FINANCE COMMITTEE SUMMARY MINUTES

Special Meeting
February 16, 2021

The Finance Committee of the City of Palo Alto met on this date in virtual teleconference at 6:02 P.M.

Present: Burt, Cormack, Filseth

Absent:

Oral Communications

Steve Rosenblum urged Palo Alto (City) to continue and accelerate its effort in not supporting companies that support fossil fuel extraction.

Rebecca Eisenberg reminded the Finance Committee (Committee) that the City is in a budget emergency and cutting costs is a sure-fire way to lead the City into a depression. She urged the Committee to explore and establish an emergency Business Tax to help the City survive the economic hardship it was in.

Agenda Items

1. Preliminary Financial Forecasts and Proposed Rate Projections for Electric, Gas, Water and Wastewater Collection Utilities for Fiscal Year 2022.

Kiely Nose, Administrative Services Director shared that Staff requested the Wastewater Utility be discussed first.

Dean Batchelor, Utilities Director introduced Eric Keniston and Lisa Bilir who presented the rate projects for the Wastewater, Electric, Water, Storm Drain, and Gas Utility for Fiscal Year (FY) 2022 to the Finance Committee (Committee).

Eric Keniston, Utilities Senior Resource Planner disclosed that Staff's recommendation was a 3 percent increase for the Gas and Wastewater Utility. The Storm Drain Utility would increase 2 percent increase and Staff recommended no rate increase for Electric, Water, or the Refuse Utilities. The future rate increases for all utilities was estimated to be a 3 to 5 percent increase for the next 3-to-5-years. Staff continued to investigate ways to cost contain which included, but was not limited to, establishing renewable energy exchange programs, negotiated improvements to the Western

Contract, expanding use of the bank draft to reduce credit card fees for large accounts, and others.

Lisa Bilir, Utilities Resource Planner announced that she was presenting the Wastewater Collection Utility to the Committee. In FY 2021, there were no Wastewater Utility rate increases and the existing rates had been in place since July 1, 2019. Staff's proposal was a 3 percent rate increase for FY 2022, an additional rate increase of 3 percent in FY 2023, and then a 5 percent rate increase in each future year. The key driver for the rate increase was due to a series of large increases in treatment costs during the 5-year planning horizon. The 3 percent increase for FY 2022 allowed funds for the Collection System Capital Improvement Project (CIP) to be replenished, while at the same time keeping up with the increase in treatment costs. To keep the increase contained at 3 percent, Staff has reduced the cost of each sewer replacement project as well as differed two of the upcoming replacements during the 5-year forecast period. Staff also proposed an alternative approach of a zero percent increase to respond to the ongoing impacts of the Coronavirus (COVID-19) pandemic. To achieve this, Palo Alto (City) would need to reduce spending by an average of $200,000 annual between FY 2022 and FY 2026. The Utility Department has conducted a Cost of Service Study that examined the cost allocation by customer class. The Wastewater Operations Reserve's 10-year projection showed that the reserve would dip close to the minimum guideline in the later years even with rate increases in the first 5-years. The wastewater treatment plant has five partners; Stanford, East Palo Alto, City of Los Altos Hills, City of Los Altos, and the City of Mountain View. The City's Public Works Department manages the plant and the City pays roughly 36 percent of the wastewater treatment fund expenses. Treatment costs were expected to increase steeply, but it did depend on the timing of large infrastructure projects at the treatment plant. In regards to the treatment plant, most of the existing equipment has been in place for more than 40-years, and replacement of that equipment was necessary to ensure that the City can operate it safely and comply with regulatory requirements. In terms of the collection system, the cost break down was 60 percent from operations and 40 percent from debt service. Cost drivers on the operation side came from salary and benefits, the 2 to 3 percent annual inflation cost, and a one-time revenue loss due to COVID-19 of $960,000 in FY 2022. The key cost drivers for capital cost increases included underground construction costs and sanitary sewer replacements. In comparison to surrounding Cities, the City's monthly residential bill was 29 percent lower than the average. The City of Mountain View and the City of Los Altos share the treatment plant with the City and the City of Menlo Park and Redwood City use a different treatment plant that has been upgraded more recently. On the commercial side, the City's commercial bill was 10 percent higher than comparable Cities, but restaurants were lower by 6 percent. Staff requested that the CIP Reserve be more active so that the CIP funding is transferred from the Operations Reserve to the CIP Reserve and then spending would come directly from the CIP Reserve. Under that proposal, the CIP Reserve would dip close to the minimum guideline in the later years of the 10-year forecast.

Rebecca Eisenberg asked if Staff has done a comparative analysis of how business users compare to local jurisdictions and if there are step-ups for larger businesses.

Vice Mayor Burt noted that the big issue was the pending capital costs for rebuilding the wastewater treatment plant. He asked if Santa Clara used the City of Sunnyvale's treatment plant.

