Committee on Resources

Witness Testimony

Testimony of
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My name is Ward Uggerud and I am Vice President for Operations at Otter Tail Power Company. Otter Tail is an investor-owned utility headquartered in Fergus Falls, Minnesota. We serve over 123,000 customers in the states of Minnesota, North Dakota and South Dakota.

The purpose of my testimony is to provide the subcommittee with information and analysis concerning the Power Marketing Administrations (PMAs) in general and the Pick-Sloan Eastern Division of the Western Area Power Administration (WAPA) in particular.

While I had been aware that PMAs were providing below-market, subsidized power to preference customers, it was not until last summer that I was made aware of the greatest fraud: the PMAs were giving away free power to preference customers at the expense of the American taxpayers.

This fact was revealed during a secret meeting of preference customers that took place in Sioux Falls, South Dakota, on July 17, 1995, to which I was inadvertently invited.

I know that you will be as astonished as I was when you hear the details of this meeting. But first, allow me to provide some background information to put this story in context.

A. Background

Proposals to sell the nation's PMAs have been around since the Reagan Administration. The privatization of the PMAs makes economic sense and would provide substantial savings to the American taxpayers.

PMAs no longer carry out their historic mission of providing power to poor rural and farm areas that could not receive power through the market. Today, PMA power goes -- without regard to need or entitlement -- to any customers who, because of allocations made decades ago, happen to be served by a rural electric cooperative or municipal operation. Nothing in terms of geography or income level distinguishes the customers who receive preference power from those who do not. The truth is that PMA preference power goes to a broadly diversified mix of residential, commercial and industrial customers who are completely homogeneous with surrounding customers served by utilities who do not receive it.

As was discussed last year, PMAs are heavily subsidized by the taxpayer in a variety of ways:

- PMAs are subsidized with below-market interest rate loans and disproportionately long repayment schedules.
- PMAs pick and choose which loans to repay, and when, leaving any shortfall with the American taxpayer to offset.
- PMAs and their preference customers are subsidized with preferential tax treatment.
- PMA rates are artificially low because they do not recover all costs of operation.

Thus, it is the taxpayer who pays the price for the discounted power that PMA preference customers receive.

As you might expect, there was significant, well orchestrated opposition to privatization efforts from PMA preference customers who have become used to their taxpayer subsidy. They continue to insist -- despite all evidence to the contrary -- that the PMAs:

a. are well managed;

b. recover all their costs;
c. provide power only to truly needy and deserving customers; and,
d. are a positive return to the U.S. treasury.

Finally, they continue to assert that privatization groups just want to raise rates for their own financial benefit.

So you can imagine my surprise when I received an invitation to the Mid-West Electric Consumers Association PMA Forum to discuss strategies to deal with privatization proposals for the PMAs.

B. The Meeting

The meeting took place in Sioux Falls, South Dakota on July 17, 1995. The primary speakers at the meeting were Alan Richardson of the American Public Power Association (APPA), Glen English of the National Rural Electric Cooperative Association (NRECA) and Jeff Nelson of the East River Power Cooperative. During the meeting I took copious notes, which are attached to my testimony as Exhibit A.

The focus of the meeting was the House-Senate Budget Resolution Conference Report, which proposed the sale of a few of the PMAs.

Alan Richardson began his comments by stressing that the collective and adamant opposition by PMA customers to any sale of PMA assets seemed to be working for now. He also stressed that there was considerable Senate opposition to any sale.

Richardson stated that the driving issue was the need for Congress to find revenue sources to help balance the budget and reduce the deficit, and that APPA and NRECA had to deal with the question of how to maintain political clout in this atmosphere. He said that most observers believe that the status quo of maintaining government control of federal power projects cannot continue and that options that give existing customers some additional control of the projects should be explored.

Glen English echoed Richardson's comments and stated that several options should be considered, including opposing the sale of PMAs, having existing customers either lease or buy PMAs or arguing that some PMAs should be sold while others should not. English thought it would be harder to prevent the sale of PMAs in every succeeding year.

English also acknowledged the tax problem associated with PMAs, namely, that they do not pay any because of federal sovereignty. Because of this, he stated that a lease of PMA facilities may be the best option for preference customers. Under a lease, it may be possible to remain exempt from paying future taxes and there may be other benefits owing to government ownership that could be maintained.

