TO: HONORABLE CITY COUNCIL

ATTN: FINANCE COMMITTEE

FROM: CITY MANAGER

DATE: DECEMBER 2, 2008

DEPARTMENT: UTILITIES

CMR: 449:08

REPORT TYPE: INFORMATIONAL

SUBJECT: Discussion and Options for Using Funds in the Electric Utility Calaveras Reserve Fund

This is an informational report and no Finance Committee action is required. This item is provided as background information in conjunction with the Finance Committee’s study session on the subject.

EXECUTIVE SUMMARY
Prompted by changes to the City’s electric supply portfolio; market conditions; and increasing electric commodity cost, staff has reassessed the level of funding necessary in the Electric Fund’s Calaveras Reserve. Staff’s current assessment is that, under many scenarios, the Calaveras Reserve may have excess funds. Council could choose to use any excess funds for another electric fund purpose within certain parameters. The Utilities Advisory Commission (UAC) reviewed a preliminary proposal from staff and provided input that resulted in a modified proposal for discussion with the Finance Committee. This report provides background information for a discussion with the Finance Committee to help staff formulate a recommendation on how and whether to change current policy. Any changes that staff may propose for managing the Calaveras Reserve, reallocating its funds, or adjusting the Council-approved guidelines will return to the UAC and Finance Committee for discussion before a final recommendation is prepared for Council consideration.

BACKGROUND
California Assembly Bill 1890 was adopted in 1996, which provided for the deregulation of California’s electric industry effective January 1, 1998. A key element of deregulation was the provision for Direct Access, which would allow electric customers to choose their electric commodity supplier. The City of Palo Alto Utilities (City), along with other California utilities, were faced with the prospect of losing customers and load to Direct Access and being saddled with expensive generation assets which were purchased or built to serve these customers. In response to such risk, Pacific Gas and Electric Company and other investor- and municipally-
owned utilities established competition transition charges (CTC) to collect funds from ratepayers to cover the amount that these uneconomic assets were projected to cost above their market value in the future (i.e., “stranded cost”). In 1996, the City Council authorized the collection of funds from the City’s electric ratepayers to cover the City’s stranded cost and established the Calaveras Reserve (CMR 214:96) for these revenues. The assets that had stranded costs included the Seattle City Light Exchange contract, the Calaveras Hydroelectric Project, and the California-Oregon Transmission Project (COTP).

When the Calaveras Reserve balance reached $71 million in 1999, stranded costs were deemed fully collected. At that time, Council authorized the cessation of the collection of the stranded cost surcharge and established the Calaveras Reserve Target and Guidelines (CMR 222:99) with a schedule to drawdown the funds and manage electric rates through transfers from the Calaveras Reserve to the Electric Supply Rate Stabilization Reserve (E-SRSR) through the end of Fiscal Year (FY) 2031-32.

In 2001, the California electric industry faced an energy crisis triggering wholesale power price spikes and rolling blackouts throughout the state. The crisis was blamed on poor deregulation market design and market manipulation by energy suppliers. As a result, Direct Access was suspended in California for the investor-owned utilities and subsequently, the City suspended its Direct Access program. Further, as a result of changing market conditions and the layoff of certain electric assets, the estimate of the City’s stranded cost is lower now than when stranded cost collections stopped in 1999.

**DISCUSSION**

Potential stranded costs are associated with certain assets in the Electric Fund: the Calaveras Hydroelectric Project, the Seattle City Light Exchange contract and the COTP. Staff developed an updated estimate of the stranded cost for each of those assets.

1. **Calaveras Hydroelectric Project**
   The stranded cost associated with the Calaveras project is highly dependent on electric market prices and on generation from the plant. Given expected market prices and average hydro generation, the stranded cost estimate for the project is about $3 million. If market prices drop 20% from current prices and long-term hydro production is down 10% (as a result of changes in availability of water to generate electricity due to either climate changes or water management policies), the stranded cost associated with the Calaveras project could be $28 million. Further, the stranded cost could climb to $68 million under a scenario where market prices drop 40% and hydro production is 20% below average.

2. **Seattle City Light Exchange Contract**
   In June 2008, the City permanently assigned its share in the Seattle City Light Exchange contract to the City of Santa Clara, an action which eliminated the stranded cost associated with this contract estimated to be $1.4 million.

3. **California-Oregon Transmission Project (COTP)**
   The estimated stranded cost associated with the COTP is $15 million. A 15-year assignment of COTP, scheduled to be in effect by January 2009, is expected to eliminate the COTP stranded
cost. Staff, however, has estimated a potential stranded cost risk of $4.5 million over the 15-year assignment period under the following conditions:

- Assignment is terminated earlier than planned or is not executed. Staff has assessed a 20 percent probability on this event happening for a potential stranded cost of $3 million.
- Structural improvements are made to COTP during the course of the assignment which the City is obligated to fund. Staff estimates this risk to be up to $1 million.
- One or more of the assignees fails to pay the monthly cost and debt obligations. This can occur for up to three months before being remedied with a potential cost to the City of $0.5 million.