Ed Shikada, City Manager clarified that Santa Clara uses the City of San Jose's plant.

Vice Mayor Burt believed that the City of Sunnyvale was an important comparable point and requested to see that comparison. He asked Staff how well was the City spreading the cost of the upcoming capital costs and if the City should consider an increased debt amount.

Ms. Bilir answered that the debt service for the collection system was approximately $130,000 per year.

Jaime Allen, Utilities Manager Water Quality Control Plant mentioned that the Environmental Protection Agency (EPA) offered a 35-year loan where the interest is moved out of the first 5-years and added to the principle. Staff was in discussions regarding that loan and other financing mechanisms that could be used for capital projects.

Vice Mayor Burt asked that the rates are for the EPA loans.

Mr. Allen shared that the current state rate was .9 percent and the highest rate within the last 2-years was 1.4 percent.

Vice Mayor Burt questioned if the City should start the major replacement projects sooner rather than later.

Mr. Allen mentioned that Staff continued to put the engineering packages together as quickly as they could.

Vice Mayor Burt inquired if the process could be accelerated.

Mr. Shikada clarified that many discussions were happening among Staff to move things as fast as possible.

Vice Mayor Burt wanted to understand how much the City would save if the City was able to secure the loans under the current rates and requested that Staff share that at a future meeting.

Council Member Filseth asked what was lost if the City chose a zero percent rate increase.

Ms. Bilir articulated that the $200,000 average would be differed for the first 5-years and then $1 million in the next 5-years.

Silvia Santos, Utilities Manager of Water Gas Wastewater shared that the current cost to replace a main for wastewater was $1.4 million per mile and $200,000 was equivalent to two or three City blocks.

Ms. Bilir added that the Collection CIP Budget was a $20 million 5-year budget and Staff has cut $4 million of that budget by differing main replacements and reducing the size of projects. The $200,000 annual additional cuts in the first 5-years would result in higher reductions in the subsequent 5-years.

Ms. Santos expressed that with a less budget, Staff would increase maintenance to differ the replacement of certain defects in the pipe.

Council Member Filseth restated what was the City doing if $200,000 is not spent.

Mr. Batchelor summarized that the City would patch the system instead of replacing the full section with new pipes.

Council Member Filseth declared that the replacements needed to take place and asked why Staff brought forth the idea of a zero rate increase with a $200,000 annual reduction.

Mr. Batchelor announced that the option was to show the justification of why the 3 percent increase is the best approach.

Council Member Filseth questioned if it was true that the City had held rates artificially low by not saving for future capital expenses in prior years.

Ms. Bilir noted that there was adequate funding in the Operation Reserve for the upcoming sewer replacement that is occurring within the next year. The issue was being able to build up enough funds in outer years for CIPs as costs increase.

Mr. Shikada stated that the fundamental question was is the City keeping up with the need for replacement.

Jonathan Abendschein, Utilities Resource Management Assistant Director clarified that the system was turned over every 80 to 100-years and there is a rate of replacement that things need to be turned over. The challenge was that Staff had already made cuts and the 3 percent rate increase was to avoid making additional cuts. If the rate increase was not made now to catch up with the Collection System investment, it would be harder to make the rate increases further out. Also, in prior years Staffing constraints lead to delays and several major capital improvement projects that took longer than expected.

Council Member Filseth inquired how much of the annual cost each year was salaries and benefits.

Mr. Abendschein indicated that Staff will return with an answer.

Chair Cormack appreciated Staff's work on balancing the long-term needs of the City and the short-term concerns. She wanted to understand the intended purposes of the reserve targets.

Ms. Bilir explained that for the Operations Reserve for the Wastewater Utility, the minimum guideline was 60-days and the maximum was 150-days of operations and maintenance and treatment expense.

Chair Cormack questioned if that was a best practice guideline.

Ms. Bilir agreed that the minimum and maximum is an industry-standard.

Mr. Abendschein added that it was based on the 90-day cash reserve rule of thumb made by the Government Finance Officer of Association.

Chair Cormack questioned what was needed from the City to get the major capital projects started.

Ms. Bilir declared that there were re-appropriation and commitments included in the Operations Reserve outlook.

