Review of Seattle City Light's Financial Policies
Fall 2009 Working Paper

I. Introduction

City Light's financial policies are designed to ensure uninterrupted access to the bond markets, allocate capital costs over time, promote long-term rate stability for customers and maintain long term operational and fiscal health for the Utility. Targeting all these objectives helps the Utility to provide high quality service at the lowest possible cost to its customers in the long run.

To satisfy its existing financial policies in the near future, City Light must either significantly increase customer rates during an economically sensitive time or reduce programs and services to unacceptable levels. Thus, City Light considers it appropriate to re-evaluate its financial policies so that it can minimize rate impacts to customers and continue providing quality services. In this review, City Light aims to achieve these objectives by modifying the existing financial policies. The following recommendations are made:

1. In combination with an automatic rate adjustment mechanism that would stabilize the Utility's revenue from surplus energy sales, reduce the debt service coverage target for rate setting from the current 2.0 to 1.6 in 2010, 1.7 in 2011, and 1.8 in 2012 and thereafter.
2. Implement an automatic rate adjustment on a quarterly basis that would increase or decrease retail rates depending on whether net wholesale revenue was higher or lower than planned for the previous quarter in the adopted budget.
3. Drop the current policy of setting rates to assure 95% confidence that there will be at least $1 of revenue available to fund capital requirements in each year, taking into consideration the variability in cash flows resulting from uncertainty in hydro conditions, market prices and system load.
4. Delay achievement of a 60% debt to capitalization ratio from 2010 to 2012.
5. Coordinate the budget and rate-setting processes to ensure that they are aligned.

In this paper City Light presents an overview of the history of financial policies used in rate setting, its current financial policies, and a discussion of how they are used in the rate setting process today. Next, the performance of some of the financial policies are discussed under the current financial environment. Finally, City Light's proposals to amend the current policies to help mitigate rate increases in the coming years, while providing revenue certainty for the Utility to meet its debt service obligations and carry out its planned programs, are discussed.
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II. Historical Background

Since 1977 City Light has set electric rates in compliance with specific financial policies adopted by the City Council. The following resolutions preceded Resolutions 30761 of 2005 and 30933 of 2006, which contain the current policies discussed in the next section.

Resolution 25469 of March 1977:

- Debt service coverage provided by current revenues should be 2.0 and should never fall below 1.5.

- Fifty percent of general CIP should be financed with current revenue, though financing of major new CIP projects will be determined by the Mayor and City Council on a case-by-case basis.

Resolution 26849 of March 1983:

- Annual net revenue available for debt service should be at least 2.0 times current annual debt service payments.
- Fifty percent of general CIP should be financed with current revenue, though financing of major new CIP projects will be determined by the Mayor and City Council on a case-by-case basis.
- Revenues must be sufficient to provide an 80% level of confidence that the Department's net earnings will be positive each year.

Resolution 28085 of October 1989:

- Rates should be set to provide for 1.8 debt service coverage on a planning basis.
- Rates should be set to ensure that, with a high degree of confidence, the Department will make a positive cash contribution to its capital improvement program each year.
- Rates should normally be set to achieve positive net income on a planning basis.

Resolution 30428 of December 2001:

- Net revenue available to fund capital requirements in each calendar year should be positive with a probability of at least 95%, taking into account the variability of cash flows resulting from the uncertainty of water conditions, market prices and system load.
- A Contingency Reserve account of $25 million is established. It is to be funded by adding $12.5 million each year, for two years, to the rates that would accomplish the first goal, described above. This period of funding would not commence until City Light had paid off certain short-term obligations and its month-end operating cash balance had reached $30 million, as described below. Funds in the account could be used to cover current obligations in any year in which the amount of net revenue available to fund capital requirements was not positive (no ordinance required).
- In its rate proposals, City Light should target a minimum month-end operating cash balance of $30 million, an amount that was equal to approximately three months of non-power operating expenses.
- Financial policies should be reviewed no later than the second quarter of 2006, and should also be reviewed if there was a significant change in City Light's resource portfolio or if the utility's financial performance deviated significantly from the forecasts underlying the development of the policies in the resolution.

III. Current Rate Setting Financial Policies

The existing financial policies were established in City Council Resolution 30761, adopted May 2, 2005. These policies were re-affirmed in Council Resolution 30933 adopted November 20, 2006, with a change to the requirement for use of the contingency reserve fund.