Jeff Nelson followed English and passed out a study done by the East River Cooperative Power on the financial aspects of selling the Pick-Sloan portion of WAPA. Nelson began by stating that the Pick-Sloan power rates were the lowest in WAPA.

Then Nelson dropped the "free power" (his words, not mine) bomb . Nelson said that $204 million of Pick-Sloan's costs were not being recovered because irrigation projects are not being built and the portion of generation construction costs allocated to these future irrigation projects is not being charged to existing power customers. Since these costs are not being recovered, the electricity production to be used for those future irrigation projects is being used now at no cost to existing PMA customers! (Exhibit A, p.6)

At first I thought that Nelson may have misspoke. But then he said it again later in the meeting. In response to a question about irrigation revenue, Nelson said the biggest issue was how to deal with the costs that are presently allocated to future irrigation projects which will never be built. He went on to say that PMA customers were getting the free use of that generation now and may not be able to get this portion for free if the PMAs are sold. (Exhibit A, p.11)

Following Nelson's presentation, a question and answer period ensued. If Congress and the American taxpayer are not

surprised enough by the disclosure of the free power issue, the following statements by the preference customers indicate that they are willing to do and say anything to perpetuate their fraud on the public:

- In discussing a proposal to buy the PMAs, Richardson stated that if you can buy the PMAs for $2.6 billion (the budget reduction figure), that is 50 percent of their net present value and it would be "a steal." (Exhibit A, p.10)
- English followed up on this point by saying that a deal for $2.6 billion and a guarantee of no rate increases is a deal to get it for "less than it's worth" and "that's what we want." (Exhibit A, p.10)
- Richardson went on to say that $2.6 billion is a difficult price to support politically, but "(i)t's a damn good deal if you can get it through." (Exhibit A, p.14)
- Another preference customer said that the best deal would be to buy the assets for $2.6 billion and sell them back to the investor-owned utilities for $9-14 billion. (Exhibit A, p.17)
- Echoing the statements of others at the meeting, another executive said that his group believes that rates can go down if the PMAs are sold because the PMAs can be more efficiently operated than they presently are. (Exhibit A, p.9)

By the end of the meeting there was general agreement that the "just say no" approach to PMA sales was not sustainable and that the group was still searching for a new, unifying position.

The Sioux Falls meeting confirmed what many already believed: that PMA customers were receiving subsidized power. More importantly, it revealed for the first time that the power was not only being subsidized, it was being sent to preference customers free of charge. The meeting also revealed a potential shift of strategy for preference customers -- from fighting to maintain the free power status quo to pursuing a sweetheart deal for the purchase of PMA assets. Either way, the preference customers remain committed to ripping-off the taxpayers.

As a result of the meeting, considerable local and national press has been aimed at this issue. Articles in The Wall Street Journal (Exhibit B) and The Fargo Forum (Exhibit C) confirmed the major aspects of what was discussed at the meeting.

Perhaps most importantly, reports of the meeting led this subcommittee to ask the General Accounting Office (GAO) to investigate the PMAs and the free power issue. The GAO has confirmed the free power scam and quantified its depth in Pick-Sloan -- over a half a billion dollars.

C. The Disclosure Issue

While the admission by public power executives that they are receiving free power is significant, it is doubly disconcerting because any information about the transaction is missing from WAPA's financial statements. In other words, this is a phantom transaction that would not otherwise be known if not for it inadvertent disclosure at the meeting in Sioux Falls. The over half billion dollars is not captured on the documents that are supposed to keep all Americans aware of their investment -- The WAPA Annual Report and accompanying Statistical Appendix.

It is interesting to note that the PMAs are not subject to the same disclosure standards as a normal business. Thus, the two statutes that were enacted to correct the abuses that led to the stock market crash of 1929 and the financial collapse of the U.S. economy and Great Depression of the 1930's, do not apply to the PMAs. Ironically, the 1933 Securities Act and the 1934 Securities and Exchange Act were directed at protecting small, local investors by establishing a program of full and fair disclosure. Under this program, "bright sunshine" would be the prescription for curing the ills of waste and abuse wrought by those who were benefitting from such activities.

