depreciation over the useful life of the asset (which averages 85 years for hydroelectric projects) and allow annual depreciation to be the measure of repayment or (2) adjust the calculation of depreciation to conform to the 50-year repayment period previously sanctioned by the Congress. Under the first option, provisions would be needed to assure that it does not create an additional burden for the Nation's taxpayers. Such provisions could entail an agreement whereby, in each year of repayment beyond the 50-year maximum, Bonneville would replace the authorized project interest rate with a rate equal to the Treasury's average cost of borrowing for that year. By such means, taxpayers would not bear the costs of extending repayment periods beyond the sanctioned "reasonable period of years" at lower project interest rates.

Finally, Bonneville has not adequately explained how the recent cumulative repayment decreases are consistent with sound financial accounting practices or departmental policy. It appears to us that these decreases could represent recapitalizing previous repaid capital investments (at original project interest rates) in order to free funds for paying annual expenses. Because of the large differential between current and original project interest rates, this practice could create an unsanctioned burden for taxpayers. Rather than recapitalizing previous repaid debt at original project rates during revenue-short years, departmental policy directs that unpaid annual expenses be capitalized and repaid at relatively current interest rates before any other amortizations.

RECOMMENDATIONS

In order to meet requirements of the Pacific Northwest Electric Power Planning and Conservation Act, provide more reliable and understandable information to ratepayers and

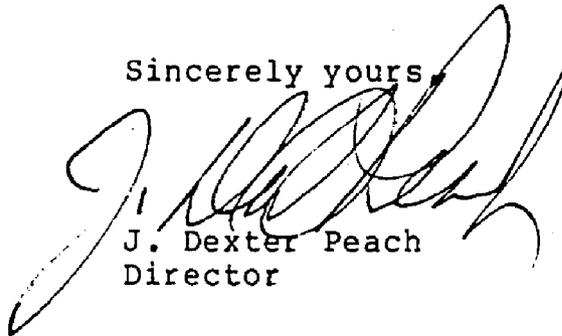
the Congress, promote increased management efficiency and effectiveness, and better protect taxpayers' interests, we recommend that you direct Bonneville to:

- Develop and implement a cost-based approach to revenue need determination to replace the current repayment study methodology to use in preparing the July 1983 rate proposal. Bonneville should develop a schedule for implementation within 60 days of this report. In implementing such an approach, Bonneville should carefully consider approaches such as retaining the congressionally sanctioned 50-year maximum repayment period or, if repayment periods are extended to equal asset lives, should consider adjusting interest rates during each year of the extension period to equal the Treasury's average cost of borrowing.
- Evaluate and explain decreases in cumulative repayments in responding to this letter, and, if these decreases are found to be recapitalizations or refinancing of previously repaid investments, stop the practice immediately.

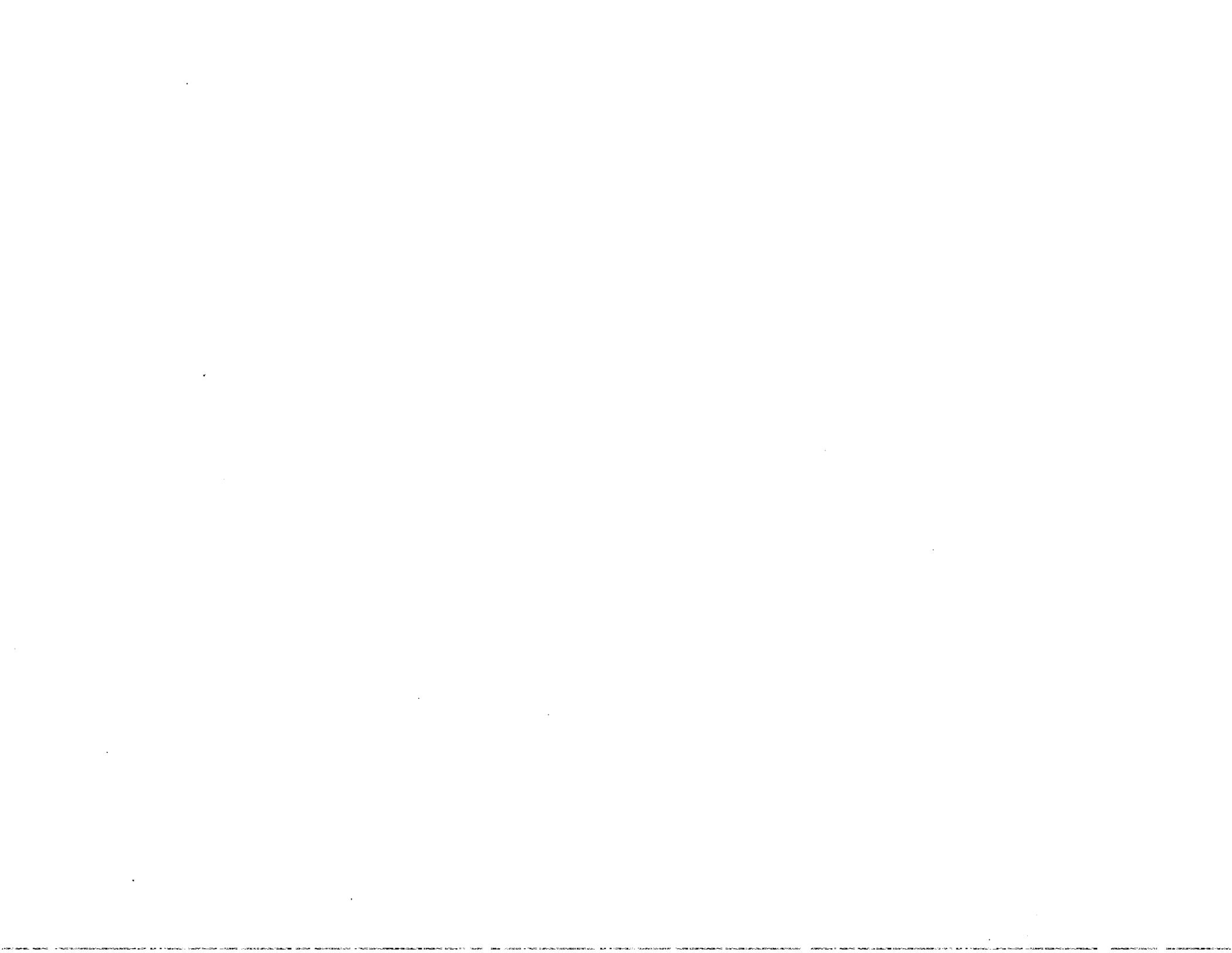
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As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House Committee on Government Operations and the Senate Committee on Governmental Affairs not later than 60 days after the date of this report, and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

