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BY THE U.S. GENERAL ACCOUNTING OFFICE
Report To The Secretary Of Energy

Policies Governing Bonneville Power Administration's Repayment Of Federal Investment Still Need Revision

The federal government, through the Bonneville Power Administration, has invested over \$7 billion in hydroelectric facilities in the Federal Columbia River Power System. Through 1964, Bonneville repaid the federal investment using fixed annual repayments. However, in 1965, Bonneville dropped fixed annual repayments and adopted the repayment study method for determining revenue requirements. The repayment study is designed to produce revenues to pay costs, including repayment of the federal investment. The only requirement is that the projects be repaid within their scheduled life. The federal investment, however, is the lowest category of expense; therefore, if revenues are insufficient to cover all expenses, the federal investment is deferred. In the past 6 years Bonneville has experienced operating losses, resulting in nonpayment of the federal investment.

In 1981, GAO reported that Bonneville's repayment study method was inadequate and should be changed to a fixed/mortgage basis with required annual repayments. Since GAO's earlier report, Bonneville has not made any repayment because operating losses occurred in each year. GAO again recommends that Bonneville adopt a fixed mortgage-type repayment system in order to assure timely and equitable repayment of the federal investment.



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

RESOURCES, COMMUNITY
AND ECONOMIC DEVELOPMENT
DIVISION

B-201824

The Honorable Donald P. Hodel
The Secretary of Energy

Dear Mr. Secretary:

This report addresses the Bonneville Power Administration's repayment of the federal investment in the Federal Columbia River Power System. The report is a followup to a 1981 report and reiterates our prior recommendation that Bonneville adopt a mortgage-type repayment system. Recommendations to you are found on page 17.

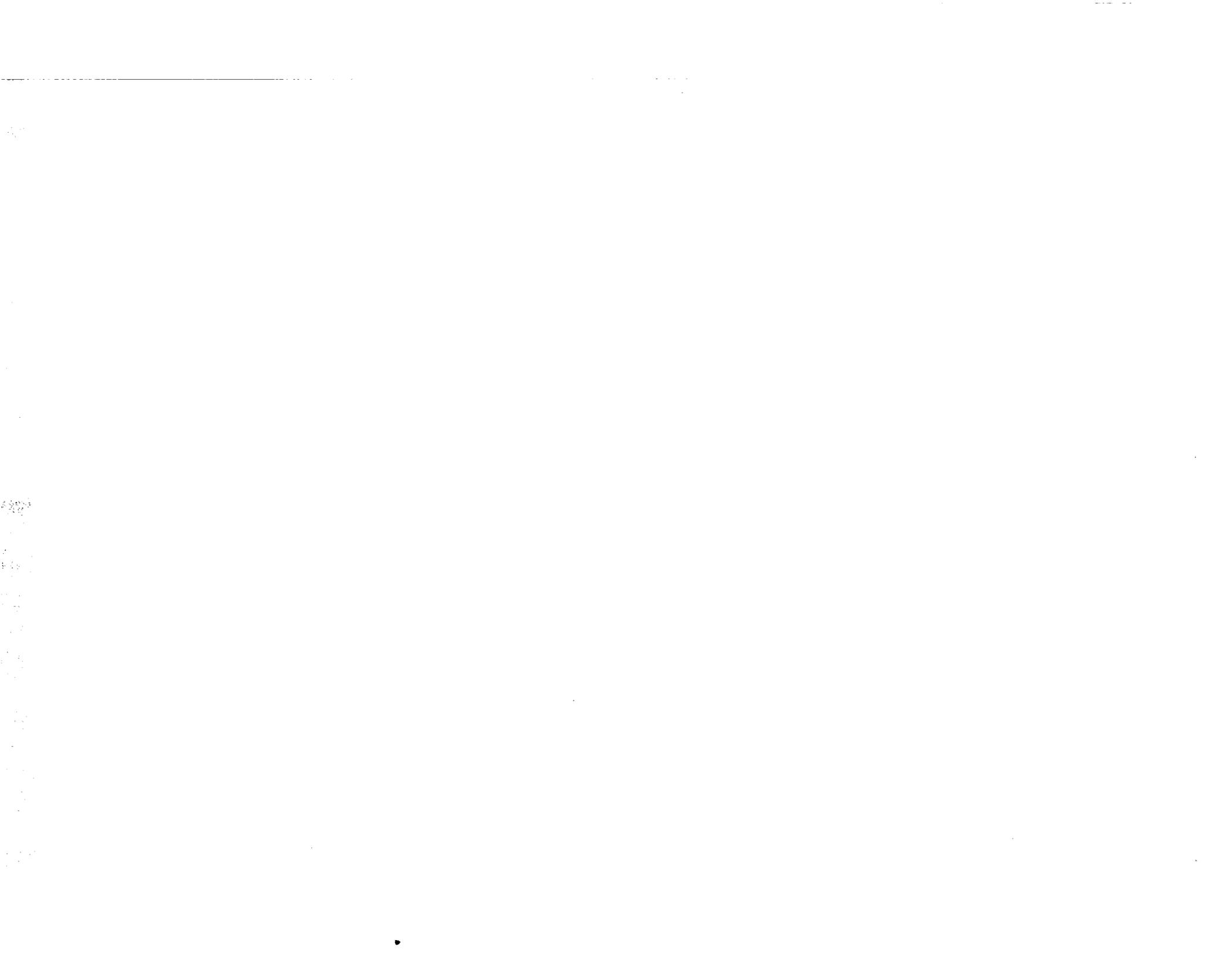
As you know, 31 U.S.C. §720 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are also sending copies of this report to the Administrator, Bonneville Power Administration, and the Director, Office of Management and Budget.

Sincerely yours,

A handwritten signature in black ink, appearing to read "J. Dexter Peach".

J. Dexter Peach
Director



D I G E S T

The Bonneville Project Act of 1937 created the Bonneville Power Administration and authorized it to market power from federal dams; construct and operate transmission facilities; encourage widespread use of electricity; and set rates to recover the cost of generation, transmission, and investment. This act and subsequent legislation require Bonneville to repay the federal investment in power generating facilities and set electric power rates at the lowest possible level consistent with sound business practices.

BONNEVILLE REPAYMENT METHOD

Bonneville adopted a fixed annual payment approach to repayment through 1964. However, in 1965 Bonneville dropped fixed annual repayments and adopted the repayment study method for determining revenue requirements. The repayment study is designed to demonstrate revenue adequacy by showing the recovery of annual costs each year by producing a schedule of amortization payments governed by the policy of repaying Federal investments within 50 years.

Annual revenues are applied to pay for the costs of operation and maintenance, purchased and exchange power, transmission service, and amortization of the federal investment. The federal investment is the lowest category of expense; therefore, if revenues are insufficient to cover all expenses the federal investment is deferred. The only requirement is that the project be repaid over its scheduled useful life. (See p. 2.)

