Final Report

of the

City Light Advisory Board

Seattle, Washington

January 30, 2006

Seattle City Light Advisory Board

Third Annual Report

Seattle, Washington
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Background

The Seattle City Light Advisory Board was created in May 2003 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."[1] The advisory board began its work when the West Coast energy crisis had created "substantial new financial and management challenges for the utility"[2] and City Light was still reeling from its effects.

After a year of study and investigation, the board concluded that City Light must "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."[3] To restore stability and security at City Light, the board recommended a strengthened financial policy, improved risk management, annual strategic planning, and management systems and practices to create a "high-performance organization." We believed then, and still believe, that City Light can 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.

[1] Ordinance No. 121059.
[2] Ordinance No. 121059.
[3] "Seattle City Light: From Recovery to Stability and Security - First Annual Report of the Seattle City Light Advisory Board" Seattle, WA, January 29, 2004, p. 2. http://www.cityofseattle.net/light/news/advisory/docs/report_01_29_04.pdf. ("First Annual Report")

Today, as the board reaches the end of its three-year term, we see significant progress. This report details City Light's accomplishments in each of these critical areas. At the same time, City Light continues to face significant challenges, and our recommendations for the future reflect a concern that City Light is still not adequately equipped to weather future storms.

Summary Recommendations

The board recommendations for the future are:

1. Financial Policy. Stay the course toward financial integrity and stability, reducing debt to appropriate levels before instituting prudent rate cuts. Enhance cooperation between executive and the council to ensure adherence to sound financial policies.

2. Risk Management. Adopt and implement appropriate risk management strategies. Recognize both that a lucky good water year can mask a bad performance by City Light and that an unlucky bad water year can result in unwarranted and damaging budget cuts.

3. Resource Planning and Management. Develop integrated resource planning, transmission and distribution planning, and other appropriate long-range analyses of major utility investments that compare broad ranges of alternatives on their economic, financial, environmental and social impacts. Develop power resource management practices, with special emphasis on identifying and realizing the $5 to $10 million of annual resource optimization benefits, which the board believes are achievable in the short run and lay a foundation for the critical future resource decisions of the next 5 to 10 years.

4. High-Performance Organization. Focus on improved productivity and asset management. Offer City Light management flexibility tools and competitive compensation levels to create a business capable of playing in the complex and competitive electric business of today and tomorrow. Implement periodic multi-year planning to link City Light's annual operating plans and budgets to long-term goals and initiatives. Value City Light's dedicated workforce, honoring past commitments and training its employees for the future.

5. Regional Leadership. Continue playing a significant role in regional and national energy and transmission planning and resource development.

6. Public Participation and Outside Input. Develop a comprehensive, predictable process for public participation in major decisions. Public power requires responsiveness to the people it serves, and City Light will make better decisions when it solicits and considers stakeholder and expert input from outside the utility. Stakeholder and public interest participation will provide elected officials with the informed input they need for effective oversight.

7. Governance. Address the difficult challenges of oversight and governance. As a city department, the utility is burdened with onerous personnel strictures; a budget process that is neither a planning tool nor intended for utility accounting; non-competitive compensation limits; uneconomic and inefficient purchasing practices; and lack of flexibility to manage its $800 million annual business. Insulate City Light from political debate. Develop streamlined oversight to foster management

flexibility. Make City Light accountable to the people of Seattle and their elected representatives.

City Light's Progress in Critical Areas

1. Financial Policy

In our first annual report, we provided a roadmap for City Light to move beyond recovery from the 2000 West Coast energy crisis to the stability and security that have been hallmarks of its 100-year history. Our roadmap assigned the highest priority to restoring the utility's financial strength, without which the basic mission of providing reliable, low-cost and environmentally responsible energy could not be assured. Virtually all of our recommendations – including improved planning, risk management, and measures to transform City Light into a more performance-based enterprise – were designed to enhance its ability to avoid future crises and achieve lower, more stable rates over time. But in the near and mid term, City Light's financial condition is most directly affected by the city's "financial policy," which determines how much long-term debt the utility will incur every year and what sort of cash reserves it will maintain. Accordingly, the advisory board made three recommendations regarding City Light's financial policy.

Financial Policy Recommendations

In the wake of the 2001 crisis, which left City Light virtually insolvent, the City raised rates and adopted a financial policy that placed City Light on track to pay off its $300 million short-term debt in three to four years and thereafter to make gradual – but sure – progress toward reducing the burden of its $1.5 billion long-term debt.[4] Once the short-term debt was paid, rates were to be set so that there would be a 95 percent

[4] Resolution 30428, December 10, 2001.

probability each year that at least some contribution would be made to the capital budget from net current revenues from rates and wholesale sales. Given the severe volatility in City Light's wholesale revenues, due to water and market conditions, this contribution could vary from zero to $200 million dollars. On average and over time, however, the current revenue contribution was expected to be around $100 million or roughly 60 percent of the annual capital budget. New long-term debt would still be incurred for about 40 percent of the capital budget, but the overall ratio of debt to capital on the balance sheet gradually would be reduced from more than 90 percent to the range of 50 to 60 percent within five to10 years.

The advisory board's first recommendation on financial policy was to "stay the course," implementing the council's 2001 financial policy without dilution once the short-term debt was paid so that, in the long run, City Light would have "head room" to meet the challenges of an increasingly complicated and uncertain business environment. Deregulation, new technologies such as distributed generation, restructuring of Bonneville, strategic threats not yet apparent, and short-term financial crises like that in 2000-2001, all remained real possibilities that could require massive rate increases unless City Light's capacity to make substantial long-term borrowings was restored. Furthermore, reducing City Light's debt levels would contribute to lower rates over time by reducing the portion of each ratepayer's dollar that must go to service that debt.

The second recommendation was closely related to the first: the financial policy should be amended to provide explicitly for a debt-ratio target so that the utility and the city would have a meaningful benchmark for assessing progress toward true financial health. Such a benchmark would also provide a basis for adjusting the rate-setting formula over time based on the pace of progress toward this goal. We recommended adoption of the goal of bringing the debt ratio down into the range of 50-60 percent (the typical debt ratio for comparable well-rated utilities) by the year 2011, the year in which City Light's current long-term supply contracts with Bonneville were due to expire. This change would not have required any adjustment in rates under the existing financial policy because, despite recent low-water years, City Light was still on track to reach the 60 percent target in the 2009-11 timeframe.