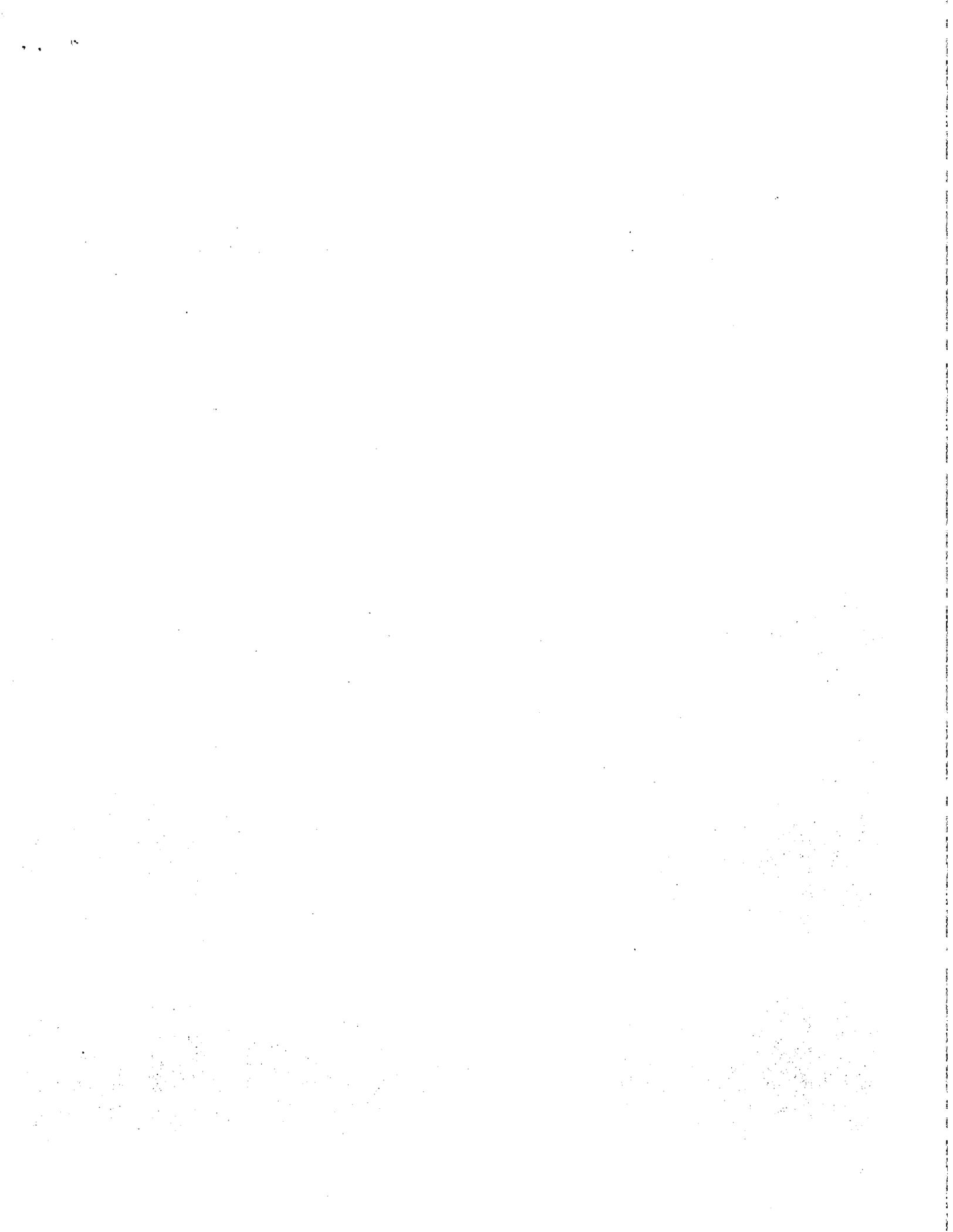
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J. Dexter Peach
Director







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