**Recommended Reserve Scenarios**

Given the above assessment of stranded cost and uncertainties, staff believes a prudent amount to reserve for stranded cost is $32.5 million. This estimate includes $28 million for the Calaveras project to cover a scenario where market prices drop 20% and hydro production drops 10% over the long-term and $4.5 million to cover COTP assignment contingencies. Since the Calaveras Reserve balance will be $64.5 million by the end of FY 2008-09, it will contain approximately $32 million more than needed to cover the estimated stranded cost of $32.5 million.

Staff discussed options for managing the Calaveras Reserve with the Utilities Advisory Commission (UAC) in December 2007 and February 2008. The UAC provided several ideas for staff's evaluation and consideration. In an effort to evaluate the various alternatives, staff developed the following guiding principles for evaluating the options and developing a proposal to manage the Calaveras Reserve:

1. Disbursement of funds should benefit electric ratepayers
2. Plan must contain guidelines for disbursement and a draw down schedule
3. Plan must be easy to implement and monitor

In November 2008, staff presented a preliminary proposal to the UAC for managing the Calaveras Reserve and the $32.5 million in the Calaveras Reserve that may not be needed for stranded costs. Staff's proposal included the following three elements:

- Reduce the Calaveras Reserve to $32.5 million by the end of FY 2009-10 and deplete the reserve by FY 2023-24.
- Transfer $12.0 million to the Electric Supply Rate Stabilization Reserve (E-SRRS) in FY 2009-10 and manage funds according to the E-SRRS guidelines (Attachment C).
- Create a new reserve, funded at $20 million, for potential electric utility capital improvement and/or other projects which benefit electric ratepayers with funds disbursed by the end of FY 2014-15.

**COMMISSION REVIEW AND RECOMMENDATIONS**

At the November 5, 2008 UAC meeting, staff provided the UAC with an updated assessment of stranded cost and presented the proposal described above for the UAC's consideration and
feedback (see Attachment A). After much discussion on the merits of staff’s proposal, the UAC provided the following general feedback and direction to staff:

- Agreement with staff’s assessment that the current estimate of stranded cost is likely lower than the $64.5 million in the Calaveras Reserve and recognized that staff’s stranded cost estimate of $32.5 million is a prudent amount of funds to reserve for stranded cost.
- Recognition that the Calaveras Reserve has about $32 million more than is needed to cover stranded cost.
- No support for transferring funds to the Electric Supply Rate Stabilization Reserve (E-SRSR) because such a strategy sends the wrong price signal to customers and only defers the need to raise electric rates to cover cost. The UAC noted that E-SRSR funds were drawn down in FY 2007-08 and are planned to be drawn down in FY 2008-09 resulting in retail rates that do not fully cover operating costs. An additional transfer would continue to defer the alignment of retail rate revenues with costs.
- Support of the use of funds in the Calaveras Reserve that may not be needed for stranded costs to pay for capital improvement projects to the benefit of electric rate payers and identification of several types of projects which may be funded (see discussion below). However, the UAC did not support the idea of creating a new fund to do so.
- Belief that there is no immediate need to reduce the Calaveras Reserves given market price and hydroelectric generation uncertainty.
- Support use of funds in the Calaveras Reserve that may not be needed for stranded costs for capital project development and only after reviewing and concurring with a specific project recommendation by staff.

In addition to discussing staff’s preliminary proposal, the UAC discussed examples of capital projects that could be considered for funding using the funds in the Calaveras Reserve that may not be needed for stranded costs. The Commissioners’ capital project ideas included:

- Development of local and/or distributed generation as a baseload resource;
- Upgrade of transmission voltage from PG&E to the City’s distribution system;
- Development of smart grid elements and purchase of smart meters;
- Purchase of land from City which the electric utility currently rents; and
- Loan funds to other Utilities funds and/or the General Fund in order to save financing costs related to issuing bonds for capital projects.

Draft minutes from the UAC meeting are attached (Attachment B).

As a result of the UAC’s input, staff has revised its proposal and now proposes to not change the Calaveras Reserve balance or Council-approved guidelines at this time. A preliminary proposal to transfer some of the funds to the E-SRSR and to a new fund to be spent quickly over the next five years or so is no longer recommended by staff. However, staff wishes to advise the Council that the Calaveras Reserve contains funds that may not be needed for stranded costs. Staff may recommend the use of those funds for capital projects that benefit electric ratepayers. Any such recommendation would be reviewed by the UAC and the Finance Committee prior to consideration by the Council.
ENVIRONMENTAL REVIEW
Consideration of this informational report does not constitute a “project” pursuant to Section 21065 of the Public Resources Code, thus no environmental review under the California Environmental Quality Act is required.