The advisory board's third and final financial policy recommendation was to strengthen the cash reserves available in a financial emergency. City Light's revenues every year are highly volatile due primarily to variations in the revenue derived from wholesale sales of surplus power, that is, power not required to meet its customers' needs. Year-to-year differences in snow pack and water conditions determine the amount of power that City Light can generate from its own dams and that it is entitled to receive from Bonneville under its "slice" contract. Combined with additional variations in wholesale market pricing and retail demand, the net wholesale-power revenue figure often fluctuates as much as $50 million from year to year and can even vary by more than $200 million. The proportion of the capital budget that can be paid out of current revenues thus will swing widely from year to year. The financial policy must rely upon the level of capital funding from current revenue that can be expected to be realized on average over time to achieve its debt reduction targets.

A more immediate risk, however, is that in an extreme year, the total amount of current revenue will be so low that it will not even cover current operating costs and debt service. In this case, the utility will have a deficit of the sort it had in 2001 and may have to engage in short-term borrowing and adopt an emergency rate increase to pay that debt.[5] Under the 2001 financial policy, the risk of this happening was supposed to be only one in 20 years – the inverse of the 95 percent probability of making some contribution from current revenues to the capital budget. To deal with that risk, the policy created a $25 million contingency cash reserve that could be used to avoid or reduce the size of any such operating deficit.

The advisory board was concerned that the $25 million was too small. The level of emergency cash reserves maintained by comparable well-rated utilities would have been closer to $100 million. The rating agencies had noted with concern City Light's relatively meager cash reserves in its own account.[6] Although the financial policy provided that in theory an operating deficit would arise in only one year out of 20, the recent trend of low-water years raised the possibility that, unless rates were raised again, the risk was actually much higher – possibly one in 10 or even one in five.[7] Because of the consequences of another financial crisis befalling City Light so close to 2001, with short-term debt barely paid, with long-term debt still unacceptably high, and with the

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[5] Long-term debt cannot be used to finance operating deficits. It may be possible to use additional long-term debt to finance the portion of a prior year's debt that was financed with cash and thereby free up that cash to cover a current year deficit. However, this will not work if the prior year was also a low-water year and there was little or no cash used to finance capital in that year.

[6] Although City Light's access to the City's cash pool affords it liquidity in an emergency, City Light is obliged to pay the City back, and cash pool borrowing is, in the end, the same as other forms of short-term borrowing from third parties.

[7] The assumption underlying the 1-in-20 risk is that the 80-year historical "base period" used for extrapolating future climatic variation is a perfect predictor of the next 5, 10 or 20 years. However, recent trends, concerns about global warming, and advances in knowledge about the magnitude of climatic cycles since the end of the Ice Age raise the possibility that the last 80 years is not a perfect predictor of the next. If the last 80 years were somewhat wetter than "normal," the result of applying the financial policy would be to produce more frequent deficits than 1-in-20.

economic impact of another major emergency rate increase severe, the board felt that City Light needed a bigger cash cushion at this stage in its recovery. At the same time, the board was reluctant to recommend anything that would result in a further increase in the rate burden on ratepayers.

The recommendation we eventually made did not involve increasing City Light's overall cash position but rather reclassifying a cash reserve that City Light maintained under its bond covenants (and which could only be used to pay bond holders in the extremely unlikely event of a bond default) so that this same cash could be used in case of a financial emergency like the 2001 crisis. The bond reserve, which was roughly $80 million, would have been replaced with a surety at a one-time fee that was cost effective on its own merits. When added to the contingency reserve provided for in the 2001 financial policy, the cash from the bond reserve would have given City Light a contingency reserve of about $100 million.

2005 Financial Policy

In March, 2005, the executive submitted draft legislation to the Seattle City Council that would have adopted all of the recommendations made by the advisory board, except that the contingency reserve would not have been increased to $100 million until and unless the voters had approved a charter amendment restricting future council's ability to modify the contingency reserve by majority vote. This was not acceptable to the council, which prepared its own legislation that would have diluted the 2001 financial policy by relaxing the debt reduction required under that policy.

After a number of hearings and several drafts of this legislation, on May 2, 2005, the City Council adopted Resolution 30761, which amended the city's financial policy in several respects. Basically, the council adopted substantially all of the advisory board's recommendations regarding debt reduction, but rejected the board's recommendation on the amount of the contingency cash reserve.

First, the council accepted the board's request that the city should "stay the course" on debt reduction and not dilute the rate-setting standard established in the 2001 ordinance. The council actually tightened the rate standard somewhat by adopting a "two-times-debt-service" or "2X" test (in addition to the 95 percent probability of contributing to capital test), a test that is slightly more stringent in reducing debt levels over the next five years.[8]

The 2X debt service test has the additional virtue of being easier to understand and explain. However, in setting rates under this test, the city does not escape the uncertainty of projecting revenues in volatile water conditions. Once rates are set based on the assumption of "normal" or "average" water conditions, the reality of each operating year will be that the actual net revenue available for debt service will be (possibly substantially) more or less than two times the debt service owed. In years when water conditions are lower than normal, City Light will still have to borrow more to finance its capital program.   In years when higher water generates revenues in excess of 2X debt service, the additional revenue will be used for the capital program, reducing borrowing by an amount that hopefully will offset the additional borrowing required in bad water years.

[8] Rates should be set so that net revenue available to pay debt service each year (after operating expense but before capital investment) would equal two times the actual debt service owed in that year.

The council also adopted the board's recommendation for an explicit debt-to-total-capital target of 60 percent by 2011 ("year-end 2010") and provided that, if necessary, rates will be set in order to achieve that goal. The council provided for a review of the financial policies based on changed circumstances, significant deviation from current forecasts, and at such time as City Light's debt ratio is reduced to 70 percent. The goal of the review would be to better align rates with the actual results produced by the new financial policies – and not to dilute the commitment to the debt reduction target and deadline. The board is fully supportive of such a periodic review.

Regarding cash reserves, the council rejected the board's recommendation that the $25 million contingency reserve be supplemented by the proceeds of the bond reserve account. Although the council directed the release of the bond reserve proceeds by posting a surety, the council instructed the utility to use those proceeds first to fund the $25 million contingency reserve and second to pay for additional debt reduction, either by defeasing outstanding debt or reducing the amount of debt otherwise required to pay for capital projects in future years. Although the board respectfully disagrees with the council's decision not to increase City Light's contingency reserves, we are pleased that the bulk of the bond reserves will be dedicated to additional debt reduction. The council has also shown itself open to revisiting the contingency reserve and other issues in the future, based on changed circumstances or new assumptions.

