

**TO: HONORABLE CITY COUNCIL**

**FROM: CITY MANAGER DEPARTMENT: UTILITIES**

**DATE: FEBRUARY 20, 2007 CMR:143:07**

**SUBJECT: FINANCE COMMITTEE RECOMMENDATION ON CHANGES TO THE GUIDELINE LEVELS FOR THE UTILITIES RATE STABILIZATION RESERVES AND UTILITIES EMERGENCY PLANT REPLACEMENT RESERVES**

**RECOMMENDATION**

The Finance Committee recommends that Council approve changes to certain Utilities reserve fund guidelines, detailed below. In addition, it recommends that the development of an assessment of the risks facing each fund be undertaken as part of the annual budget and retail rate development and approval process.

**BACKGROUND**

The table below summarizes the proposed changes to the Emergency Plant Replacement (EPR) and Rate Stabilization Reserve (RSR) guidelines.

<b>Reserve</b>	<b>Existing Guidelines</b>	<b>Proposed New Guidelines</b>
<b>Electric, Gas, Water and Wastewater Collection EPRs</b>	No minimum (maximum, as stated in the City Charter, is = 5% of the book value of the fund's capital in service)	Minimum = greater of: 1) the City's liability insurance coverage deductible or 2) an amount covering the most expensive critical item
<b>Electric Supply RSR</b>	Maximum = 103% of purchase cost Minimum = half of maximum	Maximum = 100% of purchase cost Minimum = 50% of purchase cost
<b>Gas Supply RSR</b>	Maximum = 75% of purchase cost Minimum = half of maximum	Maximum = 75% of purchase cost Minimum = 35% of purchase cost
<b>Electric Distribution RSR</b>	Maximum = 38% of sales revenue Minimum = half of maximum	Maximum = 50% of sales revenue Minimum = 20% of sales revenue
<b>Gas Distribution RSR</b>	Maximum = 40% of sales revenue Minimum = half of maximum	Maximum = 50% of sales revenue Minimum = 20% of sales revenue
<b>Water RSR</b>	Maximum = twice the minimum Minimum = sum of: 1) 15% of sales revenue; plus 2) sales revenue decline due to abnormal weather	Maximum = 50% of sales revenue Minimum = 20% of sales revenue
<b>Wastewater Collection RSR</b>	Maximum = twice the minimum Minimum = sum of: 1) 15% of sales revenue; plus 2) sales revenue decline due to abnormal weather	Maximum = 50% of sales revenue Minimum = 20% of sales revenue
<b>All RSRs</b>	Target = midpoint between minimum and maximum	Target to be established following an annual evaluation of risks to each fund as part of budget preparation

### **COMMITTEE REVIEW AND RECOMMENDATIONS**

At its January 17, 2007 meeting, the Finance Committee unanimously approved staff's recommendations on changes to the Utilities Reserves Policies and Guidelines. In its discussion, the Finance Committee clarified that the annual risk assessment would not go back to the Committee separately, but as part of the budget and Utilities rates proposal.

### **POLICY IMPLICATIONS**

Approval of the recommended changes is consistent with existing City policy, but would establish new Utilities practices and guidelines.

**ATTACHMENTS**

1. CMR:107:07: Utilities Advisory Commission Recommendation on Changes to Certain Utilities Reserve Guidelines

**PREPARED BY:**

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**JANE RATCHYE**  
Senior Resource Planner

**DEPARTMENT HEAD:**

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**VALERIE O. FONG**  
Director of Utilities

**CITY MANAGER APPROVAL:**

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**EMILY HARRISON**  
Assistant City Manager

**TO: HONORABLE CITY COUNCIL**

**ATTN: FINANCE COMMITTEE**

**FROM: CITY MANAGER**

**DEPARTMENT: UTILITIES**

**DATE: JANUARY 17, 2007**

**CMR:107:07**

**SUBJECT: UTILITIES ADVISORY COMMISSION RECOMMENDATION ON  
CHANGES TO CERTAIN UTILITIES RESERVE GUIDELINES**

**RECOMMENDATION**

Staff and the Utilities Advisory Commission (UAC) recommend that Council approve changes to certain Utilities reserve fund guidelines. Specifically, staff and the UAC recommend that the development of an assessment of the risks facing each fund be undertaken as part of the annual budget and retail rate development and approval process. This annual assessment will be compared to the established guideline levels to assist in the determination of the Rate Stabilization Reserve level target for each fiscal year.

Additionally, minor changes to the guidelines of the following Utilities Fund Reserves are recommended are noted below:

1. For the Electric, Gas, Water and Wastewater Collection Emergency Plant Replacement Reserves, establish a minimum guideline level equal to the greater of: 1) the City's liability insurance coverage deductible or 2) the amount that covers the most expensive item of equipment which, if lost, would cause interruption in the normal activity of that utility;
2. For the Electric Supply Rate Stabilization Reserve, change the minimum and maximum guideline levels equal to 50% and 100% of the annual supply purchase cost, respectively;
3. For the Gas Supply Rate Stabilization Reserve, change the minimum and maximum guideline levels equal to 35% and 75% of the annual supply purchase cost, respectively; and

4. For the Electric Distribution, Gas Distribution, Water and Wastewater Collection Rate Stabilization Reserves, change the minimum and maximum guideline levels equal to 20% and 50% of the annual sales revenue, respectively;

The table below summarizes the proposed changes to the Emergency Plant Replacement (EPR) and Rate Stabilization Reserve (RSR) guidelines.