ATTACHMENTS
A. November 5, 2008 report to the UAC: Proposal for the Calaveras Reserve
B. Draft Minutes from the November 5, 2008 UAC meeting
C. Council-approved Rate Stabilization Reserve Guidelines

PREPARED BY: MONICA PADILLA
Senior Resource Planner

REVIEWED BY: JANE O. RATCHYE
Utilities Assistant Director, Resource Management

DEPARTMENT APPROVAL: VALERIE O. FONG
Director of Utilities

CITY MANAGER APPROVAL: JAMES KEENE
City Manager
MEMORANDUM

TO: UTILITIES ADVISORY COMMISSION
FROM: UTILITIES DEPARTMENT
DATE: NOVEMBER 5, 2008
SUBJECT: PROPOSAL FOR THE CALAVERAS RESERVE

REQUEST
Staff requests feedback from the Utilities Advisory Commission (UAC) on the following proposal to manage the Calaveras Reserve:

- Reduce the Calaveras Reserve to $32.5 million by the end of fiscal year (FY) 2009-10 and plan to deplete the reserve by FY 2023-24.

- Transfer $12.0 million to the Electric Supply Rate Stabilization Reserve (E-SRSR) in FY 2009-10 and manage funds according to the E-SRSR guidelines.

- Create a new reserve, funded at $20 million, for potential electric utility capital improvement and/or other projects which benefit electric ratepayers with funds disbursed by the end of FY 2014-15.

BACKGROUND
Council established the Calaveras Reserve in 1996 and authorized collections from electric ratepayers to cover the amount that certain electric assets’ costs were projected to be higher than their market value in the future (i.e., stranded cost). The assets identified as stranded included the Seattle City Light Exchange contract, the Calaveras Hydroelectric Project, and the California-Oregon Transmission Project (COTP). In 1999 Council ceased collecting funds for these stranded costs and established the Calaveras Reserve Target and Guidelines with a schedule to draw down the funds and manage electric rates through the end of FY 2031-32 (Attachment A).

As a result of changing market conditions and the layoff of certain assets, the total stranded cost is much lower now than when stranded cost collections stopped in 1999. Since then electric market prices have increased significantly, reducing the stranded cost associated with the Calaveras Hydroelectric Project. In June 2008 the City permanently assigned its share in the Seattle City Light Exchange. Further, a long-term assignment of the City’s share in the COTP is in process. The layoffs of the COTP and Seattle City Light Exchange Project effectively eliminate stranded costs associated with these two electric assets. Under certain conditions, staff estimates that future stranded costs from Calaveras and COTP could reasonably get to $32.5 million. The balance of the Calaveras Reserve will be $64.5 million as of the end of FY 2008-09; therefore, the Calaveras Reserve can be reasonably reduced by the $32 million no longer needed to cover future stranded costs.
At the December 2007 and February 2008 UAC meetings, staff discussed the background and rationale for developing the Calaveras Reserve, provided an assessment of the current need for the Calaveras Reserve and options for managing the Calaveras Reserve including surplus funds going forward. Staff and the UAC identified the following options for the excess funds:

1. Stay the course – maintain the Council-approved drawdown schedule for the Calaveras Reserve and deplete reserves by 2032 as shown in Attachment A.
2. Deplete the reserves more quickly than scheduled by either a one-time transfer or transfers over a period of time to the Electric Supply Rate Stabilization Reserve (E-SRSR).
3. Borrow from (and repay) the Calaveras Reserve to cover extreme events. In this option, the Calaveras reserve would serve as a secondary buffer to the E-SRSR. Each early drawdown would be approved by the Council, but would have an accompanying replenishment schedule.
4. Fund capital projects.
5. Pay down part of the Calaveras project and/or COTP related debt.
6. Create a new dedicated reserve to cushion the large hydrologic-cost-related-uncertainties of the electric supply portfolio.

After discussing the various merits of the options identified above (see Attachment B), the UAC requested that staff return to the UAC with a recommendation of how to manage excess funds in the Calaveras Reserve in the context of the budget and retail rate proposals being developed for FY 2009-10.

DISCUSSION
Current Assessment of Stranded Cost

Calaveras Hydroelectric Project
Staff estimates the stranded cost associated with the Calaveras project to be about $3 million given expected market prices and average hydro generation. However, this estimate is highly sensitive to changes in market prices and hydro generation. In a scenario where market prices drop 20% from current prices and long-term hydro production is down 10% (as a result of changes in availability of water to generate electricity due to either climate changes or water management policies), the stranded cost associated with the Calaveras project can be $28 million. Further, the stranded cost could climb to $68 million under a scenario where market prices drop 40% and hydro production is 20% below average.

