Summary of City Light's Financial Policies and Proposed Changes

Since 1977 City Light has set electric rates in compliance with specific financial policies adopted by the City Council. These policies have been periodically revised, with the current policies affirmed in Council Resolution 30933 adopted November 20, 2006. The objectives of City Light's financial policies are to ensure City Light access to the bond markets, allocate capital costs over time, promote long-term rate stability for customers and maintain long-term operational and fiscal health for the Utility. Targeting all these objectives helps the Utility to provide high quality service at the lowest possible cost to its customers in the long run.

City Light has already identified and proposed difficult cuts to the 2010 adopted budget, and eliminated $24 million of spending from the endorsed 2010 budget. However, even with these reductions, City Light faces an extremely challenging financial picture. To satisfy existing financial policies in the near future, City Light would require either significantly increasing customer rates (a 20.8% increase rather than the proposed 8.8% increase) during an economically difficult time or making drastic spending reductions to the O&M budget exclusive of power contracts (of about $60 million, or nearly 30% of that budget, which would require hundreds of layoffs and corresponding impacts to customer service). Thus, City Light has reevaluated its current financial policies in order to avoid either of these extreme outcomes, and is proposing changes to gradually restore the Utility's financial strength over three years while aiming to maintain to the extent possible the Utility's strong credit ratings that enable access to low cost bond financing to fund the utility's capital improvement program. The proposed changes are as follows:

1. **Reduce** the debt service coverage target for rate setting from the current level of 2.0 to 1.6 in 2010, 1.7 in 2011, and 1.8 in 2012 and thereafter.
   - This would allow for a gradual increase in customer rates over the next few years.
2. Adopt a Power Revenue Adjustment Mechanism (PRAM)
   - See the attached PRAM summary.
3. Delay the target date for a 60% debt to capitalization ratio from 2010 to 2012.
   - Under the proposed changes, the debt to capitalization ratio would still trend downward, reaching 51% by 2019, versus 44% by 2019 with the existing policies.
   - City Light's financial advisors recommend a long term debt to capitalization ratio of between 50% and 60%.
4. Align the Budget and Rate Setting Processes.
   - In recent years, the budget setting process and rates setting process have not been coordinated.
   - Coordination between the two will ensure the adopted budget either satisfies City Light's financial policies, or triggers a rate change (or at minimum, an actionable plan to address the deficiencies).

The table below shows that the proposed financial policies will allow for a significantly lower rate increase in customer base rates than the existing financial policies. A complete Financial Policy Paper is available that contains additional information on City Light's existing and proposed financial policies.

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Average System Rate ($/MWh)										
SCL Proposed Financial Policies	62.61	66.40	71.33	73.58	72.77	78.09	79.98	82.44	86.66	88.62
Existing Financial Policies	69.37	71.55	75.01	75.38	74.23	79.28	80.89	83.05	87.06	88.74
Percent Difference	10%	7%	5%	2%	2%	2%	1%	1%	0%	0%

Summary of Proposed Power Revenue Adjustment Mechanism ("PRAM")

Need for the PRAM

City Light is proposing to amend its financial policies to adopt an automatic rate adjustment mechanism to address volatility in the Utility's wholesale revenues which serve to offset a portion of the costs that are otherwise charged to retail customers. In recent years, these wholesale revenues average about $115 million per year, but have ranged from $70-$140 million. The PRAM automatically adjusts rates in the event that wholesale revenues deviate significantly from the amount assumed when rates are set. The PRAM would enable the Utility to continue to provide necessary customer service in years where wholesale revenue falls short, and its introduction allows the relaxation of other financial policies, resulting in a significantly smaller rate increase to customer base rates in 2010. To meet existing financial policies (specifically, a 2.0 times debt service coverage factor), customer base rates would need to increase by 20.8% compared to 8.8% with a PRAM and a 1.6 debt service target. A change in coverage from 2.0 to 1.6 without the addition of the PRAM would jeopardize City Light's ability to provide stable operations and customer service, and would almost certainly lead to a downgrade in the utility's credit ratings (currently AA- Standard and Poors/AA2 Moody's), resulting in higher borrowing costs.

Operation of the PRAM

On a quarterly basis, the PRAM would provide a refund to customers when wholesale revenue is more than planned, and charge customers when wholesale revenue is less than planned. Every three months, City Light will calculate the difference between the actual and planned wholesale revenue (the figure used when rates are approved by the City Council). The difference would either be disbursed to or collected from customers by placing a credit or charge on energy sales over the following 3 months (with a one-month lag to get the information into the billing system), subject to the following constraints:

- The adjustment (credit or charge) would not exceed 1 cent per kWh from the base rate level. Any differences in wholesale revenue above that cap would be carried forward to future periods.
- No rate adjustment would be made until the cumulative wholesale revenue difference is either $10 million above or below the planned level.

The PRAM is not a rate increase in disguise; on average the impact on customer's bills resulting from the PRAM ***would be zero***. The PRAM does result in some additional rate uncertainty for City Light customers, as it transfers a portion of the ups and downs of wholesale revenue variations into retail rates. However, the potential additional volatility in customers' rates is offset by the benefit of lower rates in the near term, given the ability for the utility to revise its debt service coverage factor from 2.0 to 1.6. A mechanism like the PRAM is common in the utility industry, and is referred to elsewhere as a "fuel cost adjustment mechanism". In fact, City Light already passes through changes in Bonneville Power Administration power costs to ratepayers in a similar manner. Finally, the PRAM would only be used for variances in wholesale revenue—no other City Light cost variances would be recovered through the PRAM.

Conclusion

City Light currently addresses wholesale revenue volatility through its financial policy of maintaining 2.0x debt service coverage. This approach has a direct cost to ratepayers that can be reduced in 2010. City Light explored several alternatives to this approach, and many different structures for the PRAM prior to putting forward the current proposal. City Light views the current PRAM proposal as offering the best balance of benefits and costs to our customers and the utility at this time, and it will enable the utility to continue services to customers in the event of wholesale revenue downturns. For more information, see the full PRAM proposal paper.