

MEMORANDUM

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TO: UTILITIES ADVISORY COMMISSION

FROM: UTILITIES & ADMINISTRATIVE SERVICES DEPARTMENT

DATE: MARCH 7, 2007

SUBJECT: ANNUAL RISK ASSESSMENT OF RATE STABILIZATION RESERVES

REQUEST

This is an informational report. No action is required

OVERVIEW

The memo discusses short term cost uncertainties and risks faced by six utility funds, and sets rate stabilization reserve levels for each of the funds for FY 07-08. This risk assessment will be considered in developing retail rates for the corresponding utility services.

BACKGROUND

In 1993, Council adopted utility reserve policies and approved establishing Rate Stabilization Reserves (RSR) to help stabilize rates for each utility (CMR: 263:93). The key elements of the policy were:

- Reserves should be used to finance extraordinary, one-time contingencies and to cover increased operating costs in the short-run, while allowing rates to gradually increase over a reasonable period.
- Reserves should not be used to solve long-term financial problems nor to cover potential major catastrophic disasters.
- RSR level guidelines should be set to allow reserves to float up or down. The decision to set aside more money or less money than the guideline should be based on an assessment of the uncertainties and financial risk facing the utilities
- The adequacy of the guidelines shall be reviewed internally each year, and if appropriate, revised guidelines will be recommended.

Subsequently, Council revised the Rate Stabilization Reserve guideline levels in 1998 (CMR:194:98), 2001 (CMR:248:01), and 2003 (CMR: 483:03). On February 20, 2007, the Utilities Advisory Commission recommended and Council approved changes to the Utilities Reserve Guidelines (CMR:143:07).

The current Council approved minimum and maximum reserve guidelines are tabulated below. These minimum and maximum guidelines represent long term assessments of reserve level requirements based solely on anticipated changes in commodity costs. Other key risk factors, such as hydro risk and credit risk, can not be accurately assessed in the long term and therefore are not included in the guidelines. These risks are included in this short term annual risk assessment.

Table 1: Rate Stabilization Reserve Guidelines

Utilities Fund	Minimum Reserve Guideline	Maximum Reserves Guidelines
1. Electric Supply	50% of purchase cost	100% of purchase cost
2. Gas Supply	35% of purchase cost	75% of purchase cost
3. Electric Distribution	20% of sales revenue	50% of sales revenue
4. Gas Distribution	20% of sales revenue	50% of sales revenue
5. Water	20% of sales revenue	50% of sales revenue
6. Wastewater Collection	20% of sales revenue	50% of sales revenue
All	Reserve level requirements for next fiscal year to be established following an annual evaluation of risks to each fund as part of budget preparation	

The 2007 RSR guideline calls for an annual assessment of risks facing each utility fund during the annual budget preparation process. The purpose of the assessment was to establish that projected supply reserve levels were adequate to cover anticipated risks for the following fiscal year. These required levels of reserves were then to be factored into the calculations for the retail rates to be charged to customers.

DISCUSSION

The Risk Assessment examined the expected cost and cost uncertainties facing each of the six funds in the next fiscal year. The preliminary budget for FY 07-08 was developed in December 2006 based on costs projected at that time. Based on assumptions as of December 2006, the uncertainty assessment evaluated the adverse outcomes or risk levels for FY 07-08. The reserves were established to cover these adverse outcomes. Staff will recommend retail rates based on risk assessment as well as the guidelines.

1. Electric Supply Risks

The primary and largest cost risk facing the electric supply fund is a result of hydroelectric production uncertainty. The City’s strategy is to manage this uncertainty by maintaining adequate rate stabilization reserve levels (LAP Guideline #2). Staff has set the reserve levels to cover hydro risk at the cost of purchasing additional electricity to offset one year of low hydroelectric production (1 in 10 year dry hydro scenario). The expected market price uncertainty is a function of unhedged supply portfolio. As of December 2006, 11% of the electric supply portfolio for FY 07-08 was unhedged. Transmission related cost uncertainties, plant outage, and Western cost uncertainties were also computed.

In addition to the recurring cost uncertainties outlined above, a number of one-time contingencies such as regulatory and legal risks, and supplier credit default risks were also assessed. Table 1

summarizes all the cost uncertainties evaluated which total \$44.2 million, the sum of these adverse outcomes.

Table 1: Electric Supply Cost Risks

Categories of Electric Supply Cost Uncertainties	Estimates of Adverse Outcomes (M\$)
	FY 07-08
1. Hydro Production: Western & Calaveras	16.5
2. Market Price	3.4
3. Transmission/CAISO	1.5
4. Plant Outage	1.0
5. Western Cost	1.4
6. Regulatory & Legal	12.8
7. Supplier Default	7.6
Electric Supply Fund Risks	\$44.2 million

2. Gas Supply Risks

Gas supply fund cost uncertainties are primarily driven by changes in market cost and supplier defaults. The market cost uncertainty is a function of the unhedged portion of the pool supply portfolio. As of December 2006, 25% of the pool position for FY 07-08 was un-hedged. The credit uncertainty assessment was based on the current exposure level, financial condition and default probabilities of the existing counterparties, as well as an assessment of potential increases in credit risk resulting from market price changes. Based on this assessment, staff has estimated total risks to be \$3.7 million as summarized in Table 2.

