

**Seattle City Light:
From Recovery to Stability and Security**

**First Annual Report of the
Seattle City Light Advisory Board**

**Seattle, Washington
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I. Introduction

Seattle City Light has a long and proud history of delivering reliable, low-cost and environmentally responsible electric power to the people of Seattle and surrounding communities. Owned and operated as a department of the City of Seattle, City Light is one of the largest public utilities in the United States. It owns hydroelectric generation capacity to meet over 50% of its needs and has long-term contracts with Bonneville Power Administration and others for the remainder. City Light has roughly 1,700 employees serving 345,000 customers and a population of 680,000 in a service area of 131 square miles. The utility's annual budget exceeds \$800 million and it contributes more than \$30 million each year in taxes to the City's general fund.¹

Following the west coast energy crisis of 2001, in which City Light was required to raise rates by 58% and substantially increase its outstanding debt to more than \$1.5 billion, the Mayor and City Council accepted the recommendation of the Mayor's City Light Review Committee (Report dated October 10, 2002) to create the Seattle City Light Advisory Board "to provide expert industry-specific knowledge and nonpartisan advice to the Mayor, the Council, and the City Light Superintendent on key energy issues facing the City."² (Ordinance 121059, January 27, 2003.)

The Board consists of six members, three members appointed by the Mayor, three by the Council, and all six confirmed by the Council. The members are: Carol Arnold, Randy Hardy, Jay Lapin, Maura O'Neill, Sara Patton, and Don Wise. The

¹ City Light also pays more than \$20 million in taxes to the State of Washington and to the other local jurisdictions in its service area.

² Unlike many citizen advisory boards, the City Light Board is meant to serve as a board of technical experts and not as advocates for specific interest groups.

members bring a diverse range of experience and expertise in business, law, finance, energy efficiency, environmental protection, utility operations and power/risk management. (See Appendix for the background of the members.)

In the eight months since its first meeting on May 21, 2003, the Advisory Board has been engaged in an intensive process to educate itself about City Light, to select and prioritize the issues that the Board would focus on during its first year, and to develop recommendations on those issues for City Light and the City. This Report, which is responsive to the Ordinance establishing the Advisory Board, describes the Board's major initial findings and recommendations regarding Seattle City Light. Detailed summaries of the Board's 2003 activities and its current Work Plan for 2004 are contained in the Appendix.

II. Overview and Summary of Recommendations

City Light is recovering from the west coast energy crisis. Within a few months, the utility is expected to pay off the short-term debt it incurred to cover operating deficits from the crisis.³ This is a very good start. However, City Light is also working to move beyond recovery toward the stability and security required to restore the trust and confidence it had earned and enjoyed for most of its history. With the support of the Mayor and Council, City Light has developed a number of policies and initiatives aimed at these goals. The Advisory Board has reviewed these policies and initiatives and has worked with City Light to enhance and support these efforts.

³ This recovery has taken longer than was originally anticipated due to low wholesale power revenues in 2002 and low water in 2003. Although the external short-term notes issued in 2001 to cover City Light's operating deficits were repaid on schedule, City Light was required to increase its short-term borrowing from the City's general cash pool to do so, and it is that borrowing which is expected to be fully repaid during the summer of 2004.

The paramount goal for City Light is to restore the trust and confidence of its customers, the citizens and businesses of Seattle, in its capacity to deliver reliable, low-cost, and environmentally responsible power in the decades ahead. The physical reliability of its supply and distribution system is not in question – although maintaining reliability will always remain a priority. Likewise, there is no doubt about City Light’s commitment to energy efficiency, clean renewable energy and environmentally responsible utility operations generally. City Light’s leadership in these areas is nationally recognized. Nor is there a question about City Light’s commitment to assuring universal access to electric service through its programs offering rate discounts and energy efficiency programs to low-income households, the disabled and elderly.

However, after a 58% rate increase in 2001, the citizens of Seattle have sustained significant erosion in the historic rate advantages of public power.⁴ Although Seattle’s rates remain relatively low compared to other major cities across the nation, the gap has closed substantially between Seattle’s rates and those of some investor-owned utilities serving the Pacific Northwest.⁵ Furthermore, the heavy long-term debt burden that City Light took on during the energy crisis weighs on its financial stability and long-term security.

In spite of credit downgrades from both major bond rating agencies as a result of

⁴ Public power should afford its customers lower electricity rates than investor-owned utilities (all other things being equal) because of access to tax-free, lower-interest-rate financing and the lack of any requirement to pay dividends to shareowners.

⁵ For example, the average monthly bill for several categories of Puget Sound Energy’s customers in Bellevue, Washington recently fell below that of City Light, and for other customer categories, the rate advantage for City Light has been much smaller than it has been in the past. See Prospectus for City Light’s 2003 Revenue Bonds, July 29, 2003, at page 17.

the energy crisis, City Light has been able to maintain relatively good bond ratings (and a relatively low cost of credit) largely because of the City's demonstrated willingness to raise rates as necessary to meet the utility's financial obligations to its bond holders. But, what is good for bondholders is not necessarily good for customers.⁶ City Light's challenge is to restore its financial strength while at the same time restoring the rate advantages of public power to the citizens of Seattle – and also continuing to deliver the full range of other values that the citizens of Seattle want from their utility.

In emphasizing that City Light must improve its economic value-added to customers and maintain its leadership on the environment, the Advisory Board embraces the view that these goals are complementary. Certainly, City Light's nationally recognized energy efficiency programs have been highly cost-effective in delivering economic benefits for the citizens of Seattle through lower energy bills. These investments have made Seattle homes more comfortable and Seattle businesses more competitive. Other environmental programs, such as fish and wildlife restoration and hazardous waste mitigation, represent both prudent investments in a more secure financial future free of massive remediation costs and other contingent liabilities, as well as responsible stewardship of the environment. Investing in clean renewable sources of energy is both "green" and a prudent risk management strategy in an uncertain economic and regulatory future. This Report focuses on restoring financial strength and reducing rates because these are the areas at City Light in most need of attention at this time – not because of a policy preference for low rates over clean energy. In fact, a major

⁶ Standard & Poor's, Rating Direct. Research: Maximizing Public Power Rating Potential, May 20, 2003 at page 1

reason to restore financial stability and security at City Light is to enable it to continue its leadership on the environment in the future.⁷

Restoring City Light's financial strength is not a luxury but a necessity in the increasingly dynamic, uncertain and challenging environment in which City Light must operate. Another hydro- and market- driven shortage like the recent west coast crisis cannot be ruled out. If it were severe enough, City Light could not survive such a crisis in its present financial condition without another disruptive emergency rate increase. Long- and mid-term structural threats from deregulation, distributed power generation, and the potential loss of low-cost power from the Bonneville Power Administration (BPA), are real and could require City Light to undertake massive restructuring and/or major investments in new power generation. Again, unless City Light substantially strengthens its financial condition, it would be unable to finance these responses without imposing large rate increases and perhaps other financial burdens on the citizens of Seattle.

Even if these threats can be avoided, the actions we are recommending to strengthen the financial condition of City Light are totally consistent with creating value for the customers of City Light. These recommendations are intended to restore to the businesses and citizens of Seattle the rate advantages of public power that were so severely eroded during the recent crisis.

