

MEMORANDUM

2

TO: UTILITIES ADVISORY COMMISSION

FROM: UTILITIES DEPARTMENT

DATE: MARCH 7, 2007

SUBJECT: REVENUE REQUIREMENT CHANGES FOR FY 2007-08 AND FY 2008-09

REQUEST

This report is for information only. No action is required.

OVERVIEW

This report presents the overall projected changes to the annual revenue requirements for the Electric, Gas, Water and Wastewater Collection Utilities for Fiscal Year 2007-08 and Fiscal Year 2008-09.

Staff proposes the following revenue requirement changes:

1. For the Electric Utility, a 5 percent revenue increase, or \$4.4 million, is proposed for FY 2007-08, and a 10 percent revenue increase, or \$9.2 million, for FY 2008-09.
2. For the Gas Utility, a 9.5 percent revenue increase, or \$5.0 million, for FY 2007-08, and a 9.1 percent revenue increase, or \$4.5 million, for FY 2008-09.
3. For the Water Utility, a 10 percent revenue increase, or \$2.2 million for FY 2007-08 and a 10 percent revenue increase, or \$2.5 million, for FY 2008-09.
4. For the Wastewater Collection Utility, no revenue change is proposed for either FY 2007-08 or FY 2008-09.

BACKGROUND

The Utility revenue requirements consist of a number of components including sales volumes, wholesale supply expenses, distribution system operating and Capital Improvement Program (CIP) expenses, prudent Rate Stabilization and Emergency Plant Replacement Reserves, debt service, and, for some Utilities, providing a transfer to the General Fund. Any change in one or more of these components can trigger a change, up or down, to the revenue requirement. During the budget process, staff forecasts load, revenues and expenses to quantify the annual revenue requirement.

On December 6, 2006, the Utilities Advisory Commission approved staff recommendations to establish annual rate stabilization reserve (RSR) levels for the prompt year based on annual risk assessments. The risk assessment value for the Electric and Gas SRSRs for FY 2007-08 is based on a risk assessment for this specific year. Due to the lack of additional information regarding future years, the same RSR levels escalated at 3 percent is used in the proposed revenue requirement for FY2008-09. During FY2007-08, an updated risk assessment will be prepared for FY 2008-09.

Risk assessment values for the Electric and the Gas Distribution Rate Stabilization reserves (DRSRs) and for the Water and Wastewater RSRs are based on a risk assessment that includes potential revenue shortfalls from falling sales levels, and 10 percent of the annual CIP.

DISCUSSION

The Electric Fund

Proposal:

An increase of 5 percent, or \$4.4 million, is proposed for the Electric Utility in FY 2007-08. For FY 2008-09, based on expenses and risk assessment, a 10 percent, or \$9.2 million revenue increase is projected. Staff will evaluate the actual revenue requirement change which would be needed for FY 2008-09 during next year's budget process. The FY 2007-08 risk assessment value for the SRSR is based on the annual risk assessment, however, for following year the risk assessment value is a 3 percent escalated figure but will be more accurately calculated before the next budget is prepared.

To avoid future rate shocks, staff proposes to stabilize rate increases over the next several years to maintain the financial health and acceptable reserve balances.

Background:

During FY 2005-06, very favorable hydro conditions resulted in lower wholesale purchase costs and significant additional funds were added to the Supply Rate Stabilization Reserve (SRSR). The actual ending balance of the SRSR for FY 2005-06, was \$9.8 million over the maximum level approved by the City Council. As for FY 2006-07, hydro conditions of the past year still have the same positive effect and a risk assessment has been performed. As a result, it is proposed reserves be drawn down in FY 2007-08; no electric supply rate increase is proposed at this time.

The 5 percent revenue increase of \$4.4 million will be applied to distribution rates to recover the increased expenses and provide funding of the Distribution Rate Stabilization Reserve (DRSR). Withdrawals of Electric DRSR funds have taken place over the last several years to mitigate the increase in customer Supply costs, CIP's and additional expenses such as allocated Workman's Compensation and retiree medical liabilities. With the rate increase, the ending balance of the DRSR is projected to be below the minimum guidelines approved by the City council, but above the risk assessment value. However, staff will continue to evaluate the DRSR balance on an ongoing basis.

The Gas Fund:

Proposal:

An increase of 9.5 percent or \$5.0 million is proposed for FY 2007-08 with a 9.1 percent, or 4.5 million revenue increase for FY 2008-09. Staff will reevaluate the actual revenue change needed for FY 2008-09 during the next year budget process. The FY 2007-08 Risk assessment value for the SRSR is based on the annual risk assessment, however, for the next year the risk assessment value is escalated at 3 percent, but will be accurately calculated before each budget is prepared.

Background:

In June 2006, the City Council approved a 20 percent rate increase for July 2006 implementation. This rate increase was to cover the projected increased gas supply costs. In recent years, gas sales in Palo Alto have declined due to the energy efficiency investments on the part of customers (responding to price signals), or efficiency programs designed by the City. For the first six months of FY 2006-07, residential consumption was lower than projections by about 5 percent. In addition, some energy intensive commercial customers have relocated and left the distribution system. Consumption levels for FY 2007-08 and beyond are projected to remain relatively flat.