Table 2: Gas Supply Cost Risks

Categories of Gas Supply Cost Uncertainties	Estimates of Adverse Outcomes (M\$)
	FY 07-08
1. Market Purchase Cost	1.7
2. Regulatory	-
3. Supplier Default	2.0
Gas Supply Fund Risks	\$3.7 million

3. Electric Distribution Risks

Electric distribution fund cost uncertainties are primarily driven by potential shortfalls in customer consumption and short-run Capital Improvement Program (CIP) cost increases. Potential revenue shortfall risk was calculated by averaging the two highest budgets to actual revenue deviations over the last 5 years. Reserves needed to cover unexpected CIP cost increases in a given year were estimated at 10% of CIP projected cost. Based on this assessment, staff has estimated total risks at \$4 million as summarized in Table 3.

Table 3: Electric Distribution Cost Risks

Categories of Electric Distribution Cost Uncertainties	Estimates of Adverse Outcomes (M\$)
	FY 07-08
1. Consumption shortfall	3.17
2. CIP Cost increases	0.86
Electric Distribution Fund Risks	\$4.03 Million

4. Gas Distribution Fund Risks

Gas distribution fund cost uncertainties are primarily driven by potential shortfalls in customer consumption and short-run CIP cost increases. Potential revenue shortfall risk was calculated by averaging the two highest budgets to actual revenue deviations over the last 5 years. Reserves needed to cover unexpected CIP cost increases in a given year were estimated at 10% of CIP projected cost. Based on this assessment, staff has estimated a total of \$3.3 million in risks as summarized in Table 4.

Table 4: Gas Distribution Cost Risks

Categories of Gas Distribution Cost Uncertainties	Estimates of Adverse Outcomes (M\$)
	FY 07-08
1. Consumption shortfall	2.67
2. CIP Cost increases	0.64
Gas Distribution Fund Risks	<u>\$3.31</u>

5. Water Fund Reserve Risks

Water fund cost uncertainties are primarily driven by potential shortfalls in customer consumption and short-run CIP cost increases. Potential revenue shortfall risk was calculated by averaging the two highest budgets to actual revenue deviations over the last 5 years. Reserves needed to cover unexpected CIP cost increases in a given year were estimated at 10% of CIP projected cost. Based on this assessment, staff has estimated \$3.3 million in total short term risks as summarized in Table 5.

Table 5: Water Fund Cost Risks

Categories of Water Cost Uncertainties	Estimates of Adverse Outcomes (M\$)
	FY 07-08
1. Consumption shortfall	2.78
2. CIP Cost increases	0.48
Water Fund Risks	<u>\$3.26</u>

6. Waster Water Collection Risks

Wastewater fund cost uncertainties are primarily driven by potential shortfalls in customer consumption and short-run CIP cost increases. Potential revenue shortfall risk was calculated by averaging the two highest budgets to actual revenue deviations over the last 5 years. Reserves needed to cover unexpected CIP cost increases in a given year were estimated at 10% of CIP projected cost. Based on this assessment, staff has estimated \$1.7 million in risks as summarized in Table 6.

Table 6: Waste Water Collection Cost Risks

Categories of Wastewater Cost Uncertainties	Adverse Outcomes (M\$)
	FY 07-08
1. Consumption shortfall	1.37
2. CIP Cost increases	0.31
Wastewater Fund Risks	\$1.68 million

SUMMARY

Based on the analysis of possible cost uncertainties and risks faced by each of the six utility funds, staff has projected that reserves are sufficient to cover anticipated risks in FY 07-08 given current conditions. All reserves except the Electric Supply RSR are projected to be below the minimum guidelines (Table 7). In order to meet the long term minimum guidelines, projected long-term retail rates will allow increased funding to the supply reserves. The companion UAC Report, Revenue Requirement Changes for FY 07-08 and 08-09, will discuss the long-term revenue and cost assumptions required to fund the RSRs to the minimum guideline.

Table 7: Summary of Projected Reserve Levels and Estimated Risks for FY 07-08

Utilities Fund	Estimate of Short Term Risks	Projected Year End Reserve Levels	Minimum RSR Guidelines	Maximum RSR Guidelines
1. Electric Supply	\$44.2 million	\$43.6 million	\$30.4 million	\$60.8 million
2. Gas Supply	\$3.7 million	\$4.3 Million	\$9.2 million	\$19.7 million
3. Electric Distribution	\$4.0 million	\$4.6 Million	\$6.6 million	\$16.6 million
4. Gas Distribution	\$3.3 million	\$3.4 Million	\$4.0 million	\$10 million
5. Water Supply & Distribution	\$3.3 million	\$12.4 Million*	\$4.9 million	\$12.4 million
6. Wastewater Collection	\$1.7 million	\$5.0 Million	\$2.7 million	\$6.8 million

* \$8.5 million from closed CIP will be transferred to the reserves in July 2007. Funds will be used for the Wells/Reservoir CIP in FY 08-09.

RESOURCE IMPACT

None.

POLICY IMPLICATIONS

The assessment was made to conform with Council approved Reserve Guidelines and supports Council approved Utilities Strategic Plan.

ATTACHMENT

- A. Changes to the Guideline Levels for the Utilities Rate Stabilization Reserves and Utilities Emergency Plant Replacement Reserves (CMR: 143:07)

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