Financial Integrity and Stability for the Future

On balance, the board supports the new 2005 financial policy. City Light must stay the course by continuing to reduce debt and build up reserves. However, we have some concerns and some further recommendations looking to the future.

First, the new financial policy took too long to be adopted. After the board delivered its first annual report in January of 2004, which was developed in consultation with both the executive and legislative branches, there seemed to be something very close to consensus among elected officials and their staffs in support of debt reduction and freeing up the bond reserve. The only real issues were the size of the contingency reserve and how the city could manage a contingency reserve as large as $100 million. However, instead of ironing out what should have been technical and minor differences, there was little cooperation to resolve the issue. As a result, the process dragged into an election year. We recommend that in the future, the executive and council and their staffs work effectively together to develop workable and timely amendments to financial policies.

Second, although in the end the Seattle City Council stayed the course on debt reduction, the council's first draft of this resolution would have diluted the financial policies, adding more than $150 million in debt, in order to deliver a rate reduction requested by certain customers. The inclination to give in to this pressure was troubling because it reflected short-term thinking and called into question the city's commitment to debt reduction, to the long-term health of the utility, and to long-term lower rates for City Light's ratepayers. After considerable uproar and after the advisory board, for the first and only time in its tenure, was forced publicly to disagree with elected officials, the council approved a sound financial policy. We have no recommendation here – only a hope that in the future the executive and council will remain committed to the long-term view.

2. Risk Management

In its first report, the Board recommended that City Light strengthen its risk management processes to minimize the impact of an increasingly volatile operating environment on City Light's financial stability and long-term security. City Light has made significant progress in implementing this recommendation.

Management of Revenue Risk

In the wake of the 2000-2001 West Coast energy crisis, the City adopted the 95 percent coverage policy, which requires City Light to maintain long-term power supplies sufficient to meet its load in all but the most extreme water conditions. This policy means that City Light will have surplus power to sell in 19 years out of 20. Net surplus wholesale power revenues thus are a critical element of City Light's cash flow. With revenue swings in excess of $100 million from year to year, City Light needs a strategy to manage this volatility by optimizing revenues over time without exposing the utility to severe downside risks in any given year.

One objective of managing revenue risk is maximizing the value of surplus power in the resource portfolio. City Light has hired Bill Gaines as the Power Supply and Environmental Affairs officer. Mr. Gaines, the former vice president for Energy Supply at Puget Sound Energy, is an experienced resource manager. Mr. Gaines is directing City Light's risk management, power management, resource planning, and regional transmission initiatives. Recognizing that its capabilities will need to evolve over time, City Light has engaged a respected local consultant and has developed a multi-element work plan and timeline for implementing a best-practices risk management capability.

The utility is progressing well along that timeline, and some of the risk management elements are beginning to be implemented.

City Light is making significant progress in developing hedging strategies for managing revenue risk. The utility has recently adopted a two-part hedge strategy, initially selling a volume of surplus power one year forward based on the 95 percent confidence policy, then making additional sales over the course of the spring/summer runoff period as uncertainty in the streamflow forecast decreases with time. City Light is also reviewing the feasibility of mitigating its hydroelectric volume risk through the purchase of commercially available hedge products, although initial indications are that the cost of these products may not be competitive.

While recognizing the need for risk management, the policy-makers responsible for City Light must face the realities of a hydro-based utility. The executive and council must recognize that long-term water trends – not year by year performance – are the key. A lucky good water year can mask a bad performance by City Light, and an unlucky bad water year could result in unwarranted and damaging budget cuts.

City Light has made good progress in managing the sales of surplus wholesale power. City Light's power management unit, however, is not adequately supported by a staff with the expertise to develop hedging strategies and analyze and evaluate market opportunities. City Light continues to struggle with the need to develop or buy software capable of monitoring and stress testing its portfolio positions, and predicting market and water conditions to guide futures sales. For the short term, City Light relies upon an outside consultant to assist in evaluating these forward sales and resource optimization opportunities. For the long term, however, City Light must either hire expert market analysts and traders or contract with third parties to perform these functions.

Policies Governing Revenue Risk

The City Council and the executive bear ultimate responsibility for deciding the level of revenue risk City Light is willing to take. Elected officials set forth the metric guidelines that govern both long-term power sales and short term trades. However, the setting of risk metrics must take into consideration the degree of risk mitigation that is possible for City Light to achieve given the availability and depth of markets for risk mitigation products. As part of setting risk policy, elected officials must also review and approve City Light's hedging strategy, including the use of commercial hedge-type instruments that might be available on the market.

The effort to develop and set risk parameters has been pending for several years, and elected officials have understandably become frustrated. Decisions about risk parameters, however, cannot be made in a vacuum. Recommendations for metric risk parameters are long overdue from City Light and should be developed and submitted to policy-makers immediately.

Organizational Change

In its first report, the board noted that another source of risk in City Light's wholesale power portfolio arose out of its organizational structure. Outside auditors and consultants had criticized City Light's organizational structure. In "best practice" utilities, the risk control and compliance functions are independent of power marketing leadership. At City Light, these functions reported directly to the head of Power Marketing.

The board commends City Light for addressing this risk as part of the reorganization in 2005. The independent risk control manager now reports to the finance director rather than to the power manager. When the reorganization is complete, hedge strategy verification, credit management, confirmations, price forecast verification and other "middle office" functions will also report to the finance director. These changes are consistent with best practices and should reduce the risk inherent in the utility's power trading function.

95 Percent Coverage Policy

The 95 percent coverage policy was intended to prevent resource shortages and the potentially ruinously expensive wholesale power purchases. While the policy assures adequate supply for City Light's load under most conditions, it also means that on average, City Light will have more power than it needs and be required to sell that surplus into the wholesale market. The annual volatility in the amount of the surplus to sell, and the vagaries of the wholesale market, together contribute to the huge swings in total current revenue described above.

Although City Light still adheres to the 95 percent coverage policy, the utility is reviewing the policy and will consider it as part of its long-term integrated resource planning efforts. The board continues to urge the city to revisit the costs and benefits of the 95 percent coverage policy and consider whether a lower confidence limit, along with a stronger risk management process, would make more sense in the current environment.

Partnering for Risk Management

As the Board noted in its second report, some utilities have partnered with organizations that have aggregated a high level of power marketing and risk management expertise that smaller individual utilities cannot sustain. We understand that as part of its risk management initiative, City Light currently is considering the feasibility of varying degrees of joint wholesale marketing and risk management efforts with certain other organizations. We encourage City Light to continue this review and to bring forward recommendations concerning partnering.