Additional changes occurred in 1972, when Bonneville began applying a policy of making repayments on its highest interest bearing debt first rather than repaying debts on the basis of when they were incurred.

While federal law requires Bonneville to repay the federal investment in power facilities, it

has only repaid about \$638 million of the \$7.9 billion federal investment in the Federal Columbia River Power System. In the past 10 years, Bonneville has only repaid about \$43 million. In fact, Bonneville has experienced net operating losses over the past 6 years and has not been able to repay all the interest due during these years. No repayments were made in 1982 nor will any be paid in 1983. This can occur under the repayment method since the only requirement is that each project be repaid within its scheduled life. (See p. 5.)

PRIOR GAO REPORT

In 1981, GAO issued a report to the Secretary of Energy which stated that Bonneville's repayment study method was inadequate and should be changed to a fixed/mortgage type basis (required annual repayment of debt). Because of the problems noted in 1981, GAO decided to followup on the status of our prior recommendations.

GAO's followup work shows that Bonneville prepared, at the request of the Subcommittee on Energy and Water Development, House Committee on Appropriations, a study analyzing various repayment alternatives. The analysis compared Bonneville's repayment method with two fixed annual repayment methods, each with 50- and 85-year payback periods. The analysis showed that the currently used repayment method would return less to the U.S. Treasury than three of four repayment alternatives analyzed. The one exception assumed an 85-year repayment life with compound interest.

Bonneville did not make any changes to its repayment method and continues to object to any change because (1) shortfalls can still occur, (2) flexibility is lacking, (3) Department of Energy policy requires the repayment study method, and (4) higher electric rates would result. GAO recognizes these objections. However, solutions to each one are available. For example, shortfalls may occur, but there needs to be a disciplined approach where the shortfalls are made up, not continually deferred. The Congress in establishing the repayment system for the Tennessee Valley Authority provided for deferrals of up to 2 years. This type of discipline needs to be a part of Bonneville's repayment system. (See pp. 7 to 9.)

The federal investment is required to be repaid. GAO, therefore, continues to recommend that the Secretary of Energy require Bonneville to adopt a repayment method based on costs with fixed annual payments. In addition, GAO recommends that late or missed repayments incur interest costs at the higher of project interest costs or the Treasury's current cost of borrowing.

BONNEVILLE'S COMMITMENT TO CATCH UP

In addition to studying alternative repayment methods, Bonneville presented the Subcommittee with a plan to catch-up on deferred repayments by 1985. Bonneville recently estimated, however, that revenues for fiscal year 1983 will be about \$350 million less than anticipated. Bonneville estimates that it will fall further behind on payments to the Treasury by about \$119.4 million. The primary reason for these revenue shortfalls has been Bonneville's continual overestimation of expected electricity sales. However, Bonneville still plans to catch up on interest deferral by 1985 and make amortization payments for 1984 and 1985. (See p. 12.)

HIGHEST-INTEREST FIRST POLICY

Bonneville adopted a policy in 1972 of paying its highest interest debt first rather than paying the oldest debt. This policy change was adopted to help offset projected revenue deficits.

The practice of paying highest interest first reduces Bonneville's payments to the Treasury. As a result, the Treasury has to borrow more money at interest rates usually higher than those paid by Bonneville, thus costing the taxpayer more. For example, if Bonneville repaid the highest interest debt first on its outstanding debt (assuming straight-line depreciation, amortizing highest-interest debt first, and disregarding future additions or replacements), cumulative payments to the Treasury would be about \$222 million less after 5 years than if the debt was repaid in equal installments and Treasury's increased interest costs would be about \$18 million in year 5. This occurs because of the difference between Bonneville's borrowing costs and the Treasury's borrowing costs. To date, this practice has had little effect on either the

taxpayer or Bonneville, however, since only \$43.3 million has been repaid since 1972 when the policy was adopted. Under a fixed repayment schedule, however, the effect would be more significant.

GAO recommends that the Secretary of Energy abandon the policy of repaying highest interest first and require scheduled repayment of each increment of the federal investment in the power system based on its cost and repayment period. If revenues in any given year exceed the annual debt service, Bonneville should be authorized to apply surplus revenues to the highest interest-bearing projects. (See p. 17.)

AGENCY COMMENTS

The Department of Energy, in commenting on a draft of GAO's report, disagreed with GAO's recommendation that Bonneville replace its repayment study method of determining revenue requirements with a cost-based method incorporating a fixed annual repayment schedule. Subsequent to receiving the Department's comments, the Bonneville Administrator, in an October 3, 1983, letter to GAO, reaffirmed his commitment to catch up on repayment in 1984-1985 through several actions.

The Department's primary reason for disagreeing with GAO's recommendation is that the cost-based method would reduce Bonneville's flexibility and render it unable to deal with revenue shortfalls. GAO still believes that it would be more appropriate to develop a scheduled repayment system which would place more discipline into the repayment process and believes the flexibility needed to deal with revenue shortfalls can be designed into any system as shown by the Tennessee Valley Authority.

While GAO has not reviewed the actions the Bonneville Administrator outlined in his recent letter to catch up on repayment, GAO notes that the Administrator also stated in March 1982 that he had taken some "tough-minded" actions in order to prevent nonrepayments from occurring. However, Bonneville expected to fall further behind on repayments in 1983 by about \$120 million. Given Bonneville's repayment performance over the last 10 years, GAO continues to believe that a more systematic approach is needed to assure timely and equitable repayment of the federal investment. (See p. 18.)

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ABBREVIATIONS

CPA	certified public accountant
DOE	Department of Energy
FERC	Federal Energy Regulatory Commission
GAO	General Accounting Office
MW	megawatt
PMAs	Power Marketing Administrations
TVA	Tennessee Valley Authority



CHAPTER 1

INTRODUCTION

The Bonneville Project Act of 1937 (16 U.S.C. 832) created the Bonneville Power Administration and authorized it to market power generated from the Bonneville project in the Pacific Northwest. The act authorized Bonneville to (1) sell electricity at wholesale to public bodies, rural electric cooperatives, and private agencies, (2) construct, operate, and maintain a transmission system in order to interconnect the Bonneville Dam with other federal projects and publicly owned power systems; encourage the widespread use of all the electricity generated; and prevent monopolization by limited groups, (3) give preference to publicly owned distribution systems, and (4) set rates to recover the cost of generation, transmission, and investment. By virtue of the Federal Columbia River Transmission System, Bonneville now markets all power generated at federal facilities in the Pacific Northwest.

