TO: HONORABLE CITY COUNCIL

FROM: CITY MANAGER

DEPARTMENT: UTILITIES & ADMINISTRATIVE SERVICES

ATTENTION: FINANCE COMMITTEE

DATE: SEPTEMBER 19, 2006 CMR:358:06

SUBJECT: RECOMMENDATION FOR FINANCE COMMITTEE TO REVIEW CERTAIN UTILITY EMERGENCY PLANT REPLACEMENT RESERVE AND RATE STABILIZATION RESERVE POLICIES, GUIDELINES, OR PURPOSES AND DIRECT STAFF TO WORK WITH THE UTILITIES ADVISORY COMMISSION TO DEVELOP RECOMMENDATIONS FOR CHANGES TO THE SAME

RECOMMENDATION
Staff recommends that the Finance Committee direct staff to work with the Utilities Advisory Commission to develop recommendations for changes to the policies, guidelines, or purposes of the following Utilities Fund Reserves:

- Emergency Plant Replacement Reserve for the Water, Electric, Gas, and Wastewater Collection Funds;
- Supply Rate Stabilization Reserve for the Electric and Gas Funds;
- Distribution Rate Stabilization Reserve for the Electric and Gas Funds; and
- Rate Stabilization Reserve for the Water and Wastewater Collection Funds.

BACKGROUND
By Charter or by Council action, a number of Utilities reserves have been established for various purposes. Over time, Council has changed the name, purpose, policies and guidelines for many of the reserves to address certain requirements or to accommodate specific needs. This report provides descriptions of each reserve and an assessment of whether additional analysis is warranted to develop recommendations to make an adjustment in the reserve policies. The Utilities Fund reserves include:
Emergency Plant Replacement Reserves
Calaveras Reserve
Rate Stabilization Reserves
Central Valley Project (CVP) Operations and Maintenance Reserve
Underground Loans Reserve
Public Benefit Plan (PBP) Reserve
Transfer Stabilization Reserve

The table below identifies the applicable fund(s) for each of these reserves.

<table>
<thead>
<tr>
<th>Name of Reserve</th>
<th>Water</th>
<th>Electric</th>
<th>Gas</th>
<th>Wastewater Collection</th>
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<tr>
<td>Emergency Plant Replacement</td>
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<td>X</td>
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<td>Calaveras</td>
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<td>Central Valley Project (CVP) Operations and Maintenance</td>
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<td>Rate Stabilization</td>
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<td>Underground Loans</td>
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<td>Public Benefit Plan (PBP)</td>
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<td>Transfer Stabilization Reserves</td>
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**DISCUSSION**
This section describes the existing reserves and identifies any issues that may prompt further review and analysis.

**Emergency Plant Replacement (EPR) Reserve**
This reserve is established by the City Charter for the Electric, Water, Gas, and Wastewater Collection Funds for unplanned emergencies only. The Charter directs that EPR reserve balances are not to exceed 5 percent of the net book value of the fixed assets of the fund. In 1988, Council approved minimum funding of the EPR reserves to be 5 percent of the annual increase in the net book value of the fixed assets of the fund. At that time, Council also directed that the balance of the reserve should be equal to an amount that covers the most expensive item of equipment which, if lost, would cause interruption in the normal activity of that utility. As required by the City Charter, these funds are available for use only for replacement or emergency repairs of damaged equipment; and such uses require special appropriation by Council.

Staff recommends that the EPR reserves be re-examined. Specifically, the existing fund levels should be compared to the rules in the Charter and the funding levels should be compared to the Council-directed minimum annual funding levels. In addition, updated estimates for the cost of critical facilities or equipment that could interrupt service should be developed and compared to the fund levels.

**Calaveras Reserve**
In 1983, Council established this reserve in the Electric Fund to provide for financial obligations arising from participation in the Calaveras Hydroelectric Project. In May 1997, Council revised
the reserve target level to cover above-market, or “stranded,” costs of certain electric fund assets, including the Calaveras project, the California-Oregon Transmission Project, and a contract with Seattle City Light. At that time, the fund target was set to $93 million by December 31, 2001 to be collected from a Transition Cost Recovery Charge (TCRC) imposed on electric rates. In May 1999, Council revised the reserve target to $65 million by December 31, 2001 and eliminated TCRC collection. Council also established reserve target levels for each year from FY 1999-2000 to FY 2032-2033, when the reserve would be exhausted.

