TO: HONORABLE CITY COUNCIL

ATTN: FINANCE COMMITTEE

FROM: CITY MANAGER **DEPARTMENT:** ADMINISTRATIVE SERVICES

DATE: MAY 26, 2009 **CMR:260:09**

SUBJECT: Recommendation to City Council to Change the Methodology Used to Calculate the Equity Transfer from Utilities Funds to the General Fund

EXECUTIVE SUMMARY

On March 31, 2009, staff presented to the Finance Committee recommendations for changes to the calculation methodology for the Utilities Equity Transfer to the General Fund (CMR: 190:09, Attachment 1).The Finance Committee had additional questions regarding the rationales for the tax and risk adjustments and requested that staff return with the responses during the FY 2010 and 2011 Proposed Budget hearings.

RECOMMENDATION

Staff recommends that the Finance Committee recommend that the Council approve the proposed Utility Enterprise Methodology (UEM) that bases the Equity Transfers from the Gas and Electric Funds upon a rate of return on the asset base. The UEM is proposed for implementation in Fiscal Year (FY) 2010.

DISCUSSION

During the Finance Committee's review of the UEM on March 31, 2009, questions arose regarding the comparison of the City of Palo Alto's transfer amount to those of other municipalities, and the rationale behind the two adjustment factors that the proposed UEM relies on: the 30 percent adjustment to account for being a tax-free entity and the 15 percent adjustment to account for reduced risk.

Comparison to Other Municipalities

Information on comparisons of General Fund transfers from other municipally-owned utilities was provided by the 2009 annual survey conducted by the Northern California Power Agency (NCPA). This information was for transfers from electric funds only, since there are only two other municipally-owned gas utilities besides Palo Alto in the state. Showing as dollar amount and as a percentage of annual electric sales revenues, the data is as follows:

- City of Alameda - $2.8 million (6 percent)

- City of Briggs - $150,000 (6 percent)
- City of Gridley - $800,000 (14 percent)
- City of Lompoc - $1.3 million (7 percent)
- City of Roseville - $6.5 million (4 percent)
- City of Santa Clara - $13.4 million (5 percent)
- City of Ukiah - $1.1 million (7 percent)

By comparison, the Electric Fund Equity Transfer for Palo Alto in FY 2009 is $9.3 million, (8 percent). In FY 2010, the proposed Electric Fund Equity Transfer for Palo Alto is $11.1 million, or 9 percent of the budgeted sales revenue. Compared to the other cities listed above, Palo Alto's Equity transfer of $11.1 million (9 percent) for FY 2010 is on the upper end of the range.

Tax and Risk Adjustment Factors

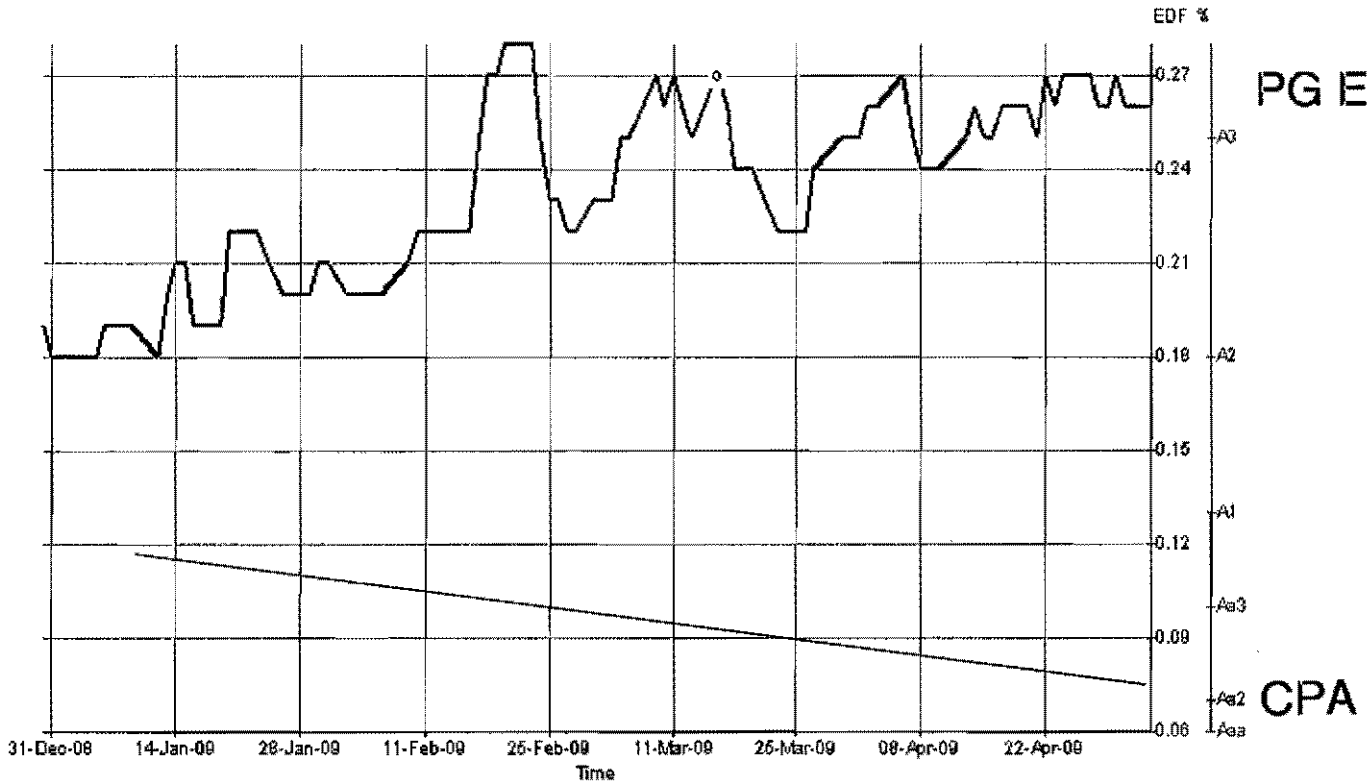
The City's consultant for the equity transfer methodology, R.W. Beck, has recommended that the City use PG&E's approved rate of return on equity as a base, with two adjustments to account for differences between an investor owned utility and a municipally owned utility. An investor in City bonds compared to an investor in PG&E bonds is not taxed on interest earnings and will not experience the risk of default associated with PG&E's lower-rated bonds. It is appropriate, due to the tax exempt status of City bonds as well as the City's high rating on its utility revenue bonds (AAA), to adjust the PG&E rate of return with a tax adjustment and a risk adjustment. The recommended tax rate adjustment of 30 percent is used as a proxy for the marginal tax rate that an investor in municipal bonds would avoid paying compared to a corporate bond holder.