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 act does not further define the phrase "amortization of the capital investment over a reasonable period of years." However, as Bonneville attorneys noted in a 1980 court memorandum, the act's legislative history is "replete with discussion of Congress' concern that the Federal debt be repaid"

Subsequent legislation, the 1974 Federal Columbia River Transmission System Act (16 U.S.C. 838g) and the 1980 Pacific Northwest Electric Power Planning and Conservation Act (16 U.S.C. 839e(a)(1)), requires Bonneville to set rates for selling federal power and transmitting nonfederal power to recover the amortization of the federal investment over a reasonable period of years. Further, Bonneville is directed to set electric power rates at the lowest possible level, consistent with sound business practices. Early in its history, Bonneville adopted a cost-based approach to determine its revenue needs. This approach incorporated a fixed repayment schedule. With this approach, Bonneville repaid the cost to construct power facilities in a series of prescribed payments. Bonneville considered fixed repayment 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." In its fiscal year 1944 report to the Congress, Bonneville said that

it was adopting business principles 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."

In the late 1950's and early 1960's, Bonneville had insufficient revenues to meet its scheduled annual repayments and departed from the annual amortization schedule. Believing that a rate increase (Bonneville's first since 1939) would seriously impair the region's economic growth and should be avoided if at all possible, the Administrator chose to study other alternatives. In 1962 he concluded that:

"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."

With Department of the Interior¹ approval, the Bonneville Administrator eliminated scheduled annual repayments in fiscal year 1964 and adopted a revised policy of forecasting future revenues--the repayment study method. Under this method, estimated revenues are projected to cover projected expenses, including the federal investment, over the repayment period of the facility. The repayment study is designed to demonstrate revenue adequacy by showing the recovery of annual costs each year and by producing a schedule of amortization payments governed by the policy of repaying federal investments within 50 years.²

Annual revenues are applied to pay for the costs of operation and maintenance, purchased and exchange power, transmission service, and amortization of the federal investment. If revenues in a single year are insufficient to repay the federal investment, the unpaid amount is then included in the total outstanding investment to be amortized over the remaining life of the project.

The Administrator said that the change would level out year-to-year revenue fluctuations and provide rate stability over

¹Bonneville was an Interior Department agency until October 1, 1977, when it was transferred to the Department of Energy.

²As a matter of policy, Bonneville has adopted a repayment period of 50 years. However, the 1974 Transmission Act requires transmission lines to be repaid within 35 years, and the authorizing legislation for the third powerhouse at Grand Coulee Dam requires repayment in 66 years.

extended periods. Supplemented by revised project cost allocations and accounting practices, the repayment study method had the effect of removing what the Administrator considered burdensome problems created by scheduled repayment. According to the Administrator, in 1965, the revised repayment policy, together with efforts to market more power and improve long-range power production planning, reduced a possible 30-percent rate increase to 2.4 percent.

Additional changes occurred in 1972, when Bonneville began applying a policy of making repayments on its highest interest-bearing debt first rather than repaying a portion on each increment of debt. This policy had the effect of reducing Bonneville's overall interest expense, resulting in lower payments to the U.S. Treasury.

In June 1981 we issued a report³ to the Secretary of Energy concerning Bonneville's repayment of the federal investment. The report stated that adopting a cost-based method to determine revenue requirements and the fixed repayment schedule such a method entails would

- 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.

The report recommended that the Secretary of Energy direct Bonneville to return to a cost-based method of determining revenue requirements as used from fiscal years 1939 through 1964.

At Bonneville's fiscal year 1982 appropriations hearings (March 2, 1982) the agency was criticized for its poor repayment history. Bonneville was directed by the Chairman, Subcommittee on Energy and Water Development, House Committee on Appropriations, to examine our June 1981 report on its repayment policies and to report its position on the recommendation that it adopt a cost-based method with a fixed schedule of amortization. Bonneville's Administrator responded to this directive with a study comparing Bonneville's current repayment method with two alternative systems he considered to be cost-based, but took no action as a result of this study.

³Policies Governing the Bonneville Power Administration's Payment of Federal Investments Need Revision, EMD-81-94, June 16, 1981.

The Administrator responded to Subcommittee criticisms by stating that the two alternative cost-based systems did not reveal marked differences and that he had taken actions to prevent missed repayments in the future. The Administrator also stated that he has made provisions to recover all deferred interest since 1979 and to make regular amortization payments by the end of fiscal year 1985. The Administrator, through the Secretary of Energy, in a September 14, 1982, letter, disagreed with our recommendation that Bonneville adopt a cost-based method of repayment. He stated there are many methods that might be used which would be "cost-based" and that Bonneville is already doing what we recommended.

OBJECTIVES, SCOPE, AND METHODOLOGY

Our objectives in this review were to followup on actions Bonneville has taken on our earlier recommendations and analyze Bonneville's proposal for catching up on its repayment.

To determine the actions Bonneville has taken on our prior recommendations, we relied on our June 1981 report for background material. We interviewed Bonneville officials responsible for repayment studies to determine what actions had been taken since our report was issued. We also analyzed the alternative repayment study that Bonneville prepared to determine how the study coincided with our recommendations. In addition, we reviewed federal laws and agency policy statements relating to repayments.

We analyzed Bonneville's proposal to catch up on deferred interest by 1985. In analyzing this proposal, we talked to Bonneville officials who developed it. We also reviewed documentation relating to Bonneville's initial 1983 rate proposal to determine how revenues and costs were estimated.

Due to the complexity of the repayment study, we did not independently verify all costs and calculations it contained. However, the financial data we used was from Bonneville's financial statements which were reviewed and approved by an independent certified public accounting firm. Therefore, we did not believe another review of all costs was warranted. Rather, we focused our attention on the reasonableness of key assumptions built into the repayment study, such as future sales of electricity and economic growth. We did not contact Bonneville customers, such as electric utilities or direct service industries, to determine their views on Bonneville's repayment practices.

Our review was performed in accordance with generally accepted government auditing standards and was completed in July 1983.

CHAPTER 2

BONNEVILLE HAS NOT CHANGED ITS

REPAYMENT PRACTICES AS WE RECOMMENDED

Bonneville's repayment of the federal investment occurred primarily in the early years of the agency's operations, with little repayment in the last decade. In 1981 we noted that Bonneville's current repayment study method made it almost impossible for Bonneville to adequately meet the requirements of the Northwest Power Act and to conform to principles of good government. Bonneville has not changed its repayment methods and it continues to fall behind in repaying the federal investment.

CURRENT STATUS OF REPAYMENT

At the end of fiscal year 1972 Bonneville had repaid about \$595 million of the total federal investment of \$3.1 billion, or about 19 percent. As shown in table 1, however, Bonneville has repaid only about \$43 million since 1972, for a total of \$638 million, or about 9.1 percent of total federal investment of \$7.03 billion.

