



## City Council Staff Report

**From: City Manager**

**Report Type: CONSENT CALENDAR**

**Lead Department: Utilities**

**Meeting Date: August 19, 2024**

Staff Report:2401-2510

### **TITLE**

Recommend City Council Adopt a Resolution Amending the Gas Utility Long-term Plan (GULP) Objectives, Strategies and Implementation Plan, Amending the Gas Utility Reserves Management Practices, Amending the FY 2025 Gas Fund Budget Appropriation, and Amending Rate Schedules G-1 (Residential Gas Service), G-2 (Residential Master-Metered and Commercial Gas Service), G-3 (Large Commercial Gas Service), and G-10 (Compressed Natural Gas Service); CEQA Status: Not a Project Under Public Resources Code 15378(b)(5) and Exempt Under Public Resources Code 15273(a)

### **RECOMMENDATION**

Staff and the Finance Committee recommend that City Council adopt a resolution (Attachment A):

- (1) Amending the Gas Utility Long-term Plan (GULP) Objectives, Strategies and Implementation Plan which includes collecting funds via a gas price mitigation adder (Adder) to manage potential future short-term natural gas price spikes;
- (2) Amending the Gas Utility Reserves Management Practices;
- (3) Amending the Fiscal Year 2025 Budget Appropriation for the Gas Supply Fund by:
  - a. Increasing the Net Sales Revenue by \$1,200,000; and
  - b. Increasing the Gas Rate Stabilization Reserve by \$1,200,000; and
- (4) Amending Rate Schedules G-1 (Residential Gas Service), G-2 (Residential Master-Metered and Commercial Gas Service), G-3 (Large Commercial Gas Service), and G-10 (Compressed Natural Gas Service) to include a gas price mitigation adder of 5.5 cents per therm within the Commodity Charge.

### **EXECUTIVE SUMMARY**

If Staff's recommendation is approved, it will take effect November 1, 2024. On June 4, 2024, the Finance Committee voted unanimously to recommend City Council direct staff to apply a

gas price mitigation adder of 5.5 cents per therm for a period of three years and transitioning from the current maximum Gas Commodity Charge of \$4 per therm to a maximum Gas Commodity Charge of \$3 per therm. On June 17, 2024, as part of the FY 2025 Proposed Budget process occurring in parallel with the development and discussions around the gas commodity price hedging program, City Council approved a 12.5% increase in Gas Utility rates for FY 2025. City Council's adoption of this proposed resolution would further increase Gas Utility rates.

The proposed amendments to the GULP Objectives, Strategies and Implementation Plan will provide a mechanism, adjusting gas rates to build reserve funding, for the City to mitigate the impact on customers and the Gas Utility of future short-term natural gas commodity price spikes, such as the one that occurred in the winter of 2022-2023.

The proposal recommended maintains the practice of basing gas commodity charges on the monthly market index, acknowledging that this inherently results in unpredictable volatility in cost for customers. The recommended gas price mitigation adder (Adder) to the Gas Commodity Charge will accumulate in the Gas Rate Stabilization Reserve. Funds in this reserve will be used to offset the impact of a gas market price spike above the maximum Gas Commodity Charge. Adoption of the proposed resolution will result in application of an Adder of 5.5 cents per therm (estimated 2.8% increase on an annual bill) for a three-year period to the Gas Commodity Charge, generating \$4.5 million in revenues to be reserved for future short-term gas price spikes. Starting during the 2nd quarter in FY 2028, provided that sufficient funds have accumulated in the Gas Rate Stabilization Reserve, staff expects to seek City Council approval to lower the maximum Gas Commodity Charge from the current \$4 per therm to \$3 per therm.

The \$4.5 million in reserved funds estimated to be collected in 3 years is expected to be sufficient to maintain the Commodity Charge at \$3 per therm for a single month even if the gas market prices spike to as high as \$4.20 per therm in that month.