Because the difference in yield between a corporate and municipal bond cannot solely be explained by the tax adjustment, R.W. Beck also advised that a risk adjustment be included in the UEM. An investment in a City of Palo Alto utility revenue bond provides a degree of security or risk avoidance that a PG&E bond would not. The recent increase of the City's utility revenue bond to a triple A rating informs an investor that their investment bears a minimum of risk or that the issuer is most unlikely to default.

The graph below illustrates the past 90 days of PG&E's (current S&P rating A-) Expected Default Frequency (EDF) and the City of Palo Alto Utilities (CPAU) EDF based on the recently upgraded ratings from AA- (0.10%) and AA+ (0.7%) to AAA. The equivalent median EDF credit measure as defined by Moody's KMV for an A- rating is 0.26% and the same measure for an AAA rating is 0.06%. The difference is 0.20%, illustrating the higher risk that an investor in PG&E faces, and the consequent higher rate of return on their investment. Therefore, some adjustment to the equity transfer calculation is reasonable. Staff is recommending a 15 percent risk adjustment as reasonable and one

and one that keeps the equity transfer at a steady level compared to prior years.

Chart Builder PG&E CORP [PCG]



Plot: Values
Period: Last 90 Trading Days
From: December 30, 2008
Currency: U.S. DOLLAR[USD]
To: May 4, 2009

Description	Value	As Of
—PG&E CORP [PCG] EDF	0.26	04-May-09

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The calculations using the proposed UEM for the electric and gas rate base on which the equity transfer is calculated is as follows:

Electric Rate Base for Equity Transfer – Proposed Utilities Enterprise Methodology (UEM)
In Thousands:

$ 151,044 – Net asset value as of June 30, 2008 from the FY 2008 CAFR
\+ 5,669 – Supply working capital (supply purchases divided by 12)
\+ 5,141 – Operating expense working capita (operating expense divided by 8)
\+ 8,074 – FY 2009 budgeted CIP less customer funded improvements
\- 5,386 – FY 2009 depreciation
$ 164,542 – Total electric rate base

Gas Rate Base for Equity Transfer – Proposed Utilities Enterprise Methodology (UEM)

In Thousands:

$ 69,525 – Net asset value as of June 30, 2008 from the FY 2008 CAFR
+ 2,238 – Supply working capital (supply purchases divided by 12)
+ 1,580 – Operating expense working capita (operating expense divided by 8)
+ 6,747 – FY 2009 budgeted CIP less customer funded improvements
- 1,552 – FY 2009 depreciation
$ 78,538 – Total electric rate base

The calculation of the rate of return on equity appropriate for Palo Alto and as recommended by staff is equal to PG&E's approved return on equity multiplied by 0.70 (1-.30, the tax adjustment) multiplied by 0.85 (1-.15, the risk adjustment). This rate of return percentage approximates the difference that an investor could expect to experience when investing in a municipal bond as opposed to a corporate bond. Using PG&E's current approved return on equity of 11.35 percent as example, the total return for Palo Alto would be equal to 11.35 percent times 0.70 times 0.85, or 6.75 percent. An alternate risk adjustment of 10 percent discount would result in a 7.15 percent rate of return and a risk factor of 20 percent discount would result in a 6.36 percent rate of return.

The table below shows the change in the equity transfer for 0, 10, 15 and 20 percent risk discounts. Staff has recommended a risk adjustment of 15 percent, as reasonable and one that keeps the equity transfer at a steady level compared to prior years.