This reserve is operating as designed, levels are on target and there are no issues with the current guidelines. Staff does not recommend a review of this reserve at this time.

**Rate Stabilization Reserve (RSR)**

Council established RSRs in May 1993 for the Water, Electric, Gas and Wastewater Collection Funds. The RSRs were created by combining the System Improvement Reserve in these funds and the Transfer Stabilization Reserve for the Water, Gas, and Electric Funds. This decision reflected the change in the use of the reserves to a mechanism to stabilize rates. At the time of the creation of these reserves and their associated guidelines, staff advised Council that “selecting a guideline involves a degree of judgment and uncertainty, the adequacy and prudence of these guidelines will be reviewed internally each year and, if appropriate, revised guidelines will be recommended.”

The purpose of the RSRs is to ensure funds are available to cover short-term situations when expenditures exceed revenues, to provide a depository of excess funds when expenditures are less than projected or revenues are higher than budgeted, and to plan for certain known future occurrences that are of a one-time nature, or to ramp up if the expense is of an ongoing nature.

In May 1998, Council split the Gas and Electric Fund RSRs into Supply and Distribution RSRs when the retail rates in those funds were unbundled into supply and distribution components of the rate. The Gas and Electric Funds were split into supply and distribution business units to clarify the financial picture of the cost of distribution services (including the Capital Improvement Program [CIP]), operations and maintenance, transfer to the General Fund, rent, administration, allocated charges and other expenses) and supply services (including the cost of purchased commodities, direct and indirect administrative overhead allocated to the supply services) for the funds. The reserve guidelines established at that time were consistent with the approach taken in the development of the original 1993 reserve guidelines where cost contingencies were evaluated.

1. **Electric Distribution RSR** – at the time Council created this reserve in 1998 [CMR:194:98], the minimum reserve level guideline was set at 15 percent of the distribution sales revenue. The maximum level guideline was twice the minimum and the target was the midpoint between the minimum and maximum.

   In December 2003 [CMR:467:03], Council revised the guidelines of this reserve so that the minimum reserve level guideline was set at 19 percent of the distribution sales revenue. The guidelines were developed from a revision in the electric distribution cost contingencies, including: 1) a 10% decline in sales revenue for two years, 2) rise in
ongoing operating expenses for two years, and 3) unusual one-time cost contingencies (e.g. potential seismic upgrades at the Municipal Service Center, effectiveness of efficiency programs, regulatory and legal cost uncertainties or expansion of the CIP). As before, the maximum level guideline was twice the minimum and the target was the midpoint between the minimum and maximum.

An issue with this reserve’s guideline is that it is based on distribution sales revenue. The purpose of the reserve is to cover cost contingencies, which do not necessarily relate to sales revenue. Staff recommends that this reserve’s guidelines be evaluated, and a recommendation be developed to address the problem with the existing link between the guideline and sales revenue.

2. Electric Supply RSR – at the time Council created this reserve in 1998 [CMR:194:98], the minimum reserve level guideline was set to 30 percent of the supply sales revenue. The maximum level guideline was twice the minimum and the target was the midpoint between the minimum and maximum.

In May 2001 [CMR:248:01], Council revised the guidelines of this reserve so that the minimum reserve level guideline was set at 40 percent of the supply purchase cost, instead of supply sales revenue. The guidelines were revised to reflect the major uncertainties associated with the electric supply cost as the Western contract would change at the end of 2004, resulting in greater reliance on the market for electric commodity purchases and greater exposure to hydrologic conditions. A description of each major uncertainty and the potential cost impact from that uncertainty was provided to Council. As before, the maximum was twice the minimum and the target was the midpoint between the minimum and maximum.