⁷ Despite the perception in some quarters that City Light's commitment to environmental stewardship is somehow responsible for its recent financial distress, the Advisory Board has found that this is simply not the case. City Light's expenditures on efficiency programs represent sound investments which provide a high degree of economic payback to the City's customers. Most of the spending on other environmental programs at City Light is required by federal and state laws and regulations. The remaining expenditures, reflecting discretionary environmental programs, are not financially material in the context of City Light's overall budget.

It is the view of the Board that the ongoing process of restoring stability and security at City Light includes several key elements, each of which is discussed in later sections of this Report. They are:

- Cash Reserves. City Light should establish and maintain adequate cash reserves that (when combined with sound risk management practices) will substantially reduce the likelihood of future hydro- and market-driven emergency rate increases. The Board is recommending an increase in City Light's cash reserves available to forestall an emergency rate increase from \$25 million to \$100 million. (See Section III.B.)
- Debt Reduction. City Light should reduce its long-term debt substantially over the next 5-7 years in order to enhance the utility's ability to withstand future 2001-type crises and potential structural challenges. The Board is recommending that City Light reduce its debt-capital ratio (now near 90%) into the range of 50-60% before 2011, when City Light's power contract with BPA expires. (See Section III.B.)
- Risk Management. City Light should strengthen its risk management processes to minimize the impact of an increasingly volatile operating environment on its financial stability and long-term security. The Board will be working with City Light on specific risk management issues in 2004. (See Section III.C.)
- Integrated Resources Planning. City Light should strengthen its integrated resources planning (IRP) to assure that the utility has reliable and cost-effective sources of power to meet the future energy needs of the City. The Board is recommending that City Light undertake a biennial IRP exercise,

starting in 2005, and utilize a “mini-IRP” process in 2004 to evaluate the decision whether to renew its current contract for power from the Klamath Falls project. (See Section III.D.)

- High Performance Organization. City Light should strengthen its management systems and practices – becoming a “High Performance Organization” that is committed and able to deliver economic value to the citizens of Seattle through financial strength and lower rates – while maintaining its leadership on the environment, its commitment to the needy, and otherwise meeting its public service obligations to the City and all its citizens. While asking its customers to help finance the reduction in City Light’s debt, it is appropriate for City Light to undertake a systematic effort to strengthen its organizational capability to run its \$800 million business more efficiently and innovatively in order to accelerate both debt reduction and the restoration of the lower-rate advantages of public power. (See Section III.E.)

There is progress to report in every one of these areas, and the Advisory Board’s findings and recommendations are intended to support these ongoing initiatives.

III. Findings and Recommendations

A. The Challenges Facing City Light

City Light operates in one of the most complex and volatile environments of any enterprise, public or private. The popular assumption that hydro-electric power is as “simple” as opening a valve at a dam and running limitless supplies of water through a generator could not be further from the truth. For one thing, the water behind City Light’s dams is not “limitless.” Even in the wettest of years, there is

not enough water to meet all of Seattle's power needs and there is always a mismatch between the seasonal high water and the seasonal high-power demand. (Meeting the operational requirements for salmon protection and restoration, providing for flood control, and fulfilling legal commitments to facilitate recreation in dam reservoirs adds to the challenge.)

Further, there is a huge variation in the amount of water available in any given year, requiring City Light to contract for a larger long-term supplemental power supply than it may need in most years and creating the obligation to sell an uncertain amount of surplus power into an uncertain and dynamic wholesale power market. This market changes constantly in response to both regional hydro conditions and the price of fossil fuel, primarily natural gas. In addition, City Light must try to predict the changing level of economic activity in its customer base, which affects not only the aggregate demand for power, but also the specific geographic distribution of that demand. Finally, it must keep its supply and demand precisely in balance, not just every year but each month, day, hour and minute of operation of its supply grid.

The combination of hydro, market and economic uncertainty introduces a high level of short-term volatility and uncertainty into City Light's revenues every year, with potential annual swings of more than \$100 million. To prevent this uncertainty from affecting rate-payers through unstable rates and emergency rate increases, City Light must continue to integrate risk management best practices into its planning and operating decisions and restore and maintain adequate cash reserves as the first line of defense against operating deficits.

The volatility that City Light faces annually has been compounded by a long-term trend toward integrated and market-driven electrical power markets in the Pacific

Northwest and across the Nation. While the west coast energy crisis gave “deregulation” a bad name and slowed down the evolution toward more open and competitive power markets, the trend toward competition continues and, in the judgment of the Advisory Board, is unlikely to be reversed. Clearly, the federal agency with paramount national authority over the national electrical grid – the Federal Energy Regulatory Commission or FERC – remains strongly committed to develop an even more integrated and competitive market for electricity. Even as Seattle fights to protect its current insulation from federal regulation of the energy and transmission markets, it would be unwise for City Light to plan for the future by assuming that it need never face competition from other power providers.

As Standard & Poor’s recently concluded:

“S&P believes that some sort of restructuring is inevitable. It is therefore essential that [public] utilities continue to prepare for competition by improving their cost structure and maintaining rate advantages over area investor-owned utilities.”⁸

Even if the threat of completely open markets never materializes, it makes sense for City Light to prepare for possible competition by improving its financial condition and restoring the “rate advantages of public power” because that is plainly in the interest of the owners of City Light, the citizens and ratepayers of Seattle.

But there are other reasons for City Light to do this. Another market-driven crisis

⁸ Standard & Poor’s, Rating Direct. Research: Maximizing Public Power Rating Potential, May 20, 2003 at page 2

such as that in 2001, arising from “runaway” natural gas prices, a multi-year drought and/or transmission constraints, could strike again without warning. Although City Light’s power portfolio now provides a substantial cushion against a market-driven shortage, the utility faces other business risks and will need both cash reserves and a strong balance sheet to successfully confront them.⁹

Furthermore, looking out 5-10 years, there is considerable uncertainty about the structure of the environment in which City Light will operate. Today, City Light depends on Bonneville Power Administration (BPA) for about 30% of its overall power supply. But BPA’s long-term role as a wholesale supplier of low-cost power to City Light is not guaranteed. BPA has itself had to raise rates dramatically as a result of the higher costs of serving the needs of public and private utilities and direct service industries whose demand far outstrips BPA’s own hydro supply. If BPA is forced to ration its cheap hydroelectric power or share the economic benefits of relatively cheap power from federally operated dams outside the Pacific Northwest, the security and pricing of this major component of City Light’s power resource portfolio would be in jeopardy. The right decision for City Light at that time may be to invest in expanding its own generation capacity. To afford such a major investment without a significant increase in rates, City Light will need to have reduced its level of debt substantially and to restore the balance sheet strength needed to finance such an investment over the long term.

A very different kind of long-term structural risk might arise from a significant

⁹ Although long-term debt cannot be used to pay directly for operating deficits, City Light can use debt to reimburse itself for a limited amount of prior years’ capital expenditures that it had previously funded from operating surplus and go to 100% funding of ongoing capital spending during the crisis – thus freeing up more operating revenue to cover a deficit.

loss of City Light's load – either from a competing utility siphoning off its commercial and industrial customers or through a technology breakthrough allowing industrial, commercial and even some residential customers to install their own “distributed” power supplies, such as fuel cells or micro-turbines. This latter development, which is certainly plausible and perhaps likely in the 5-10 year time frame we are considering, could devastate City Light and impose a heavy burden on the City and its tax-payers and remaining rate-payers to finance the necessary restructuring or down-sizing of City Light – unless City Light by that time had restored the balance sheet cushion, as discussed above, to finance its restructuring internally or even to invest in the business of providing distributed power to its customers. Also, by reducing debt and its associated debt service costs, Seattle City Light can reduce rates over time and thus mitigate the incentive for customers to leave its system.