Absent full disclosure by the PMAs, many small communities who are supposed to be the beneficiaries of the PMAs did not even know they were being taken for ride -- like the investors who lost it all in 1929.

D. KMPG Peat Marwick Independent Auditor's Report for WAPA

The importance of full disclosure is highlighted by what is disclosed on WAPA's Independent Auditors Report conducted by the public accounting firm KMPG Peat Marwick.

While KMPG Peat Marwick has provided unqualified opinions on WAPA's financial statements for fiscal years 1993

through 1995, their reports on WAPA's internal control structure and on compliance with laws and regulations expose a variety of questionable practices that could have a material effect on WAPA's financial statements in the future.

The 1993 through 1995 audits showed that at various times WAPA had:

- Delivered power to customers who were no longer under contract with WAPA; and,

- Failed to test and calibrate all meters yearly, in accordance with WAPA policy, possibly resulting in the incorrect metering of electrical power charged to customers.

KMPG Peat Marwick first reported these problems in 1993 and 1994, respectively. As of KMPG Peat Marwick's 1995 audit, the problems still existed. It seems elementary that a power company should only provide services subject to an existing contract and that the meters that measure the amount of power provided should be accurate.

Continued failure by WAPA to fully address the reportable conditions could lead to an adverse independent auditors report. For a publicly traded company, an adverse report spells disaster. The Securities and Exchange Commission (SEC) would halt trading on the company's securities and the company's directors could be subject to a shareholder liability suit.

For WAPA an adverse report would obviously not have the same effect, but it would certainly undermine management credibility and call into question the viability of WAPA to manage federal assets. Of course, Otter Tail firmly believes that exposure of the free powerscam and the stated intent of some public power executives to seek a substantially below-market deal for PMA assets already indicates that the time is right for privatization.

E. The PMA's Are Unregulated Monopolies that are Pursuing Monopoly Practices in the Marketplace

Would the issue of free power have escaped public scrutiny for as long as it did if the PMA assets had been owned by private regulated entities? The answer is emphatically no.

Since the inception of modern electric utility regulation, the states and the Federal government and Congress have known that the generation, transmission and distribution of electricity was a monopoly practice. As a result, private electric utilities are the most heavily regulated industry in the United States. Private electric utilities are subject to regulation over its corporate structure and business activities by the SEC through the Public Utility Holding Company Act of 1935. They are also regulated as to the rates, terms and conditions of wholesale sales and transmission access by Federal Power Act as administered by the Federal Energy Regulatory Commission. Private electric utilities are also regulated as to the rates charged to retail customers in the states in which they provide service by state public utility commissions. Finally, private electric utilities are subject to the information, disclosure and accounting requirements of federal securities laws. Such requirements provide that the disclosure of material information be fairly presented so that the american public can easily discern the activities of the business.

Multi-tiered regulation as applied to private utilities was directed at eliminating the abuses inherent in the monopoly of generating, transmitting and distributing power. Those abuses included: pricing power so low as to limit competition; disclosing only selected information associated with respect to operations so as to mislead the public at large; and obtaining services from certain corporate departments at costs that are not in line with the market.

Ironically, the PMA's are NOT subject to the vast majority of these laws. Indeed, the only law that tangentially applies is the Federal Power Act (FPA). However, under the FPA PMA's are not regulated as to the rates, terms and conditions of wholesale sales like a private utility nor are they subject to transmission regulation to the same extent as private utilities.

1. Rate Regulation

In 1978, the Secretary of Energy issued Delegation Order 0204-33 vesting the ratemaking authority she possessed under the various statutes described above in the PMA administrators and providing for limited FERC review. Subsequent to initial Delegation Order 0204-33, the Secretary expanded and clarified what the PMA administrators

would be required to perform and what FERC's actual review process would be in Delegation Order 0204-108. Under Delegation Order 0204-108, each PMA administrator has the authority to develop power and transmission rates for their respective PMAs. These rates are required to be certified by the PMA administrator as consistent with "applicable law" and at the "lowest possible rate to customers consistent with sound business principles." Interim rates prior to the final FERC review are established by the Deputy Secretary of DOE. The Bonneville Power Administration is governed by a different standard.