	PG&E approved rate	Tax Adjustment 30% Risk Adjustment 0%	Tax Adjustment 30% Risk Adjustment 10%	Tax Adjustment 30% Risk Adjustment 15%	Tax Adjustment 30% Risk Adjustment 20%
Rate of Return	11.35%	7.95%	7.15%	6.75%	6.35%
Electric Fund	18,676	13,081	11,765	11,112	10,448
Gas Fund	8,914	6,244	5,615	5,304	4,987
Total Equity Transfer	27,590	19,325	17,380	16,416	15,436
Change from staff recommended	11,174	2,909	964	-	(980)
2010 Equity Transfer					

RESOURCE IMPACT SECTION

The current FY 2009 equity transfers equal $15.07 million. The staff recommended Electric and Gas transfers in FY 2010 with a tax adjustment of 30 percent and a risk adjustment of 15 percent result in a transfer of $16.42 million, an increase of $1.35 million. Changing for the alternative risk adjustment to 20 percent results in a decrease of $1 million in total equity transfers and the alternative risk adjustment of 10 percent results in an increase of $1 million in total equity transfers when compared to the 15 percent risk adjustment.

POLICY IMPLICATIONS

The recommended action changes the equity transfer methodology for the Electric and Gas Funds to the General Fund.

ENVIRONMENTAL REVIEW

Changing the equity transfer methodology does not meet the definition of a "project" pursuant to Section 21065 of the Public Resources Code, thus no environmental assessment under the California Environmental Quality Act (CEQA) is required.

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CITY MANAGER APPROVAL:

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ATTACHMENTS

Attachment 1 – CMR: 190:09

Attachment 2 - EDF Equivalent Median EDF credit measures from CreditEdge

ATTACHMENT 1

BUDGET
FY 2010-FY 2011

TO: HONORABLE CITY COUNCIL

FROM: CITY MANAGER **DEPARTMENT:** UTILITIES AND ADMINISTRATIVE SERVICES

ATTENTION: FINANCE COMMITTEE

DATE: MARCH 31, 2009 **CMR:** 190:09

SUBJECT: **Recommendation to City Council to Change the Methodology Used to Calculate the Equity Transfer from Utilities Funds to the General Fund**

EXECUTIVE SUMMARY

Staff regularly reviews the methodology used to calculate the equity transfer to the General Fund from certain Utilities Funds. The last time a change was made to the methodology was for FY 2002. Staff's recommendation is to return to the Utility Enterprise Methodology that the City used starting in 1983. The proposed methodology is recommended for the Electric and Gas Funds to take effect for FY 2010. The City will cease making an equity transfer from the Water Fund in FY 2010.

The Utilities Advisory Commission (UAC) recommended changes to the staff's recommendation at its March 4, 2009 meeting. Staff has slightly modified its recommended equity transfer method, but does not recommend adoption of all of the changes in the UAC's proposal. Both staff's and the UAC's proposals are described in this report for consideration by the Finance Committee.

RECOMMENDATION

Staff recommends that the Finance Committee tentatively recommend that the Council approve the proposed Utility Enterprise Methodology (UEM) that bases the equity transfers from the Gas and Electric Funds upon a rate of return on the asset base. This UEM is proposed to be implemented beginning in Fiscal Year (FY) 2010. The Finance Committee will make a final recommendation to the Council when it reviews the entire budget proposal later this spring.

The Utilities Advisory Commission (UAC) recommends that Council adopt an alternate UEM with modifications including that the equity transfers from the Electric and Gas Funds neither increase nor decrease by more than five percent from the preceding year's transfer.

BACKGROUND

As a result of the initial investment made by the City and its citizens, Palo Alto's residents and businesses have enjoyed favorable rates and utility services provided by the City's municipal utility. The services provided by the Gas, Water and Electric Funds provide a return on investment to the General Fund in the form of Utility Fund transfers, as established in the City's Charter. Article VII, Section 2 – Public utilities revenue, of the City Charter states:

> The revenue of each public utility shall be kept in a separate fund from all other receipts and shall be used for the purposes and in the order as follows:
> (a) For the payment of the operating and maintenance expenses of such utility, including the necessary contribution to retirement of its employees.
> (b) For the payment of interest on the bonded debt incurred for the construction or acquisition of such utility.
> (c) For the payment of the principal of said debt, as it may become due.
> (d) For capital expenditures of such utility.
> (e) For the annual payment into a reserve fund for contingencies, of an amount not to exceed ten percent of the expenditure for capital outlay for the year, exclusive of bond fund expenditures. The total accumulated in this reserve for contingencies shall at no time exceed five percent of the book value of the utility's capital in service. This reserve fund shall be available for use by the utility, only for replacements or emergency repairs and after special appropriation by the council.
> (f) The remainder shall be paid into the general fund by quarterly allotments.

The historical transfers to the General Fund from the Gas, Water and Electric Funds from FY 1982 to FY 2009 are shown in Attachment A to this report.

1982 Price Waterhouse Study

In July 1982, the City executed a contract with Price Waterhouse to evaluate and determine the appropriateness of the method utilized for determining the transfer from the Utilities Funds to the General Fund. Price Waterhouse confirmed that the wastewater and refuse funds are considered "governmental functions" and no transfers to the General Fund are made, so the study focused on the "proprietary" utilities – gas, water and electricity.

