TO: HONORABLE CITY COUNCIL
FROM: CITY MANAGER
DEPARTMENT: UTILITIES
DATE: JUNE 2, 2008
CMR: 252:08

SUBJECT: ADOPTION OF A BUDGET AMENDMENT ORDINANCE INCREASING:
(1) THE BUDGET FOR ELECTRIC SUPPLY COST BY $6,350,000, (2) REVENUE FOR ELECTRIC SURPLUS ENERGY BY $800,000, (3) BUDGET FOR GAS SUPPLY COSTS BY $1,500,000, (4) REVENUE FOR GAS SUPPLY SALES BY $900,000, (5) REVENUE FOR GAS DISTRIBUTION SALES BY $1,000,000, (6) BUDGET FOR WATER SUPPLY COSTS BY $700,000, AND (7) REVENUES FOR WATER SALES BY $2,000,000

RECOMMENDATION
Staff recommends that Council adopt the attached Budget Amendment Ordinance (BAO) (Attachment 1) which addresses the need for:
   a) additional funding for Electric Supply Costs in the amount of $6,350,000;
   b) additional revenues for Electric Surplus Energy Revenues in the amount of $800,000;
   c) additional funding for the Gas Supply Costs in the amount of $1,500,000;
   d) additional revenues for Gas Retail Supply Sales Revenues in the amount of $900,000;
   e) additional revenues for Gas Retail Distribution Sales Revenues in the amount of $1,000,000;
   f) additional funding for the Utilities Water Supply Costs in the amount of $700,000; and,
   g) additional revenues for Water Retail Sales Revenues in the amount of $2,000,000.

BACKGROUND
Palo Alto’s Municipal Code Title 2 Administrative Code, Chapter 2.28 Fiscal Procedures, Section 2.28.050 categories of expenditure control lists “utility commodity and commodity transmission services purchased for resale” as items between which funds can’t be moved. Therefore, if additional funds are needed for such a category, they must be appropriated by Council rather than administratively moved from another category for which savings may be available.
On June 11, 2007, Council approved the Utilities Electric, Gas, and Water Fund Fiscal Year (FY) 2007-08 budgets [CMR:272:07]. Since then, supply costs have increased for each of those funds.

During the winter and spring of 2007, drought conditions resulted in lower than projected hydroelectric generation for the year. As a consequence, the City bought replacement electric energy from the market to meet City loads. Council was informed of the increased electric supply costs due to the drought on January 22, 2008 [CMR: 122:08], when staff and the UAC recommended a drawdown of reserves to cover the increased costs in lieu of a FY 2007-08 mid-year rate increase. To cover these higher costs, Council approved a mid-year Electric Fund budget increase of $8 million for FY 2007-08 on February 19, 2008 [CMR:151:08].

Gas supply costs also increased during the winter and spring of 2007 due to colder than normal weather conditions resulting in higher than projected gas use in the City. Additionally, market prices for natural gas increased significantly above the prices estimated when the budget was prepared.

Council approved a mid-year budget increase of $304,000 for the Water Fund for FY 2007-08 on February 19, 2008 [CMR:151:08] to cover higher wholesale water supply costs than were estimated when the budget was prepared.

**DISCUSSION**

**Electric Fund**

Based on actual costs through the third quarter of FY 2007-08 and projections for the remainder of this fiscal year, the Electric Supply Commodity Purchases budget requires additional funding of $2.6 million. These costs increased due to wholesale electric market prices that were higher than budget estimates and hydroelectric generation that was lower than budget projections. These projections are based on actual bills received through February 2008, estimated bills for March 2008 and the forecast of costs for April, May and June 2008.

There is also a high degree of uncertainty about the actual electric commodity costs for April, May and June 2008. If market prices are higher than are forecast and hydroelectric generation is lower than is forecast for these months, supply costs could be even higher. In such a “worst case" scenario for the remainder of this fiscal year, electric commodity costs could increase by an additional $3.75 million. Therefore, staff requests that the budget for the Electric Supply Commodity Purchases Budget be increased by an additional appropriation of $6.35 million in order to cover both the expected $2.6 million cost increase and an additional appropriation of $3.75 million to cover costs in case the high cost/low hydro scenario materializes.

The FY 2007-08 budgeted Electric Surplus Energy Revenue is $2.502 million. However, this is expected to increase by $800,000. Therefore, staff requests that the budget for these revenues increase by $800,000. In the high market prices and lower hydroelectric generation scenario, these revenues may not increase from the budget estimate.
The funds to cover the requested cost increases will come from the Electric Supply Rate Stabilization Reserve (E-SRSR). Any increased Electric Surplus Energy Revenue will go into the E-SRSR.