## **BACKGROUND**

### ***The Shift to Market Price-Based Commodity Charges***

In 2012, [Resolution 9244](https://www.cityofpaloalto.org/files/assets/public/v/1/city-clerk/resolutions/reso-9244.pdf)<sup>1</sup> changed the gas purchasing strategy from one in which [gas commodity rates](https://www.cityofpaloalto.org/files/assets/public/v/1/agendas-minutes-reports/reports/city-manager-reports-cmrs/year-archive/2011/id-2106-110111.pdf)<sup>2</sup> changed about once per year to one in which a monthly market price-based charge was passed through to customers. In the 10 years prior to that change, the majority of Palo Alto's natural gas needs were met through fixed-price gas purchases. This strategy succeeded in achieving relatively stable gas supply costs, and hence, relatively stable commodity rates. In times of declining market prices, however, Palo Alto's costs and resulting commodity rates were higher than the market and higher than Pacific Gas & Electric's (PG&E) rates which change on a monthly basis and generally mirror the market. City Council's approval

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<sup>1</sup> Resolution 9244 <https://www.cityofpaloalto.org/files/assets/public/v/1/city-clerk/resolutions/reso-9244.pdf>

<sup>2</sup> Gas Commodity Rates <https://www.cityofpaloalto.org/files/assets/public/v/1/agendas-minutes-reports/reports/city-manager-reports-cmrs/year-archive/2011/id-2106-110111.pdf>

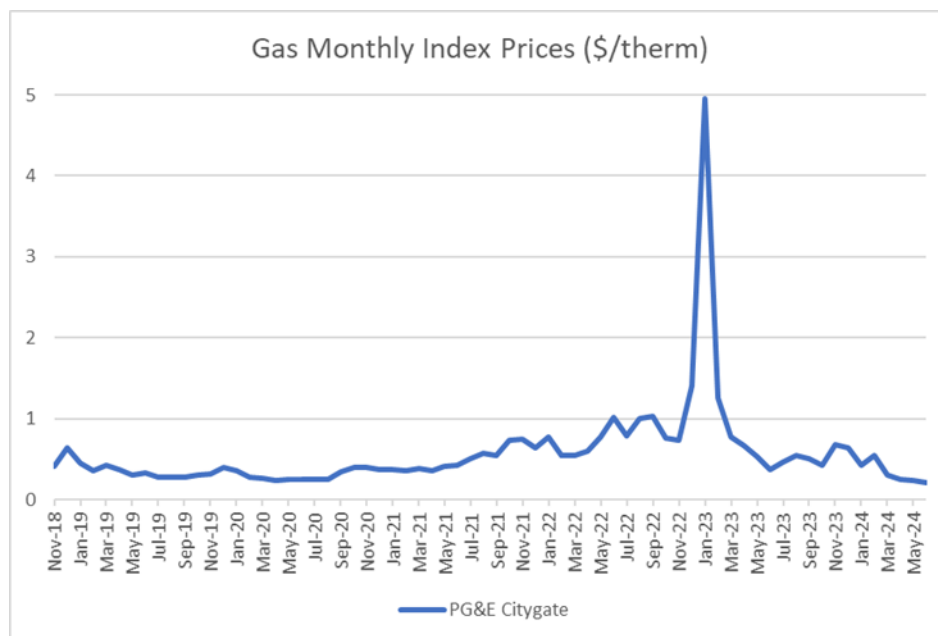
of monthly market price-based commodity rates reduced the need for financial reserves and reduced the need for staff resources to manage the gas portfolio.

#### Gas Commodity Price spike of Winter 2022-2023

During winter 2022-2023, natural gas prices rose dramatically across the western United States. Entering that heating season, there was upward pressure on prices due to a confluence of factors including: (a) historically cold December temperatures, (b) unusually low regional gas storage levels, (c) constraints on the availability of natural gas supplies flowing into California, and (d) an increased reliance on natural gas in the electric power sector as a result of the ongoing drought's impact on hydroelectric supplies. However, those fundamental market conditions alone did not explain the sudden and extreme increase in natural gas prices which is currently under investigation by Federal Energy Regulatory Commission (FERC) and California Public Utilities Commission (CPUC). The preliminary timeline for these investigations to yield findings is in the spring of 2026.

Figure 1 shows the published gas market monthly indexes from November 2018 through May 2024 for the PG&E Citygate hub in Northern California, including the winter 2022-2023 price surge. January 2023 natural gas prices were five times greater than November 2022 prices. The PG&E Citygate hub is a delivery point for Palo Alto's gas purchases and the index on which Palo Alto's gas commodity rates are based.

**Figure 1 – Gas Market Prices**



When staff began to see signs of higher gas prices in late November and early December 2022, customers were informed through utility bill messaging, website notices, social media, email newsletters, and other community forums. Customers were encouraged to save energy to dampen the impact of rising prices on their utility bills.

On [December 19, 2022](#)<sup>3</sup>, City Council adopted [Resolution 10090](#)<sup>4</sup> which increased the maximum allowed Gas Commodity Charge from \$2 per therm to \$4 per therm. Because the January 2023 gas market monthly index of nearly \$5 per therm exceeded the higher maximum Council-approved Gas Commodity Charge, the full cost of January gas was not recovered through rates; instead, about \$1.84 million was withdrawn from the Gas Operations Reserve to cover the shortfall.