COTP
The current estimated stranded cost associated with the COTP is $15 million. A 15-year assignment of COTP is scheduled to be in effect by January 2009 in which the recipients of the assignment will cover all cost obligations over the next 15 years. The assignment is expected to eliminate the COTP stranded cost. However, staff has estimated a potential stranded cost risk of $4.5 million over the course of the assignment under the following conditions:

- Assignment is terminated earlier than planned or does not get implemented. Staff has assessed a 20 percent probability on this event happening for a potential stranded cost of $3 million.
• Structural improvements are made to COTP during the course of the assignment which the City is obligated to fund. Staff estimates this risk to be up to $1 million.

• One or more of the assignees fails to pay the monthly cost and debt obligations. This can happen for up to three months before being remedied with a potential cost to the City of $0.5 million.

Given the above assessment of stranded cost and uncertainties, staff believes a prudent estimate of stranded cost is $32.5 million. This estimate includes $28 million for the Calaveras project to cover a scenario where market prices drop 20% and hydro production drops 10% over the long-term and $4.5 million to cover COTP assignment contingencies.

Options for Managing Surplus Calaveras Reserve
Staff developed the following guiding principles for evaluating options to manage funds currently in the Calaveras Reserve:
• Disbursement of funds should benefit electric ratepayers
• Plan must contain guidelines for disbursement and drawdown schedule
• Must be easy to implement and monitor

Of the six options discussed with the UAC at the February 2008 meeting, staff has eliminated three options for consideration for the following reasons:

Options 3 and 6: Utilize Surplus Reserve as a Secondary Buffer to E-SRSR or Create a Hydro Uncertainty Reserve: The creation of a new reserve to stabilize rates under prolonged adverse market and/or hydro conditions is not recommended as it essentially provides the same rate stability mechanism which the E-SRSR is intended to provide. Further, creating multiple reserves to cover cost uncertainties is administratively burdensome. An alternate way to remedy those contingencies is to incorporate these uncertainties into the evaluation of the E-SRSR and ensure that it is sufficient for the risk it is designed to cushion against. Having two reserves dedicated to the same or similar function is not recommended.

Option 5: Utilize Reserve to Pay Down the Calaveras project and/or COTP Debt: Debt service cost on the two projects is close to the returns earned by the City on the Calaveras Reserve thus making the retirement of debt financially neutral. The more economical bonds to pay-off are those in the outer years, which would not provide rate relief in the near term. In addition, the projects are jointly owned by other public agencies and it is not a trivial matter to have one agency separately pay off part of the debt for the projects.

Of the remaining options identified, staff has grouped them into the following general areas for consideration:

1. Reserve funds for potential stranded cost
2. Return funds to ratepayers in the near term via transfers to the E-SRSR
3. Reassign funds for new capital projects

1. Reserve Funds for Stranded Cost
This option is consistent with the objective of the Calaveras Reserve, which was established to cover the stranded cost of certain assets.
The merits of this option include:
- Manages costs (and rates) in the long-term to ensure that costs are not above market costs;
- Helps to maintain the competitive position of the electric utility; and
- Provides added financial security and flexibility associated with having large funds in reserve to cover cost uncertainties.

Arguments against holding funds in a stranded cost reserve include:
- The reserve may contain more than needed for stranded costs; and
- The ratepayers who paid into the reserve may not fully realize the benefits of lower rates over time.

2. Return Funds to Ratepayers in the Near Term
This option would have the City return all or a portion of the Calaveras Reserve to ratepayers over the next two to five years either in the form of a immediate rate reduction or by transferring the funds to the E-SRSR to offset increases in future operating costs associated with higher commodity costs, implementation of renewable and alternative energy goals; legislative and regulatory mandates and other cost uncertainties.

The advantages of this option include:
- Immediate rate relief for ratepayers; and
- Reduced administrative costs related to managing and monitoring the reserve.

The main disadvantages include:
- Reduced financial security and flexibility to manage unanticipated cost changes in the future; and
- False “price” signal to customers through rates that are significantly lower than costs, which will have the effect of encouraging more energy use which is counter to the goal of energy conservation.

3. Reassign Funds for New Capital Projects
A new reserve could be created to fund new capital improvement projects for the benefit of electric ratepayers. This option is similar to the Option #2 in that to the extent the projects to be funded are included in current cost and rate projections, utilization of Calaveras Reserve funds would provide some rate relief to customers in the near term by offsetting capital improvement costs. Guidelines and a schedule for the disbursement of the funds would need to be developed and approved by Council to ensure that the reserve is managed to the benefit of electric ratepayers.