**Gas Fund**

Gas commodity costs are expected to be higher than was budgeted by about $1.1 million based on actual cost projections through the third quarter of FY 2007-08 and projections for the remainder of this fiscal year. The increase is due to higher than anticipated market prices as well as higher than anticipated natural gas demand in the City due to colder than normal weather. In January 2008, the expected gas market price for fourth quarter (April through June 2008) was about $0.80 per therm. Currently, the expected price for gas is $1.04 per therm, a 30% increase. Market prices were driven by late-season cold weather in the Midwest, low amounts of gas in storage nation-wide, low amounts of liquefied natural gas (LNG) coming to the country, and record high crude oil prices worldwide.

If prices remain higher than expected for the remainder of the year, costs could increase by an additional $400,000. Therefore, staff requests additional appropriations of $1.5 million for the Gas Supply Commodity Purchases Budget, which includes the $1.1 million of expected cost increases plus $400,000 of potential cost increases.

Since part of the reason for increased supply costs is that natural gas consumption increased due to cold weather, the retail sales revenue is expected to increase as well. Based on actual sales to date, total sales revenue is expected to increase by about $1.8 million above the budgeted amount with supply revenues increasing by about $800,000 and distribution revenues increasing by $1 million. If gas prices are higher than expected for the remainder of the fiscal year, retail supply sales revenue would increase by an additional $100,000 since the largest customers have a cost pass-through type retail rate for supply. Therefore, staff requests that the budget for Gas Supply Sales Revenue be increased by $900,000 and the budget for Gas Distribution Sales Revenue be increased by $1,000,000.

The Gas Supply Rate Stabilization Reserve (G-SRSR) is the source for the requested additional appropriation. Additional revenues will go into both the G-SRSR (for additional supply revenues) and the Gas Distribution Rate Stabilization Reserve (G-DRSR) (for additional distribution revenues).

**Water Fund**

Water consumption for the fiscal year to date is above the adjusted FY 2007-08 budget estimates. This may be attributed to drier than normal precipitation levels during the winter and early spring months prompting water use to increase for irrigation. Increased water consumption requires additional water supply purchases that are expected to cost an additional $165,000 above the budget level. If consumption levels for May and June are higher than expected, then the costs could increase by an additional $535,000. Therefore, staff requests additional funding of $700,000 for the Water Supply Commodity Purchases Budget, which includes the $165,000 of expected cost increases plus $535,000 of potential cost increases.
The increased water costs are due to increased water consumption, which also increases the retail sales revenue for the Water Fund. Based on actual sales to date, total retail sales revenue is expected to increase by about $500,000 above the budgeted amount. In addition, if consumption is high for May and June, water sales revenue could increase an additional $1.5 million. Therefore, staff requests that the budget for Water Sales Revenue be increased by $2.0 million, which includes the $500,000 of expected increased retail sales revenue plus $1.5 million of potential increased retail sales revenue.

The requested increased appropriation will come from the Water Rate Stabilization Reserve (W-RSR). Increased revenue will go into the W-RSR.

**RESOURCE IMPACT**

**Electric Fund**
The expected impact on the Electric Supply Rate Stabilization Reserve (E-SRSR) is a reduction of $1.8 million, or $2.6 million of expected commodity cost increases less $800,000 of expected surplus energy revenue.

In a worst case scenario, the E-SRSR could be reduced by $6.35 million, if commodity costs increase by $6.35 million and there is no additional surplus energy revenue.

The E-SRSR is expected to be within the minimum and maximum reserve guideline levels as of the end of FY 2007-08.

**Gas Fund**
The expected impact on the Gas Supply Rate Stabilization Reserve (G-SRSR) is a reduction of $100,000, or $1.1 million of expected commodity cost increases less $1,000,000 of expected gas supply retail sales revenue. The expected impact on the Gas Distribution Rate Stabilization Reserve (G-DRSR) is an increase of $800,000.

If gas prices are higher than expected for the balance of the fiscal year, the G-SRSR could be reduced by $400,000, if commodity costs increase by $1.5 million and retail supply sales revenues increase by $1.1 million. The G-DRSR is not impacted by a change in commodity costs so the impact on it would be the same as expected, or an increase of $800,000.

As of the end of FY 2007-08, the G-SRSR is expected to be below the minimum guideline level, but above the risk assessment levels. The G-DRSR is expected to be within the minimum and maximum guideline levels.

**Water Fund**
The expected impact on the Water Rate Stabilization Reserve (W-RSR) is an increase of $335,000, or $165,000 of expected commodity cost increases less $500,000 of expected water retail sales revenue.

If consumption is high for the balance of the fiscal year, the W-RSR could increase by $1.3 million due to commodity costs increasing by $700,000 and retail water sales revenue increasing by $2 million.
The balance of the W-RSS at the end of FY 2007-08 will be within the minimum and maximum reserve guideline levels.

**POLICY IMPLICATIONS**
This request does not represent a change in policy.

**ENVIRONMENTAL REVIEW**
This is not a project under the California Environmental Quality Act.

**ATTACHMENT**
1. Budget Amendment Ordinance

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