The Price Waterhouse study noted that the City had a practice for its 82-year history of generating net income based on the provisions of the City Charter cited above. As part of the study, Price Waterhouse conducted a survey of how cities determine an appropriate transfer to their General Funds. This survey concluded that many methods were in use, but that cash transfers from proprietary funds to the General Fund are a common and accepted practice for cities in California and other states. The most common method was based on a percentage of revenues. The most common method for investor-owned utilities was the UEM. The City wanted to ensure that it would have a method that was in-line with the practice of other cities.

The study, which was completed in December 1982, noted that the City's ratemaking methods varied for each utility at the time. The gas utility set retail rates equal to retail rates in Pacific Gas and Electric Company's (PG&E) service area that surrounds Palo Alto. The equity transfer

method for the gas utility was equal to the total revenues minus total costs for the gas utility. This formula could result in a negative transfer in the event that total costs exceeded total revenues. For the water utility, a "return on ratebase" method (also known as the Utility Enterprise Method, or UEM) was used to calculate the transfer to the General Fund. Price Waterhouse noted that the UEM is used by investor-owned utilities, such as PG&E, in California. The method links the transfer to the total investment made in the utility. For the electric utility, the transfer method was based on a Utilities Department ratemaking goal to include "a reasonable transfer to the City's General Fund."

In January 1983, Council was provided with the Transfers to the General Fund Study completed by Price Waterhouse (CMR: 143:3). The study recommended the use of the UEM in which the three proprietary enterprises (water, gas and electric) are viewed as taxpayers' assets that should yield a reasonable return on the assets dedicated to the systems. Using the UEM, the transfer to the General Fund is calculated by multiplying the net plant assets of each utility by the rate of return. The study also recommended the City Council consider a "range of reasonableness" in determining the appropriate transfer to the General Fund.

The recommended "range of reasonableness" included a lower and upper boundary on the rate of return to be used in the UEM calculation. The lower end of the range used a rate of return equal to the current rate on Treasury bonds, a long-term, risk-free investment. The upper end of the range would be based on the rate equal to that used by the California Public Utilities Commission for investor-owned utilities, such as PG&E.

1997 Council Action

In 1996, a landmark electric utility deregulation bill (AB 1890) was passed by the California legislature. It allowed, as of March 31, 1998, customers to choose their electric commodity supplier. In addition, the Utility Infrastructure Improvement Program (UIIP), which began in FY 1991, had led to increased funding of Capital Improvement Program (CIP) projects, increasing the asset bases of the Water, Gas, and Electric Funds. Since the UEM is based on the asset base, the UIIP led to an increase in the level of transfers to the General Fund.

The combined effect of customers potentially "leaving" the Palo Alto system in order to be served by an alternate commodity supplier and the upward pressure on rates caused by rapidly increasing transfers to the General Fund led staff to review the equity transfer methodology. Responding to these conditions, in 1997, the City Council froze transfers from the Gas, Water and Electric Funds to the General Fund at FY 1997 levels of $11.835 million annually.

2000 R.W. Beck Study

In 1999, the City selected R. W. Beck to evaluate methodologies for Utility Fund transfers to the General Fund. The study's scope included the review of existing transfer methodologies, identification of alternative methodologies, and the development of recommendations.

The R. W. Beck Utility Funds Transfer Study was completed in March 2000. The study concluded that the current UEM transfer methodology is viable if it undergoes certain modifications to recognize the risk associated with the electric and gas supply business. The analysis performed in 2000 resulted in a recommendation that the City adopt an equity transfer

policy around the Utility Enterprise Method that had been adopted by the City after a 1982 study by Price Waterhouse. The Utility Enterprise Method is based on a Rate of Return on Rate Base methodology. The final recommendation contained in R.W. Beck's 2000 report was not ultimately adopted by the City.

The UAC reviewed the R. W. Beck Utility Funds Transfer Study in March 2000 and concurred with staff's recommendation to change the transfer methodology as follows:

- For the Water Fund, increase the transfer at an annual rate of 3 percent per year from the initial level of $2.044 million for FY 2000.

- For the Electric Fund, calculate the transfer based on 14.5 percent of Adjusted Sales Revenue (ASR), where ASR is defined as the metered sales revenue less the Capital Improvement Program (CIP) expenditures.

- For the Gas Fund, use the same basic methodology, but use 15 percent of ASR in the calculation.

- Include in the methodology a sharing arrangement in case of a loss faced by one of the utility funds.

In April 2000, the City Council approved the recommended methodology for the equity transfers (CMR: 223:00) beginning in FY 2001.

Change in Fiscal Year 2002

In the FY 2002 budget, staff recommended that the equity transfer from the Electric and Gas Funds change so that increases to the transfers are capped at 3 percent per year due to volatility of electric and gas commodity costs. Since FY 2002, the equity transfers have increased by 3% from the previous year's transfer amounts.