In December 2003 [CMR:467:03], Council further revised the guidelines of this reserve so that the minimum reserve level guideline was set to 51.5 percent of the supply purchase cost. The guidelines were developed from a revision in the electric supply recurring and one-time cost contingencies. The recurring cost contingencies included: 1) Western hydrologic production and market price variability for two dry hydrologic years, 2) Calaveras hydrologic production and market price variability for two dry hydrologic years, 3) Calaveras plant service interruption, 4) market price risk related to unhedged load positions, and 5) transmission cost uncertainties. One-time cost contingencies included: 1) regulatory and legal cost uncertainties, 2) supplier default, and 3) thermal plant investment initial working capital. As before, the maximum level guideline was twice the minimum and the target was the midpoint between the minimum and maximum.

A major issue with this reserve’s guideline is that it is based on supply purchase cost. The purpose of the reserve is to cover cost contingencies, which don’t directly relate to supply purchase cost. Staff recommends that this reserve’s guidelines be evaluated and a recommendation be developed to address the problem with the existing link between the guideline and sales revenue and to relate the size of the reserve to the risks the reserve is designed to mitigate.
3. Gas Distribution RSR – at the time Council created this reserve in 1998 [CMR:194:98], the minimum reserve level guideline was set at 20 percent of the distribution sales revenue. The maximum level guideline was twice the minimum and the target was the midpoint between the minimum and maximum. The 20 percent was stated to be an approximation that could vary slightly from year to year.

In December 2003 [CMR:467:03], this reserve was examined, but the existing guidelines were determined to be adequate to cover the impact of gas distribution cost contingencies, including: 1) a decline in sales revenue of 10 percent for two years, 2) rise in ongoing operating expenses for two years, and 3) unusual one-time cost contingencies (e.g. potential seismic upgrades at the Municipal Service Center, effectiveness of efficiency programs, regulatory and legal cost uncertainties or expansion of the CIP).

As with the Electric Distribution RSR, a major issue with this reserve’s guideline is that it is based on sales revenue. The purpose of the reserve is to cover cost contingencies, which don’t directly relate to sales revenue. Staff recommends that this reserve’s guidelines be evaluated and a recommendation be developed to address the problem with the existing link between the guideline and sales revenue, and to relate the size of the reserve to the risks the reserve is designed to mitigate.

4. Gas Supply RSR – at the time Council created this reserve in 1998 [CMR:194:98], the minimum reserve level guideline was set to 20 percent of the supply sales revenue. The maximum level guideline was twice the minimum and the target was the midpoint between the minimum and maximum. The 20 percent was stated to be an approximation that could vary slightly from year to year.

In May 2001 [CMR:248:01], Council revised the guidelines of this reserve so that the minimum reserve level guideline was set to 20 percent of the supply purchase cost, instead of supply sales revenue. The guideline reflected the major uncertainties associated with the gas supply cost: sales volume changes due to weather effects, market price risk, and credit risk. A description of each major uncertainty and the potential cost impact from that uncertainty was provided to Council. As before, the maximum was twice the minimum and the target was the midpoint between the minimum and maximum.

In December 2003 [CMR:467:03], Council further revised the guidelines of this reserve so that the minimum reserve level guideline was set to 37.5 percent of the supply purchase cost. The guidelines were developed from a revision in the gas supply cost contingencies, including: 1) an increase in gas pool customer sales volumes of 10 percent, 2) market price risk, and 3) unusual one-time cost contingencies (e.g. regulatory and legal cost uncertainties and supplier default/credit risk). As before, the maximum level guideline was twice the minimum and the target was the midpoint between the minimum and maximum.
As with the Electric Supply RSR, a major issue with this reserve’s guideline is that it is based on supply purchase cost. The purpose of the reserve is to cover cost contingencies, which don’t directly relate to supply purchase cost. Staff recommends that it evaluate this reserve’s guidelines be evaluated and a recommendation be developed to address the problem with the existing link between the guideline and sales revenue and to relate the size of the reserve to the risks the reserve is designed to mitigate.