Recognizing the significant impact on customer bills, the City offered resources to customers including access to free home efficiency assessments and utility bill payment arrangements. In April 2023, City Council approved gas and electric ([Staff Report 2303-1209](#))<sup>5</sup> rebates of \$2.4 million, funded by the City's General Fund, to compensate residential customers for the high energy bills they experienced.

#### *Capped-Price Winter Natural Gas Purchasing Strategy through October 2024*

In response to the dramatic and unprecedented price spike, City Council approved a capped-price winter natural gas purchasing strategy in [September 2023](#)<sup>6</sup> for the gas year November 2023-October 2024 by adopting [Resolution 10126](#)<sup>7</sup>. The Gas Commodity Charge continues to be based on a monthly market index price. The capped-price winter natural gas purchasing strategy involved purchasing price caps on the City's cost of gas for December-February, limiting the price the City paid for gas to \$2 per therm for a portion of City's anticipated gas needs. The impact on customers of what is, in essence, an insurance policy to mitigate the potential for a repeat of high winter gas prices, was limited to a maximum 15 cents per therm (estimated 7.6% increase to annual bill) applied for 12 months to customer usage through the Gas Commodity Charge.

Within the cost constraints approved by City Council, staff was able to purchase \$2 per therm price caps for about half of Palo Alto's expected load for the months of December 2023, January 2024 and February 2024. The total cost of the price caps, or insurance, was \$1.5 million. Spread out over the entire year, an adder of 5.5 cents per therm is currently applied to the Gas Commodity Charge through October 2024. This represents approximately \$1.81 per month on a typical residential customer's bill or an approximate 2.8% increase, not considering changes in the underlying commodity price, which is still based on a market index. The monthly market index price remained under \$2 per therm for the December 2023, January 2024, and February 2024 months, so the City did not make use of the contracted price caps it had purchased.

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<sup>3</sup> December 19, 2022 <https://www.cityofpaloalto.org/Departments/City-Clerk/Citys-Meeting-Agendas/Meeting-Agendas-and-Minutes>

<sup>4</sup> Resolution 10090 <https://www.cityofpaloalto.org/files/assets/public/v/1/city-clerk/resolutions/resolutions-1909-to-present/2022/reso-10090.pdf>

<sup>5</sup> Staff Report 2303-1209 <https://cityofpaloalto.primegov.com/Portal/viewer?id=1954&type=0>

<sup>6</sup> September 2023 <https://cityofpaloalto.primegov.com/Portal/Meeting?meetingTemplateId=13026>

<sup>7</sup> Resolution 10126 <https://portal.laserfiche.com/Portal/DocView.aspx?id=67825&repo=r-704298fc>

In addition to approving the capped-price winter natural gas purchasing strategy, City Council directed staff to explore other alternatives for managing potential commodity price spikes in the future.

## **ANALYSIS**

On June 17, 2024, as part of the FY 2025 Proposed Budget process occurring in parallel with the development and discussions around the gas commodity price hedging program, City Council approved a 12.5% Gas Utility rate increase for FY 2025. Increases resulting from City Council adoption of this resolution will be in addition to those approved in June.

### **Establishing a New Strategy for Mitigating Short-term Gas Price Spikes Beginning November 2024**

A gas price mitigation Adder is recommended to be included in the Gas Commodity Charge, maintaining the practice of purchasing gas based on a monthly market index price. The funds will accrue in the Gas Rate Stabilization Reserve and would be used to offset potential future short-term price spike impacts.

With a recommended Adder of 5.5 cents per therm (estimated 2.8% increase on an annual bill) starting November 2024, an estimated \$1.5 million per year will accumulate each year with a total estimated balance of \$4.5 million after three years (if no funds are withdrawn to mitigate short-term market price spikes in the interim). The proposed 5.5 cents per therm Adder is equivalent to the unit cost of the winter capped-price strategy, which will be fully recovered via Gas Utility rates by the end of October 2024.

Starting during the 2<sup>nd</sup> quarter of FY 2028, provided that sufficient funds have accumulated in the Gas Rate Stabilization Reserve, staff expects to seek City Council approval to reduce the customer maximum Gas Commodity Charge, lowering the price spike risk to the customer. If the funds have not been used for short-term price spikes in the interim, the maximum Gas Commodity Charge could be reduced from the current \$4 per therm to \$3 per therm during FY 2028.

