Overview and Initial Issues Identification
SEATTLE CITY LIGHT

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Executive Summary:

City Light is faced with some extraordinary near-term financial challenges. This year (2009) the gap between its revenues at current rates and its authorized spending levels is approximately $140 million. The deficit stems in equal measure from a run up in spending since rates were last set in 2007, and a severe shortfall in wholesale revenue this year resulting from the worldwide collapse of energy prices.

Although City Light cut its spending this year as its financial situation became clear, it has been forced to draw down its cash reserves faster than anticipated and will need to borrow a significant amount of money early next year to support its capital program. Unfortunately, the deficit also means that it is underperforming on a key financial metric—debt service coverage—commonly used by lenders to assess the credit worthiness of borrowers. Without Council action to strengthen its financial performance the utility may be unable to borrow the funds it needs to finance its capital program next year.

The Mayor's proposed solution to City Light's financial challenges does little to address the spending side of the problem. Indeed, the spending level in the 2010 Proposed Budget is higher than it is today and also higher than the 2010 Endorsed Budget. Instead, it focuses on a package of changes to rates and financial policies. Specifically,

- Increasing rates in 2010 by 8.8% and again in 2011 and 2012 by about 6% each for an overall increase of approximately 22%. Only the first-year increase is part of the current rate proposal.
- Relaxing City Light's financial policies to allow a lower debt service coverage going forward than is currently the case.
- Instituting an automatic rate adjustment mechanism that would use rate increases to compensate City Light for shortfalls in wholesale revenue. Under this proposal, retail rates would adjust automatically each quarter to true up actual revenue to forecast, and although the proposal caps the increase in any quarter, rate payers could see significant increases in their rates through the year. In essence, this approach moves the risk of short-term fluctuations in wholesale market revenues to the rate payers.

Introduction

We begin this paper with a high-level overview of City Light's 2010 Proposed Budget. We follow that with an abbreviated explanation of the source and nature of the financial problems facing the utility, and then go on to outline the Mayor's proposed approach to putting the utility on a more stable financial path. The Mayor's proposal for rate and financial policy changes will be dealt with more fully by the Energy and Technology Committee during three special meetings to be held in the next several weeks. Finally, we offer some changes to the 2010 Proposed Budget designed, in conjunction with a rate increase in 2010, to strengthen the utility's financial performance in the near term.

Table 1 below groups City Light's budget into functional areas and compares the 2010 Proposed to the 2010 Endorsed Budget. This representation is different from that presented by the department on October 2. The departmental presentation was by Budget Control Level (BCL) and focused on the changes between the 2009 Adopted and 2010 Proposed budgets. That table is included on page 7 of this paper for reference. Although it does not show BCLs, the representation in Table 1 has the distinct advantage of allowing the Council to distinguish more easily between discretionary and non-discretionary expenditures.

Table 1: 2010 Proposed Budget

	2009 Adopted Budget	2010 Endorsed Budget	% Chg from 2009 Adopted	2010 Proposed Budget	% Chg from 2010 Endorsed
Expenditures					
Non-Power O&M	$190,798,368	$199,755,259	4.7%	$191,566,147	-4.1%
Conservation (Deferred O&M)	$39,662,271	$42,339,724	6.8%	$42,339,724	0.0%
Power Costs:	$377,602,570	$408,347,129	8.1%	$408,347,129	0.0%
Long-term Contracts	$279,022,305	$309,203,284	10.8%	$309,203,284	0.0%
Short-term Wholesale	$98,580,265	$99,143,845	0.6%	$99,143,845	0.0%
CIP	$169,979,544	$153,860,469	-9.5%	$163,558,000	6.3%
General Expense	$64,478,568	$67,568,253	4.8%	$66,976,000	-0.9%
Debt Service & Taxes	$213,008,635	$218,013,162	2.3%	$219,336,000	0.6%
Total Expenditures	**$1,055,529,956**	**$1,089,883,996**	**3.3%**	**$1,092,123,000**	**0.2%**
Total FTEs	1,881.8	1,886.8	0.3%	1,829.5	-3.0%
Revenues					
Retail	$532,618,325	$536,266,450	0.7%	$585,238,000	9.1%
Wholesale	$233,444,178	$233,756,907	0.1%	$184,936,000	-20.9%
Other Revenues	$74,717,368	$85,397,594	14.3%	$72,738,000	-14.8%
Transfers from Cons Fund	$214,750,085	$234,463,045	9.2%	$249,211,000	6.3%
Total Revenues	**$1,055,529,956**	**$1,089,883,996**	**3.3%**	**$1,092,123,000**	**0.2%**