Thus, the prescription for preparing City Light and the City to thrive in an uncertain future with the significant risk of structural change and major financial burdens is the same, regardless of the risk – to reduce City Light's long term debt and strengthen its balance sheet so that City Light can finance any needed restructuring, minimizing the need for the City to raise its rates or undertake borrowing of its own to bail City Light out. And, because the threats or risks we identify (another 2001-type crisis, loss of BPA supply, competition from other utilities, and competition from alternative technology) will require a stronger, more competitive City Light to meet these challenges, City Light should aim to improve its “competitiveness” generally by strengthening its balance sheet and delivering lower rates and more value to its rate-payers.

In the sections that follow, we discuss the elements of a strategy to achieve this overall goal.

B. Restoring Financial Strength

When City Light pays off the last of its short-term operating debt in a few months, it will – on that day – still lack the cash reserves needed to withstand the volatile environment in which it must operate. Further, it will have over \$1.5 billion in long-term debt, representing nearly 85% of its total capitalization. The utility will have little cushion for future shocks or structural challenges.

Fortunately, in response to the energy crisis, the City Council and Mayor adopted a new Financial Policy for City Light. The Financial Policy requires that future rates for City Light should be set in such a way as to establish and maintain certain cash reserves and to reduce City Light’s long term debt substantially over time. (Resolution 30428, 12/2001.) In fact, the Financial Policy prohibits any rate reduction until the short-term debt is retired and certain operating cash balances are established. Thereafter, rates may be adjusted but only in accordance with the Policy. The Advisory Board is proposing modest, but we believe necessary, changes to strengthen the Financial Policy, as discussed below. We are supporting more significant changes in the way City Light works to assure that the goals of the Financial Policy are actually achieved, as discussed in Section E.

Cash Reserves. The Financial Policy requires the establishment and maintenance of a “contingency reserve” fund of \$25 million to cover a multi-year drought or other extraordinary outcome that could lead to a significant operating deficit in a given year. We think that this reserve is too low given the size and volatility of City Light’s operating budget.¹⁰ The \$25 million reserve would represent only

¹⁰ The Board has no problem with the level of a separate “operating reserve” of \$30 million, which is also required under the Financial Policy. This operating reserve is intended to cover within-month swings in cash balances and give flexibility in the timing of capital borrowing during the year.

about 30 days of operating costs (excluding purchased power costs) for City Light.

Combined with risk management and balance sheet strength generally, cash reserves are the first line of defense against an emergency rate increase caused by volatility in revenues. Some emergency cost cutting is possible to supplement these tools but the kinds of costs that can be quickly cut are limited and are frequently precisely the wrong costs to be cutting for the long-term financial health of the utility. Although there is no rigid formula governing the optimal size of a contingency reserve, public utilities have historically followed a “rule-of-thumb” of maintaining contingency reserves sufficient to cover roughly 60-120 days of operating costs. Following the onset of deregulation of the wholesale power markets in the mid-1990’s, many utilities increased their contingency reserves to anticipate greater volatility in their revenues. Today, the median days of cash on hand for public utilities comparable to City Light is around 130 days. (Fitch Ratings, Public Power Financial Peer Study, June 2003, at page 9). Given City Light’s relatively greater dependence on hydro power, its revenue volatility and reserve requirements are arguably greater than average.¹¹

The Board believes that the City and its rate payers would be better served if City Light had a contingency reserve closer to the 120-130 day range of its peer public utilities. This would translate into a \$100 million contingency reserve.¹² This change in the Financial Policy could be accomplished without significant cost to its customers by reclassifying an existing Bond Fund Reserve (now containing roughly \$80 million) to a contingency reserve. This Bond Fund Reserve is now

¹¹ See, e.g., Moody’s Investors Service, Global Credit Research, New Issue, June 30, 2003: “Moody’s Assigns Aa3 Rating to City of Seattle’s Electric Revenue Bonds” at page 2.

¹² The \$30 million operating reserve should not be counted as a contingency reserve because it is needed to finance ongoing working capital needs.

required under technical bond covenants but could be replaced by a single-premium surety bond (a form of guaranty insurance policy) of relatively modest cost,¹³ thereby allowing the entire reserve to be utilized in an emergency to finance an operating deficit and minimize the risk of a sudden rate increase. Given its lack of significant cost to the customers¹⁴ and its ultimate benefit of increasing rate stability, the Board strongly supports reclassifying the bond fund reserve and raising the level of the contingency reserve to \$100 million. At the same time as this change is implemented, the Financial Policy should restrict the use of these funds by making clear that the contingency reserve will not be used except when necessary to avoid an emergency rate increase.

Debt Reduction. As noted above, after paying off its short-term debt, City Light will still have over \$1.5 billion in long-term debt, representing nearly 85% of its total capitalization. This level of debt means that, if City Light faced another major crisis like that experienced in 2001, it would be severely limited in its borrowing capacity to help finance its way out of trouble – without again incurring short-term debt and saddling its customers with a substantial emergency rate increase to repay it. Worse, a protracted structural crisis such as an unexpected major loss of load could send City Light into a financial tailspin and require the City of Seattle not only to raise electric rates, but possibly to use its balance sheet to help bail City Light out. Obviously, this is not a desirable or fiscally responsible risk. Moreover, the high level of debt puts a burden on existing and future customers by imposing relatively high debt service costs, which are

¹³ Such an insurance policy might not be available -- and certainly would carry a higher cost -- if City Light waited until it was in the midst of a crisis before attempting to reclassify its bond reserves.

¹⁴ If the Financial Policy were so amended and the Bond reserve fund reclassified, City Light would only need to accumulate about \$20 million more to fully fund its contingency reserve, which is actually less than the \$25 million originally called for under the current Policy.

projected to increase over time as interest rates rise above their current historically low levels. In the long run, debt reduction will reduce rates in Seattle and is a solid investment in our future.

Recognizing these benefits, the City's recently adopted Financial Policy for City Light provides that rates will be set at such a level that, over time, City Light will reduce its long-term debt ratio by funding a substantial portion of its ongoing Capital Improvement Program from operating surpluses. The precise formulation is that rates will be set such that, after establishing the cash reserves discussed above, there will be a 95% probability that annual revenues will cover operating costs and debt service, taking into account the revenue variability resulting from uncertainty of water conditions, market prices and system load. Thus in 19 of 20 years, there will be some operating surplus, which will be used to fund capital improvements. In relatively "poor" years, most of the capital program will still be funded by new long-term debt. But, in "good" years (i.e., with higher levels of operating surplus), most and sometimes all capital investments will be funded out of operating surplus. Of course, in one year in 20, one could expect an operating deficit – and thus the need for the contingency reserve fund discussed above.