1. Expected Debt Service Coverage of 2.0

Retail rates should be set so that the expected debt service coverage on first and second lien debt shall achieve 2.0 coverage. A value of 2.0 was selected because, given the volatility in wholesale revenue, it provides a high level of probability that City Light will meet its minimum debt service coverage commitments. By setting rates to achieve at least 2.0 coverage, City Light provides a high level of certainty to the financial community that the Utility will have ample revenue to cover its debt service payments, which helps City Light to maintain its access to low cost financing. A 2.0 coverage was also selected because it provides for a gradual decrease in the debt to capitalization ratio. This has enabled the utility to decrease its debt to capitalization ratio from above 80% for the 2001-2004 period to the low 60% range presently.

2. 95% Confidence of Revenue Available for Capital Requirements

Retail rates should be set so that there is 95% confidence that there will be at least $1 of revenue available to fund capital requirements in each year, taking into consideration the variability in cash flows resulting from uncertainty in hydro conditions, market prices and system load. This policy greatly increases the certainty that SCL will not have to borrow money to cover its operating expenses in a given year. The specific metric of 95% was sized so that, along with the $25M contingency reserve, there would be 99% confidence that the Utility would not have to borrow to pay for its annual operations. The additional retail revenue required to ensure this policy is met is determined from a probabilistic forecast of wholesale and retail revenue given the uncertainty in the factors listed above.

3. $25 Million Contingency Reserve Fund

City Light is required to hold $25 million in a contingency reserve fund. According to Resolution 30761 of 2005, funds from the contingency reserve were to be used to pay for extraordinary costs of operating the electrical system and could only be released with a Council ordinance. However, Resolution 30933 of 2006 allows them to be used to "cover current obligations in any year in which the amount of net revenue available to fund capital requirements is not positive." It does not specify that an ordinance is required to use these funds.

Both resolutions say that if funds are withdrawn, they must be replenished within two years. As stated above, a fund size of $25 million was chosen so that along with the 95% confidence policy there would be a 99% probability that SCL would not have to borrow to pay for its annual operations.

4. $30 Million Minimum Operating Cash Balance

City Light is required to maintain sufficient operating cash balances in the Light Fund to absorb fluctuations in its operating cash flow. A minimum month-end balance of $30 million, which is meant to cover approximately three months of non-power operating expenses, is to be targeted when setting rates. In most circumstances, this minimum balance applies to the timing of future bond issues. However, if a policy decision or other circumstances delay the size or timing of future bonds during the rate setting process, City Light may have to increase rates above the constraints of other financial polices to ensure that it will have the minimum amount of operating cash.

5. Target a Debt to Capitalization Ratio of 60% by 2010

This policy provides that City Light will set rates to target a debt to capitalization ratio of 60% by the end of 2010. The debt-to-capitalization ratio is the total amount of debt outstanding divided by the sum of accumulated equity and debt outstanding. This policy was designed to help the City Light gradually bring down its debt to equity position after taking on a substantial amount of debt resulting from the 2001 energy crisis, when debt to capitalization exceeded 80%. A high debt level reduces the financial flexibility of the utility, and would make it difficult to take on additional debt in the event of extraordinary circumstances. The existing financial policy resolution does not specify a lower target after 2010.

IV. How the Financial Policies are Used in a Rate Setting Process

Revenue requirements are sized so that both 2.0 debt service coverage and the 95% confidence policies are met (one of these is the "binding constraint"). The other financial policies indirectly impact the revenue requirements. The minimum cash balance ($30 million) influences the timing and potentially the size of future debt issues, which will impact the amount of debt service that needs to be covered in the future. The target debt to capitalization ratio is not binding but can be influenced by adjusting the two binding constraints. Setting the percentage of confidence of revenue available for debt service or the debt service coverage policies at a higher level would lower the debt to capitalization ratio relative to its current trajectory.

It is important to note that the financial policies have little impact on the amount the Utility is going to collect from customers over a specified long period of time but, instead, they impact when collections will take place over that time frame. In the short run, the adopted budget dictates the amount of expenses net of outside revenue that customers will be responsible to cover. Since it is a fundamental policy that all planned <u>operating expenses</u> be covered with current year operating revenue, the financial policies essentially determine how much of the <u>capital program</u> will be financed with current year revenue and how much will be financed with bonds. Over the long run, the only difference between the amount collected from customers under different financial polices will be a result of the financing cost of issuing debt (including interest costs and bond issuance costs).