Table 1^a

Bonneville Operating and Repayment History

<u>Fiscal</u> <u>years</u>	<u>Net oper-</u> <u>ating in-</u> <u>come (loss)</u>	<u>Cumulative</u> <u>plant in</u> <u>service</u>	<u>Repayment</u>		<u>Repayment</u> <u>as % of</u> <u>investment</u>
			<u>Annual</u>	<u>Cumulative</u>	
----- (000 omitted) -----					
1939-65	\$202,791	\$1,802,230	\$363,694	\$363,694	20.2
1966-72	151,364	3,131,054	231,313	595,007	19.0
1973	(24,055)	3,563,570	1,424	596,431	16.7
1974	(37,859)	3,680,337	0	596,431	16.2
1975	22,318	4,007,868	21,875	618,306	15.4
1976	67,126	4,705,129	3,347	621,653	13.2
1977	(49,933)	5,114,022	6,807	628,460	12.3
1978	(17,064)	5,533,230	7,131	635,591	11.5
1979	(69,949)	5,754,800	940	636,531	11.1
1980	(59,490)	6,009,790	75	636,606	10.6
1981	(5,891)	6,432,585	1,703	638,309	9.9
1982	(129,456)	7,030,110	0	638,309	9.1
1983 ^b	(126,038)	7,876,863	0	638,309	8.1

^aAll costs are net of Teton Dam costs.

^bProjected.

Department of Energy (DOE) policy¹ requires that deferred interest must be repaid before any payments can be made on the

¹Department of Energy Policy Statement RA 6120.2.

federal investment. Bonneville's recent operating losses have also made it impossible to pay all the interest due on the federal investment in 3 of the last 4 years as shown in table 2.

Table 2

Unpaid Interest^a

<u>Fiscal year</u>	<u>Total annual interest expense</u>	<u>Total interest paid</u>	<u>Unpaid interest</u>	<u>Cumulative unpaid interest</u>
------(000 omitted)-----				
1979	\$168,001	\$ 69,417	\$98,584	\$ 98,584
1980	183,779	169,958	13,821	112,405
1981	206,526	210,469	(3,943)	108,462
1982	251,800	208,073	43,727	152,189

^aA portion of the funds returned to the Treasury for fiscal years 1979 through 1982 was credited to repayment rather than to reducing the deferred interest because of year-end accounting adjustments.

RECOMMENDED CHANGES
IN REPAYMENT METHODOLOGY

Our June 1981 report recommended that Bonneville adopt a cost-based approach to repayment. We identified several problems with Bonneville's repayment study method which included:

- A lack of credibility and confusion. The repayment study method is inconsistent with utility practice. DOE's power marketing agencies, while part of the federal government, are the only "utilities" using this method and deferring repayments of debt. Also, since the repayment study method has been chosen, ratepayers have been confused about how revenues are calculated.
- High preparation costs. Preparing repayment studies is time consuming, difficult, and expensive.

We also noted that in January 1981, DOE's Office of Power Marketing Coordination encouraged Bonneville to explore a cost accounting amortization method as an alternative to the repayment study methodology. Others have also commented on Bonneville's repayment practices. For example, the accounting firm Price Waterhouse has also objected to Bonneville's repayment study method. A July 1981 Price Waterhouse report to the Army Corps of Engineers stated

". . . it is our position that the lack of a systematic annual reduction of the federal investment and legal subordination to nonfederal obligations is not

in accordance with sound business principles and does not coincide with the spirit of the aforementioned legislation. [The 1980 Pacific Northwest Electric Power Planning and Conservation Act]

"We therefore recommend that the BPA [Bonneville Power Administration] and the Corps undertake a coordinated effort with the Department of Energy to amend DOE Order RA 6120 whereby all increments of federal investment relating to Corps projects are systematically reduced on an annual basis"

Because of these shortcomings, we recommended in June 1981 that Bonneville adopt a cost-based approach that would:

- Provide detailed, supportive evidence of repayment progress and a better basis for the Congress and others to judge whether Bonneville was meeting its repayment obligations.
- Improve defensibility and credibility of rate level determinations by using financial statement principles.
- Reduce costs incurred in preparing the repayment study.
- Enable Bonneville to develop more timely, responsive, and reliable management tools.

Bonneville officials told us in September 1981 that they would retain the repayment study method for now, but for the future they were willing to consider cost accounting amortization as well as other cost-based alternatives we advocated. Bonneville officials recognized that cost-based alternatives to the repayment study method would require a fixed schedule of current annual payments on each increment of federal investment.

In considering cost-based approaches to determine revenue needs, Bonneville analyzed two alternate repayment methods (straight-line and compound interest), using two repayment periods (50- and 85-year), and determined the annual repayment that would be required under each method through 1985, calculated based on 1981 indebtedness. Bonneville then compared these annual repayments with those calculated under its repayment study method in terms of transfers to the U.S. Treasury. The analysis showed that the repayment study method would return less to the Treasury than all alternative methods, except the 85-year compound interest method. Bonneville has not adopted a cost-based approach to determine revenue needs nor has it taken action as a result of this analysis.

Bonneville's objections to a fixed repayment can be readily answered

Bonneville officials continue to argue against using a fixed repayment schedule, but their objections can be readily answered.

Their chief arguments are that (1) changing the repayment method will not stop shortfalls from happening, (2) a fixed repayment schedule is not flexible, (3) DOE policy requires the repayment study method, and (4) a fixed repayment schedule would result in higher electric power rates in the Pacific Northwest.

Shortfalls

Due to the nature of a hydroelectric generating system, shortfalls can occur under any repayment system because of the variability in the amount of water available. If the amount of water available for power production is less than estimated in the repayment study, generation and consequently revenues will be less than projected. This phenomena was recognized by the Congress in considering the 1965 authorizing legislation for the third powerhouse at Grand Coulee Dam and again in enacting the 1974 Transmission Act.

In 8 of the past 10 fiscal years, Bonneville has experienced revenue shortfalls, yet during this period below average water conditions have occurred in few of these years. Thus, it appears factors other than poor water conditions attributed to Bonneville's revenue shortfalls. A recent Federal Energy Regulatory Commission (FERC) Order approving Bonneville's rates noted that Bonneville's continued overestimation of loads, despite information to the contrary, has been a primary factor in revenue shortfalls.

The Tennessee Valley Authority (TVA), another federal utility, is an example of how discipline can be brought into repayments while at the same time dealing with the problem of revenue estimating. TVA received self-financing authority in 1959, and at that time, the Congress put TVA on a fixed repayment schedule to repay \$1 billion of the federal investment in the TVA system. TVA was to pay \$10 million the first 5 years, \$15 million for the next 5 years, and \$20 million thereafter until the \$1 billion was repaid--a period of about 54 years. Included in TVA's repayment requirement is a provision for deferral of up to 2 years in case of drought, poor business conditions, emergency replacements, or other factors beyond the agency's control.

TVA, however, has never missed a repayment since 1959 even though it has suffered low water years and, over the past few years, steadily increasing rates and less than anticipated demand. TVA's repayment system provides flexibility while at the same time the discipline needed to ensure that rates are adequate to assure all costs are met.