The Advisory Board believes that the basic approach and objectives of the Financial Policy with regard to City Light's long-term debt are sound. However, we believe the Policy should be strengthened by incorporating a specific debt ratio target and a specific deadline for achieving it. Nothing in the Policy requires City Light to achieve any particular debt-to-capital ratio by any given time. City Light has forecast that its debt ratio will be brought down substantially by the end of this decade. As of now, however, there is no long-range plan to get there. If the forecast assumptions about the level of capital spending and inflation of City Light's operating budget are changed, this goal would not be met. In order to

strengthen City Light's ability to deliver value to its customers and to the citizens of Seattle and to enhance the City's oversight of City Light, clear strategic targets should be incorporated into City Light's planning and performance measurements. A target debt ratio and deadline for achieving it are two of the most important of these. As discussed in Section E, City Light must then focus on achieving or exceeding these goals, along with restoring the lower-rate advantages of public power, by developing and executing plans to improve the efficiency of its capital and operating budgets.

Again, there is no rigid formula for what is an appropriate debt ratio. It is appropriate and financially sound for a public utility to fund a substantial portion of its capital investments, which benefit future ratepayers, through long-term debt. But too much debt deprives a utility, as it does a family or any other business, of the flexibility to withstand significant and unpredictable changes in future circumstances. The electric power world has changed and is changing so much that a healthy balance sheet is not a luxury but a necessity for City Light. Looking at City Light's peer public utilities, it appears that an appropriate target for City Light would be in the range of a 50-60% ratio of debt to total capital. (See Fitch Ratings, Public Power Financial Peer Study, June 2003, at page 9).¹⁵

The Advisory Board believes that it is important for City Light to get back into this debt ratio range before 2011 when City Light's power contract with BPA expires. 2011 is also in the 5-10 year window during which technology could make distributed power a reality and in which regulatory change could drive

¹⁵ Tacoma Power's debt ratio is about 55%.

significant restructuring and increased competition for City Light's customer base. It is a prudent deadline for restoring City Light to this level of financial strength.

As mentioned above, City Light's current long-range forecast predicts that it will arrive at a 50-60% debt ratio in the 2009-2011 timeframe under the existing Financial Policy. There is, however, no long-range plan to make this happen. The first step toward creating such a plan is for the City to incorporate this target, a 50-60% debt ratio before 2011, explicitly into the Financial Policy. The next step is for City Light to develop strategic and operating plans incorporating this target and its other goals (e.g., lower rates, reliability, and environmental stewardship) and to strengthen its capacity as an organization to execute those plans. We discuss these topics in Section E.

C. Strengthening Risk Management

Risk management consists of a set of management tools and processes for measuring, monitoring, controlling and reporting risk. City Light is working to strengthen its risk management processes to minimize the impact of an increasingly volatile operating environment on its financial stability and long-term security. During 2003, the Board has focused its attention on several risk management issues, including (1) the costs and benefits of the "95% coverage policy," (2) City Light's progress in developing a risk metric, (3) the use of financial hedges, and (4) the role of the "Middle Office" in City Light's power marketing organization.

The 95% Coverage Policy. Based on its costly experience in the recent energy crisis, which forced City Light to purchase a substantial portion of its electricity requirements on the spot market, City Light adopted the "95% coverage policy." The policy requires City Light to secure sufficient long-term power resources so

that there will be a 95% probability that City Light will have more than enough power to meet its customer load in any given year. City Light should therefore have excess power in all but the most extreme drought conditions – conditions occurring normally in only one year out of 20 – during which year the utility would face a shortfall in three low-water months. The 95% coverage policy dramatically reduces the utility’s financial risk of having to buy power on the spot market during a period when prices are escalating.

However, the 95% coverage policy creates a different albeit a somewhat more manageable risk. Since City Light has enough power to cover its needs in 19 out of 20 expected water years, in most years it will be “long” and have surplus power to sell. Because the wholesale revenue from surplus power sales is a major component of City Light’s planned operating revenues, it is critical to the success of each year’s fiscal plan.

City Light’s objective is to sell enough surplus power to achieve its revenue targets without jeopardizing its ability to meet its customers’ monthly, weekly, and hourly needs. However, the amount of surplus power available for sale cannot be known at the beginning of any given water year. Likewise, the price to be realized from the sale of surplus power, which is based on market prices that change daily, cannot be known at the beginning of the year. City Light cannot forecast revenues from surplus sales with any certainty until the winter snow pack and spring melt patterns are measured and the range of market prices for wholesale power for the year can be better estimated. This uncertainty introduces a great deal of volatility into City Light’s revenue forecasts.

The Board believes it would be appropriate for City Light and the City to undertake a review of the appropriateness of continuing the 95% coverage policy.

Although the policy was an understandable reaction to the unprecedented market prices that City Light and the entire West Coast experienced during the energy crisis, the policy may now be excessively conservative and may be adding substantial unwarranted costs to City Light customers. The Board has not reached a conclusion on the appropriateness of this policy in today's environment. However, as noted below, the Board is suggesting that City Light use the occasion of the decision required in 2004 whether to renew the Klamath Falls CT power supply contract as an opportunity to conduct a limited Integrated Resource Planning exercise. As part of this exercise, it would be most appropriate if City Light, with the Board's help, would reexamine the continuing value of the 95% coverage policy. Market and weather risks still exist, but a more comprehensive evaluation of the risks avoided versus costs incurred by this policy is now timely. This is especially true since recent IRP's done by Idaho Power and PacifiCorp have led to the adoption of substantially different resource coverage policies (70% and 80%, respectively).

Development of a Risk Metric. City Light uses risk management tools to manage the volatility inherent in its wholesale power sales. The Risk Management Committee, chaired by the Superintendent, prepares an 18-month operating plan for the forward sale of one-half of the expected surplus. Each week, the Risk Management Committee reviews updated water conditions and market prices to decide how much of the remaining power will be needed for City Light's customers and how much can be sold on the daily and hourly markets. Until recently, the Risk Management Committee made these decisions based on its judgment and experience.

Recently, City Light developed a risk metric tool to enable it to make better decisions. Currently, the risk metric has been submitted to an outside consultant

for review and validation. The risk metric should allow City Light to recommend appropriate risk limits.¹⁶ The Board will review the risk metric and proposed limits as part of its 2004 Work Plan.

Financial Hedges. City Light has also been exploring the management of risk through the use of financial hedges, such as using “covered puts” to allow City light to sell power forward into the wholesale market subject to its right to cancel the sale if the power is needed later in the year to serve its retail load. In effect, City Light would pay something extra (the option price) to allow it to stabilize both its wholesale power revenue and its retail power supply. There is some question on the part of City Light staff whether these hedges are practically available for City Light to use in its risk management. There is also a question whether the cost of such a hedge (which would increase City Light’s operating expenses every year) is worth the reduction in volatility it would afford. The Advisory Board will work with the utility to review the availability and potential use of hedges as a risk management tool at City Light. This will also be an item in the Board’s 2004 Work Plan.