There are economic theories that can help guide the optimal financial policy for customers and the Utility. Such theories include minimizing the weighted cost of capital and allocating capital costs efficiently over time. However, for the near term, City Light proposes that the primary objective of its financial policies should be to gradually bring the Utility back to strong financial standing commensurate with its current AA level bond ratings, while minimizing customer rate impacts during this sensitive economic time. When the Utility returns to a more solid financial standing and the economy recovers, City Light's financial policies can be reevaluated and amended to include more long-term economic efficiencies.

V. Current Financial Environment

2009 has been a challenging year financially for City Light. 2009 debt service coverage is projected to be about 1.3 and there is only a low probability that SCL will have positive cash from operations, even as the Utility is making significant cuts to its operating expenses. There are two main reasons why City Light is in this current financial situation. First, wholesale revenue is projected to be around $70 million below what was forecasted when the 2009 budget was adopted. Second, there was no rate increase authorized in conjunction with the adopted 2009 budget, even though at the time the financial policies were shown as not being met (i.e., 2009 debt service coverage was expected to be 1.73). If the 2.0 financial policy had been maintained in 2009, SCL would have increased rates by around 7% and would have been able to absorb the $70 million shortfall in wholesale revenue, as debt service coverage would have most likely only dropped to 1.5. Most importantly, the Utility would not have had to make sudden disruptive cuts in its programs and service levels. During 2009, management identified the need for these reductions in programs and service levels to avoid running out of cash and to make sure it would have sufficient revenue to pay its debt service. The fact that these actions were necessary demonstrated that the overall system of ensuring the financial policies are in place and upheld needs to be enhanced.

City Light's budgeted operating expenses and their associated contribution to the revenue requirements have increased substantially in the past years. The three main reasons for the increase are: (1) new programs have been adopted that increase service levels, enhance employee safety and aim to reduce future expenditures; (2) the costs of continuing core business processes have gone up, which the Utility has had little control over; and (3) some discretionary spending has increased that the Utility has justified and City Council has adopted.[1] All increased operating expenses have been put through regulatory scrutiny and have been approved as necessary expenditures. However, despite budgetary approval, no rate increase was authorized to ensure that City Light's financial policies were met. City Light's budget does not contain any substantial level of discretionary funding that can be scaled back in a year of wholesale revenue shortfalls without directly impacting customer service, reliability or other essential aspects of providing utility services. This points to the need for an explicit linkage between the budgetary process and the rate setting process. The need to address this issue has been endorsed by the City Light Advisory Committee.

VI. SCL Proposed Changes

Table 1 below shows City Light's proposed changes to its financial policies.

Table 1. Summary of City Light Proposed Changes in Financial Policies

Financial Policy	Current	SCL Proposed
Target Debt Service Coverage	2.0 in all years	1.6, 1.7 and 1.8, respectively, in 2010, 2011 and 2012
PRAM*	No	Yes
Cash Confidence	95%	na
Debt to Capitalization Ratio	60% by 2010	60% by 2012
Coordinate the Budget and Rate Setting Processes	No	Method to be Determined

* PRAM = Power Revenue Adjustment Mechanism, described below.

[1] A more detailed explanation will be included in City Light's revenue requirements proposal.

Reduce Targeted Debt Service Coverage
SCL has proposed a number of reductions from the 2010 endorsed budget in order to mitigate the size of the retail rate increase that would be necessary to achieve revenue consistent with the existing financial policies. However, even with these cuts, City Light needs roughly a 21% increase in retail rates to satisfy the current financial policy of 2.0 coverage in 2010. This is viewed as too large an increase for its customers to accept at this time, given difficult economic circumstances. As a result, City Light is proposing that customer rates gradually increase over time to provide sufficient revenue for debt service coverage of 1.6, 1.7 and 1.8, respectively, in 2010, 2011 and 2012, with 1.8 continuing as the target in subsequent years. As a result of this and other changes, the rate increase for 2010 could be reduced to approximately 9%, with subsequent single-digit increases in both 2011 and 2012. This would comply with the principle of gradualism, which is one of the Council approved policies upon which City Light rates are to be established. Over this period, City Light would be on a path to sustainable and strong financial performance.

Adopt an Automatic Power Revenue Adjustment Mechanism ("PRAM")
While revising the targeted debt service coverage will put downward pressure on rates, it will not adequately protect the Utility from volatility in wholesale revenue without other policies in place. This would be unacceptable from the standpoint of ensuring sufficient funds to continue stable operations, as well as the nearly inevitable downgrade in City Light's current credit ratings (AA- Standard and Poors/AA2 Moody's) that would result. It is for this reason that City Light is proposing an automatic mechanism to adjust rates in the event of significant volatility in its wholesale revenues.