As noted, Delegation Order 0204-108 also empowered FERC to confirm, approve and place in effect rates developed by each PMA administrator. However, FERC's review of the rates is extremely limited and cannot replace the PMA administrator's actions.

FERC may not look "behind the numbers" in determining the extent to which the PMA administrator is in compliance with the above criteria. As FERC Chair Moler stated this past year in testimony provided to the House Resources Committee on PMAs, "[s]ignificantly, the Commission can only approve, disapprove or remand a PMA's proposed rates. Unlike our regulation of public utility rates, the Commission cannot modify a PMA's proposed rates." Indeed, Delegation Order 0204-108 notes, "[t]he Commission shall not review policy judgments and interpretations of laws and regulations made by power generating agencies."

In sum, rate regulation applied to public utilities under sections 205 and 206 of the Federal Power Act is not applicable to the PMAs. The 205 and 206 standard, which requires that a utilities' rates be just, reasonable and nondiscriminatory, has no bearing on the establishment of PMA rates. Because PMA power and transmission rates are not subject to evaluation under the 205 and 206 standard, the PMA administrators, oftentimes in conjunction with the preference customers, are able to establish gross assumptions for repayment and cost recovery, thereby grossly undercharging for this power. Because FERC cannot look behind the numbers, and must take the assumptions they are provided from DOE as fact, the PMAs are able to evade rate regulation.

2. PMA Transmission Facilities are Not Regulated Like Other Private Utilities

Similarly, FERC does not have the same jurisdiction over PMA transmission facilities that it does with respect to private utilities. In this respect, on April 24, 1996 FERC issued its final rule requiring jurisdictional utilities to provide open access, thereby eliminating potential transmission monopoly abuses. The rule requires that all public utilities subject to FERC jurisdiction offer transmission services that are comparable to the services they provide themselves when they use their own transmission systems to make wholesale sales or purchases of electric energy. FERC issued the Mega-NOPR in order to effectuate a competitive wholesale power market. As Chairman Moler noted in testimony last year before the House Resources Committee:

We believe that open access is necessary to eliminate existing utility practices that are unduly discriminatory and to have competitive bulk power markets in which all wholesale sellers can reach all wholesale buyers. We concluded that ordering transmission service on a case-by-case basis under section 211 of the Federal Power Act, by itself, is not sufficient to remedy undue discrimination. This is because section 211 service is not a substitute for open access, i.e., service on request. Many competitive opportunities will be lost if customers have to go through the procedural requirements of a case-by-case request.

Under existing law, FERC does not have the authority to order open access transmission by non-public utilities, e.g., the PMAs, municipal electric systems and electric cooperatives. Accordingly, PMA transmission facilities along with those owned by municipal electric systems and electric cooperatives are not subject to FERC's comparability standard, and are effectively beyond the reach of the agency's deregulation efforts.

The impact of this problem has been evidenced today by the disclosure of the free power issue. It is also evidences by virtue of the fact that WAPA has begun soliciting new retail customers in the Pick Sloan region. These customers are currently customers of private utilities. It's clear from WAPA's solicitation that private utilities cannot compete with an unregulated monopoly who can price electricity far below the market.

F. Conclusion

The uncontroverted statements of public power and rural co-op company executives reporting by the media and now the GAO all confirm the undeniable fact that the PMAs are giving away free power to preference customers and the American taxpayer is paying for it.

The disclosure of this outrageous fact has been obfuscated by those who seek to perpetuate this waste and abuse on the U.S. government and upon unsuspecting local entities that may otherwise need this money for a variety of natural resource management issues. The full extent of this abuse, which may have yet to be determined criminal implications, is not altogether known. Hopefully, pending GAO reports on the other PMAs will provide more information.

What is known is that consumption of free power by certain entities is hurting local communities with viable natural resource issues that could be addressed with proper funding. By providing free power to a select few, revenues that could be benefitting state and local water resource support is being syphoned off for the exclusive benefit of others who seek to maintain the status quo.

The best way to put an end to the free power scam is to put and end to the PMAs. The PMAs no longer operate according to their historical charter or in the best interests of the nation. Privatization offers a positive fiscal result for the American taxpayer, and current customer services will continue under new, private ownership.

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