Independence of the Middle Office. At City Light, the “Middle Office” reports to the Power Management branch, which manages the power resource portfolio. The Middle Office is directly responsible for resource operations planning, forward market pricing, marketing transactions settlements, fish compliance

¹⁶ The risk metric tool is partly responsive to the City Council’s resolution requiring City Light to develop and propose a risk metric and risk limits (Resolution 30632). Deloitte & Touche (August 2000) specifically recommended that market limits should be formally established and monitored on a daily basis. The Vantage Final Report (October 31, 2002) similarly noted that loss limits are “essential.” Most recently, R. W. Beck advised that a decision on risk metrics should be made in the near term, noting: “A key component of a risk management program is the use of risk metrics to measure, monitor, and report risk associated with the portfolio.”

monitoring, snow survey administration and reporting, and risk management. The Middle Office thus performs resource planning, marketing, and risk management oversight functions.¹⁷

After reviewing the Deloitte Touche and R.W. Beck reports and discussing this issue with appropriate City Light Power Management and Finance staff, the Board concludes that the present organization of the utility does not fully comply with utility best practice in the risk management area. Best practice requires that the risk management functions of the Middle Office should not report to the Power Marketing Branch, the same organization that is responsible for trading and marketing. This total segregation of duties and reporting lines affords “robust risk oversight” and helps prevent inappropriate transactions.

The Board recommends that personnel carrying out the current risk management functions of the Middle Office should report within City Light to an organization that is independent of the Power Management Branch. A decision as to how to accomplish this is a matter for the new Superintendent. However, the Board would suggest that personnel in the present Middle Office who perform essential risk management oversight be transferred to the independent Risk Officer, who currently reports to Finance rather than to Power Management.

D. Integrated Resources Planning

Integrated Resource Planning (IRP) is critical to the future stability and security of City Light and its ratepayers. The Regulatory Assistance Project describes IRP in its Best Practices Guide as follows:

¹⁷ According to R. W. Beck, the role of the Middle Office is to independently monitor portfolio risk and transaction activity, manage risk reporting, and “lead conversations” on overall risk management strategy.

IRP is the combined development of electricity supplies and energy-efficiency improvements, including managing the growth of demand (DSM options), to provide energy services at minimum total cost including environmental and social costs.¹⁸

Integrated Resources Planning can provide the assurance that a utility's resource portfolio will meet the energy needs of its customers at a reasonable cost. Limited or no planning in this area means that resource decisions can be made ad hoc and sub-optimally. Resource planning is such a central aspect of the strategy of a utility that more and more utilities, public and private, are returning to IRP as their primary strategic planning exercise because IRP incorporates the full range of policy goals, such as energy efficiency and environmental stewardship, into the process.

IRP at City Light. It is the Board's initial recommendation that City Light should institute a biennial IRP process that fully reflects utility best practices and provides a framework for the critical energy resource and demand-side management decisions facing City Light in the next 5-10 years. The Board recognizes that a full-blown IRP may take some time to implement at City Light. City Light's planning and analysis capability, especially for long-range decisions, has been substantially reduced in recent years. This reduction, while similar to

¹⁸ "This integration seeks the broadest reasonable range of options to meet demand for electric service, including technologies for energy efficiency and load control on the demand-side, as well as decentralized and non-utility generating sources, into the mix of potential resources. By selecting technologies and programs to minimize the total cost of electric service, and by including environmental and social costs in the cost criteria, IRP makes it possible to design and plan for electric supply and demand-side options to meet electricity demands without wasting economic or natural resources." Regulatory Assistance Project, "Best Practices Guide: Implementing Power Sector Reform" (Office of Energy, Environment and Technology, USAID 2000) at page 70 (<http://www.raponline.org/Pubs/General/BPPwrStr.pdf>).

that experienced by other electric utilities in the 1990s, has significant adverse consequences. It can lead to marginally informed decisions and, at worst, to decisions driven exclusively by short-term market or political considerations. Neither result is desirable.

Accordingly, the Board recommends that, in connection with establishing an IRP process at City Light, the utility should upgrade its planning capability and specifically consider:

- 1) whether selective staff or consultant additions/transfers are needed in this area,
- 2) the most effective organization for the utility's resource planning staff , and
- 3) what tools and other resources are needed for strong integrated resource planning.

The Board expects that City Light would institute a full IRP process in 2005.

Klamath Decision Analysis. In late 2004, City Light faces a decision on whether to renew its 100 megawatt (MW) option on the Klamath Falls project. Ideally, this decision would be made in the context of a full IRP process. However, since the Klamath renewal decision will have to be made before City Light is likely to have completed its IRP,¹⁹ the Board recommends that City Light undertake a type of “mini-IRP” for the Klamath decision, incorporating certain elements of the IRP

¹⁹ City Light's analysis and recommendation on the Klamath decision will actually need to be completed by October 2004 to allow the Mayor and Council to complete their review process in time for the renewal option deadline in December.

process to assure that City Light will evaluate the full range of resource choices in light of the most relevant criteria.

The first step should be to review the City's broad energy policy goals for evaluation of resource acquisitions (and other utility actions). The City Council has provided considerable guidance in this area, but the utility may want to consider additional policy goals (e.g., reliability criteria) that may be appropriate and helpful.²⁰ One of the City's goals or policies that directly affects the Klamath decision is the 95% coverage policy discussed above. As noted, we believe the City and City Light should reassess this policy as part of the Klamath decision.

The next step in the Klamath mini-IRP process should be to consider the full range of resource alternatives to renewal of the Klamath contract. At a minimum these alternatives would include the following:

- renegotiation of the present Klamath contract to obtain more favorable terms, particularly price, dispatchability and unit contingent risks;
- solicitation, either through a request for proposals or informally, of bids from other generating resources or power purchase agreements to replace Klamath;
- analysis of the feasibility of expanded energy efficiency programs to fill part/all of the Klamath 100 MW;
- investigation of the feasibility of adjusting the 2006 step up provision in City Light's Block contract with BPA to fill part/all of the gap;

²⁰ Typically, such policy goals will be in tension, if not conflict – e.g., low rates versus stable rates. But having a list of goals/objectives, and being able to ascertain (at least qualitatively) how any resource acquisition meets those objectives, will help the utility and the City to evaluate the appropriate policy balance in this complex area.

- examination of resource acquisition partnership possibilities with neighboring utilities to fill the gap (e.g., Puget Sound Energy, Tacoma, and Snohomish);
- for Klamath and other generating resources, evaluation of surplus sale opportunities, plus access to the California market for possible marketing/revenue benefits; and,
- allowing the Klamath contract to expire and not replacing this component of City Light's power supply for the time being.

Finally, City Light should evaluate these alternatives, in light of the applicable broad policy goals, against a matrix of key variables, such as market prices, BPA rates, and other factors which directly bear on both the need for additional resources and which resource alternatives look most attractive.²¹ City Light should examine the interactions among these variables in the 2006-2011 and 2011-2016 periods, before and after the expiration of City Light's current power supply contract with BPA.²² In addition to analyzing these quantitative variables, City Light should perform a qualitative evaluation of the possible impacts of technological and regulatory change on future resource options.

We recognize that this effort represents a significant amount of work to be accomplished over the next several months. The Board appreciates the magnitude

²¹ In our view the list of key factors includes at least the following:

- Market prices
- Natural gas prices
- BPA rates
- Retail load growth in City Light's service territory and in the region
- Available transmission capacity or lack of it
- Likelihood of greenhouse gas regulation more stringent than the City's present carbon neutrality policy
- Environmental impacts
- Financial impacts
- Forecast of City Light's owned resource and contract resource performance

²² The examination should use full life-cycle cost analysis since some alternatives have useful lives longer than the two designated periods.

of this undertaking and that City Light may need to supplement the limited planning staff now available to accomplish it. To make this undertaking more manageable, the Board's expectation is that City Light focus on the key variables and not on marginal details. We hope that this analysis will:

- 1) identify the principal first and second order issues which influence this resource decision,
- 2) specify key sensitivities which substantially influence outcome, and
- 3) ensure that any ultimate decision can survive the worst credible combination of unanticipated assumptions.