DISCUSSION

More recently, the City decided to conduct a review of the methodologies for the water, gas and electric equity transfers. The City hired the firm of Black and Veatch in 2008 to review the water fund equity transfer. After examining the water equity transfer methodology study and the practices of other public agencies, staff decided to cease the equity transfer to the General Fund from the Water Fund beginning in FY 2010. In addition, R. W. Beck was engaged in early 2009 to review its recommendations from 2000 and to again evaluate alternate equity transfer methodologies. R. W. Beck completed its review of the electric and gas equity transfers in February 2009, identifying alternative methodologies and recommending a methodology for the future that is fair and reasonable.

R. W. Beck's Recommendation

R. W. Beck's letter report (Attachment B) identified some of the common methods used by municipally-owned utilities to determine an equity transfer to the general fund of the city. These methods are described in the report and include:

- Return on Rate Base – essentially the UEM
- Percent of Gross Revenue – based on retail revenues
- Percent of Net Revenue – based on retail revenues less certain identified expenses
- Rate per Unit Delivered – a fixed amount per kilowatt-hour delivered
- Fixed Amount – predetermined amount independent of operational costs or revenues

R. W. Beck recommends that the City employ a Return on Rate Base method similar to the UEM utilized in the past by Palo Alto.

The recommended method requires the annual calculation of the "rate base" for the Electric and Gas Funds. The rate base contains the following components that are added together:

- Net asset value of the utility assets as of the latest audited fiscal year. This is calculated every year by the Administrative Services Department. The net asset value is adjusted every year by that year's capital additions and reductions for depreciation, which is based on the life of each asset. The latest audited net asset value will be found in the City's Comprehensive Annual Financial Report (CAFR);
- Working capital for the supply purchases for the upcoming fiscal year. This is calculated by multiplying the budgeted cost for supply purchases by 1/12 since the City needs to reserve sufficient funds for one month of these costs;
- Working capital for the non-energy supply operating costs for the upcoming fiscal year. This is calculated by multiplying these costs by 1/8 since there is approximately a 45-day lag from customer usage of the energy deliveries and payment received for the energy deliveries;
- Additional capital projects budgeted during the current fiscal year. This is equal to the additional budgeted capital improvements minus the expected customer funded improvements;
- Depreciation for the current fiscal year. This is the estimated depreciation on the utility assets for the current fiscal year, which will result in a reduction of the asset base; and
- Additional capital projects planned to be added during the upcoming fiscal year. This is equal to the additional budgeted capital improvements minus the expected customer funded improvements. This total amount is divided by two to approximate the average CIP and customer funded improvements during the fiscal year.

The rate base is then multiplied by an appropriate return on equity to calculate the equity transfer. R. W. Beck recommends using an adjusted return on equity based on the return on equity allowed by the California Public Utilities Commission for PG&E. R. W. Beck recommended methodology has two adjustments to PG&E's allowed return on equity to account for differences between an investor owned utility (IOU) like PG&E, and a municipally owned utility. The first adjustment is a tax adjustment and the second is a risk adjustment.

The tax adjustment compensates for the fact that the City of Palo Alto Utilities is a tax-exempt entity and the City does not pay taxes on its collected return. The tax adjustment is 30%, which is reflective of the total tax rate for taxable entities. The risk adjustment is based on the concept that an investment in a municipal utility is less risky than an investment in an IOU. R. W. Beck advised that the difference in yield between corporate bonds and municipal bonds cannot be

entirely explained by the tax adjustment alone. R. W. Beck recommends a 15% factor for this risk adjustment.

The calculation of the return on equity appropriate for Palo Alto, then is equal to PG&E's approved return on equity multiplied by 0.70 (1-.30, the tax adjustment) multiplied by 0.85 (1-.15, the risk adjustment). As an example, using PG&E's current approved return on equity of 11.35%, the total return for Palo Alto would be equal to 11.35% times 0.7 times 0.85, or 6.75%. When this return on equity is multiplied by the rate base, calculated as described above, the answer is the equity transfer for the Electric and Gas Funds.

The chart below shows the equity transfers to the General Fund for FY 2009.

Fiscal Year 2009 Equity Transfer

Fiscal Year	Water Fund	Electric Fund	Gas Fund	Total	Increase (%/year)
2009	$2,666,956	$9,267,688	$3,135,256	$15,069,901	+3.0%

If R. W. Beck's methodology were in place for FY 2009, the calculation would be as follows for the Electric and Gas Funds:

Electric Equity Transfer:

$143,377,000 – net asset value as of June 30, 2007 from the FY 2007 CAFR[1]
+ 6,393,000 – supply working capital (supply purchases divided by 12)
+ 5,241,000 – operating expenses working capital (operating expenses divided by 8)
+ 9,260,000 – FY 2008 budgeted CIP less customer funded improvements
- 5,387,000 – FY 2008 depreciation
+ 4,037,000 – FY 2009 budgeted CIP less customer funded improvements divided by 2
$162,921,000 – total electric rate base

Electric Equity Transfer = $162,921,000 * 0.0675 = $10,997,000

Gas Equity Transfer:

$ 65,471,000 – net asset value as of June 30, 2007 from the FY 2007 CAFR
+ 2,324,000 – supply working capital (supply purchases divided by 12)
+ 1,534,000 – operating expenses working capital (operating expenses divided by 8)
+ 6,365,000 – FY 2008 budgeted CIP less customer funded improvements
- 1,552,000 – FY 2008 depreciation
+ 3,355,000 – FY 2009 budgeted CIP less customer funded improvements divided by 2
$ 77,497,000 – total gas rate base

Gas Equity Transfer = $77,497,000 * 0.0675 = $5,231,000

R. W. Beck's recommended method results in estimated equity transfers to the General Fund for FY 2010 of $11,400,000 from the Electric Fund and $5,367,000 from the Gas Fund for a total

[1] Adjusted for fiber optic net asset value

equity transfer of $16,767,000. The table below shows the projected transfers using the proposed method for the next five fiscal years given the projected CIP expenditures for each fund.