The proposed PRAM would provide a quarterly credit to customer bills when wholesale revenue is more than planned and place an additional quarterly charge on retail energy sales when wholesale revenue is below planned levels. If net wholesale revenue came in close to planned levels, no change to retail rates would occur; thus, the expected value of the PRAM in any given year would be zero.

The PRAM is a mechanism that allows expected rates to be lower than they would otherwise be under the current financial policies. Without the PRAM, City light would have to either: (1) increase base rates significantly more than what is being proposed; (2) reduce programs and customer services to unacceptable levels; or (3) take on imprudent financial risk. The Utility and its customers can avoid the extremes of any of the above options by adopting a PRAM, which will allow the Utility greater revenue certainty, and keep the expected rates to its customers low.

The PRAM would to some extent decrease rate stability, which is one of the principles of City Light's rate setting. That is, the PRAM will transfer a portion of the volatility of wholesale revenue into retail rates; this is mitigated, however, by having a maximum flow through amount and a band of fluctuation within which no rate change would occur. The volatility in rates that customers will experience will be offset by the benefit of lower rates in the near term. By adopting a less restrictive debt service coverage policy along with the PRAM, customer base rates will be much lower than they would be without the PRAM and a more restrictive financial policy. In other words, adopting a PRAM reduces the expected energy costs to customers but allows the actual rates to fluctuate up and down (subject to the proposed limitation of a one cent increase or decrease in rates per kWh). Unless customers value rate certainty to a higher degree than lower near term rates, they will be better off with the PRAM than they are with rates set under the current financial policies.

Remove the Cash Confidence Constraint
The existing policies include the requirement that that retail rates should be set so that there is 95% confidence that there will be at least $1 of revenue available to fund capital requirements in each year, taking into consideration the variability in cash flows resulting from uncertainty in hydro conditions, market prices and system load. SCL's proposed PRAM will provide sufficient confidence that the Utility will have positive cash from operations available to put towards its capital improvement program, so this constraint would no longer be necessary if the PRAM proposal is adopted. However, if the PRAM is modified to provide less assurance than the proposal that City Light has put forward, it may be important to retain some comparable cash confidence constraint.

Delay the 60% Debt to Capitalization Ratio Target to 2012
In general, there is no optimal debt to capitalization ratio applicable to all utilities. As a municipality, City Light has a tax advantage, providing it access to a lower cost of capital than most private utilities and customers. Taking advantage of this low cost financing enables customers to benefit, as they usually have a higher discount rate than City Light's cost of capital. However, a lower debt to capitalization ratio would better position the Utility to borrow large amounts of money should another crisis emerge or if the Capital Improvement Program is suddenly accelerated. City Light's financial advisors suggest that long-term debt to capitalization should be somewhere in the 50%-60% range. Given that City Light expects to need to borrow more in the next couple of years than it would if retail rates were higher, the proposed change would delay meeting the 60% target by two years.

Coordinate the Budget and Rate Setting Processes
As indicated above, there is a need to ensure that City Light's financial policies are met. The most straightforward and transparent means to address this would be to have alignment between the budget and rate setting process. This would ensure that the adopted budget satisfies City Light's financial policies, or a rate change would be authorized along with the adopted budget.

At a minimum, we propose that the financial policies and the City's budget adoption process require a reconciliation between the level of the budget assumed when rates were last set, and the level of the budget currently proposed, and that any difference be explicitly recognized along with a plan to address any gap.

Summary of the Impacts of the Proposed Changes
Table 2 below compares City Light's proposed changes to its financial policies with the existing policies. Specifically, the table compares the average system rate, debt to capitalization ratio and the 10-year net present value (NPV) of the amount collected from customers for each policy option.[2] Below are some general results that can be expected if SCL were to change its financial policies as proposed.

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[2] It should be noted that the 10-year NPV is not a long term comprehensive indicator of customer welfare. Its purpose is to show the near term benefits to customers when the Utility borrows more to finance its capital program.

- In the near term, the expected average system rate would be significantly reduced.
- The debt to capitalization ratio would be reduced more slowly, but still trend downward, reaching 51% by 2019 with the proposed changes, versus 44% by 2019 with the existing policies.
- Customers would benefit from lower expected rates over the 10-year period.

Therefore, all other things being equal, when the Utility has lower rates and borrows more to finance its capital programs, the Utility takes on more debt and the current customers benefit in the near term. However, in the longer term, the Utility has more debt that customers will eventually have to pay off.