It is definitely not the Board's intent for City Light to spend significant resources on third order issues, which will have only a marginal impact on the overall outcome.

Regional Transmission Issues. Potential constraints on transmission capacity in the Northwest could impair City Light's ability to acquire and manage its power resources in the future. The Board believes that City Light and the City should evaluate the appropriateness of a regional transmission entity (as distinct from the previously proposed RTO West structure) to help overcome these constraints. The City's original opposition to RTOs came about during a period of intense concern about FERC's proposed Standard Market Design (SMD) and the RTO structure necessary to implement that market concept. It was an understandable reaction to a market concept that might work in east coast thermal-based systems, but had serious shortcomings in the storage deficient, hydro-base load system of the Northwest.

Conditions have now changed substantially. As a practical matter, thanks in part to City Light's opposition, SMD for the Northwest is no longer a serious threat. The RTO West Regional Representatives Group (RRG) is now attempting to form a voluntary independent regional transmission entity for the Northwest. This entity is meant to solve the real transmission problems that exist in the region (e.g., reliability, significant congestion, insufficient construction of new transmission) rather than to respond slavishly to an ill-considered, one-size-fits-all FERC directive. Further, we believe that among the benefits to City Light from this type of organization would be creation of a near term market for ancillary services in which City Light would probably be second only to BPA as the major provider.²³

In light of these considerations, the Board recommends that City Light, and the City, evaluate potential benefits of the RRG type of regional transmission entity based on a careful review of the costs and risks versus the potential benefits to the utility and the City.²⁴

²³ Ancillary services include various activities to control generation and/or load to balance an electrical system.

²⁴ The following set of considerations, positive and negative, is not meant to be exhaustive but represents a starting point for examining all of the relevant factors in determining Seattle's position on an independent Northwest transmission entity:

- Value of City Light's participation in a real time/day ahead ancillary service market.
- Avoidable costs of BPA transmission curtailments to City Light during the past five years (e.g., West of Hatwai, Northern Intertie) had a regional transmission entity facilitated more timely construction of new transmission, or been able to redispatch regional generation to avoid such curtailments.
- Regional benefits of such a transmission entity (e.g., improved reliability, resource portfolio diversity, enhanced ability to construct new transmission, improve operational efficiency and avoid the type of "gaming" impacts that occurred in the recent crisis).
- Costs to start up and operate a regional transmission entity.
- Risks associated with possible increased FERC control over BPA transmission.
- Concern over possible price volatility introduced by a market based congestion management system (run by the regional transmission entity).

E. Becoming a High Performance Organization

The current leadership at City Light has recognized that, in order to achieve the goals set out in this Report and to thrive in the challenging and uncertain world of public power, the utility must become more of a “High Performance Organization” – an enterprise that sets clear goals, empowers its people to achieve them, and holds itself accountable for success or failure. This is an imperative of all organizations which find themselves in changing and more competitive operating environments and is not an indictment of the current organization or its people.

It is not the intent of this Report, nor the focus of the Advisory Board, to lay blame for the past. We are looking forward and working with City Light, as well as the Mayor and Council, to build and improve City Light for the future. Although our Report recommends the expansion and development of new capabilities, we want to emphasize that we believe the utility enjoys a strong base of talented, dedicated and experienced professionals. Further, we believe the men and women of City Light care deeply about the utility and its customers. Many of the good ideas and innovations that are needed to move the utility forward already exist within the organization and simply need to be nurtured and expanded.

Given the current challenges and the recent recovery from the west coast crisis, however, the time is right for a more systematic approach to facilitate the transformation of City Light into a High Performance Organization. Accordingly, the Board applauds and will fully support the initiative now underway at City Light to make this a reality. While asking its customers to help finance the reduction in City Light’s debt, it is appropriate for City Light to strengthen its organizational capability to run its \$800 million business more efficiently and innovatively in order to deliver value to its owners, the City of Seattle and its

citizens. A high priority should be attached to restoring both the financial strength and rate advantages of public power that were eroded by the recent crisis.

But, the goals of becoming a High Performance Organization go beyond achieving financial stability and lower rates. They include providing excellence in customer service, including system reliability, as well as minimizing the environmental and social impacts of its operations – and all the other public policy objectives the City of Seattle seeks to achieve through its municipally owned utility. They also include the more intangible goal of restoring the spirit of innovation – even entrepreneurship – that is City Light’s legacy from J.D. Ross and the other early visionaries who built the dams and secured a future for public power in Seattle and the Pacific Northwest. In the 21st Century, facing a new set of challenges and uncertainty, City Light’s becoming a High Performance Organization will make it possible for the people of City Light to reshape the utility to meet the future needs of the City.

As mentioned above, the current leadership team at City Light is now developing an initiative for transforming City Light into a High Performance Organization. This process will continue and accelerate after the new Superintendent takes office, and the Advisory Board is planning to devote a major portion of its 2004 Work Plan to supporting this initiative. While this initiative must belong to the new Superintendent and the people of City Light, the Board has a number of recommendations that it believes are critical for the success of this effort:

Strategic Planning. City Light should institute an annual strategic planning process, with a multi-year strategic plan that is integrated into each year’s operating plan so that the strategic goals of the utility are tied to current operating initiatives. The strategic plan should not be a one-time event or special exercise.

Rather, it should be updated annually through a dynamic planning process that enhances both long-term and short-term decision making. Integrated resources planning (IRP), discussed above, needs to be part of an overall strategic plan reflecting all resource and risk-related decisions. At the same time, the strategic plan provides important inputs into the IRP process by balancing the full range of the utility's competing values and priorities. We expect City Light to produce its first annual strategic plan in 2004, with the first plan year of 2005. This will dovetail with our expectation that City Light will produce its first biennial IRP in 2005. We have already noted, in the context of the IRP discussion, that City Light needs to strengthen its planning capability, and this same conclusion applies to the kind of strategic planning that we are suggesting here.

Financial Management. Beyond planning, City Light needs to invest in upgrading or creating new tools and systems to allow it to generate the management information necessary to measure, and thereby improve, its performance. For example, City Light's current accounting systems may not capture and analyze the kind of information (i.e., cost and productivity by activity and/or function) necessary to identify efficiency improvements and track their implementation. As part of the High Performance Organization initiative, City Light should review each of its management information systems and determine whether new tools or upgrades are required. The initiatives already underway to upgrade and improve City Light's risk management processes, discussed in Section C above, should also be continued.