The TVA example shows that flexibility can be built into a repayment system to deal with unforeseen circumstances. Flexibility should not include, however, continued deferral of payments.

Flexibility

Bonneville officials are concerned that, under a fixed repayment schedule, a shortfall would force them to borrow to make payments instead of simply postponing the payments. We do not advocate borrowing to make scheduled payments. Instead, missed payments should be added to future year(s) repayments in order to keep Bonneville current on total repayments. This flexibility of making up shortfalls in future year(s) could be built into any system Bonneville designed. The point is to have repayments made.

DOE policy

DOE Order RA 6120.2 requires power marketing agencies to prepare a repayment study to assess whether rates are adequate. Bonneville officials have interpreted this to mean they must prepare a repayment study to determine revenue needs rather than using a cost-based method with a fixed repayment schedule. DOE's order does not prohibit using a fixed schedule, and the Bonneville Administrator's recent actions establishing a defined repayment to catch up on all deferred interest and amortization during 1983-85 support our belief that Bonneville has the authority to adopt a fixed repayment schedule. Further, the Secretary of Energy has the authority to change DOE's policy.

Increased rates

Bonneville officials are concerned that a fixed annual repayment schedule would result in higher rates--this concern caused Bonneville to abandon a fixed repayment schedule in fiscal year 1965. Legislation relating to Bonneville does direct the agency to set the lowest possible rates to customers, but it also requires that the rates be consistent with sound business principles and sufficient to recover the federal investment over a reasonable period of years.

WE RECOMMEND BONNEVILLE ADOPT A COST-BASED REPAYMENT METHOD

In our opinion, a cost-based method of determining revenue needs, with the fixed schedule of repayments, could eliminate several problems inherent in the repayment study method. Our 1981 report identified four objectives that adopting a cost-based method of revenue determination could accomplish:

- Establish credible and reliable processes.
- Facilitate management decisionmaking.
- Encourage economy and efficiency.
- Avoid unsanctioned burdens on taxpayers.

While Bonneville officials have made some efforts to accomplish these objectives, success is unlikely until Bonneville replaces the repayment study method with a more businesslike approach. Bonneville management should adopt cost-based practices that will return the agency to a fixed schedule for repaying the federal investment. Also, late or missed repayments should incur interest costs at the higher of project interest costs or the Treasury's current cost of borrowing.

Bonneville now pays interest on unpaid debt at the rate established for each federal hydroelectric project or the interest rate at the time the investment was incurred. However, if Bonneville fails to repay the Treasury, the Treasury must borrow money at current market rates. Bonneville's failure to make annual repayments over the past several years has increased the Treasury's cost of borrowing, which is supported through general tax revenues.

BONNEVILLE'S COMMITMENT TO CATCH UP ON REPAYMENT

In March 1982 Bonneville's Administrator responded to Subcommittee criticism² of poor repayment performance by stating that he had taken some "tough-minded" actions to reduce costs and increase rates in order to prevent nonrepayments from occurring in the future and also to make a provision in the upcoming rate case³ for recovery of deferred interest.

In May 1982 the Administrator wrote to the Subcommittee Chairman in response to a request that Bonneville study alternatives to its repayment study methodology:

"We have taken several steps to simplify the existing repayment system and to strengthen the integrity of the methodology by clarifying assumptions and improving our estimating procedures. . . . We have also modified our power sales contracts to provide for annual rate increases as needed. With these steps, we feel that we can be responsible to make appropriate payments to the Treasury while meeting our obligations to our customers and the region as a whole by maintaining the existing repayment method and obtaining appropriate rate increases."

Further, in August 1982, the Administrator stated that:

". . . BPA must be a responsible member of the Federal community as well as the region and therefore must pay

²Hearings before the Subcommittee on Energy and Water Development, House Committee on Appropriations.

³Rates effective October 1, 1982.

its debts in a timely fashion. I also feel that BPA's credit worthiness with the financial markets and the Federal Government is suffering because of its outstanding deferred annual expenses. . . . Not only must the current deferrals be eliminated but we also must make future planned amortization payments on schedule. However, in recognition of the economic condition of the region, I have determined that this burden will be built into the rates over a 3-year period and that during this 3-year period the payment of amortization will not be delayed. . . ."

To implement the Administrator's plan, Bonneville developed a revenue estimate in 1982 that was intended to assure repayment of deferred interest as well as the federal investment through 1985.

In fiscal year 1983 Bonneville increased its rates intending to generate sufficient revenues to cover expenses, amortize the federal investment, and catch up on past deferrals. These rates were expected to yield \$2.2 billion in fiscal year 1983 revenues, an increase of \$814.5 million over 1982. According to Bonneville, this increase would be sufficient to pay the total estimated deferral of \$217.9 million over the 3-year period of fiscal years 1983-85, plus the amortization normally scheduled for these years. The rate increase would produce a total transfer to the Treasury of \$222.7 million in fiscal year 1983, as shown by table 3.

Table 3

Bonneville Payment Schedule

<u>Fiscal year</u>	<u>Amortization</u>	<u>Deferred interest</u>	<u>Payment to the Treasury</u>
----- (000 omitted) -----			
1983	\$145,485	\$ 77,259	\$222,744
1984	115,623	63,697	179,320
1985	117,840	76,956	194,796
Total	<u>\$378,948</u>	<u>\$217,912</u>	<u>\$596,860</u>

Bonneville will fall short of achieving its revenue forecasts for fiscal year 1983. Bonneville recently estimated that revenues for fiscal year 1983 will be about 15.7 percent lower than projected. When Bonneville's rates were set in October 1982, it estimated revenues would be \$2.2 billion; however, revenue estimates are now only expected to be \$1.88 billion or \$350 million less than anticipated. Bonneville expects to fall further behind on payments to the Treasury by about \$119.4 million.

BONNEVILLE MAY NOT BE ABLE TO
CATCH UP ON DEFERRED INTEREST
AND AMORTIZATION PAYMENTS BY 1985

In order to make up these revenue shortfalls, Bonneville believes it has set rates sufficient to create revenues to catch up by 1985. Bonneville's success in achieving its forecasted revenues is highly dependent on the accuracy of forecasted electricity sales. In its Revenue Forecast Study, March 1983, Bonneville predicted that its total revenues would rise to \$2.815 billion by operating year (July to June) 1985, or a 36-percent increase over fiscal year 1983.⁴ Over the same period, forecasted power sales increase from 12,609 average megawatt (MW) to 13,802 average MW, a 9.5-percent increase.

For the past 10 years Bonneville has overestimated electricity sales. In addition, the extent of deviation between actual and forecasted sales has been increasing with the 1980-81 operating year forecast being over 15-percent greater than actual sales for non- and small generating public utilities.