The expenditure side of City Light's budget is broken into:

1. Non-Power O&M: Operating costs other than the cost to purchase power;
2. Conservation: Costs related to acquiring conservation. Since the benefit of conservation extends through time it is treated much like a capital expenditure and the costs are amortized over time;
3. Power Costs: The costs to purchase power through long-term contracts (such as the Bonneville Power Administration contract), and to engage in short-term balancing transactions on the wholesale market. The amount of expenditure authority in the 2010 Proposed Budget to support short-term wholesale purchases ($99 million) is considerably more than the $66 million City Light forecasts it will need. The cushion is included to ensure that City Light will have the legal authority to purchase short-term power if it can subsequently sell it at a profit. The additional expenditure authority is, in that sense, self funding and has no impact on net costs except perhaps to lower them;
4. CIP: New capital projects and major maintenance of existing capital assets;
5. General Expense: Includes the costs of employee benefits and City central services; and
6. Debt Service & Taxes: The utility pays taxes to the City (6%) and the state (3.9%) on its sales to retail customers. Together these total around $68 million in the 2010 Proposed Budget. The second component, debt service, includes about $150 million to pay the principal and interest on debt outstanding.

Within certain limits, items 1, 2, and 4 above are discretionary and will be the focus of options explored below to lower costs. In contrast, items 3 and 5 are largely beyond the utility's control.

The revenue side of City Light's budget is broken into:

7. Retail: Determined largely the rates set by the Council as consumption is relatively stable and predictable;
8. Wholesale: The gross revenue City Light anticipates earning from the sale of surplus power. The net revenue is this number ($185 million) less the amount of short-term wholesale purchases it expects to make—that is, less about $66 million (see bullet 3 above). This yields a net wholesale revenue of just under $120 million.

   It is important to understand that this number is a forecast around which there is a great deal of uncertainty. For example, City Light had forecasted (and counted upon) netting approximately $140 million this year from short-term wholesale transactions. The reality is closer to half that number because of a collapse in wholesale power prices as the worldwide recession took hold. That shortfall has contributed to the very serious financial situation City Light faces today. It is worth noting that the Executive has over-forecast wholesale revenue every year since 2002;
9. Other Revenues: A catchall of revenues, the largest of which is contributions by customers

for service hookups ($27 million); and finally

10. Transfers from Cons Fund: This is essentially City Light's cash balance and as such is not strictly a revenue source. It shows up here because the utility uses adjustments to it to balance its revenues and expenses.

On the revenue side of the equation only retail revenue is discretionary.

Context for Budget and Rate Decisions

Although the discussion of City Light's proposed rate increase for 2010 will be conducted through special Energy and Technology Committee meetings scheduled for later in the budget process (Oct 21, Nov 4, and Nov 5), the Council's review of the proposed budget is necessarily intertwined with the Council's review of the proposed rate increase. Furthermore, both of these need to be understood in the context of City Light's stressed financial circumstances.

Today, City Light faces a gap between its revenues and expenses of about $140 million. About $70 million of that reflects the shortfall in wholesale revenues noted in bullet 8 above. The other $70 million reflects an increase in base costs—approved through the last three budgets—since rates were last set in 2007. That represents an increase in combined O&M and CIP spending over the period of more than 22% after allowing for inflation. Since the spending level in the 2010 Proposed Budget is 3.5% higher than the 2009 level it does nothing to address the cost side of the equation.