Staff anticipates that as of November 2027, if no funds are withdrawn to mitigate price spikes, the rate mitigation adder will have raised \$4.5 million. This would be enough to maintain the Gas Commodity Charge at \$3 per therm for a single month even if market index prices increased to \$4.20 per therm for that month. The highest price during the 2022-23 winter price spike was nearly \$5 per therm.

At the end of three years during the 2<sup>nd</sup> quarter of FY 2028, which will be, staff will return to City Council with a recommendation to either continue, eliminate, or make changes to the Adder. Ultimately, the Adder would be included as part of the annual utility rate setting process.

Table 1 below illustrates the reduction of the maximum Gas Commodity Charge over three years as well as the maximum market index prices spikes and corresponding frequency of months (one, two, or three) protected against by the collected funds after one to six years,

assuming no fund withdrawals to mitigate short-term market price spikes in the interim, and assuming the Adder is kept in place throughout the six-year period.

**Table 1 – Gas Commodity Charges and Market Price Protection (\$ per therm)**

	Max Gas Commodity Charge	Max Price Spike (1 Month)	Max Price Spike (2 Months)	Max Price Spike (3 Months)
After Year 1	\$4.00	\$4.40	\$4.20	\$4.13
After Year 2	\$4.00	\$4.80	\$4.40	\$4.27
<b>After Year 3</b>	<b>\$3.00</b>	<b>\$4.20</b>	<b>\$3.60</b>	<b>\$3.40</b>
After Year 4	\$3.00	\$4.60	\$3.80	\$3.53
After Year 5	\$3.00	\$5.00	\$4.00	\$3.67
After Year 6	\$3.00	\$5.40	\$4.20	\$3.80

Gas Commodity Charges are one part of the City’s [monthly gas volumetric and service charges](#)<sup>8</sup>, which are listed in the City’s gas rate schedules and shown by month. If approved by City Council, the strategy will be implemented effective November 1, 2024. Proposed changes to the rate schedules approved by City Council in June 2024 are shown in Attachment A.

#### GULP Revisions

The [September 2023](#)<sup>9</sup> GULP update modified the purchasing strategy to include the capped-price winter natural gas purchases. The new strategy, if adopted, requires changes to GULP as shown in Table 1 below. While some other items also need updates, staff is not proposing changes other than those associated with the gas purchasing strategy at this time for the sake of simplicity. Administrative updates will be brought to City Council for consideration in a separate staff report.

**Table 2 – Gas Utility Long-term Plan Revisions**

GULP	Current	Proposed
Objective 1	Pass a market supply cost signal through to customers with measures to protect against price spikes applied during winter months.	Pass a market supply cost signal through to customers with measures to mitigate the impact of short-term natural gas market price spikes.
Strategy 1	<ul style="list-style-type: none"> <li>a. Purchasing natural gas at monthly and daily market index prices;</li> <li>b. Changing gas supply rates monthly to reflect market prices; and</li> <li>c. Purchasing physical capped-price gas for some or all forecasted natural gas volumes for December through February, provided that the cost of the price caps results in no more than a 15 cents per therm impact on retail commodity gas rates</li> </ul>	<ul style="list-style-type: none"> <li>a. Purchasing natural gas at monthly and daily market index prices;</li> <li>b. Changing gas supply rates monthly to reflect market prices;</li> <li>c. Collecting funds in the Gas Rate Stabilization Reserve to manage potential short-term price spikes; and</li> <li>d. Utilizing those funds if a short-term natural gas market price spike occurs</li> </ul>

<sup>8</sup> Monthly gas volumetric and service charges <https://www.cityofpaloalto.org/files/assets/public/utilities/rates-schedules-for-utilities/residential-utility-rates/monthly-gas-volumetric-and-service-charges-residential.pdf>

<sup>9</sup> September 2023 <https://cityofpaloalto.primegov.com/Portal/Meeting?meetingTemplateId=13026>

GULP	Current	Proposed
Implementation Plan Item 1	<p>Implement market-based supply purchases and commodity rates with measures to protect against price spikes applied during winter months by:</p> <ul style="list-style-type: none"> <li>a. Developing a new purchasing plan to be approved by the Director of Utilities; and</li> <li>b. Conducting customer communication and outreach.</li> </ul>	<p>Implement market-based supply purchases and commodity rates with measures to protect against price spikes by:</p> <ul style="list-style-type: none"> <li>a. Adding 5.5 cents per therm to the Gas Commodity Charge from November 2024 through October 2027; and</li> <li>b. Conducting customer communication and outreach.</li> </ul>

### Revisions to the Gas Utility Reserves Management Practices

Staff recommends modifying Section 7 (modifications highlighted below) in the Gas Utility Reserves Management Practices, which are the guidelines followed in the Utility's financial planning process, to reflect the new reserve strategy. This proposed language is modified for clarity but not in substance compared to what the UAC and Finance Committee reviewed.