PROPOSAL
Staff proposes a hybrid approach of all three options listed above in an effort to provide some immediate rate relief from the use of surplus funds while maintaining necessary funds to cover stranded cost and provide financial security and flexibility. Staff's proposal includes:

- Reduce the Calaveras Reserve to $32.5 million by the end of FY 2009-10 and accelerate the plan to draw down the reserve from FY 2031-32 to FY 2023-24.
- Transfer $12 million to the E-SRSR in FY 2009-10 and manage funds according to the E-SRSR guidelines.
• Create a new reserve funded at $20 million for potential electric utility capital improvement and/or other projects (e.g. increase efficiency measures, acquisition of land for electric projects/installations; electric transmission or generation projects, etc.) which benefit electric ratepayers with all funds disbursed by the end of FY 2014-15.

This hybrid approach combines the need to maintain some funds for the original purpose of the Calaveras Reserve, return some funds to ratepayers sooner than later through transfers of funds to the E-SRSR, and provide funds for capital projects.

NEXT STEPS
Incorporating the UAC’s feedback on the proposed plan, staff will discuss options for managing the Calaveras Reserve with the Council Finance Committee on December 2, 2008. The final recommendation on how to manage the Calaveras Reserve will be incorporated in the budget and rate proposals for FY 2009-10.

ATTACHMENTS
A. 1999 Council-Approved Calaveras Reserve Target and Guidelines
B. Pros and Cons of Six Options to Manage Calaveras Reserve (discussed at February 2008 UAC meeting).

PREPARED BY: MONICA PADILLA
Senior Resource Planner

REVIEWED BY: JANE RATCHYE
Assistant Director, Resource Management

DEPARTMENT HEAD: VALERIE O. FONG
Director of Utilities
## Attachment A

**1999 Council Approved Calaveras Reserve Target & Guideline**

<table>
<thead>
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<th>Ending</th>
<th>Reserve Target (M$)</th>
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<td>Pros and Cons of the Six Options to Manage the Calaveras Reserve</td>
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<tr>
<td><strong>Option 1: Stay the Course – no change to 1999 Guideline</strong></td>
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<tr>
<td><strong>Pros</strong></td>
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<tr>
<td>- Maintains large cash reserves as a cushion against unexpected events</td>
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<td>- Could be used as a secondary cash buffer to the E-SRSR to cover higher costs associated with prolonged droughts or other natural disasters</td>
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<td>- Lower retail rates in the long-term</td>
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<td><strong>Cons</strong></td>
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<td>- Maintains funds well above levels required to maintain competitiveness of supply assets at prevailing market prices</td>
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<td>- Does not return surplus funds to retail customers in the near term (i.e. more likely to be those who paid in to the fund)</td>
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| **Option 2: Utilize Reserves to Defer Rate Increases**     |
| **Pros**                                                      |
| - Provides the ability to have more gradual rate increases |
| - Returns money to customers earlier – particularly to customers who contributed towards the fund in the 1996-99 period |
| - Customers enjoy a lower retail rate in the short-term        |
| **Cons**                                                      |
| - Early drawdown will result in higher retail rates in the long term |
| - Eliminates secondary reserves buffer to cover higher costs in the event of prolonged drought |
| - Reduces financial flexibility in the future (e.g. potential to fund major capital expenditure, natural disaster) |
| - Potential to adversely affect credit rating                  |

| **Option 3: Utilize Reserve as a Secondary Buffer to E-SRSR** |
| **Pros**                                                      |
| - Utility retains financial flexibility to withstand unexpected cost increases without having to raise rates (e.g. prolonged drought, earthquake) |
| - Lower retail rates in the long term                         |
| **Cons**                                                      |
| - Maintains funds well above levels required to maintain competitiveness of supply assets at prevailing market prices |
| - Does not return surplus funds to retail customers in the near term |

| **Option 4: Utilize surplus to fund capital projects**       |
| **Pros**                                                      |
| - Reserve could be primarily characterized as a capital reserve and hence may be prudent to utilize it towards capital expenditures |
| **Cons**                                                      |
| - No major capital expenditure planned in the near future, except for annual distribution system upgrade related CIPs |
| - Cost of borrowing for new capital expenditure is relatively low for the City and comparable to the yield enjoyed by the City’s investment portfolio |

| **Option 5: Pay down Calaveras Hydro and/or COTP Transmission Debt** |
| **Pros**                                                      |
| - Reduces debt burden and debt service costs |
| - Utilize reserves collected to cover costs associated with these two capital assets |
| **Cons**                                                      |
| - Debt service costs are close to the returns earned by the City of on the Calaveras reserves, making such retirement of debt financially neutral |
| - Among the series of bonds, the more economical bonds to pay-off are those in the outer years (2023 to 2032) and does not provide much cash flow relief in the short term. |

| **Option 6: Utilize surplus to create a hydro uncertainty reserve** |
| **Pros**                                                      |
| - Segregates the largest uncertainty facing the electric supply portfolio and will reduce the required E-SRSR levels |
| **Cons**                                                      |
| - Creating multiple reserves to cover recurring cost uncertainties may be administratively burdensome and doesn’t benefit from diversification of risks |
| - Will require modifications to existing E-SRSR guidelines |
CALL TO ORDER
Chair Dawes called to order at 7:00 P.M. the scheduled meeting of the Utilities Advisory Commission (UAC).