While the gap is obviously a serious problem, a less obvious consequence of the current deficit is that City Light is failing to meet the financial policies set for it by the Council. A key financial measure is the level of debt service coverage. By current financial policies, City Light should have rates sufficient for a 2.0 debt service coverage ratio, meaning that after paying all other expenses it should have ***twice*** as much cash as it needs to meet its debt service obligation. For 2010, that means that it should *plan* on having around $150 more than it needs to pay all costs including its required debt service. Excess debt service coverage is an important signal to lenders that the utility is fully capable of repaying its debts even if it runs into financial difficulties. Of course, City Light only pays the principal and interest it needs to pay and the remainder goes as a cash contribution towards the capital program and helps limit the growth of overall debt.

Squeezed on the one hand by cost increases and on the other by revenue shortfalls, City Light's actual coverage is now about 1.3. Absent action by the Council it could be even lower next year. Failure to meet the target of 2.0 set for it by the Council is particularly damaging at this time. Because of the drain on cash reserves this year, City Light will run out of cash early next year and will need to issue a significant amount of debt to fund its capital program. If no action is taken to address the coverage problem, it is entirely possible that in the current jittery financial climate the utility will be unable to borrow; and, even if it is able to borrow, it would pay a significant risk premium on its debt now and into the foreseeable future.

Since the debt service coverage is the cushion available to pay debt service after paying all other necessary costs, it is determined by the level of those other costs and the revenues available to meet them. The Council could increase City Light's retail revenue next year—the only source it controls—by enough to get the utility's coverage back to 2.0. Given the level of spending in the 2010 Proposed Budget, that would require both a rate increase next year of more than 20% and that City Light earn about $50 million more in wholesale revenues next year than it did this year.

Alternatively, the Council could cut about $105 million from City Light's proposed budget. Unfortunately, less than $300 million of City Light's $1 billion budget is discretionary in any realistic sense, and cutting that much spending could require abrogating more than half the utility's current staff positions. That is not to say that there is no opportunity to cut costs from the 2010 Proposed Budget, and below we identify a number of areas the Council should explore for cost savings. It is to say, rather, that cost cutting alone cannot solve the problem City Light faces and some level of rate relief, coupled with a change in financial policy, appears to be necessary.

Key conclusion: In normal times, cost cuts we propose below would be a way to reduce the amount of the proposed rate increase. But times are not normal and cost cutting and rate increases should be viewed as complementary.

<u>Mayor's Rate Proposal</u>: The Mayor's plan to avoid a worsening financial problem is:

(a) to raise rates approximately 22% over the next three years;

(b) to lower the target debt coverage ratio next year to 1.6, but increase it to 1.8 by 2012; and

(c) to establish a revenue stabilization mechanism to protect City Light from volatile wholesale revenues in the future.

While that is the overarching plan, the proposed rate increase presented by the Mayor to the Council is only for 2010. The proposed 8.8% increase would, given the costs assumed in the 2010 Proposed Budget, raise City Light's debt coverage from 1.3 this year to 1.6 next year, *<u>assuming wholesale revenues come in as currently predicted.</u>*

As experience this year painfully shows, accurate predictions of net wholesale revenue are difficult and inherently risky. But the problem is not limited to this year. Actual net wholesale revenue has been lower than the Executive's annual forecast in each of the last seven years. The Executive recognizes this volatility and is proposing a new Power Revenue Adjustment Mechanism (PRAM) to stabilize City Light's revenues. The basic concept is to provide for automatic adjustments to retail rates any time wholesale revenue deviates too much from the level assumed when rates were set. The assessment would occur each quarter and if City Light's cumulative wholesale revenue deviated by more than $10 million from the cumulative amount forecasted, retail rates would adjust automatically by enough to close the gap over the following quarter. However, the Mayor's proposal caps any quarterly rate change at about 15%. In this way, rate payers would bear the risk of wholesale market revenue volatility in a much more immediate way than they do now.

The presumption behind the Mayor's plan is that even though the target coverage next year would be below the previous target level—a red flag to potential lenders—the assurance that rates would adjust automatically (i.e., without formal Council action) to keep City Light close to the 1.6 coverage in 2010, together with the plan to raise that to 1.8 over the following two years through rate increases, will assuage concerns financial markets may have about the underlying stability of the utility. The elements of the plan thus reinforce one another—the near-term debt service is lower than ideal but is tolerable for the bond markets because of the automatic rate adjustment that protects against financial deterioration below this level.