3. Resource Planning and Management

City Light has made modest progress in implementing board recommendations on resource planning and management, but much more remains to be done. The utility has started to develop an Integrated Resource Plan (IRP), has hired an IRP director and senior analytical staff, and it has undertaken an analysis of how to optimize its "long" resource position. City Light has actively participated in development of regional transmission alternatives put forward by Grid West and the Transmission Improvements Group (TIG). Reflecting both the risk management initiative and the organization-wide transformation effort, City Light is working toward bringing additional industry expertise into the Power Management unit, as well as re-aligning the organizational structure in that area for better efficiency and performance.

Power Management

Also under Mr. Gaines' direction, City Light is focusing on portfolio optimization. The utility has engaged in several short-term, low-risk transactions while an IRP is under way to guide long-term resource decisions. City Light recently demonstrated the benefits of resource optimization when it sold the 2006 output from its Lucky Peak hydro project to a power marketer for a net gain of $3.2 million over its expected 2006 revenues from that project. A strategy for sales to the California ISO is now under way, and City Light is working to optimize the value of the utility's transmission rights by selling surplus capacity both on the short-term markets and in the higher value long-term transactions.

Integrated Resource Planning

In its second annual report, the board identified four reasons for developing a new IRP. Of those four, City Light has made progress on three: (1) analyzing energy efficiency potential and best delivery options; (2) identifying options for better optimizing use of existing resources; and (3) hiring the necessary staff to evaluate long-term resource opportunities. The fourth reason, integrating energy generation and efficiency resource with transmission and distribution system planning, has been postponed at least for the initial IRP effort. City Light has developed a scope and work plan for its 2006 IRP, obtained resource planning software and consulting support from Global Energy Decisions for the IRP itself and from Quantec for the energy-efficiency potential assessment. In the board's view, the pace of these activities needs to increase. We recognize that lack of competitive salaries for senior City Light executives and the resultant inability to hire key staff has been a major reason, until recently, for slow progress.

City Light depends on continued delivery of more than seven average megawatts a year of energy efficiency in order to maintain its current level of resource balance. The Quantec assessment of energy efficiency potential for the City Light service territory will be the first in six years. This analysis will presumably contribute to a stronger integrated resource plan, but it must be followed up with consistent and comprehensive implementation data acquisition and planning for the optimum delivery, price and equity of energy efficiency investments.

The importance of developing a credible IRP and realizing near-term resource optimization opportunities cannot be overemphasized. The board believes that City Light could achieve cost savings or revenue gains worth $5 to $10 million per year. These gains could come from better utilization of City Light's share of the third AC transmission line to California, selling some or all of City Light's present surplus (estimated at 75 mw through 2011), marketing some of its 175-megawatt Stateline wind purchase on an interim basis to California utilities to help them meet California's renewable performance standard,[9] or taking advantage of numerous other options that City Light has available because of its long resource position.

There are many opportunities available if City Light can obtain the staff or consultant resources to identify them and then negotiate the appropriate arrangements with credit-worthy counterparties. This requires not just raw analytical expertise, but a detailed knowledge of the Northwest electric industry and the economic motivations of utilities and power marketers in the region. Although the new Power Supply and Environmental Affairs officer is providing needed leadership in this area, City Light must

[9] We note that any resale of City Light's contract for Stateline wind power, even on a temporary basis, needs to have complete transparency and to respect the utility's commitment to a carbon neutral emissions policy. If City Light resells this power, it must actively disclose the fact that Stateline wind power is no longer meeting City Light customers' electrical needs. In addition, the portion of surplus power from the Stateline contract that is currently being used to mitigate the utility's carbon emissions might no longer be available for that purpose. The utility's commitment to a carbon neutral emissions policy would then require replacement mitigation. Such an interim resale would also support the need for a continued high level of City Light energy efficiency resource acquisitions throughout the surplus period.

promptly hire directors for Power Marketing, Resource Planning, and other key analytical staff positions.

Transmission Planning

Another important element of resource planning for City Light involves consideration of the multiple transmission constraints, which affect the Pacific Northwest grid. In previous reports, the board recommended that City Light actively participate in regional planning to solve the region's transmission problems. While City Light does not own significant transmission, its participation could: (1) help ensure regional transmission planning and operating frameworks favorable to City Light; (2) improve overall transmission planning; (3) allow City Light to provide critical ancillary services (from its Boundary and Skagit hydro resources), which could help relieve transmission congestion and provide another market for its generation resources; and (4) potentially realize both reliability and economic efficiency benefits by combining its load control area with those of Bonneville and other Northwest utilities.

The board is pleased to note that the superintendent and key City Light staff have been actively involved in development of both Grid West, a proposed not-for-profit corporate entity that would be an independent transmission provider in the western states, and in the proposed Transmission Improvements Group (TIG). City Light took the lead in trying to help Bonneville find some middle ground between those two approaches. While that effort has not been successful, we expect that regional efforts to form a more limited transmission entity will likely continue. It is also likely that Bonneville, although not a formal member of this modified Grid West entity, will work closely with it by providing ancillary generation services to its markets and managing the transmission interface between the two entities.

It is crucial that City Light be a fully involved, constructive participant in these transmission activities. Whether the original Grid West or a restructured Grid West, the benefits of City Light participation could be substantial, both for City Light and for the region.

4. High-Performance Organization

To be successful in today's utility environment, City Light must become a highly effective organization, truly capable of achieving its long-range goals, executing its strategic initiatives, and meeting its operating targets. City Light must run its $800 million annual business efficiently and innovatively to deliver value to the city and its citizens. For this reason, the board urged City Light to become a "high-performance organization," an enterprise that ensures excellence in customer service, provides reliable cost effective power that minimizes environmental impacts, has the ability to move quickly when conditions warrant, sets clear goals, empowers its people to achieve them, and holds itself accountable for success or failure. In our first report we made specific recommendations that are critical for this effort. Superintendent Jorge Carrasco has begun to move the utility in the direction of a high-performance organization, but there is a long way to go.