Estimated Equity Transfer Using RW Beck Recommended Methodology ($million)

Equity Transfer	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014
Electric Fund	11.40	11.80	12.00	12.17	12.41
Gas Fund	5.37	5.18	5.88	6.18	6.44
Total Equity Transfer	**16.77**	**16.98**	**17.88**	**18.35**	**18.85**
Annual Rate of Change	**N/A**	**1.3%**	**5.3%**	**2.7%**	**2.7%**

Staff's Recommendation

Staff proposed the R.W. Beck's recommended methodology to the UAC at its March 4, 2009 meeting. Based on discussions by the Commissioners, staff has modified its recommendation slightly from the methodology recommended by R. W. Beck. Staff now recommends removing the utilization of one half of the additional capital projects planned to be added during the upcoming fiscal year. This part of R. W. Beck's recommendation is meant to base the upcoming fiscal years rate base on the estimated net assets as of the mid-point of the fiscal year. Staff has decided that calculating the rate base for the upcoming fiscal year at the start of the fiscal year improves the method and limits the amount of future estimates required for the calculation.

If staff's recommended methodology were in place for FY 2009, the calculation would be as follows for the Electric and Gas Funds:

Electric Equity Transfer:

$143,377,000 – net asset value as of June 30, 2007 from the FY 2007 CAFR[2]
+ 6,393,000 – supply working capital (supply purchases divided by 12)
+ 5,241,000 – operating expenses working capital (operating expenses divided by 8)
+ 9,260,000 – FY 2008 budgeted CIP less customer funded improvements
- 5,387,000 – FY 2008 depreciation
$158,884,000 – total electric rate base

Electric Equity Transfer = $158,884,000 * 0.0675 = $10,725,000

Gas Equity Transfer:

$ 65,471,000 – net asset value as of June 30, 2007 from the FY 2007 CAFR
+ 2,324,000 – supply working capital (supply purchases divided by 12)
+ 1,534,000 – operating expenses working capital (operating expenses divided by 8)
+ 6,365,000 – FY 2008 budgeted CIP less customer funded improvements
- 1,552,000 – FY 2008 depreciation
$ 74,142,000 – total gas rate base

Gas Equity Transfer = $74,142,000 * 0.0675 = $5,004,000

Staff's recommended method results in estimated equity transfers to the General Fund for FY 2010 of $11,112,000 from the Electric Fund and $5,304,000 from the Gas Fund for a total equity

[2] Adjusted for fiber optic net asset value

transfer of $16,416,000. The table below shows the projected transfers using the proposed method for the next five fiscal years given the projected CIP expenditures for each fund.

Estimated Equity Transfer Using Staff's Recommended Methodology ($million)

Equity Transfer	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014
Electric Fund	11.11	11.53	11.74	11.91	12.15
Gas Fund	5.30	4.93	5.64	5.94	6.29
Total Equity Transfer	**16.42**	**16.46**	**17.38**	**17.84**	**18.43**
Annual Rate of Change	**N/A**	**1.3%**	**5.3%**	**2.7%**	**2.7%**

COMMISSION REVIEW AND RECOMMENDATIONS

The method proposed by R.W. Beck for the equity transfer methodology was presented to the UAC at its March 4, 2009 meeting. The UAC noted that the method must take into account assets that are added to the system that are debt-financed. There were also questions as to why the rate base formula includes one-half year of the future fiscal year's capital additions. Staff also clarified for the UAC that property for which Utilities pays rent to the General Fund is not included in the Utilities net asset base.

Commissioner Rosenbaum provided staff and the UAC a perspective from the last time there was a change in the equity transfer method in 2000. Rosenbaum felt that the discussion about the change this time was not adequate and that staff did not prepare the UAC for the sudden increase in the proposed transfer amount. He also expressed dismay that the additional funds appeared to be proposed coincident with the City's announcement of a budget deficit.

Other commissioners generally supported the Utilities Enterprise Methodology, calling it reasonable and based on non-arbitrary information, but made some suggestions for modifications.

Commissioner Melton made a motion that the UAC recommend that Council approve the methodology proposed by staff modified by removal of 50% of the future year's budgeted CIP and by an appropriate asset base in the event of debt issuance. Chair Dawes proposed that the motion be amended so that the UAC recommend that Council approve the methodology proposed by staff modified by:

1. Removal of 50% of the future year's budgeted CIP;
2. Removal of the operating expense working capital;
3. Require that the annual transfer cannot change by more than plus or minus 5%; and
4. Require debt-funded assets to be appropriately characterized in the rate base recognizing that a rate of return is being paid to bond holders on such assets.