Table 2. Summary of Impacts of City Light's Proposed Financial Policies (Nominal Dollars)

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
SCL Proposed Financial Policies										
Debt Service Coverage	1.60	1.70	1.80	1.80	1.80	1.80	1.80	1.80	1.80	1.80
Average System Rate ($/MWh)	62.61	66.40	71.33	73.58	72.77	78.09	79.98	82.44	86.66	88.62
Debt to Capitalization Ratio	62%	62%	60%	58%	57%	55%	54%	53%	52%	51%
Retail Revenue* ($m)	588	630	690	718	716	773	801	831	881	909
10 Year NPV at 5% ($m)	5,712									
10 Year NPV at 10% ($m)	4,466									
Existing Financial Policies										
Debt Service Coverage	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00
Average System Rate ($/MWh)	69.37	71.55	75.01	75.38	74.23	79.28	80.89	83.05	87.06	88.74
Debt to Capitalization Ratio	61%	59%	55%	53%	51%	49%	48%	47%	45%	44%
Retail Revenue* ($m)	651	678	726	735	730	785	810	837	885	910
10 Year NPV at 5% ($m)	5,896									
10 Year NPV at 10% ($m)	4,628									
Percent Reduction in Expected Rates from SCL Proposed Policy Change	10%	7%	5%	2%	2%	2%	1%	1%	0%	0%

* before rate discounts

Potential Additional or Alternative Financial Stability Tools

An alternative (or possible supplement) to the PRAM could be the establishment of a revenue stability fund. This would be a cash reserve with the sole purpose of covering deviations from planned wholesale revenue. The fund could be established with cash from operations, meaning the Utility would need to borrow more for its capital program during the year(s) when the fund is being created. Establishing a revenue stability fund would have an opportunity cost, as the Utility would have to take on more debt. However, current customers could still benefit from a revenue stability fund if the Utility sufficiently decreased their base rates in the near term. If funds were drawn from the account they could be replenished with cash from operations in the following year(s), which might involve a temporary rate increase.

At the present time, City Light is not allowed to fund a revenue stabilization account by its bond covenants (where it is called a "rate stabilization account"), as codified in Ordinance 122807 passed by the City Council on September 22, 2008. This prohibition will remain in place until no 1997, 1998A, 1998B, 1999 or 2000 bonds remain outstanding. Therefore, City Light's proposed changes to its financial policies do not include a revenue stability fund.

Should City Light refund these older bonds, a revenue stability fund would potentially be able to be used to meet debt coverage requirements. If this were to happen, a revenue stability fund could be used to replace or supplement a PRAM. A combination of a PRAM and a revenue stabilization fund would also work effectively together. The combination of a moderate PRAM and a moderately sized revenue stabilization fund would maintain revenue certainty while: (1) reducing customer rate volatility, as compared to a PRAM that passes through to customers larger deviations; and (2) reducing the opportunity cost to customers, relative to a large revenue stabilization account with no PRAM. However, a revenue stabilization fund is not currently being considered for the near future, as it is uncertain whether City Light will find it advantageous from a cost standpoint to refund these older bonds.

It should also be noted that a revenue stability fund would be separate from the existing contingency reserve fund, which by itself at the current level of $25 million does not adequately protect the Utility from the volatility it experiences in net wholesale revenue.

VII. Conclusion

City Light is proposing to make amendments to its current financial policies to:

- Better address volatility in its revenue stream, and prevent the need for significant reductions in customer service that such volatility causes.
- Enhance the financial resilience of the Utility, for both current year financial stability as well as longer term financial strength.
- Ensure a financial profile consistent with high bond ratings to ensure continued access to low cost bond financing necessary to support the Utility's capital improvement program.
- Help mitigate the increase in customer rates over the next several years that would be necessary with a continuation of the existing financial policies.

The main policy change would be lowering the targeted debt service coverage to 1.6, 1.7 and 1.8, respectively, in 2010, 2011, and 2012. In addition, to ensure that the Utility has enough operating revenue during years of low wholesale revenue, City Light is proposing to implement an automatic Power Revenue Adjustment Mechanism that would place a charge on customer energy sales when wholesale revenue is below planned levels and provide a credit to customer bills when it is above. Finally, if the PRAM is adopted, it is proposed that the policy of 95% confidence of positive net revenue to contribute to the capital program be dropped. The Utility views these policy changes as important tools to mitigate rate impacts on customers during the current challenging economic situation.