Ms. Bilir responded that 20 percent of the Wastewater Collection costs were salary and benefits related. She continued to the Water Utility and announced that Staff recommended no rate increase for the Water Utility for FY 2022. The year-end balance in the Operations Reserve was at the maximum guideline level with additional funds that were not allocated. City Council (Council) has approved in a prior year that the CIP Reserve be used more actively. With a zero percent rate increase for FY 2022, Staff projected a 5 percent increase annually for FY 2023 through FY 2026. The key driver for the increase was a series of large increases in the supply cost from the

San Francisco Public Utility Commission. The City received all its supply from the San Francisco Public Utility Commission's Hetch Hetchy System and included in the cost was the upkeep of that system. The City maintained its water distribution system within the City and that maintenance was equivalent to 60 percent of the Water Utility cost. The distribution costs were projected to increase by 3 percent and supply cost was increasing by 6 percent on average. Water distribution cost trends included a capital cost increase of 3 percent over the next 5-years and operation costs were growing at 3 percent. Operation cost increases were due to health and retirement costs and generator back up pumping stations. Capital cost increases were due to construction increases as well as a large one-time cost for emergency water supply and reservoir rehabilitation. The City's residential customer bills were 9 percent higher than surrounding Cities and commercial customers also had a higher bill by 4 to 7 percent.

Rebecca Eisenberg emphasized her frustration that residents continue to pay more than businesses. She questioned why larger commercial entities were given lower rates than residents.

Chair Cormack asked Staff to disclose when their presentation was made to the Utilities Advisory Commission so that the public can review that meeting.

Ms. Bilir predicted that Staff will be making the same presentation to the Committee in April of 2021.

Vice Mayor Burt announced that it was helpful for Council Members and the public to know prior 5-year rate increases and having the average included. He inquired if Staff has done any Cost of Service Studies to determine what the City can charge customers.

Ms. Bilir confirmed that Staff does do Cost of Service Studies.

Vice Mayor Burt requested that those be posted online and made readily available to the public.

Ms. Bilir shared that the Cost of Service Studies are available in the Staff report of when those studies were adopted.

Vice Mayor Burt mentioned that the City has explored in prior years drawing groundwater up to mix with Hetch Hetchy water to help mitigate costs. He mentioned that filling manmade lakes in the Foothills with groundwater may cut costs.

Council Member Filseth agreed that pumping water up to the Foothills to fill reservoirs was a key driver in why water was expensive within the City. He wanted to understand the rationale behind that.

Mr. Abendschein could not answer that question.

Council Member Filseth noted that the Water Utility rate has increased by 3.75 percent a year.

Vice Mayor Burt made the distinction that FY 2016 was the last big bump from the rebuild of the Hetch Hetchy system. Any rates going forward are what should be analyzed.

Chair Cormack asked how every other year capital investment was working.

Ms. Bilir mentioned that there is not enough data to determine how it is working because the strategy was implemented for the Water Utility in FY 2021.

Mr. Batchelor believed that the strategy is working well.

Chair Cormack requested an update on the reservoirs located in the Foothills.

Ms. Santos specified that there are seven reservoirs. One was new, three have been updated, one was in the process of being rebuilt, and Staff was completing a Cost-Benefit Analysis for the remaining two.

Mr. Keniston moved to the Electric Utility. Staff proposed a zero percent rate increase for FY 2022 with the understanding that starting in FY 2023 and FY 2024 there would be 5 percent increases. In a previous year, the Utility Department borrowed $10 million from the Electric Special Project Reserve and Staff recommended that smaller installment payments be paid starting in FY 2023. The Electric Utility cost structure was 60 percent for electric supply and 40 percent for distribution. Transmission-related costs have increased rapidly over the last few years and continued to increase in the future. In terms of long-term cost trends, the Capital and Operation distribution saw an increase of 2 percent for inflation. Cost drivers for the utility were similar to the other utilities. The City was 34 percent lower than Pacific Gas and Electric (PG&E) on average for residential bills, small commercial customers were 40 to 50 percent lower, and large commercial customers were 5 to 25 percent lower. Debt service continued to remain steady and was predicted to drop off starting in FY 2025. With the proposal of a no rate increase, the Operation Reserve will reach minimum levels in FY 2020, the Hydro Stabilization Reserve will maintain above the maximum risk potential, and the Distribution Operating Reserve will dip to the minimum level in FY 2022 but will be restored in FY 2023 and FY 2024.

Rebecca Eisenberg was confused why her bill was so much higher this January than January 2020. She believed there may be different categories within the utility that customers are categorized and billed under. She did not understand why large businesses were given discounts and residents weren't.

John Kelley mentioned that the way that utility prices are set, folks who build Accessory Dwelling Units (ADU) will be paying more for service. For that reason, the policy of single service and single lower tier for electrical prices should be reexamined. Also, the City should allow two meters on a property so there can be separate billing for each unit. He was concerned about the shift to all electrical power and that there is inadequate capital expenditure set aside to cover that.

Council Member Filseth asked why generation cost is decreasing

Mr. Keniston shared it was due to implementing low-cost renewable projects.

Council Member Filseth inquired how easy is it for the City to contract out linework.

Mr. Batchelor disclosed that has not been a problem and it worked best for large projects.

Vice Mayor Burt questioned if Staff was projecting a further decline in generation cost.

Mr. Keniston believed that was baked into the analysis.