The board encourages a review of the discussion on "Becoming a High-Performance Organization" laid out in the first annual report, which is included as an appendix to this report. Many of the elements identified still need significant work. While some progress has been made with respect to financial reporting, and budget reporting has been revised to reflect the new organizational structure, a review of the current management information systems remains a necessity. City Light reports that it is currently providing quarterly performance metrics in certain key areas such as income, operating cash, risk management, electric reliability, generator availability, call center customer service, and customer billing, as well as annual reporting on other key areas. The board believes that to become a high-performance organization, most key performance metrics must be reported monthly, and the management information systems in use must accommodate that need. If key metrics are going off target, early warning is the key to righting the problems.

Development of a strategic plan and a process for continuous updates is critical. Without a strategic plan, it is impossible to establish coordinated goals that work together to achieve the objectives of the organization. This is a necessary first step to assuring that we are applying the right metrics and measuring the items that are critical to the success of the organization.

Fortunately, City Light is endowed with a highly dedicated group of valuable employees that want the utility to be successful. The members of City Light's work force are good at their jobs and – if the bureaucratic roadblocks that currently exist are removed and the utility is empowered and given the proper planning, tools, leadership and motivation – there is no doubt City Light will become a high-performance organization.

Organizational Transformation

How an organization is structured can have a profound effect on its ability to respond and perform. In 2004, the superintendent announced a major transformation in the structure of City Light to be completed in 2005. The process included an internal survey completed by 74 percent of City Light's employees, employee-led meetings with all of the utility's work groups, and significant organizational design change. The organizational design was completed in Phase 1 and Phase 2 of the reorganization, and officer and director positions are now being filled. The board enthusiastically supports the superintendent's effort.

Unfortunately, implementation of the reorganization has been slow. The transformation has happened whenever possible – such as the appointment of an environmental director and the recent announcement of seven new directors – but in many respects, the reorganization has been stalled due to hiring delays at the executive level. Only one of the top four executive positions has been filled. A major roadblock in hiring stems from the fact that executive compensation at City Light has not been competitive. As explained below, the compensation issue was partially resolved by recent council action, but the larger problem must be resolved promptly so the planned reorganization can move forward with experienced, qualified people.

Salary Levels, Incentive Pay, and Compensation Program Legislation

In October 2005, the Seattle City Council began consideration of a proposed Electric Utility Executive Compensation Program. A compensation study conducted by Mercer confirms that City Light has been well below the median for public utilities for executive and director level positions. In particular, City Light cannot compete for qualified people in industry-specific positions, such as systems operations director. Based upon the experience of its members and the results of the Mercer compensation study, the board supported the compensation program, including the base pay zones, performance awards, and flexible moving expenses.[10]

The board encourages the city to continue to increase salary at executive and other levels to attract and retain executives, directors, and key managers. It is critical for the superintendent to complete the reorganization with the talent needed to make City Light succeed and thrive. The incentive plan that City Light is expected to present to the council is a modest first step and will need to be reviewed periodically to make sure the plan is accomplishing its purpose. Under existing legislation, any incentive plan would be quite small and significantly lower than incentive systems in place in competing organizations.

Without a competitive compensation program, 1) City Light will have to settle for lower skill levels in key positions; 2) City Light will be run by executives who cannot recognize, much less anticipate and shape, ongoing competitive changes in the electric utility industry to the utility's advantage; 3) City Light key staff will consistently be overmatched in power/financial negotiations with other utilities and power marketers; 4) senior power management staff will be unable to optimize, or even consistently earn, the $150 to $200 million annual wholesale power revenues which are the key to rate stability or future rate decreases for City Light ratepayers; and 5) management supporting the superintendent will lack the strategic planning expertise to steer the utility through future crises, including unstable power markets and dramatic climate change.

[10] The Board's letter advising the City Council is included as an Appendix found on page 45.

City Light must have high quality executives to anticipate and capitalize on the full range of revenue-enhancing and cost-saving opportunities and to complete the development of a high performance organization that City Light ratepayers have every right to expect. "Business as usual" will relegate City Light to a future of mediocrity.

While the Mercer study focused mainly on officer and director positions, we have continuing concerns that there may be less-senior positions, requiring critical experience or expertise, that also warrant an adjustment in compensation in order to attract and retain well-qualified candidates. In order to assure such competitiveness across the City Light work force, we recommend that the superintendent commission a broader compensation review of those positions that are not covered under a collective bargaining agreement. If compensation studies of positions covered by collective bargaining agreements are appropriate, they should be undertaken pursuant to those agreements. If necessary, corrective-action proposals should be presented to the mayor and council.

Management Flexibility

Successfully managing a high-performance organization requires adherence to three fundamental principals: (1) a clear purpose, (2) effective leadership, and (3) flexibility to move quickly as circumstances or conditions change. For nearly three years, the advisory board has worked with the executive, the council, and City Light to identify and make recommendations to resolve major issues facing the utility, including the need for increased management flexibility.[11] Management flexibility is critical to empower City Light to become one of the premier high performance utilities in the Northwest and to optimize one of the most valuable hydro systems on the West Coast. In

[11] Management Flexibilities is included in the Appendix found on pages 41-42.

addition to competitive salary levels and incentive pay, the management flexibility changes that City Light needs to achieve success include:

<u>More Exempt Positions</u>

City Light operates in a highly competitive electric utility environment. If the utility is to attract, motivate, and manage the people it needs, then it must have more of its top positions free from civil-service constraints. City Light must be able to alter position duties, rapidly change personnel, and reassign staff, all the things essential to successful operations in the electric industry. For this reason, the vast majority of City Light managers and senior professionals should be exempt employees.

<u>Personnel Classification</u>

Circumstances in the electric utility industry change rapidly. If City Light is to respond quickly, it needs the authority to administer its own personnel classification system. Positions must be tailored to competitive needs that often require quick changes. This level of flexibility cannot be met through a centralized city personnel organization that is unfamiliar with the unique requirements of the electric industry and ill-equipped to move with the speed necessary to respond to the rapid changes driven by competition within the industry.

<u>Labor Negotiations</u>

The represented electric utility workforce is unique to City Light, which needs the ability to negotiate its own labor agreements with IBEW Local 77. City Light management knows the issues and the competitive environment in which they must operate. Since all the represented employees in the electric utility workforce work for City Light, there would be no precedents set for other departments, nor would the city's relationship with other unions be impacted significantly. Through direct negotiations with the IBEW, City Light can work on the work rule changes that are necessary to its ability to increase productivity as well as keep its pay practices competitive with other electric utilities in the Puget Sound area.