5. Water RSR – guidelines for this reserve were set by Council at the time of the reserve’s creation in May 1993 [CMR:263:93]. At that time, the minimum reserve level was set to the sum of: 1) 15 percent of sales revenue for that year; and 2) the estimated annual net sales revenue decline due to abnormal weather. The maximum reserve balance guideline is twice the minimum guideline, with the target level halfway between the maximum and the minimum levels.

In December 2003 [CMR:467:03], this reserve was examined, but the existing guidelines were determined to be adequate to cover the impact of water fund cost contingencies.

The Water Fund is subject to changes in sales revenue caused by wet or cold weather, cost and effectiveness of water efficiency programs, acceleration of the Capital Improvement Program for the distribution system, and cost impacts related to San Francisco’s upgrade of the Hetch Hetchy regional water supply system.

Staff recommends a re-evaluation of the policies and guidelines for this reserve to determine their continued appropriateness.

6. Wastewater Collection RSR – guidelines for this reserve were set by Council at the time of the reserve’s creation in May 1993 [CMR:263:93]. At that time, the minimum reserve level was set to the sum of: 1) 15 percent of sales revenue for that year; and 2) the estimated annual net sales revenue decline due to abnormal weather. The maximum reserve balance guideline is twice the minimum guideline with the target level halfway between the maximum and the minimum levels.

In December 2003 [CMR:467:03], this reserve was examined, but the existing guidelines were determined to be adequate to cover the impact of water fund cost contingencies.

As with the Water Fund, the Wastewater Collection Fund is subject to changes in sales revenue caused by wet or cold weather and the effectiveness of water efficiency programs. In addition, acceleration of the Capital Improvement Program will impact reserve levels.

Staff recommends a re-evaluation of the policies and guidelines for this reserve to determine their continued appropriateness.

Central Valley Project (CVP) Operations and Maintenance (O&M) Reserve
This Electric Fund Reserve provides a mechanism for Palo Alto to advance CVP funds for O&M projects. Revenues from the CVP are returned to this fund when the Federal Government
appropriates the O&M funds for the CVP. This reserve has been functioning well as designed and staff does not feel that a review of this reserve is necessary at this time.

Underground Loans Reserve
The City has a long-term program to remove overhead electric, telephone, and cable TV lines and place them underground. Underground districts are established by ordinance. The Municipal Code section governing the establishment of the underground districts requires that parcel owners within the districts pay the costs of converting the services on their property. To assist property owners with the expenses, the City provides a 10-year loan in the form of a property assessment. This Electric Fund reserve sets aside funds for the loans made to the property owners. This reserve has been functioning well as designed and staff does not feel that a review of this reserve is necessary at this time.

Public Benefit Program (PBP) Reserve
In May 1997 [CMR:219:97], Council approved the separation of electric rates into four cost components to allow direct access to occur. One of these components was a Public Benefits Charge. In 1998 [CMR:194:98], Council established the PBP reserve in the Electric Fund to reserve revenues collected but unspent for Public Benefits Programs. This reserve has been functioning well as designed and staff does not feel that a review of this reserve is necessary at this time.

Transfer Stabilization Reserve
This reserve was established by Council in 1985 [CMR:276:5] for the Water, Gas, and Electric Funds to ensure that prudent transfers to the General Fund are provided. A minimum balance is equal to the next year’s transfer amount and the maximum balance is equal to 20% of the next year’s sales revenue. This reserve has been functioning well as designed and staff does not feel that a review of this reserve is necessary at this time.

RESOURCE IMPACT
Existing staff resources will be used to conduct the proposed review. No outside consulting assistance is anticipated.

POLICY IMPLICATIONS
Any changes to reserves policies or guidelines that may be proposed as a result of a review must be approved by Council prior to their implementation.

ENVIRONMENTAL REVIEW
Studying reserves policies is not a project under the California Environmental Quality Act; therefore, no environmental assessment is required.

NEXT STEPS
Staff will seek advice and feedback from the Utilities Advisory Commission prior to returning to the Finance Committee with recommendations for possible changes to the Utilities fund reserves. Any proposed changes to policies, guidelines, or purposes of any reserve will require Council approval.