Vice Mayor Burt was interested in having a deeper conversation around the generation rate. He articulated that the City's bill comparison graph should be featured to show that the City is drastically lower than PG&E. He agreed with the public speaker that the City needed to discuss ADUs and the rate structure. He suggested the Committee have a study session on that topic. He concluded that Staff should consider different scenarios regarding the anticipated impacts from the economic and customer dynamics.

Mr. Keniston confirmed that there has been a reduction in the commercial sector and there was a slight increase in the residential sector. Staff anticipated it would take 2-years to recover from the pandemic, but that normal levels may never come back.

Council Member Filseth questioned if Staff was assuming anything about battery storage in the 10-year timeframe.

Mr. Keniston answered no, there was no assumption regarding battery storage.

Chair Cormack wanted to understand that using short-term revenue to fund reserves was an appropriate mix of the match of short term to short term.

Mr. Keniston concurred.

Chair Cormack appreciated that the City can contract out for line crews and she agreed with Mr. Kelley's comments about discussing ADUs.

Mr. Keniston moved to the Gas Utility. He disclosed that one-third of gas rates are supply related which meant it was the commodity cost to purchase the Gas Utility as well as the transmission charges and environmental charges. The commodity charge was changed month to month based upon what the market prices were. The transmission prices were changed when PG&E changed their rate schedule and other charges were passed to customers through pass-through charges. The remainder two-thirds of the cost was steady and was the base Staff uses to recommend rates. Staff proposed a 3 percent overall increase for FY 2022. An alternative proposal was supplied with a no rate increase but that resulted in $5.4 million reduction between FY 2023 and FY 2024. Sales have declined by 6 to 8 percent, but Staff predicted that usage would increase over the next few years. With a 3 percent increase, future years would receive a 5 percent increase and Staff would have to reduce the gas main replacement project by $2 million. The City purchases gas through third-party vendors and PG&E is used as the transport mechanism. In terms of the cost structure, roughly 40 percent was supply related and 60 percent was related to internal distribution costs. Staff predicted that capital and distribution costs would increase by 2 to 3 percent per year. Key gas supply cost drivers included volatility in the gas marketplace, PG&E transmission rates, cap and trade costs that continued to rise, and the purchase of carbon-neutral gas. The gas distribution cost drivers included health and retirement, underground construction, and temporary funding for the 3-years crossbore project. A residential customer's bill continued to be lower than PG&E by 8 percent, smaller commercial customers were 12 percent lower and larger commercial customers were 15 percent higher. With Staff's recommendation of a 3 percent increase, the Operating Reserve was projected to drop to the minimum in FY 2023 and FY 2025.

Rebecca Eisenberg emphasized that customers are dramatically impacted by how much they pay in utilities. She wanted to see the data that supported the claim that the City's utilities are less expensive than PG&E.

Council Member Filseth asked what happened to gas sales in FY 2015 to FY 2017.

Mr. Keniston noted that occurred decline in sales was due to drought.

Council Member Filseth did not support any of the alternative scenarios for any of the utilities.

Vice Mayor Burt agreed with Council Member Filseth. He was concerned about the outline years and he wanted Staff to emphasize what the strategy is and the structure of each utility for the public.

Chair Cormack requested a scenario of a 2 percent rate increase option for the Gas Utility. She agreed with her colleagues regarding not supporting the alternative scenarios and communication to the public.

Council Member Filseth was not sure getting the rate reduced for the Gas Utility was the best use of Staff time.

NO ACTION TAKEN

Future Meetings and Agendas

Kiely Nose, Administrative Services Director announced that Staff recommends the Finance Committee cancel the March 2, 2021 meeting and have the next meeting be held on March 16, 2021. The formal 2022 Rate Plan will be presented at the April 6th and 20th meetings. Budget hearings will take place on May 11th and 12th with a backup date of May 13th. Then budget wrap-up was scheduled for May 26, 2021 with possible adoption of the budget by City Council made on June 21, 2021.

Vice Mayor Burt inquired where a discussion fit in regarding the charge for electricity as they affect Accessory Dwelling Units and electrification.

Ed Shikada, City Manager shared that Staff is already investigating the topic but suggested that the item be discussed with the Sustainability Climate Action Plan (S/CAP).

Vice Mayor Burt wanted to see a discussion take place at Finance Committee after City Council discusses S/CAP.

Chair Cormack suggested there be a joint session regarding the topic between the various Boards and Commissions.

Council Member Filseth inquired if Commercial Impact Fees for affordable housing is part of the consider affordable housing funding item.

Ms. Nose shared that the item was really to give an overview on ways to fund affordable housing.

Mr. Shikada disclosed that Staff will ensure that Planning and Development Services has the commercial linkage fee as a part of its overall scope.

Adjournment: The meeting was adjourned at 8:42 P.M.