Strategic Planning

Strategic planning is vital for a high-performance organization. The City Light Review Committee or "Blue Ribbon Panel" stated that "one of the most grievous governance failures at City Light arose from the lack of any explicit multi-year plans or strategies to constrain and focus the utility's annual operating plans and day-to-day decision making and to guide policy makers."[12] In its first report, the advisory board strongly agreed that City Light should implement periodic multi-year planning to link City Light's annual operating plans and budgets to appropriate long-term goals and initiatives.

While City Light has taken some steps toward this outcome by retaining a consultant to help articulate mission, vision, and values statements, real strategic planning has not yet been instituted. The board believes strategic planning is urgent. Without it, City Light cannot address future risks and challenges with a coherent plan. The electric industry is moving ahead rapidly with technological advances. Power markets are volatile and uncertain, and competition is increasing for both resources and for customers. The electric industry in the Northwest may face drastic changes due to climate change and

[12] "Seattle City Light: Protecting the Jewel in the City's Crown - Final Report of the Mayor's City Light Review Committee" Seattle, WA, October, 2002. http://www.cityofseattle.net/mayor/pdf/citylightcom_report.pdf.

global warming. City Light must develop a strategic plan for dealing not only with short-term issues but with these long-term challenges as well.

Budgeting

City Light's revenues and expenses are accounted for in a separate fund (the Light Fund). Financial and budgeting decisions for the utility affect only retail power rates and not the general fund or tax revenues of the City. The approach taken by City Light to budgeting (capital and operations & maintenance) should reflect the needs of the utility and not be linked with or subordinated to the budgeting process for general city government. City Light management should be held accountable for the results of its financial and budgeting decisions through the high-level performance metrics discussed above.

5. Regional Leadership

Leadership is a distinguishing characteristic of a high performance organization. An important priority for the advisory board, executive and council has been the expectation that City Light would resume its traditional position as a leader in Northwest energy affairs. The board is pleased to note several instances of such renewed regional leadership over the past year. The superintendent and other key executive staff have worked with other utility executives to find solutions to Bonneville's "slice" true-up process, and the superintendent has agreed to serve on a group convened to review the future of Bonneville contracts. Because of the superintendent's direct involvement, City Light has helped formulate Bonneville's future role in the region and the Northwest Power and Conservation Council's power and conservation plan.

As discussed above, City Light has become an active and constructive participant in regional dialogue on west coast transmission. The board expects City Light's role as a regional leader to continue in the future.

6. Public Participation and Outside Input

The board urges City Light to develop a program that will lead to more effective stakeholder and outside input into key planning and decision processes. City Light already involves the public in some major decisions. For example, City Light has invited interested persons to participate in the IRP process, its Web site providing the dates and agenda for upcoming stakeholder meetings and workshops. However, the board believes that the process of public input and participation must be systematic throughout the organization.

Public participation can enhance City Light's decision-making process in the areas of rates, financial policy, integrated resource planning, major projects, critical issues, and strategic initiatives. Participants should include all classes of ratepayers, public interest groups, environmental leaders, representatives of low income ratepayers, community groups, good government organizations like the Municipal League, and experts in relevant areas of the electric industry.

The type of public input will vary depending upon the decision to be made, but effective public participation requires commitment of resources from the utility and certainty for participants. People whose interests are affected by City Light decisions must know when and in what forum their views will be heard.

The benefits of a clearly defined public process are many. A well-thought-through process will build trust and understanding of the utility in the community, provide elected officials with the informed input they need for effective oversight, improve the quality of utility analysis and decisions, enhance oversight by Seattle City Council and executive, assure consideration of outside perspectives and best practices, anticipate and avoid problems, enhance buy-in by stakeholders, enhance accountability at the utility, provide a more balanced and fair perspective and range of views, and assure that long-term interests of rate-payers are championed.

To achieve these goals, the city must implement a systematic approach, tailored to issues/decisions being considered. The process must be managed rigorously to avoid drift, paralysis by analysis, ineffective input, and undue burden on utility staff and executive time and attention. The process must:

- offer greater transparency of utility planning and decision-making;
- focus on providing useful input to the utility, not just an "exercise";
- promote broader ownership for process by City Light people – not just public affairs or communications;
- encourage community stakeholder participation – with surrogates (appointed committees, focus groups, etc.) for "unrepresented" interest groups such as residential rate payers;
- include outside expert and industry input from other utilities, academia, and other utility and management experts;
- promote high-quality interactive, two-way communication – possibly iterative to assure understanding and quality feedback;
- integrate adequate time for council and executive oversight into the time-line and hearing processes.

The advisory board has worked with utility staff to develop a proposal for a process to present a resolution to the mayor and council for a comprehensive public participation and outside input program at City Light. The "Second Century Project" proposes to convene an expert group by November 2005 to work with utility and other city staff on a project that will meet the criteria and expectations laid out above in time to be considered fully for the utility's 2007 budget (in other words, by early spring 2006). The progress, working with the advisory board, in this area has been slow, and the November 2005 date for convening the expert group has gone unfulfilled. The board would prefer to report solid accomplishment rather than a proposal for a process to develop a program. Given the distractions noted elsewhere in this report, the board strongly urges City Light to stick to this schedule for establishing this critical foundation for high performance on every level.

7. Governance

The advisory board believes that City Light faces significant challenges in becoming a high-performance organization within the present governance structures. Under the heading of "High-Performance Organization," the board's first report recommended in 2003 that the city strengthen its oversight of the utility. We suggested a review of the city's systems and policies for controlling City Light to determine whether different approaches could enhance both City Light's performance and the city's oversight. The second report noted that the Board had devoted a considerable amount of time and attention to governance in 2004 and that we intended to submit recommendations on governance in the 2005 report.

Accordingly, the board researched the governance models of many other municipal utilities and visited four "best practices" utilities in Jacksonville, Austin, Colorado Springs, and Tacoma.[13] We retained a facilitator to focus on what we had learned and to develop governance options for City Light. Following the retreat, the board discussed these options with the key officials in the executive branch, with council members, with members of environmental, civic, and public interest organizations, and with members of the public. The board also conferred with members of the blue ribbon panel, whose October 2002 report recommended changes in City Light governance.

The board concluded that the criteria for effective governance were (1) meaningful accountability, (2) clarity of roles, (3) consistency of direction and goals, (4) speed of decision-making, (5) management flexibility to achieve these goals, and (6) focus on long-term interest of rate-payers.

The board unanimously agreed that City Light governance must be changed if public power is to thrive in Seattle. As a city department, City Light is burdened with onerous personnel strictures, a budget process not designed for utility accounting, non-competitive compensation limits, some uneconomic purchasing practices, and lack of flexibility to manage its $800 million annual business. City Light is subject to political winds, with sound business judgment sometimes falling victim to struggles for political advantage.

