TO: HONORABLE CITY COUNCIL
FROM: CITY MANAGER
DEPARTMENT: UTILITIES
DATE: JANUARY 22, 2008
CMR: 122:08

SUBJECT: UTILITIES ADVISORY COMMISSION RECOMMENDATION TO UTILIZE THE ELECTRIC SUPPLY RATE STABILIZATION RESERVE TO COVER INCREASED SUPPLY COST IN FISCAL YEAR 2007-08 INSTEAD OF A MID-YEAR RATE INCREASE

RECOMMENDATION
Staff and the Utilities Advisory Commission (UAC) recommend utilizing the Electric Supply Rate Stabilization Reserve (E-SRSR) to cover increased supply cost in Fiscal Year (FY) 2007-08 instead of a mid-year rate increase. The incremental amount to be withdrawn from the E-SRSR will be determined as part of the mid-year Budget Amendment Ordinance process in March 2008.

BACKGROUND
As part of the FY 2007-08 budget process, staff developed a 5-year Financial Plan (Plan) in December 2006 which showed costs steadily increasing over the next five years as a result of higher commodity, renewable energy, transmission, regulatory, and distribution costs. Further, retail revenue was projected to be insufficient to cover costs and the Plan included a series of rate increases designed to recover costs.

In accordance with the Plan, on June 18, 2007, Council approved a five-percent electric retail rate increase, or $4.4 million in additional revenue, effective July 1, 2007, to cover distribution-related expenses; and an in-concept 10-percent electric retail rate increase, ($9.2 million in additional revenue), for FY 2008-09 [CMR 202:07] to cover distribution-and supply-related expenses. The need for a rate increase in FY 2007-08 to cover supply-related expenses was not warranted as the projected end of FY 2007-08 E-SRSR was expected to be above the minimum guideline level.
DISCUSSION
Supply Projections and Cost
Projections developed during the FY 2007-08 budget process (prior to updated hydrologic conditions being available) assumed hydroelectric supply from the Western Base Resource and the Calaveras hydroelectric project would be average for FY 2007-08 and FY 2008-09. The adopted budget for FY 2007-08 calls for a drawdown of the E-SRSR of $11 million in FY 2007-08 and $8.4 million in FY 2008-09.

Given the dry conditions actually experienced, generation from both hydroelectric resources is now projected to be below average and a total of 233 Gigawatt-hour of hydroelectric supply will need to be replaced. The cost increase over budget associated with the dry conditions is estimated at $7.5 million in FY 2007-08 and $8 million in FY 2008-09.

Alternatives to Address Increased Costs
Staff evaluated and presented to the UAC several alternatives to address the impact of the increased drought-related costs on the electric fund as discussed briefly below.

1. FY 2007-08 Mid-Year rate increase option
   Implementing a 10 percent rate increase, effective February 1, 2008, would provide additional revenues of $3.6 million for FY 2007-08. This rate increase, along with the approved-in-concept 10 percent electric retail rate increase for FY 2008-09, effective July 1, 2008, would put the E-SRSR above the minimum guidelines level by the end of FY 2008-09.

2. Drawdown of the E-SRSR and higher future rate increases
   The expected supply cost increases would increase the E-SRSR drawdown necessary to cover operating expenses to $19 million and $16.6 million in FY 2007-08 and FY 2008-09, respectively. Given both the City’s policy to set rates to recover costs and the reserve guidelines, staff would need to consider a rate increase greater than the 10 percent approved-in-concept rate increase for FY 2008-09.

3. Drawdown of Calaveras Reserve
   The Calaveras Reserve was established in 1996 as part of the City’s effort to prepare for deregulation of the electric industry and the possibility of losing customers to retail competition. The Calaveras Reserve was set to cover the difference between the cost of City-owned assets and long-term contracts, and the market value of those assets, otherwise known as stranded cost. In 1999, the Calaveras Reserve was fully funded at $71 million and Council approved a schedule of Calaveras Reserve drawdowns to be used to offset power costs for future ratepayers through FY 2031-32 [CMR: 222:99].

   Staff’s preliminary assessment shows that approximately $10 to $20 million could be drawn from the Calaveras Reserve without adversely impacting the competitiveness of the electric utility. Such a drawdown could be a single transfer to the E-SRSR or could be a transfer over multiple years. Staff is not recommending drawing down the Calaveras Reserve for FY 2007-08. However, this alternative may be considered in the future, if the E-SRSR is insufficient to cover costs. Any change to the drawdown schedule will need Council approval.
To address the increased supply costs, staff considered implementing a 10 percent mid-year rate increase effective February 1, 2008. However, with the concurrence of the UAC, staff recommends foregoing a mid-year rate increase and instead utilizing the E-SRSR based on the following:

1. The ending E-SRSR for FY 2007-08 with the increased supply cost is estimated at approximately $42 million, sufficiently above the minimum reserve guideline level of $29.3 million.

2. Hydrologic uncertainty for FY 2007-08 is reduced as a dry hydro scenario is included in the expected cost and the E-SRSR is sufficient to cover the remaining cost uncertainties in FY 2007-08.

3. Use of the E-SRSR to fund the increased cost associated with reduced hydroelectric generation is consistent with the purpose for which the reserve is intended.

COMMITTEE REVIEW AND RECOMMENDATIONS
At its December 5, 2007 meeting, the UAC voted 4-1 to “recommend to Council to utilize funds from the Electric Supply Rate Stabilization Reserve, instead of a mid-year rate increase, to offset electric supply cost increases in FY 2007-08.” Commissioner Melton voted against the motion arguing that a mid-year rate increase would send the proper signal to ratepayers that there are costs associated with dry hydrologic conditions and that a delay will result in a larger rate increase in July 2008. Commissioner Dawes countered that a mid-year increase is not warranted given the reserve level forecasts for June 2008.

Further, the UAC advised staff that in addition to considering the use of the Calaveras Reserve to offset future rate increases, staff should evaluate use of the Calaveras Reserve to 1) invest in other capital projects; and 2) pay off some of the Calaveras and/or California Oregon Transmission Project debt.

RESOURCE IMPACT
Utilization of the E-SRSR to fund the increased cost in FY 2007-08 will require approval from Council in the form of a budget amendment ordinance. The exact amount to be drawn from reserves will be determined through the mid-year budget process in March 2008.

POLICY IMPLICATIONS
Use of the E-SRSR to fund changes in cost associated with hydroelectric generation supply is consistent with the E-SRSR guidelines (CMR:467:03) and supports the Utilities Strategic Plan objective of providing competitive rates to customers. This recommendation does not represent a change in current City policies.

ENVIRONMENTAL REVIEW
The utilization of the E-SRSR to fund charges in cost associated with hydroelectric generation supply does not meet the definition of a project pursuant to Section 21065 of the California Environmental Quality Act (CEQA), thus, environmental review is not required.
ATTACHMENTS
A. UAC Minutes from November 7, 2007 meeting
B. UAC Minutes from December 5, 2007 meeting

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