Present: Commissioners Dexter Dawes, John Melton, Dick Rosenbaum, Asher Waldfogel, and Council Member Yiaway Yeh
Absent: Commissioner Marilyn Keller

ORAL COMMUNICATIONS
NONE

APPROVAL OF THE MINUTES
The minutes from the November 5, 2008, were unanimously approved.

AGENDA REVIEW
No changes to the agenda were requested.

REPORT FROM COMMISSION MEETINGS/EVENTS
NONE

UTILITIES DIRECTOR REPORT
Utilities Director Valerie Fong provided a brief update on the PaloAltoGreen U.S. Department of Energy award required at the 2008 Green Power Conference. PaloAltoGreen won the DOE Supplier Award in the Category of Small Residential/Commercial Green Power Program or Supplier of the Year.

UNFINISHED BUSINESS
Chair Dawes asked if the Commission had any additional items that it would like to see that are not already included on the 12-month rolling calendar of upcoming agenda topics for the UAC and Council. Dawes offered some bold suggestions for strategic discussion topics, including:

1. Selling the Calaveras Hydroelectric Project to reduce the large exposure to hydrologic conditions in the electric portfolio. The generation could be replaced with a base-load plant or cogeneration facility located in Palo Alto;
2. Expanding the 0.5 cent/kWh rate impact limit on renewable energy spending to encourage additional solar projects;
3. Changing the City’s primary water supplier from the San Francisco Public Utilities Commission to the Santa Clara Valley Water District in response to the dramatic price increases forecast from the SFPUC; and
4. Buying into a nuclear power facility for baseload power from another state.
The commissioners discussed developing a process to get topics added to the future agendas. Commissioner Rosenbaum stated that the historic process is that staff is in control of the agenda, but that the chair can meet with the Director to suggest topics, but that the Director would have final say. An alternative could be that a commissioner could write a letter to all commissioners advocating an item for discussion and the members could vote to support such a suggestion or not. Then the Director could respond with how the suggestion may impact plans and/or resource (staff and budget) requirements. Chair Dawes indicated he would meet with Director Fong to discuss how to proceed.

Fong also indicated that another avenue that the Commission has to request discussion on certain topics is in the annual joint UAC/Council meeting where information is exchanged between the Commission and the Council on priorities.

NEW BUSINESS

ITEM 1: DISCUSSION ITEM: Proposal for the Calaveras Reserve

Senior Resource Planner Monica Padilla presented an updated stranded cost assessment of $32.5 million for existing electric supply assets, or $32 million more than the $64.5 million in the Calaveras Reserve as of the end of Fiscal Year (FY) 2008-09. Padilla also presented staff’s preliminary proposal for managing the funds currently in the Calaveras Reserve going forward and requested the UAC’s feedback on staff’s preliminary proposal, which included:

- Reduce the Calaveras Reserve to $32.5 million by the end of FY 2009-10 and plan to deplete the reserve by FY 2023-24.
- Transfer $12.0 million to the Electric Supply Rate Stabilization Reserve (E-SRSR) in FY 2009-10 and manage funds according to the E-SRSR guidelines.
- Create a new reserve, funded at $20 million, for potential electric utility capital improvement and/or other projects which benefit electric ratepayers with funds committed by the end of FY 2014-15.

After much discussion of staff’s proposal, the UAC provided the following general feedback and direction to staff:

- The UAC agreed with staff’s assessment that the current estimate of stranded cost is less than the $64.5 million in the Calaveras Reserve and recognized that staff’s stranded cost estimate of $32.5 million is a prudent amount of funds to reserve for stranded cost.
- Given the above, the UAC recognized that the Calaveras Reserve has about $32 million more than is needed to cover stranded cost.
- The UAC does not support transferring some of those “excess” funds to the E-SRSR as it believes such a strategy sends the wrong price signal to customers and only defers the need to raise electric rates to cover cost. The UAC noted that E-SRSR funds were drawn down in FY 2007-08 and are planned to be drawn down in FY 2008-09 resulting in retail rates that do not fully cover operating costs. An additional transfer would defer the need to align retail rate revenues with costs.
- The UAC supports the use of excess funds to pay for capital improvement projects to the benefit of electric ratepayers and identified several types of projects which may be funded, however does not feel the need to create a new fund to do so.