Among other options, the board seriously considered the feasibility of a utility board with clearly defined management oversight responsibility. Such a board would be

[13] We visited Tacoma Power, Austin Energy, Colorado Springs Public Utility & Jacksonville Energy Authority; we also have conducted informal interviews and gathered information from several other public utilities.

empowered by the executive and the council to oversee specified areas of City Light management, such as resource management, asset management, budgeting, capital planning, and customer service. A board would not – and should not – impinge upon the policy-making role of the council or interfere with their statutory powers such as setting rates. Several other respected municipal utilities are governed by such boards. We strongly recommend that the city consider the merits of a utility board in the future.

An appropriate governance structure would enable city to move quickly to respond to changing conditions. Under the current governance, political issues can stand in the way of managing the urgent business of the utility expeditiously. For example, the discussion of financial policies finally adopted this past summer lasted over a year. Similarly, the effort to equip City Light with a competitive pay structure for its executive and director was in part accomplished, but only after the organization was left in limbo for the better part of the year, short-handed in accomplishing many of the elements required for a high-performance organization.

An effective governance structure will prevent "micro-managing," while at the same time holding City Light accountable for achieving its plan and for following through on critical objectives. Over the next few years, if City Light is to achieve the levels of success we all hope for, the city must consider alternative forms of governance and modify the current structure. Governance demands the serious attention of our elected officials and the community if City Light is to survive as a publicly-owned electric utility in today's competitive business environment.

In the meantime, if the city decides to continue with an advisory body, it should be constituted and operate much as the current board. It should be composed of citizens with experience and expertise in management and utility regulation. Its members should serve as champions of City Light, not as representatives or advocates for various constituencies throughout the city. The board must not be or appear to be political or partisan. However, if the board is to play any meaningful role, its members must have the ability to promote the board's views and to discuss utility matters both within the city and with the wider community.

Conclusion

The board believes that the strength of public power lies in its responsiveness to the people. City Light must cherish its heritage and maintain its status as a national leader in environmental stewardship. City Light must continue to hear the voices of low-income and public interest advocates. City Light must value its dedicated workforce, honoring its past commitments to them and opening opportunities for the future. At the same time, City Light must truly become a high-performance enterprise, capable of playing in the high stakes electric business of tomorrow. The city must develop a streamlined oversight process to grant management flexibility to the utility, making City Light more accountable to the people of Seattle and their elected representatives.

Acknowledgements

As this advisory board reaches the end of its three-year term, we wish to thank Julie Tobin, who has provided the board with unfailing administrative support and friendship, and Jean Becker, who provided the board with helpful research assistance. We appreciate the help of the members of the Municipal League and the blue ribbon panel, who have given their time and insight into several of the difficult issues addressed

by the board. Finally, the board is grateful for the support and encouragement offered to the board by the executive, the superintendent, the council, and their staffs.

Carol S. Arnold

Randall W. Hardy

Jay F. Lapin

Gary Swofford

Sara Patton

Donald M. Wise

January 30, 2006

APPENDIX

Becoming a High Performance Organization
(From First Annual Report of the Seattle City Light Advisory Board, published Jan. 29, 2004.)

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.[14]

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.[15] 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 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

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

[15] 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.

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?[16]

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 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

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[16] 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.

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 nontax-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.

Management Flexibilities

I. Background

The Seattle City Light Advisory Board has spent the last 2½ years overseeing SCL operations and has, over the past several months, investigated several potential governance options for the utility. While the Board is still undecided about the feasibility of any changes in SCL governance, it is unanimous in concluding that the Superintendent needs additional management flexibility in several key areas.

II. Rationale For Greater Management Flexibility

Greater SCL management flexibility would enhance utility accountability to both the Mayor and City Council by minimizing confusion between desired policy results, and the means to achieve those results, which currently exist. It would significantly accelerate the speed of decision making by SCL, and hence its responsiveness to both elected officials and ratepayers. It would enable City Light to act quickly in response to emerging problems and, in many cases, actually anticipate prospective crises so preventative action could be taken. It would enable SCL to better execute policy guidance from elected officials, whatever its governance structure or the specific nature of the policy direction involved. All these characteristics are vital for an organization which, unlike other City departments, has to operate in a highly competitive, fast moving wholesale electricity market. In short, these changes would allow SCL to operate more like a business while still remaining true to its public purposes and maintaining local control.

III. Specific Changes Recommended

To achieve these improved results, the Board believes five particular management changes are required.

1. Salary Levels

For selected positions, SCL salary levels should be compared to those of other publicly owned electric utilities (e.g. Tacoma Public Utilities, Snohomish County PUD). This change would allow SCL to attract quality staff in key areas (e.g. power management, risk management) where the utility has significant revenue risk and where the competition for technically competent staff is the toughest. City Light competes with other public and private utilities, and even power marketers, in a number of respects. It competes for personnel, particularly for senior managers and professionals. It competes in the purchase and sale of wholesale power. It competes for long term power supply contracts to supplement its hydro resources. More salary flexibility in particular, and all these management improvements in general, would significantly assist SCL in meeting these personnel challenges in a more effective manner.

2. **Exempt Positions**

SCL needs the ability to have more of its top positions free from civil service constraints in order to attract, incent and manage in the highly competitive electric utility environment. The management flexibility to rapidly change personnel, alter position duties, reassign staff and the like are essential to successful operations in this industry. As such most, if not all, SCL Managers and Supervisors should be exempt employees.

3. **Incentive Pay**

SCL needs the ability to administer its own incentive pay system. Such a system, whether for performance pay, retention incentives or similar tools, is in place in virtually every competitor's company today. SCL needs this capability to effectively compete for/retain high quality staff in areas where it has significant revenues at risk.

4. **Personnel Classification**

City Light needs the ability to administer its own personnel classification system. The demands for tailoring positions to competitive needs and changing position descriptions quickly to respond to altered industry circumstances simply cannot be met by a centralized City personnel entity which: (1) is completely unfamiliar with the unique requirements of the electric industry; and, (2) cannot move with sufficient speed in response to the rapid changes in this industry.