Chair Dawes seconded the motion. The motion carried 3-1-1 with Commissioner Rosenbaum voting no with a comment that the method is a blatant attempt for the General Fund to take more dollars from Utilities. Commissioner Keller abstained saying that she did not understand the method. The notes from the UAC meeting are provided as Attachment C.

UAC's Recommendation

The UAC's recommendation includes modifications to the methodology recommended by R. W. Beck. If the UAC's recommended methodology were in place for FY 2009, the calculation would be as follows for the Electric and Gas Funds:

Electric Equity Transfer:

$143,377,000 – net asset value as of June 30, 2007 from the FY 2007 CAFR[3]
+ 6,393,000 – supply working capital (supply purchases divided by 12)
+ 9,260,000 – FY 2008 budgeted CIP less customer funded improvements
- 5,387,000 – FY 2008 depreciation
$153,643,000 – total electric rate base

Electric Equity Transfer = $153,643,000 * 0.0675 = $10,371,000

Gas Equity Transfer:

$ 65,471,000 – net asset value as of June 30, 2007 from the FY 2007 CAFR
+ 2,324,000 – supply working capital (supply purchases divided by 12)
+ 6,365,000 – FY 2008 budgeted CIP less customer funded improvements
- 1,552,000 – FY 2008 depreciation
$ 72,608,000 – total gas rate base

Gas Equity Transfer = $72,608,000 * 0.0675 = $4,901,000

In addition the 5% maximum annual increased transfer is part of the UAC's recommended method. The table below shows the resulting equity transfers to the General Fund where the transfers from each fund do not change by more than 5 percent up or down from year to year. Using the method, the transfers in FY 2010 would be 5% more than they are in FY 2009, or $9,731,000 from the Electric Fund and $3,292,000 from the Gas Fund for a total equity transfer of $13,023,000. The table below shows the projected transfers using the proposed method for the next five fiscal years given the projected CIP expenditures for each fund.

Estimated Equity Transfer Using UAC's Recommended Methodology ($million)

Equity Transfer	FY 2009 (current)	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014
Electric Fund	9.27	10.77	11.16	11.36	11.52	11.75
Gas Fund	3.14	5.20	4.81	5.53	5.82	6.16
Total Equity Transfer	**12.41**	**15.96**	**15.98**	**16.89**	**17.33**	**17.91**
Annual Rate of Change		**28.7%**	**0.1%**	**5.7%**	**2.6%**	**3.3%**
Transfer if limited by 5% maximum annual change for each fund						
Electric Fund	9.27	9.73	10.22	10.73	11.26	11.75
Gas Fund	3.14	3.29	3.46	3.63	3.81	4.00
Total Equity Transfer	**12.41**	**13.02**	**13.67**	**14.36**	**15.08**	**15.75**
Annual Rate of Change		**5%**	**5%**	**5%**	**5%**	**4.5%**

[3] Adjusted for fiber optic net asset value

The table below summarizes staff's and the UAC's recommendations for the equity transfers for the next five fiscal years.

Equity Transfer Methodology Recommendations ($million)

Staff Recommendation	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014
Electric Fund	11.11	11.53	11.74	11.91	12.15
Gas Fund	5.30	4.93	5.64	5.94	6.29
Total Equity Transfer	**16.42**	**16.46**	**17.38**	**17.84**	**18.43**
UAC's Recommendation					
Electric Fund	9.73	10.22	10.73	11.26	11.75
Gas Fund	3.29	3.46	3.63	3.81	4.00
Total Equity Transfer	**13.02**	**13.67**	**14.36**	**15.08**	**15.75**

RESOURCE IMPACT

The total equity transfer from Utilities Funds for FY 2009 is $15.07 million. If the current method of increasing the equity transfer by 3% per year were used for FY 2010, the equity transfer would be $15.52 million. Staff's recommended equity transfer method will increase the total equity transfer from Utilities for FY 2010 to $16.42 million, or an increase of approximately $900,000. The equity transfers are part of the Utilities revenue requirement and the costs will be recovered from gas and electric ratepayers.

Since the equity transfer from the Water Fund will cease in FY 2010, the Water Fund revenue requirement is reduced by the amount of the transfer amount, or approximately $2.75 million. Staff's recommended equity transfer method will increase the equity transfer from the Gas Fund by about $2.1 million for FY 2010 compared to what it would have been if the current method continued. Staff's recommended equity transfer method will increase the equity transfer from the Electric Fund by about $1.57 million for FY 2010 compared to what it would have been if the current method continued.

The current FY 2009 equity transfers from the Electric, Gas, and Water Funds total $15.07 million compared to the staff recommended Electric and Gas transfers in FY 2010 of $16.42 million, or an increase of $1.35 million in equity transfers to the General Fund.

If the UAC's recommended methodology were to be adopted, then the equity transfers for FY 2010 from the Electric Fund and the Gas Fund would be $9.73 million and $3.29 million for a total equity transfer of $13.02 million. This is $2.05 million less than the FY 2009 total equity transfer to the General Fund from Utilities and $3.4 million less than staff's recommendation for FY 2010.