Commissioner Dick Rosenbaum advocated for using some of the funds to create a secondary hydro uncertainty reserve to separate this cost uncertainty out of the E-SRSR and include a rate adjustor to deal with hydro cost uncertainty. Commissioner Rosenbaum requested that staff return to the UAC with an assessment of what it would take to implement such a mechanism. However, the other Commissioners did
not support Rosenbaum’s suggestion and saw no need to manage two separate reserves to manage cost risk of the electric supply portfolio.

Although he supported using the excess funds for capital projects, Commissioner Melton did not want the funds to be used for capital projects that are already in the pipeline. He noted that this would simply result in lower rates in the short-term. Instead, he supported new strategic initiatives such as local generation.

Chair Dawes agreed with Melton’s suggestion to use the funds for local generation or co-generation facilities. He also suggested using funds for undergrounding electric lines in certain neighborhoods. Commissioner Rosenbaum disagreed with using the funds for undergrounding, noting that it doesn’t comport with the principle to use the funds for the benefit of all electric ratepayers. Commissioners agreed that any excess funds should not be a “slush fund” that would be used for projects that otherwise might not have been done.

Chair Dawes also suggested that excess funds could be used to buy more expensive renewable power, such as solar photovoltaics, to meet the Renewable Portfolio Standard (RPS) goals, if additional funds are needed that would go above the Council-approved rate impact cap of 0.5 cents/kWh.

Commissioner Waldfogel could not identify a good reason to draw on the excess funds now and advocated for leaving them in the Calaveras Reserve to be re-visited when the hydro conditions improve. Waldfogel also reminded the Commission and staff that spending the funds, either through expenditures on capital projects or through supporting operational costs, will reduce the electric fund revenue from interest earned on those funds.

Public comment on the item:
Herb Borack questioned the process being used. He noted that if any policy change is proposed, it must be approved by Council and that both the UAC and the Finance Committee are advisory bodies to the Council.

In summary, ideas generated by the Commissioners on the types of projects that could possibly be considered for funding with excess Calaveras Reserve funds, included:
- Development of local and/or distributed generation as a baseload resource;
- Upgrade of transmission voltage from PG&E to the City’s distribution system;
- Development of smart grid elements, purchase of smart meters;
- Purchase of land from City which the electric utility currently rents; and
- Loans to other Utilities funds and/or the General Fund in order to save financing costs.


Chair Dawes asked for any questions on the water report. Commissioner Melton mentioned that there would be no additional supply from the San Francisco Public Utilities Commission (SFPUC) until 2018 as a result of its adoption of the Phased Water System Improvement Program (WSIP) Variant. He then asked about the Recycled Water Facility Plan currently scheduled for presentation to the UAC in March. He asked about the process for declaration of a Mitigated Negative Declaration (MND) for the project. Assistant Director Jane Ratchye said that there would be a public comment period and that the Council would be asked to formally adopt the MND for the project. Commissioner Rosenbaum asked about the other new contract issue that is not resolved regarding how the wholesale agencies would pay for capital
projects. Ratchye explained that the method in the current contract is the "utility" method, whereby no payments are made until a project is completed. Alternately, the "cash" method requires payment during all project phases (planning, design, and construction). Although the issue has not been resolved for the new contract, a hybrid method is being proposed – using the utility method for current assets and the cash method for new assets. Commissioner Melton asked for more explanation about water quality and high nitrite levels—why and what is the risk to humans? Staff from the Utilities Operations Division were not in attendance to answer this question. Commissioner Rosenbaum asked about progress on the Emergency Water Supply and Storage project. Director Fong said that discussions with Stanford are ongoing. Commissioner Dawes asked if the SFPUC has improved its ability to run and manage the WSIP project. Ratchye said that they have.

Regarding the gas report, Chair Dawes noticed that the gas prices are now going down and that Palo Alto costs may be higher than PG&E’s if the current trend continues.

The electric and fiber report was discussed. Commissioner Rosenbaum asked if we were able to get local capacity credit for the wind projects. Director Fong said that we do, but only for between 20 and 30% of the projects’ capacity. Council Member Yeh congratulated staff on completing the assignment of the COTP project and noted the significant annual savings that are accruing. He also asked about Utilities’ role in managing fiber under the consortium. Fong said that negotiations are ongoing with the consortium, and that staff’s perspective is that we would continue to manage operations and maintenance of the fiber system backbone because of the co-location of SCADA and other utility communications with all other fiber. Commissioner Rosenbaum asked whether the requirements in AB 1763 are valuable, even if CPAU is not required to comply with them. Fong said that this has not been thoroughly reviewed, as it does not apply to us, but we are making every effort to have information and energy audits on line to help customers save energy and money. Commissioner Rosenbaum said that he would like the rate tier information to be clearer on the bill and questioned whether SAP would provide this function. Fong said that it would not in the next roll out, but in a future iteration.