The Mayor's proposal is not the only approach to strengthening City Light's financial underpinnings. Much of the focus of the Energy and Technology Committee meetings over the next several weeks will be on options to address not just the current problems facing the utility but also to establish financial policies that better serve the rate payers in the future by preventing this situation from arising again.

We argued earlier that cost containment cannot solve the entire problem. However, it can clearly play a more prominent role than the Mayor's proposal suggests. The focus of the remainder of this paper will be on reducing costs in the 2010 Proposed Budget.

Identified Issues:

We have identified a large number of potential cuts to the 2010 Proposed Budget, too many to list in the usual format. Instead, we have attached a printout of a spreadsheet summarizing cuts for you to consider. We will be in a position to discuss those that merit a green sheet after the work of the ETC Committee in reviewing the rate proposal has been concluded. We should note at this time that this list does not necessarily reflect recommendations from staff.

In total, there are $11.6 million in potential O&M cuts and $18.7 million in CIP and deferred O&M cuts on the attached printout, and $1.2 million in new revenue. Taken together, these will move City Light closer to a 1.7 debt service coverage given the 8.8% proposed rate increase.

The following pieces of legislation will also have green sheets:

C.B. (TBD)	City Light Rate Ordinance
C.B. 116700	City Light Bond Ordinance
C.B. (TBD)	City Light Financial Policies Ordinance
C.B. (TBD)	City Light Power Revenue Adjustment Mechanism Ordinance

The 2010 Proposed Budget by Budget Control Level

Seattle City Light

Budget Control Level	2008 Actuals	2009 Adopted	% Change '08-'09	2010 Proposed	% Change '09-'10
Expenditures by BCL					
Conservation and Environmental Affairs O&M	$41,309,000	$40,591,000	-1.7%	$45,372,000	11.8%
Power Supply O&M	$66,395,000	$58,712,000	-11.6%	$61,433,000	4.6%
Customer Services O&M	$25,676,000	$27,160,000	5.8%	$26,880,000	-1.0%
Distribution Services O&M	$65,314,000	$65,728,000	0.6%	$61,625,000	-6.2%
Financial Services O&M	$28,640,000	$28,274,000	-1.3%	$28,929,000	2.3%
Human Resources O&M	$5,960,000	$6,347,000	6.5%	$6,544,000	3.1%
Superintendent Office O&M	$3,631,000	$3,648,000	0.5%	$3,123,000	-14.4%
General Expenses O&M	$63,520,000	$64,479,000	1.5%	$66,976,000	3.9%
Purchased Power Budget	$359,604,000	$377,602,000	5.0%	$408,347,000	8.1%
Taxes	$63,355,000	$63,616,000	0.4%	$68,643,000	7.9%
Debt Service	$135,678,000	$149,393,000	10.1%	$150,693,000	0.9%
Energy Delivery CIP	$114,127,000	$125,229,000	9.7%	$110,902,000	-11.4%
Power Supply CIP	$41,370,000	$39,684,000	-4.1%	$46,264,000	16.6%
Financial Services CIP	$5,265,000	$5,066,000	-3.8%	$6,392,000	26.2%
Total	**$1,019,844,000**	**$1,055,529,000**	**3.5%**	**$1,092,123,000**	**3.5%**
Total FTEs	1821	1882	3.3%	1828	-2.9%
Revenues					
Retail*	$547,884,000	$532,618,000	-2.8%	$585,238,000	9.9%
Wholesale**	$256,028,000	$233,444,000	-8.8%	$154,431,000	-33.8%
Other Revenue	$64,728,000	$74,717,000	15.4%	$104,324,000	39.6%
Construction Fund	$151,204,000	$214,750,000	42.0%	$248,130,000	15.5%
Total Revenues	**$1,019,844,000**	**$1,055,529,000**	**3.5%**	**$1,092,123,000**	**3.5%**