Staff agrees with the UAC's recommendation to exclude any impact to the operating expense as a result of the issuance of debt. However, any assets created as a result of the debt issue will be included in the rate base calculation as part of the net asset value as per the CAFR. The City Attorney's office has also advised that the UAC recommendation to require that any decrease in the annual transfer be limited to a maximum of 5% is legally impermissible.

POLICY IMPLICATIONS

The recommended action changes the equity transfer methodology. This recommendation is consistent with the Council-approved Utilities Strategic Plan with regard to 1) managing supply portfolio risk to preserve a supply cost advantage; and 2) to provide low and stable rates, adequate reserves, and budgeted transfers to the General Fund.

ENVIRONMENTAL REVIEW

Changing the equity transfer methodology does not meet the definition of a "project" pursuant to Section 21065 of the Public Resources Code, thus no environmental assessment under the California Environmental Quality Act (CEQA) is required.

ATTACHMENTS

A. Historical Equity Transfers from Electric, Gas, and Water Funds
B. March 3, 2009 letter from R. W. Beck to the Director of Administrative Services regarding the equity transfer
C. Draft Notes from the March 4, 2009 UAC meeting

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Historical Equity Transfers to the General Fund

Fiscal Year	Water Fund	Electric Fund	Gas Fund	Total	Increase (%/year)
1982	1,133,000	7,829,000	139,000	9,101,000	+40.8%
1983	487,000	7,689,000	568,000	8,744,000	-3.9%
1984	811,000	5,845,000	1,003,000	7,659,000	-12.4%
1985	710,000	5,500,000	864,000	7,074,000	-7.6%
1986	726,000	5,500,000	875,000	7,101,000	+0.4%
1987	910,000	5,500,000	2,309,000	8,719,000	+22.8%
1988	909,996	6,445,620	1,594,992	8,950,608	+2.7%
1989	1,453,000	6,011,000	1,103,000	8,567,000	-4.3%
1990	1,460,000	6,098,000	1,215,000	8,773,000	+2.4%
1991	11,112	6,126,600	1,383,500	7,521,212	-14.3%
1992	1,703,000	6,498,000	1,444,000	9,645,000	+28.2%
1993	1,123,000	6,165,000	1,713,000	9,001,000	-6.7%
1994	1,300,000	6,752,000	1,693,000	9,745,000	+8.3%
1995	1,741,000	6,187,000	1,653,000	9,581,000	-1.7%
1996	1,622,000	7,200,000	1,969,000	10,791,000	+12.6%
1997	2,044,000	7,316,000	2,475,000	11,835,000	+9.7%
1998	2,044,000	7,316,000	2,475,000	11,835,000	0%
1999	2,044,000	7,316,000	2,475,000	11,835,000	0%
2000	2,044,000	7,316,000	2,475,000	11,835,000	0%
2001	2,105,328	7,315,992	2,475,000	11,896,320	+0.5%
2002	2,168,480	7,535,480	2,549,250	12,253,210	+3.0%
2003	2,233,534	7,761,544	2,625,728	12,620,806	+3.0%
2004	2,300,540	7,994,390	2,704,500	12,999,430	+3.0%
2005	2,369,556	8,234,222	2,785,635	13,389,413	+3.0%
2006	2,440,643	8,481,248	2,869,204	13,791,095	+3.0%
2007	2,513,862	8,735,686	2,955,280	14,204,828	+3.0%
2008	2,589,278	8,997,756	3,043,938	14,630,972	+3.0%
2009	2,666,956	9,267,688	3,135,256	15,069,901	+3.0%

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ATTACHMENT 2

Credit Category

The following table displays the correlation between Credit Categories and Median EDF credit measures. These values are updated on a monthly basis.

5-yr Median: Median of spot medians over a 5-year period.
Spot EDF: The EDF median calculated for companies grouped by their agency ratings, compiled at the end of each month.

Source: S&P **EDF Median Calculation:** Spot EDF **Credit Category:** 1 Year

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Credit Category	Equivalent Median EDF credit measure	Bound Range Lower	Bound Range Upper	Credit Category	Equivalent Median EDF credit measure	Bound Range Lower	Bound Range Upper
AAA	0.06%	0.01%	0.07%	BB	2.38%	1.89%	3.28%
AA+	0.07%	0.07%	0.07%	BB-	4.51%	3.28%	6.21%
AA	0.07%	0.07%	0.08%	B+	8.54%	6.21%	11.75%
AA-	0.10%	0.08%	0.11%	B	16.16%	11.75%	18.11%
A+	0.13%	0.11%	0.15%	B-	20.28%	18.11%	22.74%
A	0.17%	0.15%	0.21%	CCC+	25.48%	22.74%	28.56%
A-	0.26%	0.21%	0.32%	CCC	32.00%	28.56%	32.16%
BBB+	0.39%	0.32%	0.48%	CCC-	32.32%	32.16%	32.64%
BBB	0.59%	0.48%	0.74%	CC	32.97%	32.64%	33.47%
BBB-	0.94%	0.74%	1.18%	C	33.97%	33.47%	35.00%
BB+	1.49%	1.18%	1.89%	D	35.00%	35.00%	35.00%

Last Updated: March 31, 2009

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