#### Section 7. Rate Stabilization Reserve

The Rate Stabilization Reserve is used to manage the trajectory of future year rate increases and mitigate the impact of short-term gas market price spikes. This reserve holds revenues derived from the gas price mitigation adder adopted by Council on August 19, 2024; additional funds may be added to the Rate Stabilization Reserve by action of the City Council and held to manage the trajectory of future year rate increases. Withdrawal of funds from the Rate Stabilization Reserve requires Council action. If there are funds in the Rate Stabilization Reserve at the end of any fiscal year, any subsequent Gas Utility Financial Plan must result in the withdrawal of all funds from this Reserve by the end of the Financial Planning Period, with the exception that gas price mitigation adder revenues may be held in the Rate Stabilization Reserve until needed.

A gas price mitigation Adder is recommended to be included in the Gas Commodity Charge, maintaining the practice of purchasing gas based on a monthly market index price. The funds will accrue in the Gas Rate Stabilization Reserve and would be used to offset potential future short-term price spike impacts.

The Gas Utility Reserves Management Practices, including the changes proposed, are included in Attachment A.

### Fixed Price Purchases Alternative

An alternative to staff's proposal is to purchase some portion of winter gas needs (winter is the most likely time period when a market price spike could occur) at fixed prices. The downside of this strategy is that the City's cost of gas could deviate significantly from the market price, either higher or lower. This alternative would require structural changes in the way the Gas Commodity Charge is established for the months during which fixed-price purchases are included in the portfolio, as well as a significant amount of staff resources to implement.

### Continuation of the Capped Price Winter Natural Gas Purchasing Strategy

A second alternative is to continue the strategy of purchasing insurance against high market prices. The cost of that insurance varies, and the product is not commonly traded and is expected to be costly. Like familiar types of insurance, premiums are not refunded if the insurance is not used. The cost would occur every year and may or may not provide value to Palo Alto's rate payers.

#### *Return to Pass-through without Short-term Price and Cost Protection*

Another alternative is to return to the pre-2023 strategy. Customers will not be protected from short-term natural gas market price spikes. City Council may consider a higher maximum Gas Commodity Charge to protect the Gas Utility from costs greater than what may be recovered through rates.

#### **Variations of Staff's Recommendation**

There are three variables embedded in staff's recommendation which, if changed, yield different results. A higher Adder would result in more than the estimated \$4.5 million collected over three years and vice versa. A longer period over which the Adder is applied results in more funds collected. A slower or more modest decrease in the maximum Gas Commodity Charge would provide less protection for the rate payers but more protection for the Gas Utility Operations Reserve. A combination of changes to the three variables offers an array of alternatives.

The table below summarizes the considerations for staff's recommendation and the alternatives.

**Table 3 – Summary of Staff Recommendation and Alternatives**

Alternative	Description	Consideration
Staff Recommendation (self-insured)	5.5 cents per therm Adder; three years; decrease max Commodity Charge to \$3 per therm	Estimated \$4.5 million reserve balance
Variation	Higher/lower Adder	Larger/smaller reserve balance = more or less price protection
Variation	Longer/Shorter collection period	Larger/smaller reserve balance = more or less price protection
Variation	Leave max Commodity Charge high/reduce max Commodity Charge faster	More price protection for the Gas Utility/more price protection for the customer
Fixed-Price Purchases	Purchase some fixed-price gas for the winter months	Commodity Charges will be higher or lower than the market price and PG&E's rates
Capped Price Winter Purchases (Insurance from the market)	Replicate the winter 2023-2024 strategy	Cost and availability of insurance is uncertain; cost is sunk whether insurance is needed or not
Return to previous strategy	Pass through market price with no price mitigation	Customers pay market price in all scenarios, may consider higher maximum Commodity Charge



## FISCAL/RESOURCE IMPACT

Staff recommends City Council approval of a gas price mitigation Adder of 5.5 cents per therm to be applied to the Gas Commodity Charge effective November 1, 2024 for three years, which is estimated to result in the collection of \$4.5 million. The Adder equates to an estimated increase of 2.8% on the median monthly residential customer bill; the estimated increase will be 3.0% for the winter bill months (November-March) and 2.4% for the summer bill months (April-October).