Performance Metrics and Balanced Score Card. The Board believes that City Light should incorporate the targets, discussed above, for restoring financial stability and security – reducing debt levels dramatically before 2011 and substantially restoring the rate advantages of public power as soon as practicable –

as explicit strategic goals and performance metrics and hold itself accountable for achieving them. Further, City Light must assure that these financial goals are achieved consistently with other key goals, such as customer service and environmental stewardship. It should align its employee and organizational metrics with all these goals through use of a balanced score card. A balanced score card will reward innovative approaches to enhancing performance across several goals – for example, reducing costs while enhancing reliability and/or environmental stewardship.²⁵

Benchmarking and Best Practices. A High Performance Organization is externally focused – both on the needs of its customers and on the initiatives of its peers. While not yet in a directly competitive situation, City Light can learn much about how to better achieve its goals by continually comparing itself to peer utilities and other comparable organizations (“benchmarking”) and by adopting and adapting the best practices of others. Benchmarking and best practices have been used in parts of City Light and in some cases have yielded outstanding results.²⁶ The Advisory Board recommends that City Light implement benchmarking and best practices systematically throughout its organization and that all parts of the utility should be required to demonstrate an ongoing commitment to continuous improvement.

Productivity and Cost Effectiveness. To achieve its goals, City Light must be committed to improving the productivity of its operations and the cost

²⁵ Demand side management is an excellent example of an approach that can be both lowest cost and most environmentally sound.

²⁶ The capital cost of the Boundary Dam rehabilitation project was reduced from over \$150 million to around \$60 million as a result of looking outside City Light for utility best practices for undertaking this kind of project.

effectiveness of its capital investments. A best practices study is one way to identify more cost-effective approaches. But City Light will need to adopt a more systematic process for managing its operating and capital budgets. “Asset Management” is one such process currently under study at City Light. Asset Management represents a set of utility best practices developed in Australia, France and Great Britain. The foundation of this framework is the concept that a utility’s ultimate objective should be “to provide agreed upon customer service levels at the lowest life cycle cost, including financial, environmental and social costs.” Using the Asset Management Initiative, Seattle Public Utilities has already achieved substantial reductions in its capital and operating costs, while maintaining or enhancing service levels and other policy goals. The program is customer-focused, but is also rigorous in integrating financial, environmental and social costs into the planning process. Asset Management is also fundamentally the same approach used by the Generation Branch in achieving dramatic cost savings on the Boundary Rehabilitation Project and in the development of its ongoing Capital Improvement Program. We encourage City Light to continue to study the Asset Management Initiative and the successful experiences of its own Generation Branch as best practices for possible adaptation throughout City Light.

Organization and Human Resource Development. A High Performance Organization invests in people, through training, development and other human resource policies and practices – both to empower its people to better achieve the organization’s goals and to enrich their careers and job experiences. To this same end, a High Performance Organization fosters open, honest communication throughout the organization to involve and engage the hearts and minds of its entire workforce. The Board believes that City Light should review its policies and practices regarding its people and organization and consider whether they are meeting the needs of a high-performance organization. Do they allow City Light

to recruit and retain the best people? The average age of the City Light work force is now 48 years with 71% eligible for retirement in the next 10 years. Is current training, skill development and succession planning sufficient to assure that City Light will have the human resources it will need to accomplish its mission in the decades ahead? Does City Light have an empowering culture, a working environment that fosters both commitment and accountability for the overall success of the utility among all its employees?²⁷

Accountability and “Sacred Cows”. A High Performance Organization holds itself and its people accountable for their performance. All parts of the City Light organization must contribute to the overall success of the enterprise – everyone must come to the table and everything must be on the table. One of the obstacles to turning City Light into a High Performance Organization is the perception among many employees that the utility is burdened with so many “sacred cows” – policies and practices that can never be changed or even questioned – that meaningful improvement or change is impossible. A “sacred cow” may be an engineering rule-of-thumb about how much to load a transformer; it could be a long-standing practice of work crews in the field; it could be an environmental “mandate”; it could be a City purchasing or personnel policy. Whether true or not, the perception that “sacred cows” make improvement at City Light impossible is demoralizing and undermines enthusiasm for any meaningful organizational initiatives. The Advisory Board strongly believes that there must be no “sacred cows” at City Light and that everything about the way City Light now operates

²⁷ As this transformation at City Light goes forward, it is essential to involve all employees in the process. One way to begin this process is with a well-designed employee survey, like the one used at BPA last year as part of its effort to find out what went wrong at BPA before and during the Energy Crisis and how that organization could better perform its mission. City Light should also review its organization structure and decision-making practices to enhance cross-functional internal working relationships and lines of communication.

should be open to question and, if a particular policy or practice is shown to be unwarranted or inappropriate, it should be open to change. At the same time, this questioning and any change must be done with great sensitivity for the impact of such change. Not everything that detracts from efficiency at City Light will or should be changed, but nothing should be beyond questioning and consideration of alternatives.

Regional Leadership. The Advisory Board is of the view that to become a High Performance Organization in the face of the challenges facing public utilities in the Pacific Northwest, City Light needs to strengthen its leadership in the region. City Light has recently devoted significant effort to several regional and national issues (e.g., the BPA Slice Product and the anti-SMD campaign mounted by public power). Historically, City Light has provided critical leadership in the region on such issues as settling the WPPSS lawsuits, obtaining ownership-like participation in BPA's Third AC line, and active participation in the 1996 Regional Review. The Board recognizes that continued active participation in regional issues requires both staff time and money. The results of this participation, however, yield significant long-range benefits, both in assuring that the Northwest and BPA will preserve the benefits of the federal hydro system and in better utilizing City Light's unique resource capability/flexibility to the benefit of Seattle customers. The new Superintendent and senior staff should carefully examine whether increasing City Light's presence in regional issues/forums is desirable. Within reasonable staff resource limits, the Board believes that a more active City Light role, in both issue specific regional efforts and ongoing regional organizations is appropriate and will produce significant long run benefits.

Strengthening the City's Oversight of City Light. The Advisory Board believes that the City and City Light should also undertake a systematic review of the existing systems and policies used by the City for controlling City Light to determine whether different approaches could enhance both City Light's performance and the City's oversight of the utility. In particular, the City should consider alternatives to the current City budgeting process to better align the City's goals and performance objectives with those of the utility and to better measure and report the utility's performance. The Board is concerned that the current system is too focused on static and highly detailed cost categories and not enough on operational and strategic metrics and that such a focus does not provide optimal oversight for an "enterprise fund" such as City Light, with its own non-tax-based revenues to finance its operating expense. Currently, City Light devotes a great deal of resources and effort to complying with detailed budget requirements imposed by the City on all its governmental departments. However, the costs tracked by the City's budgeting process do not correspond directly to the costs that must be included in its operating plan. In order to monitor its real operational performance and efficiency, City Light must keep a separate set of financial records.

We believe the City should move to a more dynamic system of oversight that focuses more on the annual operating plan and key strategic and operational performance metrics and that treats expense/budgetary approvals as an important but subordinate component and not the main driver of control. Such an approach would provide more effective oversight and be more in line with the "best practices" used by other cities for their utilities. The Board recognizes the potential sensitivity of changes in this critical oversight area and will work in 2004 with the utility, with the appropriate Executive Departments of the City and with the City Council to develop a mutually acceptable proposal along these lines.

Other systems for controlling City Light should also be re-examined, with an open mind on the question whether a different approach might help the utility improve its performance with the same or better City oversight. Purchasing rules, legal support, personnel policies – everything should be on the table.