The 9.5 percent revenue increase of \$5.0 million will be applied to distribution rates to recover the increased expenses and provide funding of the Distribution Rate Stabilization Reserve (DRSR). Withdrawals of Gas DRSR funds have taken place over the last several years to mitigate the increase in customer supply costs and additional expenses such as allocated Workman's Compensation and retiree medical liabilities. With the rate increase, the ending balance of the DRSR is projected to be below the minimum guidelines approved by the City Council. However, staff will continue to evaluate the DRSR balance on an ongoing basis.

While the SRSR balance is projected to be below the minimum guideline, it exceeds the risk assessment value which is based on the risk assessment for FY 2007-08. The risk assessment value, due to the laddering strategy, is approximately \$5.2 million below the Supply RSR minimum guideline. Staff believes that the projected Gas SRSR balance is sufficient to meet the risks faced in FY 2007-08, but future supply-related rate increases will be necessary to bring the reserve balance to the minimum level if changes occur in the wholesale gas market. With the proposed rate changes for FY 2007-08, the SRSR balance for FY 2008-09 is projected to be \$6.4 million, and it will reach the Supply RSR minimum guideline in FY 2009-10.

The Water Fund

Proposal:

Staff proposes a 10 percent revenue increase, or \$2.2 million for FY 2007-08, and another 10 percent or \$2.5 million for FY 2008-09. During the FY 2008-09 budget process, staff will evaluate the financial condition of the Water Utility and recommend appropriate changes to the revenue requirement. The Water RSR balance at the end of FY 2007-08 and FY 2008-09 is projected to be still below the reserve minimum. Staff believes that the projected Water Reserve balance is sufficient to meet the risk assessment requirement for FY 2007-08, but future rate increases will be necessary to bring the reserve balance above the minimum guideline. With the proposed rate changes for FY 2007-08, the Reserve balance is projected to reach the reserve minimum in FY 2009-10.

To avoid future rate shocks, staff proposes to stabilize rate increases over the next several years to maintain the financial health and acceptable reserve balances.

Background:

In June 2006, the City Council approved a 7 percent rate increase for July 2006 implementation. The Water Fund continues to exhibit declining sales levels due to efficiency improvements, reduced economic activity, and above-normal precipitation. Consequently, the Rate Stabilization Reserve (RSR) balance the end of Fiscal Year 2006-07 is expected to be below the minimum guideline level. Due to the continuing trend of declining sales, projected water sales for FY 2007-08 and beyond have been adjusted down to match this sales pattern.

During the budget process for FY 2006-07, staff informed the Utilities Advisory Commission that the 7 percent increase was not enough to bring the RSR balance to the Minimum Guideline. It was only the first step to slowly raise the reserve balance to the minimum level over a few years to avoid a rate increase shock to customers. However, after the FY 2006-07 budget was adopted, the San Francisco Public Utility Commission (SFPUC) increased their wholesale water rates (their ratemaking cycle is not the same as the City's) which was not reflected in the adopted budget. That additional cost resulted in a drawdown of the Water Rate Stabilization Reserve. In addition, new cost allocations to each Utility related to the General Accounting Standards Board (GASB) rule changes regarding retiree medical liabilities resulted in another drawdown of the Water Fund Rate Stabilization Reserve.

Projections from the SFPUC indicate that purchased water costs may increase slightly in FY 2007-08. However, the SFPUC budget process is usually later than Palo Alto's budget process; it is highly possible that the final adopted SFPUC rates will differ from the current, early projections. In addition, CIP expenditures are projected to be \$1.1 million greater than FY 2006-07.

The Wastewater Fund

Proposal:

There is no proposed overall rate increase for the Wastewater Collection Utility for FY 2007-08 or for FY 2008-09.

Background:

Staff evaluates the financial condition of the utility annually. For FY 2006-07, the balance of the RSR is projected to end the year at \$4.3 million, slightly under the current minimum level approved by the City Council of \$4.4 million. However, the new proposed reserve minimum guideline is lower than it has been in the past. Therefore, the RSR balance is projected to end FY 2007-08 at \$4.6 million, which is over the minimum level by approximately \$1.8 million. Based on current cost estimates, the reserves will continue to be above minimum in FY 2008-09 as well. Therefore, there is no apparent need to change the revenue at this time. As always, Staff will continue to monitor reserve levels and evaluate whether a revenue change would be needed for FY 2008-09 during the budget process.

RESOURCE IMPACT

The resource impacts are as follows:

- 1 For the Electric Utility, a 5 percent revenue increase, or \$4.4 million is proposed for FY 2007-08, and a 10 percent revenue increase, or \$9.2 million, is proposed for FY 2008-09
- 2 For the Gas Utility, a 9.5 percent revenue increase, or \$5.0 million, for FY 2007-08, and a 9.1 percent revenue increase, or \$4.5 million, is proposed for FY 2008-09.
- 3 For the Water Utility, a 10 percent revenue increase, or \$2.2 million for FY 2007-08 and a 10 percent revenue increase, or \$2.5 million, is proposed for FY 2008-09.
- 4 For the Wastewater Collection Utility, no revenue change is proposed for either FY 2007-08 or FY 2008-09.

POLICY IMPLICATIONS

The recommended changes to the Utilities revenue requirements are necessary to maintain the financial health of the various Utilities and require Council approval.

ATTACHMENT

Five Year Revenue Projections for the Electric, Gas, Water and Wastewater Collection Utilities.

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APPROVED BY: _____

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