Staff also recommends increasing the net revenue in the Gas Supply Fund by \$1.2 million to recognize the expected revenue in net sales. Based on the current pricing trends and forecasts, the FY 2025 Gas Supply Fund has sufficient budget for commodity purchases for the year. At midyear, should the forecast exceed the FY 2025 commodity budget, staff will request a budget adjustment at that time.

Table 3 shows the median monthly residential customer bill and the projected impact based on the 5.5 cents per therm Adder.

**Table 3**

Median Monthly Residential Bill - Projected Impact					
Season	Therms	Bill Estimate	Bill Increase \$	Bill Increase %	
Winter (Nov-Mar)	54	\$ 99.80	\$ 2.97	3.0%	
Summer (Apr-Oct)	18	\$ 40.52	\$ 0.99	2.4%	
Annual	33	\$ 65.22	\$ 1.82	2.8%	

## STAKEHOLDER ENGAGEMENT

### Initial Proposal

Staff's initial proposal, before meeting with the UAC, included applying an Adder of 10.3 cents per therm (estimated 5.2% increase on an annual bill) for a four-year period to the Gas Commodity Charge, generating \$11.3 million in customer revenues to be reserved for future price spikes, and gradually reducing the maximum Gas Commodity Charge from the current \$4 per therm back to the historically typical level of \$2 per therm, estimated to be done during FY 2029.

### UAC Review and Alternatives

Staff presented their initial proposal to the UAC on May 1, 2024, seeking the UAC's recommendation to City Council. The UAC unanimously approved a motion outlining their two preferred alternatives below with Commissioner Segal absent. The Commissioners expressed a preference for the 2nd alternative (higher maximum Gas Commodity Charge and no short-term price spike mitigation). The Commissioners also recommended City Council advise Staff to investigate options to protect low-income customers and expand price spike informational campaigns. The Commissioners discussed options for protecting low-income customers from gas price spikes by utilizing General Fund resources.

- *UAC Alternative Scenario A:* Maintain the maximum Gas Commodity Charge of \$4 per therm with a \$0.06 per therm Adder for three years, and for Staff to return to the UAC for review in two years.
- *UAC Alternative Scenario B:* Raise the maximum Gas Commodity Charge to \$5 per therm with no Adder.

#### *Finance Committee Review and Recommended Revised Proposal*

Recognizing the inherent tension among proposal variables, including but not limited to price stabilization, reserve stabilization, market price competitiveness, and maintaining the current practice of purchasing based on a monthly market index price, staff presented their original proposal along with the two UAC preferred alternatives to the Finance Committee on June 4, 2024. After discussing the proposals and variations of the options, the Finance Committee voted unanimously 3-0 to recommend to City Council application of a gas price mitigation Adder of 5.5 cents per therm for a period of three years and transitioning to a maximum Gas Commodity Charge of \$3 per therm.

#### *Public Outreach*

If City Council adopts the proposed resolution, the City website will be updated to reflect the change in the Commodity Charge calculation in the [Monthly Gas Volumetric and Service Charges<sup>10</sup>](#) document. In addition, customers will be notified via utility outbound communications and marketing updates.

#### **ENVIRONMENTAL REVIEW**

City Council's approval of amendments to the Gas Utility Long-term Plan (GULP) Objectives, Strategies and Implementation Plan, amendments to the Gas Utility Reserves Management Practices, amendments to the FY 2025 Gas Fund Budget Appropriation, and amendments to the Commodity Charge Cost Component of gas rates schedules does not require California Environmental Quality Act review, since these actions do not meet the definition of a project under Public Resources Code Section 21065 and CEQA Guidelines Section 15378(b)(5), because these are administrative governmental activities which will not cause a direct or indirect physical change in the environment, and therefore, no environmental assessment is required.

#### **ATTACHMENTS**

Attachment A: Resolution Amending the Gas Utility Long-term Plan, Gas Utility Reserves Management Practices, FY2025 Gas Fund Budget, and Rates

#### **APPROVED BY:**

Dean Batchelor, Director of Utilities

Staff: Jason Huang, Senior Resource Planner

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<sup>10</sup> Monthly Gas Volumetric and Service Charges <https://www.cityofpaloalto.org/files/assets/public/utilities/rates-schedules-for-utilites/residential-utility-rates/monthly-gas-volumetric-and-service-charges-residential.pdf>