

# Seattle City Light Advisory Board

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April 28, 2005

Councilmember Jean Godden  
City of Seattle  
City Hall  
P.O. Box 34025  
Seattle, WA 98124-4025

Dear Councilmember Godden:

Re: Resolution 30761 – Financial Policy for Seattle City Light

The Seattle City Light Advisory Board submits this letter to assist the Council's consideration of Resolution 30761, which would change the Financial Policy governing rate-setting for Seattle City Light. This Resolution was adopted by the Energy and Environmental Policy ("EEP") Committee on April 27, 2005, and is before the full Council for a vote on May 2, 2005.

## General Comments

The Resolution essentially addresses two aspects of the Financial Policy: debt reduction and cash reserves. Subject to the clarifying comments noted below, the Advisory Board enthusiastically supports the debt-reduction elements of Resolution 30761. The EEP Committee Resolution would strengthen existing Financial Policy on debt reduction and is fully consistent with the initial recommendations of the Advisory Board in this regard. The Board believes the revised policy is well designed to restore the financial strength of the utility and to facilitate lower sustainable rates for ratepayers.

For the reasons expressed earlier in our two Annual Reports and our Letter to Council Members, dated March 15, 2005, we believe that the \$25 million contingency cash reserve to be established by Resolution 30761 provides inadequate liquidity for the utility to deal with future financial crises and increases the risk of short-term borrowing and emergency rate increases. We continue to believe that contingency reserves on the order of \$100 million would be more appropriate for City Light and in line with the reserves maintained by comparable public utilities.

## Clarifying Comments on Debt-Reduction Policies

Rate Setting Guideline – 2X Debt Service Coverage. The Resolution requires City Light rates to be set to achieve a debt service coverage ratio (for both first lien and second lien debt) of 2.0 to 1. The Committee has stated that its intent was to preserve – and even to exceed – the level of debt reduction mandated by the existing "95% confidence" policy but to use a 2X debt service ratio for simplicity and transparency. City Light staff have confirmed that the new policy would be slightly more stringent than existing policy in reducing debt levels over the next 5-year and 10-year periods. We note that the revenue requirement will have to be set using assumptions of "normal water" and other normalized conditions affecting wholesale and retail revenues, that there will be the same amount of volatility around the resulting revenue target as there would be under the existing 95% confidence policy, and that the 2X debt service coverage will have to be

thought of as a ratio to be achieved “on average” over time. We assume, and this is critical to our support for this approach, that for those years in which volatility produces revenues less than 2X debt service, City Light would increase its borrowing to finance needed capital spending, and in those years when volatility produced revenues exceeding the 2X debt service target, the additional revenues would be used to reduce the debt required for the capital program – just as would be the case under the existing financial policy.

Balance of the Bond Reserve Account for Debt Reduction. While we believe that the entire Bond Reserve account should be retained as a contingency reserve for several years while the utility reassesses its climate models and risk management strategies, we support the Committee’s proposal of using any remaining balances in the Reserve Account for debt reduction rather than for a temporary rate decrease. We assume that the intent of Resolution 30761 in this regard is to use any such balances to reduce the borrowing in 2005-06 otherwise required for the capital program. In particular, we assume that any such balances would not be used to fund a portion of the “debt service” obligations during this period. Artificially reducing the revenue requirement resulting from the 2X debt service coverage test would have the perverse result of increasing the overall debt levels at City Light.

Debt-to-Capitalization Ratio. We applaud the Committee’s commitment to set rates to achieve a 60% debt-to-capitalization ratio by 2010. The 2010 target is both appropriate and achievable, assuming reasonably normal weather conditions over the next five years and a strong commitment by City Light to improve the cost-effectiveness of its capital investments. The Board would have preferred more specific language in the Resolution specifying that rates would be adjusted beyond what was otherwise called for by the 2X coverage test if the multi-year forecasts indicate that City Light will not otherwise be likely to achieve its overall debt ratio targets by 2010. But we assume that this is the Council’s intent when it states “City Light shall set rates to achieve a debt-to-capitalization ratio of 60% by year-end 2010.”

Asset Management Program by January 2007. Our First Annual Report of January 2004 contained a recommendation that City Light should routinely apply cost-benefit analysis to its capital investments. This is basic to any enterprise, public or private. “Asset Management” as applied by Seattle Public Utilities is just one approach to improving the cost-effectiveness of City Light’s capital investments. We would be disappointed if City Light waited until January 2007 to implement this recommendation, and we also believe City Light should be free to adopt the most appropriate type of cost-benefit analytical framework for its capital programs. We assume that the Council will encourage City Light to respond to the mandates of Section 6 of Resolution 30761 in this spirit.

Resource Requirement. We understand the reasons for the Resolution’s recital of the existing 95% coverage policy in City Light’s power resources planning as part of the “Financial Policy” of City Light. However, we have recommended that City Light study, as part of its ongoing Integrated Resources Planning exercise, whether a lower percentage for such coverage would better serve the City’s needs. We assume that the Council would not object to such an evaluation being carried out as part of the IRP, recognizing that the 95% coverage policy would remain in effect until changed by the Council.

Review of Financial Policies. The Resolution calls for a review of the financial policies no later than the time when City Light’s debt-to-capitalization ratio is reduced to 70%. We support this, recognizing that recalibration of the debt reduction elements of the Financial Policy may well be appropriate if City Light makes faster progress toward achieving its overall debt-ratio goal than current forecasts predict. We assume that this “review at 70%” is not intended to dilute the commitment to the Debt-to-Capitalization ratio goal of 60% by 2010, as set out in Section 5.

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During the course of the Council's deliberations on Financial Policy, questions have been raised about the Board's role. It has been suggested by some that the Board should have merely developed options for consideration by the Council and not made a definitive recommendation or sought to advocate its views. We respectfully disagree. Although we are a creature of the Council and exist at its pleasure, we believe our mandate requires us to speak as an advocate for the long-term interests of the utility and of ratepayers. Of course, at the same time as we raise an independent voice, we must strive to be non-political and to respect the roles of both the Executive and the Council. We would welcome the opportunity for a dialogue with the Council to clarify and resolve questions about our role. Such a dialogue would be a useful starting place for our consultations with the Council on a broader set of governance issues, which we intend to address in our final Report to the City.

Respectfully,

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Seattle City Light Advisory Board

Carol Arnold, Chair

Randy W. Hardy

Jay F. Lapin

Sara Patton

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cc: Honorable Greg Nickels, Mayor  
Superintendent Jorge Carrasco, Seattle City Light