Mayor and Council. Of equal importance to strengthening oversight of City Light is restoring transparency and trust in the relations and communications between the utility and the Mayor and Council. We believe that in becoming a High Performance Organization, City Light will earn this trust, and the Advisory Board is committed to working with City Light leadership, the Mayor, and City Council, to enhance transparency, accountability, and respect for roles among all parties. City Light will need the full support of the Mayor and Council, in making the transformation to a High Performance Organization. Certainly, any goals that City Light will pursue must be approved and embraced by the City as well. The City must also embrace the initiatives that City Light develops to assure that it will meet these goals. To this end, the Advisory Board respectfully requests that the Mayor and Council both provide their clear support for the general direction charted for City Light by this Report, as well as for the specific recommendations of the Advisory Board that are contained herein.

IV. Conclusion

The timing is right for a fresh start at City Light. The utility is just now emerging from the recent crisis. Everyone associated with that event should be open to new ideas about how to manage the utility. There is soon to be a new Superintendent at City Light, and a new City Council has just been sworn in. Finally, the City and City Light have the benefit of a non-partisan, non-political Advisory Board that can act as an advisor, catalyst and buffer, as needed, to help City Light through a change process.

As noted, the leadership team at City Light is already laying the groundwork for the transformation of the utility to a High Performance Organization. It is clear that the people of City Light themselves are looking for a better way. The Advisory Board looks forward to working to support the new Superintendent's leadership of this effort in 2004 and beyond.

Carol S. Arnold
Randall W. Hardy
Jay F. Lapin
Maura L. O'Neill
Sara Patton
Donald M. Wise

January 29, 2004

APPENDIX

2004 Advisory Board Work Plan

1. High Performance Organization
 - Support Strategic Planning
 - Support Asset Management (or equivalent) for Capital and Operations
 - Review existing organization, resources and tools
 - Review and benchmarking of the City's oversight and control systems for City Light
2. Integrated Resources Planning
 - Review planning resources and tools
 - Support Klamath "mini-IRP" process and decision
 - Support review of 95% coverage policy
3. Financial Policy
 - Support amendments to Financial Policy recommended in Report
 - Support development of target for "rate advantages of public power"
 - Liaison with Rate Advisory Committee; participate in 2004 Rate Process
 - Review City Light payments to City
4. Risk Management
 - Review Risk Metric and Limits for wholesale power sales
 - Review options involving financial and physical hedges
 - Review organization and sufficiency of Risk Management resources
5. Other
 - Support new Superintendent
 - Enhance communications between City Light and Council
 - Review worker safety at City Light
 - Review relationship with and strategy for BPA
 - Review transmission issues and regional transmission entities
 - Review security and anti-terrorism measures
 - Meet with City Light employee groups
 - Reach out to community and interest groups
 - Support enhanced City Light regional leadership
 - Assess adequacy of Board staff support and appropriateness of reimbursement of Board expenses

2003 Advisory Board Work Plan and Major Activities

- First meeting – 5/21/2003 -- established Board meeting schedule and procedures
- Conducted in depth reviews with City Light to identify priority issues
 - Branch operating reviews: Generation, Distribution, Customer Service, Power Marketing, and Finance and Administration
 - Topical reviews: power resources, risk management, financial condition and policy, regulatory and industry environment, energy efficiency and environmental programs
- Participated in Risk Management Seminar with City Light and City officials
- Participated through liaison member on the Superintendent Search Committee
- Participated in launch of 2004 rate process and established liaison with Rate Advisory Committee
- Skagit Dams and Power Houses site visit – June 16-17, 2003
- To refine priority issues, consulted outside groups and organizations, including representatives of public and private electric utilities, financial institutions, large and small business customers, low-income customers, environmental groups, organized labor, and other civic organizations
- Established priority issues for remainder of 2003:
 - Power resources portfolio strategy
 - Risk management in power marketing
 - Financial strategy, policies and condition
 - Financial and operational efficiency and capability
- Investigated priority issues and developed recommendations
 - established working groups of Board members
 - extensive internal fact-gathering meetings with City Light personnel
 - supported City Light initiative for a “High Performance Organization”
 - fact finding meetings outside utility and city government
 - numerous consultations within City Light, Mayor’s Office and Council Staff to refine preliminary conclusions
 - developed consensus recommendations on above issues
- Prepared First Annual Report

2003 Advisory Board Expenses

The Advisory Board did not have a budget or incur directly any City-funded expenses in 2003. Board members did not receive compensation or reimbursement for any time or out-of-pocket expenses they incurred personally in 2003 in connection with their work on the Board. The Office of Policy & Management did provide part-time administrative and logistical staff support for the Board and provided meeting rooms, supplies, copying, conference calls, parking and meeting refreshments. OPM reports that approximately \$30,000 was charged back to City Light in 2003 for this Board-related support. City Light also provided meals and overnight accommodations for Board Members during their visit to the Skagit towns and dam sites in June 2003.

Advisory Board Member Biographies

Carol S. Arnold is a lawyer with more than 20 years experience in electric energy and utility matters. She currently serves as of counsel at Preston, Gates & Ellis, LLP. She has extensive background in issues before the Washington State Utilities and Transportation Commission and the Federal Energy Regulatory Commission.

Randall W. Hardy is a former chairman of the Electric Power Research Institute, past president of the American Public Power Association and a previous board member of the Large Public Power Council. From 1991 to 1997, he served as the head of the Bonneville Power Administration, which supplies over 40 percent of all electricity in the Pacific Northwest. From 1984 to 1991, he served as Superintendent of Seattle City Light and negotiated the successful re-licensing of the City's three major dams on the Skagit River.

Jay F. Lapin brings an important perspective as a former litigator involved in energy issues, and as former president and CEO of General Electric Japan Ltd., Lapin oversaw a division with more than 16,000 employees and \$10 billion in revenues. As a partner with Wilmer, Cutler & Pickering in Washington, D.C., Lapin built a litigation and regulatory law practice that included the practice of energy and environmental law.

Maura L. O'Neill has founded four companies that focused on developing solutions to some of the toughest problems in the energy, environment, high technology, and life sciences areas. O'Neill has served as co-chair of the Governor's Transition Team on Energy, Telecommunications and Technology, a member of the National Panel on Energy and Environmental Policy and as an executive committee member for the Northwest Electric Light and Power Association. Maura started her career as an environmental analyst for Seattle City Light, where she conducted some of the first modeling of the potential for energy efficiency and renewable energy technology to meet region-wide electricity needs.

Sara Patton is well known throughout the Northwest as an energy efficiency expert and a clean and affordable energy advocate. Patton serves as Executive Director of the NW Energy Coalition (NVEC). The Coalition works for energy efficiency, clean renewable energy, consumer and low income protection in energy decisions and restoration of fish and wildlife harmed by energy. The Coalition has more than 100 member groups ranging from environmental, low income and consumer advocacy groups to utilities, clean energy businesses and unions.

Donald Wise is currently Managing Director of Asset Services at Metzler Realty Advisors, Past President of Seattle's Building Owners and Managers Association (BOMA) - and led the organization's review of City Light's downtown network rate structure - and serves on the Seattle Chamber of Commerce's Utilities Committee. He has helped lead the building industry's local efforts to promote energy efficiency within commercial real estate properties. Most recently, he helped formulate BOMA International's national energy policy to respect "regional differences" with regard to federal energy policy. Wise has considerable financial and management expertise.