Although Bonneville has made changes in its forecasting methodology, in 1982, in response to this overestimation problem, it does not appear that Bonneville has solved the demand overestimation problem. Between June 1982 and June 1983 Bonneville overestimated average loads by 8.5 percent. Bonneville's estimates for other load categories, such as peak and industrial loads, were also high. If this degree of overestimation continues, Bonneville's forecasted 9.5-percent increase in power sales over a 2-year period may not occur, again leaving Bonneville with a revenue shortfall.

⁴All 1985 figures cited here reflect a proposed rate increase occurring in November 1983.

CHAPTER 3

REPAYING HIGHEST INTEREST BORROWINGS FIRST

SUBSIDIZES BONNEVILLE CUSTOMERS

In 1972 Bonneville abandoned its practice of repaying the oldest federal investments first and began repaying projects with the highest interest rate first. Bonneville adopted this change to help offset projected revenue deficits. Bonneville's fiscal year 1972 annual report states, ". . . This method of amortization is expected to save substantial amounts of interest expense over the full repayment period"

Since its adoption in 1972, the policy of repaying highest interest rate projects first has drawn attention from several sources. For example, Price Waterhouse (as excerpted from its Presidential Audit Reports of April 1980) stated that:

". . . 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."

The Chief of the U.S. Army Corps of Engineers stated in an April 1979 letter to the Secretary of Energy that

"The Army Corps of Engineers feels this policy is improper. We feel that this procedure results in a subsidization of power users by the general taxpayer"

The Federal Energy Regulatory Commission stated in a December 1980 order approving power rates that:

"We note with continuing concern the policy of repaying the highest interest-bearing investment first while deferring amortization of lower interest bearing investments to a later time within the repayment period. . . ."

Why does Bonneville continue the highest-first policy? The Chairman, Subcommittee on Energy and Water Development, House Committee on Appropriations, in hearings held March 2, 1982, asked the Bonneville Administrator the same question. The Administrator responded that it is policy established by DOE Order 6120.2 and ". . . Sound business principles support this guideline since prudent management dictates minimizing expenses and using revenues in the most effective way. . . ." Bonneville's highest-interest first policy has been justified under sound business principles since prudent management dictates minimizing

expenses. While at this time Bonneville's practice does minimize its project repayment, it results in higher cost to the federal Treasury.

EFFECT ON U.S. TAXPAYERS

Bonneville's practice of repaying highest cost debt first has the effect of reducing its interest expenses, which keeps power rates in the Northwest lower. The highest-first policy also reduces the money Bonneville must return to the Treasury, but it increases the Treasury's borrowing, usually at interest rates higher than those paid by Bonneville. Although Treasury borrowings are increased, there has been little overall effect on the Treasury or Bonneville, because only \$43.3 million has been paid by Bonneville to the Treasury since the policy was adopted in 1972. However, if Bonneville's financial condition changes, allowing "full repayment," the effect on the general taxpayer (and Bonneville) could be significant.

A simplified analysis of Bonneville's debt structure shows the potential impact. (See assumptions on p. 15.) As of September 30, 1980, Bonneville owed about \$6 billion to the Treasury; \$3.8 billion with a payback requirement of about 50 years; and \$2.2 billion with a payback requirement of 35 years. The interest on this debt ranges from 2.5 percent to 16.85¹ percent, depending on prevailing rates when each increment of debt was borrowed.

If Bonneville repaid the highest interest debt first, cumulative payments to the Treasury (principal and interest) would total about \$222 million less after 5 years than if each increment of debt were repaid in equal amounts over the life of the assets it financed. This occurs because of the difference between the interest costs Treasury has to pay to borrow these amounts and the interest paid by Bonneville on these amounts. For example, Treasury's cost is estimated at 12.5 percent based on the January 1983 rate on public utility bonds compared with Bonneville's average interest cost of 4.5 percent.

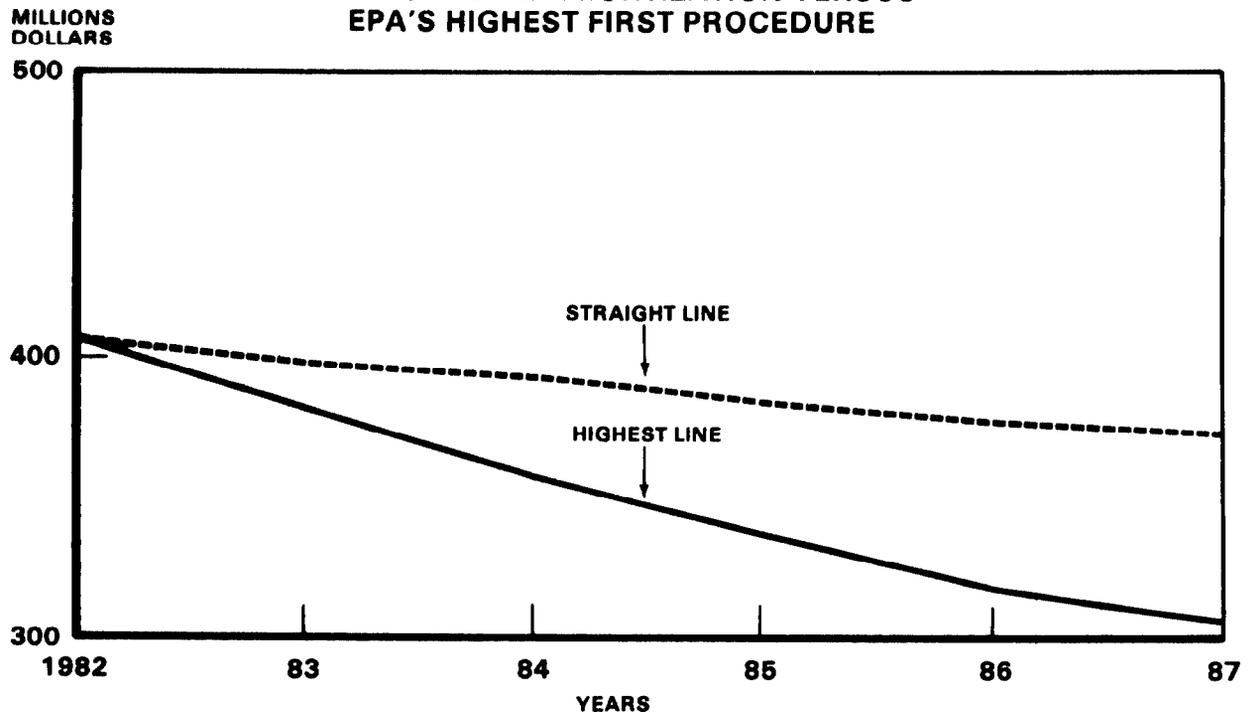
Figure 1 on the next page depicts the funds returned annually to the Treasury by the two repayment methods. A potential benefit to Bonneville customers, at the taxpayers expense, results from the difference between the interest costs Treasury has to pay to borrow these amounts and the interest actually paid by Bonneville. Based on Bonneville's average interest cost (4.5 percent), it would pay about \$10 million in interest annually on \$222 million, but the Treasury's cost to borrow \$222 million (at 12.5 percent) would be about \$28 million. Therefore, the Treasury (or taxpayer) under this analysis would incur increased interest costs of about \$18 million in year 5 if Bonneville

¹\$235 million of short-term debt at 16.85 percent was refinanced. Next highest long-term debt is 16.6 percent.

continues its policy of repaying highest interest rate projects first.

