June 8, 2005

Honorable Jan Drago, President
Honorable Jean Godden, Chair, Energy & Environmental Policy Committee
Seattle City Council
City Hall, 2nd Floor

Dear Council President Drago and Councilmember Godden:

Over the past several months, the City has engaged in a dialogue with its customers about the rates City Light should charge for electricity. I proposed a new rates process to broaden public participation and enhance our efforts to educate our customers on the diverse rate issues we face. Four public workshops have been held at which the key issues involving revenue requirements, cost allocation, and rate design have been discussed at length. Through these workshops we have gained valuable insight into the concerns and perspectives of our key stakeholders.

Progress in Financial Recovery

In deciding the best course of action on electric rates at this time, I have kept in mind not only the feedback we received through our public workshops but also City Light's current financial status. The news in this regard is mostly favorable. City Light has made significant progress in recovering from the severe financial damage resulting from the western power crisis of 2000-2001. All of the short-term debt incurred in 2001 and 2002 has been repaid, including the funds City Light borrowed from the City's cash pool. Operating cash balances have been restored to respectable levels. Last year, City Light recorded positive net income for the first time since 1999. New financial policies have been adopted by the Council. Even though these policies fall short of providing the cash reserves that the City Light Advisory Board and I had recommended, they still represent a strengthening of the financial safeguards that had been adopted by the Council in 2001.

Risks and Challenges Ahead

Although City Light has strengthened its financial positions considerably over the past three years, substantial risks and challenges remain. For the past several years, all of City Light's net operating revenues have been applied to the repayment of the short-term debt incurred during the power crisis, leaving no revenue to finance capital requirements. As a result, almost all of City Light's capital requirements during that period were financed with long-term debt. At the end of 2004, City Light's long-term debt totaled more than $1.5 billion, an increase of almost $500 million over the amount outstanding on December 31, 1999. City Light's long-term debt represents 83% of total capitalization. Bringing this figure down to a more reasonable level is a high priority. Efforts to reduce debt levels in the years ahead will be complicated by necessary investments in infrastructure (deferred during the energy crisis) and large potential capital requirements for the relocation of facilities related to a number of major regional transportation projects. These projects could add substantial amounts to City Light's capital spending, and the prospects for reimbursement by the transportation agencies involved are uncertain.

City Light also faces a high degree of uncertainty in forecasting its financial position due to variability in water conditions and wholesale market prices. Under normal conditions City Light can expect to generate about $130 million in net revenue by selling its surplus power in the wholesale market. However, in recent years conditions have been anything but normal. Since 1999 there has been only one year (2002) when water conditions were close to normal. In all other years shortfalls in precipitation have reduced the amount of surplus energy available to far below average levels. Fortunately wholesale market prices have been above expectations in those years of low water, partially offsetting the financial impact of the shortfall in surplus power. Since 2002 net wholesale revenue generated by City Light has ranged between $89 million and $113 million. I am therefore hesitant to adopt a financial forecast for 2006 that assumes wholesale revenue at "normal" levels when our recent experience has fallen short of those levels by $20-40 million per year.

A further risk in City Light's financial outlook relates to uncertainty regarding the price that we will be charged by our largest supplier of power, the Bonneville Power Administration. Bonneville's finances have also been negatively impacted by low streamflows in the current water year. It is therefore likely that Bonneville will use its authority under its current power sale contract with City Light to adjust its rates upward on October 1, 2005. The Seattle Municipal Code requires City Light to pass through to its customers the financial impact of any change in Bonneville rates. It has been the City's practice to pass through Bonneville rate changes on April 1 of each year. If we were to lower rates on January 1, 2006, we might well find ourselves increasing rates three months later to pass through a Bonneville rate increase. This would make little sense to our customers.

Rate Strategy -- 2006 and Beyond

Given the substantial risks and uncertainties that City Light faces in the immediate future, I have concluded that it would not be prudent to lower rates in 2006 by even the small amount that our current financial policies would suggest. I have therefore decided not to submit a rate proposal to the Council this year. This course of action will have several advantages.

It will allow City Light to gain one more year of experience in managing the marketing of its surplus in an environment of uncertain water conditions and market prices. As you know, City Light has been reviewing its risk management strategy and will be implementing new practices in the near future to lower the variability of its wholesale revenue. A year from now we should have some idea of the effectiveness of these new practices. We will also have one more year of experience with water conditions, which will allow us to judge whether the dry weather patterns of recent years might presage a longer-term trend.

Our discussions with our key stakeholder groups over the past few months have provided us with useful guidance on a number of issues. However, some of these issues will require additional analysis and discussion before they can be resolved and their implications incorporated into a rate proposal. These rate issues include the following:

- What is the appropriate rate treatment for large loads?
- What level of rate discount should be made available to low-income customers and which customers should be eligible for this discount?
- Should the residential rate structure continue to include three ascending rate blocks?
- What rate alternatives should be considered for large non-residential customers that would benefit both the utility and the customer?
- What principles should guide allocation of costs among classes of customers?
- How should network rates be determined and which customers should pay these rates?

The resolution of these and other issues will benefit from additional study.

City Light's financial forecast indicates that a more substantial rate reduction may be possible in 2007 if results in 2005 and 2006 are consistent with current forecast assumptions. I will continue to monitor City Light's financial performance, regional water conditions, rate actions by Bonneville, and the progress of City Light's restructuring plan. In the second quarter of 2006, after consulting with the City Light Advisory Board and gaining input from the utility's various stakeholder groups, I will submit a rate proposal if at that time a rate adjustment appears to be consistent with the Department's long-term financial recovery plan.

Sincerely,

GREG NICKELS
Mayor of Seattle

JM:jmb

cc: Honorable Members of the Seattle City Council