<b>Reserve</b>	<b>Existing Guidelines</b>	<b>Proposed New Guidelines</b>
<b>Electric, Gas, Water and Wastewater Collection EPRs</b>	No minimum (maximum, as stated in the City Charter, is = 5% of the book value of the fund's capital in service)	Minimum = greater of: 1) the City's liability insurance coverage deductible or 2) an amount covering the most expensive critical item
<b>Electric Supply RSR</b>	Maximum = 103% of purchase cost Minimum = half of maximum	Maximum = 100% of purchase cost Minimum = 50% of purchase cost
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<b>Wastewater Collection RSR</b>	Maximum = twice the minimum Minimum = sum of: 1) 15% of sales revenue; plus 2) sales revenue decline due to abnormal weather	Maximum = 50% of sales revenue Minimum = 20% of sales revenue
<b>All RSRs</b>	Target = midpoint between minimum and maximum	Target to be established following an annual evaluation of risks to each fund as part of budget preparation

## **BACKGROUND**

On September 19, 2006, the Council Finance Committee directed staff to work with the Utilities Advisory Commission (UAC) to develop recommendations for changes to the policies, guidelines, or purposes of the following Utilities Fund Reserves [CMR:358:06]:

1. Emergency Plant Replacement Reserve for the Water, Electric, Gas, and Wastewater

- Collection Funds;
2. Supply Rate Stabilization Reserve for the Electric and Gas Funds;
  3. Distribution Rate Stabilization Reserve for the Electric and Gas Funds; and
  4. Rate Stabilization Reserve for the Water and Wastewater Collection Funds.

The attached memorandum to the UAC contains staff's recommendations for the selected reserves and the rationale for the development of the recommendations, which were presented to the UAC at its December 6, 2006 meeting.

**COMMITTEE REVIEW AND RECOMMENDATIONS**

At its December 6, 2006 meeting, the UAC considered staff's recommendations on changes to the Utilities Reserves Policies and Guidelines. After discussion, Commissioner Dawes made a motion to accept staff's recommendation with the proviso that, for the rate stabilization reserves, if the target balance resulting from the risk assessment is below the minimum guideline level, that appropriately conservative risk assumptions should be used. This motion died for the lack of a second. After further discussion, the UAC unanimously approved staff's recommendations.

**ENVIRONMENTAL REVIEW**

Approval of the recommended changes to the Utilities reserves does not constitute a project that would require environmental review.

**NEXT STEPS**

If the recommendations are approved, staff will provide the annual risk assessment for each fund and make recommendations regarding the reserve levels for each reserve fund during the budget and retail rate development process as described in the report to the UAC.

**ATTACHMENTS**

1. Report to the UAC for its December 6, 2006 meeting: Changes to Certain Utilities Reserve Guidelines
2. Excerpt of December 6, 2006 Utilities Advisory Commission notes

**PREPARED BY:**

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**JANE RATCHYE**  
Senior Resource Planner

**DEPARTMENT HEAD:**

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**VALERIE FONG**  
Director of Utilities

**CITY MANAGER APPROVAL:**

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**EMILY HARRISON**  
City Manager

## Draft UAC Meeting Minutes Excerpts December 2006 Attachment 2

Jane Ratchye's presentation followed the staff report. – In September, the Finance Committee directed staff to work with the UAC on the Utilities Emergency Plant Replacement Reserves (EPRRs) and the Rate Stabilization Reserves (RSRs). The EPRRs were set-up by City Charter with the stipulation that the maximum level of those reserves cannot be more than five percent of the net book value of the fixed assets for that fund. In 1988, Council added directives that: 1) the annual funding to those reserves should be about five percent to the annual increase in the net book value and 2) the balance of those reserves should be able to cover the cost of the most expensive item in that utility that, if taken out of service, would result in a loss in utility service. The City's insurance policies also cover some disasters. The City's liability insurance has a one million dollar deductible currently. The City Charter sets the maximum for these reserves. All of these reserves are under that maximum so we are in line with the City Charter. Staff is recommending that these reserves have a minimum level equal to the greater of: 1) the deductible for the city's liability insurance; or 2) an amount that would cover the cost of the most expensive piece of equipment that would need to be repaired in order to return utility service forthwith. Under staff's recommendation, the Wastewater Collection Emergency Plant Replacement Reserve would need to be funded to meet that one million dollar minimum. Do you want to pause here and have any questions on the EPRRs?

Commissioner Dawes asked about overlap between the EPRRs and the distribution reserves. Ratchye noted that the EPRRs are meant for something where the money is needed right now because something just broke that needs to be replaced. Most of the reserves are significantly below the maximum levels from the City Charter since Utilities does have distribution rate stabilization reserves in all the funds. The RSRs did not exist at the time of the City Charter.