FIGURE 1

**FUNDS RETURNED TO TREASURY
STRAIGHT-LINE AMORTIZATION VERSUS
EPA'S HIGHEST FIRST PROCEDURE**



Assumptions

1. Both methods assume no new additions to plant and equipment and sufficient revenues exist to make repayment.
2. Straight-line amortization repays each increment of federal debt in equal amounts over the life of the asset.
3. Highest-first policy:
The first increment of repayment amortizes debt at 16.85 percent and proceeds to debt of lesser interest as repayment is completed. Disregards repayment of some lower-interest projects scheduled by Bonneville and a 5-year, no-call provision on bonds; therefore, actual differences will be less.

CHAPTER 4

CONCLUSIONS AND RECOMMENDATIONS

Federal law requires Bonneville to set rates to recover the federal investment in power facilities over a reasonable period of years. However, Bonneville has repaid little of the federal investment in the Columbia River Power System during the past 10 years. Bonneville began repaying the federal investment using scheduled annual payments and repaid about \$364 million through 1965. However, Bonneville dropped fixed annual payments in 1965 and adopted the repayment study method for determining revenue requirements. Also, in 1972, Bonneville adopted the policy of repaying its highest interest bearing debt first rather than repaying the debts incurred on earlier federal investments.

In 1981 we issued a report to the Secretary of Energy criticizing Bonneville's repayment study method and recommended that Bonneville return to the scheduled, cost-based repayment method. We also questioned Bonneville's practice of repaying highest interest debt first because it results in an undue burden on the taxpayer. In 1982 the Subcommittee on Energy and Water Development, House Committee on Appropriations, expressed concern over Bonneville's poor repayment performance and questioned whether Bonneville policies were consistent with sound business principles.

In 1982 Bonneville's Administrator committed the agency to catch up on repayment by 1985 and subsequently raised its power rates to increase revenues by 58 percent in fiscal year 1983. However, Bonneville will be unable to make its amortization payment or catch up on deferred interest in 1983 because it expects a revenue shortfall of \$350 million. Instead, Bonneville has chosen to raise power rates in 1984 and 1985 to recover \$217.6 million in deferred interest and make amortization payments in 1984 and 1985. Bonneville's success in repaying by 1985 depends on the adequacy of its revenue projections. However, Bonneville's estimates of projected revenues have been overstated in the past few years.

The practice of repaying highest interest debt first could result in a benefit to Northwest ratepayers from general tax revenues if Bonneville begins repaying the federal debt more rapidly. This practice has been justified under sound business principles since prudent management dictates minimizing costs. Although this practice reduces Bonneville's costs, it results in higher costs to the U.S. Treasury.

Bonneville continues to object to a change in its repayment system. However, given Bonneville's performance over the last 6 years, we continue to believe that a more systematic approach such as a cost-based on fixed mortgage-type basis is needed to assure timely and equitable repayment of the federal investment.

RECOMMENDATIONS TO THE
SECRETARY OF ENERGY

In order to provide more reliable and understandable information to the Congress, the federal government, and taxpayers in general and assure timely and equitable repayment of the federal investment, we recommend that the Secretary of Energy direct Bonneville to replace its repayment study method of determining revenue requirements with a cost-based method incorporating a fixed annual repayment schedule. Incorporated into the cost-based method should be a provision that late or missed repayments incur interest costs at the higher of project interest costs or the Treasury's current cost of borrowing.

We also recommend that the Secretary abandon the policy of repaying highest-interest projects first and require scheduled repayment of each increment of the federal investment in the power system based on its cost and repayment period. If revenues in any given year exceed the annual debt service, Bonneville should be authorized to apply surplus revenues to the highest interest bearing projects.

CHAPTER 5

AGENCY COMMENTS AND OUR EVALUATION

DOE, in commenting on a draft of our report, (see Appendix I), disagreed with our recommendation that it replace its repayment study method of determining revenue requirements with a cost-based method incorporating a fixed annual repayment schedule. DOE disagrees with our recommendation for several reasons.

First, DOE states that its current repayment methodology is embodied in DOE Order RA 6120.2 which governs the five power marketing administrations (PMAs) and that any change could affect the PMAs. We agree that RA 6120.2 affects all five PMAs and that a change for Bonneville could affect the others. But, we have not analyzed the other PMAs to determine if they are experiencing the same problems as Bonneville. However, if Bonneville adopts a cost-based repayment method incorporating a fixed annual repayment schedule, the extent to which the other PMAs conform to Bonneville could well improve the overall repayment of the federal investment by the PMAs.

Second, DOE stated that implementing our recommendation would reduce Bonneville's flexibility and render them unable to deal with revenue shortfalls. Our draft report recognizes that revenue shortfalls can occur under any repayment system. Further, our report clearly states that "a fixed repayment schedule should have the flexibility to make up shortfalls in the following years. This flexibility could be built into any system Bonneville designed." Making up revenue shortfalls in following years, as was recommended, is exactly what Bonneville is currently attempting to accomplish with its goal of recovering all deferred interest payments by the end of fiscal year 1985. As shown in the TVA repayment system example, needed flexibility to meet unforeseen conditions can be designed.

Third, DOE commented that it would not be appropriate to change to a fixed repayment schedule without considering a change in the repayment period. DOE suggests changing the repayment period to the useful life of the facilities--generally 85 years. Changing to a longer repayment period would have the effect of keeping rate increases low to implement our recommendation. However, it also means the Treasury will not receive its funds for a longer period of time. We believe that the 50-year repayment period is reasonable and consistent with utility practices. According to a FERC official, utilities generally amortize dams, generators, and turbines over a 50-year period. This amortization takes into account that dams may have a useful life of 70 years while the generator and turbines have a useful life of 30 years.