5. **Labor Negotiations**

SCL needs the ability to negotiate its own labor agreements with the IBEW, Local 77. Since virtually all Local 77 members who work for the City are SCL employees, the utility would not be setting precedents or adversely affecting City interactions with other unions by negotiating directly with Local 77. This ability for direct negotiations is critical given utility work rule changes that are a key to increasing productivity in the now deregulated electric industry. City Light's ability to pursue such changes is an integral part of the flexibility it needs to stay competitive and lower rates in this constantly changing environment.

All these changes are necessary for City Light to enhance its responsiveness to its customer owners and elected officials, and to maximize the benefits, from both a revenue and environmental standpoint, of the most valuable hydro system of any West Coast utility.

Advisory Board Expenses for 2005

The Advisory Board did not have a budget and Board members do not receive compensation for their services. 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, meeting refreshments and annual report printing and distribution. OPM reports that approximately $7,000 was charged back to City Light in 2005 for this Advisory Board related support. OPM also contracted with David Harrison for facilitation services at a cost of $5,000.

Advisory Board Member Biographies

Carol Arnold is a lawyer with more than 20 years experience in electric energy and utility matters. She is a retired partner 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.

Randy 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 more than 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.

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 (NWEC). 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.

Gary Swofford has more than 35 years experience in the energy industry. He currently serves as General Manager of Swofford Energy Consulting, LLC. Previously, he was Senior Vice President and Chief Operating Officer for Puget Sound Energy (PSE). Swofford has also served as V.P. for PSE in Customer Service and has two degrees, in Electrical Engineering from the University of Washington and in Engineering Economy for Public Utilities from Stanford University.

Donald Wise is currently Managing Director of Asset Services at Metzler Realty Advisors, serves on the Seattle Chamber of Commerce's Energy Committee, and is a past President of Seattle's Building Owners and Managers Association (BOMA). Wise led that organization's review of City Light's downtown network rate structure. He has also led 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" in developing and implementing federal energy policy. Wise has considerable financial and management expertise.

Seattle City Light Advisory Board

Carol S. Arnold, Randall W. Hardy, Jay F. Lapin, Sara Patton, Gary Swofford, Donald M. Wise

October 24, 2005

Seattle City Councilmembers
City of Seattle
City Hall
P.O. Box 34025
Seattle, WA 98124-4025

Dear Members of the Seattle City Council:

The City Light Advisory Board understands that the Council will be considering Council Bill 115432 regarding the proposed Electric Utility Executive Compensation Program. We want to let you know that the Advisory Board supports the Compensation Program.

1. Compensation Levels

The Board supports the Compensation Program proposed in the legislation, including the base pay zones, performance awards, and flexible moving expenses. The Board has been concerned for some time that executive compensation at City Light is too low to attract highly qualified experts in the electric utility industry.

For selected positions, City Light salary levels should be comparable to those of other publicly owned electric utilities such as Tacoma Public Utilities and Snohomish County PUD. City Light also must compete for executives with public power experience across the country. Competitive compensation will allow City Light to attract quality staff in key areas such as power management, risk management, and systems operations.

City Light commissioned Mercer Human Resources Consulting, the nation's leading compensation specialists, to evaluate the competitiveness of City Light's current compensation for Officers and Directors. Mercer found that the <u>median</u> salary for virtually all of these jobs at comparable public utilities was higher than the <u>maximum</u> salary allowable under the Seattle pay bands. The gap between the top of the City Light salary scales and median salary levels at investor-owned utilities was even more substantial. For example, Mercer observed that the median salary for a Power Supply Officer at public utilities is 15% higher than the maximum salary that City Light can now pay for this position. The IOU median is 42% higher than the current City Light maximum.

Mercer also found that City Light was uncompetitive in its incentive compensation plan and lack of a substantial relocation benefit. Finally, Mercer found that other public utilities, responding to the same pressures as City Light to improve their performance and accountability in a more complex and competitive energy environment, were increasingly sourcing talent from investor-owned utilities – a trend that will only increase the pay gap between City Light and other public utilities.

City Light faces significant revenue and operating risks in these areas where competition for technically competent staff is the toughest. Adequate compensation is critical in those areas in which City Light competes with other public and private utilities, and even independent power marketers. At present, City Light is in the middle of a major reorganization which is essentially stalled because of its inability to attract highly qualified executives. Unless the proposed ordinance passes, several consequences will result:

(1) City Light will have to settle for lower skill levels in key positions;

Julie Tobin, SCL Advisory Board Coordinator
City of Seattle, Office of Policy & Management
PO Box 94745 Seattle, WA 98124-4745 Tel: 206-684-8859 Fax: 206-233-0085
http://www.cityofseattle.net/light/news/advisory/

(2) City Light will be run by executives who cannot recognize, much less anticipate and shape, on-going competitive changes in the electric utility industry to the utility's advantage;

(3) City Light key staff will consistently be overmatched in power/financial negotiations with other utilities and power marketers;

(4) Senior power management staff will be unable to optimize, or even consistently earn, the $150 – 200 million annual wholesale power revenues which are the key to rate stability or future rate decreases for City Light ratepayers.

(5) Management supporting the Superintendent will lack the strategic planning expertise to steer the utility through future crises, including unstable power markets and dramatic climate change.

2. Manager and Strategic Advisor Compensation Programs

The Board supports the provisions for strategic advisors and managers. The Compensation Program generally applies to executive and director-level positions. In addition, the proposal provides for pay flexibility for certain management and strategic advisor positions. We understand that currently there are five positions that would fall within this program. These are strategic advisor positions that require specific knowledge and experience in the electric industry and the power markets.

The Board supports increased management flexibility to attract the well qualified individuals for these key staff positions to ensure the best analysis and strategic advice is available to the Superintendent, Mayor and City Council.

City Light is at a crossroads. Passage of this ordinance will give City Light the ability to staff the utility with high quality executives, anticipate and capitalize on the full range of revenue enhancing and cost saving opportunities and generally produce the high performance organization that City Light ratepayers have every right to expect.

Failure to pass it will be a choice for "business as usual" and will relegate City Light to a future of mediocrity. We cannot predict what the next crisis in the electric industry will be, but rate payers must not be exposed to the same kind of mistakes which produced a 50 per cent utility rate increase in 2001 - - principally because City Light was not properly equipped to deal with the West Coast power crisis.

For all the above reasons, the Advisory Board strongly urges the City Council to pass the City Light Compensation Ordinance as introduced.

Respectfully,

Carol S. A

Seattle City Light Advisory Board

Carol Arnold, Chair
Randy W. Hardy

Jay F. Lapin

Sara Patton

Gary Swofford

Donald Wise

cc: Mayor Greg Nickels