The report on efficiency was discussed. Commissioner Melton asked why PV installations must have an inspection that is different from permitting requirements. Joyce Kinneer, Manager of Utility Marketing Services, said that the Permitting Division inspects for code compliance, but that the law (SB1) requires inspections for performance, as well. Melton then asked whether Permitting staff could be trained to perform this function. Kinneer said that they could, but did not have the staff capacity. Commissioner Waldfogel asked if the inspections were being performed by a third party. Kinneer answered in the affirmative. Chair Dawes asked why PV rebates are going down as participation increases. Kinneer answered that the law (SB1) requires that rebate levels go down to attempt to increase commercialization of these systems. Commissioner Melton asked about the performance of the PV demonstration system. Kinneer answered that she did not yet have that information, but that a contract was being issued to clean and maintain them. Council Member Yeh said that he is excited about the solar water heating rebate program launch and wondered if the applicants were residential or business customers. Kinneer answered that they were residential. Yeh asked about the new fiber customers. Assistant Director Tom Auzenne said that they were downtown and in the Stanford Research park, as our dark fiber system is a good alternative to large customers. Director Fong added that the fiber business is going well. Chair Dawes asked whether the fiber funds for initial construction had been reimbursed to the electric fund. Senior Resource Planner Ipek Connolly said that they had. Dawes then added that the fiber system appears to be doing well financially, and Fong agreed.

The financial report was discussed. Ratchye noted a correction on page 5 of the financial report: the third paragraph relating to the Gas Distribution costs stated: “Other expenses were slightly higher by $285,000.”
This should be changed to "Other expenses were slightly higher by $328,000." The correct figure of $328,000 was accurately reflected in Table 6 of the report.


Karl Van Orsdol, Energy Risk Manager, presented the impacts of the credit "crisis" on the credit rating of the City’s energy counterparties which are primarily financial institutions. He discussed the uses of CreditEdge product to evaluate publicly traded companies and RiskCalc for the evaluation of privately held companies. Van Orsdol noted that the counterparties which are primarily financial-based organizations (such as JP Morgan Chase, Royal Bank of Scotland, and Sumitomo) have had their credit more significantly impacted by the recent market turbulence than have more traditional energy companies (such as Shell and BP). Van Orsdol noted that the key financial stresses on the former group include leverage and asset valuation. Van Orsdol finished by reiterating that the City’s current exposure is minimal overall, and is zero for exposure to financially-based counterparties.

In response to a question from Council member Yeh concerning the low credit rating of Ameresco, Van Orsdol noted that they have performed exceptionally well in previous contracts for landfill gas power, and that all the contracts have special safeguards and protections for the City in the event of a default.

ITEM 4: INFORMATION ITEM: Update on the October 1, 2008, Staff Recommendation to Eliminate the Residential Customer Discounts for Water and Storm Drain Service to Comply with the Requirements of Proposition 218, Approve Rate Assistance Program Changes, and Adopt a Resolution Amending the utilities Rate Schedule C-4 "Residential Rate Assistance Program"

Director Fong gave a quick overview of this informational item which had been earlier reviewed by the UAC at its October meeting. Fong noted the purpose of the November update was to inform the UAC that Utilities would not take any further action on the rate assistance program discount for the Storm Drain since the UAC does not review Storm Drain activities. Instead, the elimination of the discount for the Storm Drain Utility should not have been included in the October memorandum to the UAC, and Public Works would pursue any further actions. Additionally, the elimination of the rate assistance discount for the Water Utility would not be presented to the Finance Committee or Council until sometime in 2009 when the balance of any rate changes would be considered by the Finance Committee and Council in the context of the Fiscal Year 2009-10 and 2010-11 budgets. This would permit a rate hearing on the matter since is conceivable that the elimination of a long-standing discount to water rates may be construed as a rate increase by some customers.

Commissioner Waldfogel expressed extreme discomfort with the delay in presenting the matter to the Finance Committee and Council by a few months and asked that the matter be returned to the UAC prior to going to the Finance Committee and Council. Chair Dawes explained that having the rate hearings in the context of Proposition 218 made sense to him and that he was not troubled with the delay since the delay did not represent a change in content, only in timing. No other Commissioners spoke in support of Commissioner’s Waldfogel’s request to have the UAC re-visit staff’s recommendation.

Meeting adjourned at 10:00 P.M.

Respectfully submitted,
Marites Ward
City of Palo Alto Utilities
## Rate Stabilization Reserve Guidelines
Adopted by Council January 17, 2007 [CMR 107:07]

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<th>Rate Stabilization Reserve (RSR)</th>
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<td>Gas Supply RSR</td>
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