Finally, we would like to point out that FERC recently ruled on Bonneville's 1981 and 1982 rate schedule. FERC noted that Bonneville's payments to the Treasury of back payments and

interest were significantly behind what FERC considered to be a reasonable repayment schedule. FERC concluded:

"We find that Bonneville's continued utilization of its present method to establish rates will ultimately result in the failure of Bonneville's rates to meet the statutory standards set forth in the Regional Act. Bonneville's practice of pushing its repayment obligations into the future has generated a 'bow wave' of unpaid investment costs that are now approaching one billion dollars with no apparent end in sight. Nonetheless, Bonneville has made no discernible effort to mitigate this increasing problem. Indeed, Bonneville's 'Notice of Proposed Wholesale Power Rate Adjustment' for its superseding rates estimates that the amortization schedule in FY 1983 will be an additional \$65 million below existing repayment schedules. It thus appears that the problem will only be exacerbated, especially in light of the significant drop in BPA's system load from the levels forecasted in the repayment study."

Also, FERC stated that Bonneville's rates were far below the levels that would allow one to conclude the federal investment will be repaid within a reasonable number of years. Because of the noted deficiencies, FERC only gave limited approval to Bonneville's rates. We believe that FERC's ruling is a strong indication that Bonneville has problems with its repayment study methodology--problems which need to be rectified.

In addition to DOE's overall comments on the draft report, editorial comments were provided at the staff level. These comments were evaluated and changes made where appropriate. In an October 3, 1983, letter to us, the Bonneville Administrator reaffirmed his commitment to catch up on repayment in 1984-1985 through several improvements in its ratemaking process such as (1) more sophisticated load forecasting techniques, (2) a customer charge and an incentive rate for direct service industrial customers, and (3) increasing marketing flexibility in the Surplus Firm and Nonfirm Energy rate schedules. We have not reviewed the actions the Bonneville Administrator outlined to catch up on repayment. We would like to point out that the Administrator also stated in March 1982 that he had taken some "tough minded" actions in order to prevent nonrepayments from occurring. However, Bonneville expected to fall further behind on repayments in 1983 by about \$120 million.



Department of Energy
Washington, D.C. 20585

JUL 5 1983

Mr. J. Dexter Peach
Director, Resources, Community and
Economic Development Division
U.S. General Accounting Office
Washington, D.C. 20548

Dear Mr. Peach:

The Department of Energy (DOE) appreciates the opportunity to review and comment on the U.S. General Accounting Office (GAO) draft report entitled "Policies Governing the Bonneville Power Administration's (BPA) Repayment of the Federal Investment Still Need Revision" dated June 8, 1983, and Errata Sheet dated June 22, 1983. In essence, this draft report recommends that the BPA replace its presently authorized repayment study method of determining revenue requirements with a cost-based method incorporating a fixed annual repayment schedule. Under this latter method, a late or missed repayment would incur interest costs at the higher of project interest costs or the Treasury's current cost of borrowing. This letter provides our written comments on your overall recommendation. Under separate letter we are providing editorial comments, as well as numerical corrections of data and other informational errors.

At the outset it should be noted that the BPA is one of five power marketing administrations (PMA) whose repayment policy is controlled by DOE Order RA 6120.2. The repayment method defined by this DOE order was developed by the Department of Interior (DOI) over many years and confirmed in 730 DM 4 when BPA was in the DOI. It was continued in DOE Order RA 6120.2. Any changes to Order RA 6120.2 will affect the operation of all PMAs collectively. While Order RA 6120.2 pertains to all PMAs, each PMA does have legislation that applies to it exclusively. An example of exclusive legislation is provided by the fact that the BPA is the only self-financing PMA. In addition, the Federal Columbia River Power System (FCRPS), which includes Corps of Engineers and Bureau of Reclamation projects, is funded by bonds, appropriations and revenues from operations. This arrangement requires that any analysis focus on the particular implications for each type of funding.

The recommendation that BPA change to a fixed schedule of amortization must be considered in the total context of the complex financial situation within which BPA operates. Of primary significance is the fact that the repayment study method gives the BPA flexibility to deal with the uncertainties of revenue shortfalls and cost overruns beyond BPA's control. The need for this flexibility was recognized by Congress during the authorization hearings on the Grand Coulee Dam Third Powerplant in 1966 (Public Law 89-448). In that hearing a clear concern was expressed for BPA to have flexibility to meet

the "extremes of weather conditions, streamflows, current economic conditions, changing markets, and the absorption of new projects into the system (p. 72)." Recognition of the need for flexibility was further highlighted by a provision in the Pacific Northwest Electric Power Planning and Conservation Act (Regional Act) (Public Law 96-501) which calls for an interest rate penalty should the BPA be unable to meet its projected interest and amortization payments due to forces within its control. A fixed schedule of amortization would remove an essential element of flexibility from the BPA's financial operations.

Another beneficial aspect of the repayment study method is its greater tendency towards rate stability over time than other revenue requirement methodologies. This benefit was described in the Grand Coulee Dam Third Powerplant hearings as follows: "This (the repayment method) results in a uniform cost per unit of power sold and permits the maintenance of stable rates for extended periods (p. 72)." This benefit should be addressed in any analysis.

The circumstances which have given rise to the present under-recovery of costs would have prevailed under any method for scheduling repayment to the Treasury. Instituting a fixed amortization schedule would not bring these factors under control. It would provide a different assumption of how costs are incurred but would not in itself bring more repayments to the Treasury.

GAO's report does not consider the consequences BPA would face if it were put on a fixed amortization schedule but was not able to make scheduled payments. Depending on how the fixed amortization schedule was established, what the schedule was, and what the possible alternative ranges of requirements for repaying deficits might be, the BPA could face either a legal default or just have missed a due date which would have to be made up within some given reasonable period of time.

If the BPA is required to change to a schedule of fixed payments of capital costs, it could be necessary to provide some form of contingency fund, reserve account, additional borrowing authority or equity financing in order to provide a contingency during times when BPA experiences a short-fall of cash. At the present time the law does not provide for this type of approach. The current process is also the recognized rate setting mechanism for BPA and has been accepted as a basis for rates in the past two rate cases since the passage of the Regional Act.

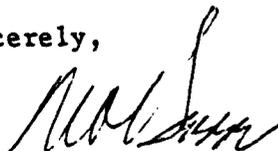
DOE also believes it would be inappropriate to change over to a fixed amortization schedule without considering other factors such as the repayment period. A maximum 50-year repayment period does not conform to generally accepted accounting principles or prevailing utility practices. Generally accepted accounting principles and common utility practices require that the costs of capital plant investments be amortized over their useful lives. In

the FCRPS the average useful lives of the generation plants of the Corps of Engineers and the Bureau of Reclamation which make up the bulk of the FCRPS investment are 85 years. Consequently, we believe that the average useful life would be a more appropriate period to consider for repayment if a change in the repayment method were to be made.

In conclusion, DOE believes that the BPA's present repayment method is an appropriate method for use at this time. The BPA will continue to consider alternative methods for amortizing the Federal investment and setting wholesale and transmission power rates.

DOE would like to express its appreciation for the opportunity to comment on your draft report and trusts that the GAO will consider these comments in preparing the final report.

Sincerely,



Martha O. Hesse
Assistant Secretary
Management and Administration

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