Commissioner Melton noted that for the Wastewater Collection EPRR, the most expensive item could cost five million dollars to replace, but the staff report says that the cost would only be one million dollars.

Ratchye noted that staff struggled with this because it is hard to imagine that somehow the entire 42-inch section that would cost five million dollars to replace would disappear without being caused by an earthquake, that is covered by FEMA, or there being a liability issue that would be covered by our liability insurance, or something covered by our property insurance. Staff could not come up with something that was reasonable, so we estimated that a reasonable number for repair would be the one million dollars.

Ratchye then discussed the six Utilities rates stabilization reserves (RSRs). The RSRs were established in 1993 and they are to finance extraordinary one time contingencies to cover increased operating costs in short run and they are supposed to allow rates to gradually increase over a reasonable period and that is how you have seen them being used over the time you have been on the Commission I am sure. They are not to solve long term financial problems or to cover major catastrophic disasters. The reserves should be allowed to flow up or down with levels generally between the minimum and the maximum guideline based on the assessment of the financial risks of facing the whole Utility. The intent when these reserves were established is to review their adequacy annually. Staff is not recommending major changes in the minimum

and maximum guidelines for any of the rate stabilization reserves. The new element is to require an annual risk assessment for each fund as part of the annual budget and retail rate setting process. The risk assessment would be used to develop the target level should be for the RSRs. The ranges for minimum and maximum that we have now should capture the risks that we expect to see. Risks assessments have been done in the past, but not necessarily annually and the results have not necessarily been made public.

Commissioner Bechtel commented that, from a practical point of view, the maximum is not as important as the minimum because the minimum is the one you really feel, bottom line, you should have that money in reserve. We should not be quibbling about too much maximums.

Commissioner Melton observed that the annual risk assessment should lie between the minimum and the maximum levels, but in the past, the reserve levels have gone below the minimums.

Girish Balachandran, Assistant Director for Resource Management noted that the risks need to be looked at for the long-term. For example, given our hedging strategy, we tend to end up being lower than minimum for the prompt 12 months. But, for the second and third years the risk exposure is substantially more. The annual risk assessment is the time when we get the dialogue going on rates and that connection happens and so the timing of this is right. We do not have a hard and fast rule as to how much we are going to hedge. It seems that the common sense approach would be to look at the real risk exposure for the rate period in question and calculate rates based on that.

Commissioner Melton agreed with this approach, but noted a certain degree of tension and uncomfortableness if that annual risk assessment is below the minimum guideline and we are not setting rates to at least keeps our reserves at the minimum guidelines.

Ratchye noted that these are guidelines and not policy. Even if reserves have been lower than the minimum for a single year, you will see the levels in the longer-term view climbing up above the minimum.

Commissioner Dawes agreed with Chair Melton. He also is concerned when reserve levels are below the guideline minimums. In addition, the risks on the electric side are highly dependent on hydro availability, which is not known with any certainty at the time of budget development.

Balachandran noted that this is what's been done for last several years. For electric, we look at two hydro years for coverage on our reserves in an attempt to accommodate the volatility of that key assumption. On the gas side, the laddering strategy for the first eighteen months has a minimum of 60 percent hedged and a maximum of 100 percent. In the last few years we are hedged at 80 percent or so. That is why the risk exposure that you see has been below the guideline. But we could actually be hedged at 60 percent so the risk exposure could be much higher.

Karl Van Orsdol, Energy Risk Manager, stated that the first time this is done, we will do it with a lot of detail and a lot of explanation as to why we have chosen the risk approaches that we have. As Girish said we need to do two years for hydro, you are using the prompt 12 months for which

there is actual data and then using the model for the following twelve months. It is much more conservative approach then doing it for a twelve month period.

Commissioner Rosenbaum commented that the section from the City Charter was interesting. The Charter does not seem to contemplate the rate stabilization reserves we now have.

Ratchye noted that not everything we do emanates from the Charter. Balachandran noted that there are other reserves established by the Council which are not written into the Charter.

Commissioner Dawes stated that he is comfortable with the proposed guidelines. If we come up to real changes in the risk assessment, we may have to adjust the reserves, but not the guidelines. So we really have to adjust the dollars and not worry about tweaking guidelines.

Commissioner Dawes move that the UAC recommends the staff recommendation in Table II for revision of guidelines with the exception that when the target reserve is below the minimum guidelines that the assumption used are the most conservative available to the particular utility.

After discussion, Commissioner Dawes agreed to change “most conservative available: to “an appropriately conservative set of assumptions.”

The motion died for a lack of a second.

Commissioner Rosenbaum moved staff recommendation. Commissioner Bechtel seconded the motion.

Commissioner Bechtel noted that the risk assessment means more than the minimum and maximum guideline levels. In the budget process, we can discuss the risk assessment.

Commissioner Dawes indicated that he supports the motion as he has great confidence in staff to envision circumstances in the market.

Commissioner Melton was still not comfortable with the Emergency Plant Replacement Reserves since it doesn't cover the cost of the most expensive item for the Wastewater Collection fund.

Motion passes unanimously.