



Finance Committee Staff Report

From: City Manager
Report Type: ACTION ITEMS
Lead Department: Utilities

Meeting Date: December 3, 2024
Staff Report: 2410-3669

TITLE

Discuss the Fiscal Year 2026 Preliminary Utilities Financial Forecast and Rate Projections

RECOMMENDATION

This item is for discussion, and no action is requested. These preliminary calculations reflect an initial estimate for review and feedback by the Finance Committee and Utilities Advisory Commission (UAC) on key assumptions for the Electric, Gas, Water and Wastewater Collection Utilities to inform recommended FY 2026 financial forecasts and proposed rate changes for each utility.

EXECUTIVE SUMMARY

The City of Palo Alto Utilities provides electricity, water, wastewater, natural gas, and fiber optics. The City's Public Works Department also provides refuse collection and processing for recycling, compost and garbage, wastewater treatment and stormwater management services. Customers benefit from the continued safe, reliable, environmentally sustainable, and cost-effective operations of each of these utilities. FY 2026 preliminary calculations model necessary rate increases to support upkeep, infrastructure replacements, and replenishment of reserves to allow the City to continue to provide high quality utility services to the community.

Preliminary forecasts reflect a need for an overall 9% or \$36.40 monthly rate increase in FY 2026 for the median residential utility bill, encompassing six services (electric, gas, refuse, sewer, stormwater, water). Table 1 shows the preliminary five-year rate projections necessary to restore reserves to within guideline ranges within the five-year planning period, maintain operations given inflationary cost increases, and enable ongoing capital work necessary to provide safe, reliable, and environmentally sustainable utilities while balancing affordability. The City of Palo Alto Utilities is engaged in some infrastructure projects including modernizing the electric grid, improving resiliency, replacing water mains and reservoirs to continue to provide pristine drinking water to residents and businesses and pay toward the rebuild of the wastewater treatment plant that provides a critical service to the community 24 hours a day, 365 days per year.

BACKGROUND

Annually, the Utilities Department prepares recommended rates forecasts and financial plans for the Finance Committee review and ultimately City Council adoption in June. Rate adjustments are recommended to maintain each utility's financial health. Recognizing staffing transitions, initial

estimates, and feedback from the rate review process, staff has prepared a preliminary forecast for review and early feedback to better inform the official recommended forecasts expected in Spring 2025 for implementation in July 2025. The rate changes shown in this report are preliminary estimates; actual rate changes will be based on updated financial data and the cost-of-service methodologies and studies for each utility, and may differ by customer class and for individual customers depending on consumption patterns. A cost-of-service study for the Gas Utility is expected to be completed in early 2025 and will be factored into proposals for FY 2026. Cost of service studies for the Electric, Wastewater and Water Utilities were completed in 2024, 2021 and 2019 respectively.

Over the past few years, utility reserve funds were drawn down due to a variety of factors. The Electric and Gas Utilities were impacted by the energy price spikes in the winter of 2022 – 2023. The Water Utility was impacted by reductions in water use during the drought in 2021 – 2023 and the subsequent recovering period as well as cool and wet weather patterns which persisted locally in 2023. The Wastewater Collection Utility experienced increased wastewater treatment costs due to a higher flow share compared to the prior year forecast and other operating cost increases. For all Utilities throughout the pandemic, the City of Palo Alto kept rate increases at minimal levels in order to alleviate the burden of utility cost hikes on residents and businesses already grappling with the pandemic's economic effects. A series of rate adjustments are necessary to restore reserves to within guidelines ranges with the 5-year planning period.

ANALYSIS

Staff seeks input from the Finance Committee prior to finalizing the Utilities Financial Forecasts and developing recommendations for rate changes that would be effective July 1, 2025. The proposed rate adjustment recommendations, along with each utility's Financial Forecasts, are currently scheduled to be presented to the Finance Committee in Spring 2025. Staff's preliminary system average rate adjustment recommendations are:

Table 1: Preliminary Projected Residential Rate Changes

	FY 2025	FY 2026 (Projected)	FY 2027	FY 2028	FY 2029	FY 2030
Electric Utility ⁽¹⁾	\$7.00 9%	\$4.60 5%	\$4.80 5%	\$5.10 5%	\$5.30 5%	\$5.60 5%
Gas Utility ⁽²⁾	\$7.80 13%	\$4.10 6%	\$4.30 6%	\$4.70 6%	\$5.10 6%	\$5.00 6%
Wastewater	\$7.30 15%	\$10.10 18%	\$9.90 15%	\$11.40 15%	\$6.10 7%	\$6.50 7%
Water Utility	\$9.80 9%	\$16.20 14%	\$18.20 14%	\$15.40 10%	\$14.80 9%	\$15.40 9%
Refuse	\$0.00 0%	\$0.00 0%	\$1.50 3%	\$1.50 3%	\$1.60 3%	\$1.60 3%
Stormwater ⁽³⁾	\$0.40 3%	\$0.40 3%	\$0.50 3%	\$0.50 3%	\$0.50 3%	\$0.50 3%
Monthly Bill Change ⁽⁴⁾	\$34.50 9%	\$36.60 9%	\$40.60 9%	\$39.80 8%	\$34.70 7%	\$36.00 7%

1. FY 2025 incorporates results of cost-of-service analysis

2. Gas rate in FY 2026 based on General Fund transfer of 18% of gross revenues in FY 2024; changes shown with commodity rates held constant; actual gas commodity rates vary monthly

3. Stormwater fees increase by CPI index annually per approved 2017 ballot measure (2.6% in FY 2025)

4. Based on projected FY 2025 monthly residential bill of \$402

Electric

The preliminary electric forecast maintains the same annual 5% rate increase presented in last year's FY 2025 financial plan. Net electric supply purchase costs are anticipated to be in line with the FY 2025 Financial Plan; revenues from surplus system Resource Adequacy and Renewable Energy Certificates further reduce supply costs. On the expense side, transmission costs continue to rise, and capital spending and distribution system maintenance spending is rising due to grid modernization, fiber-related investments and an upgrade to the Hanover Substation which will benefit all electric rate payers. Staff expects some of these costs to be offset with debt service through a bond issuance in FY 2026.

On balance, the net effect of these various one-time costs and revenues is expected to be positive, enabling the utility to refill reserves to target levels; the Hydroelectric Rate Stabilization Reserve was repaid in FY 2024 and had a balance of \$17.4 million at the end of FY 2024. Replenishing this reserve reduces the risk that, in the event of a significant degradation in hydro conditions, the City will need to use the Hydro Rate Adjuster to recover higher supply costs. In FY 2025, the forecasts anticipate the Electric Special Projects Reserve will also be repaid \$7.5 million, bringing the balance from \$22.6 million to \$30.1 million. This will fully repay the monies borrowed for the supply fund to cover higher costs during the pandemic, the drought, and high winter energy prices during 2022-2023.

In the longer term (FY 2027 through FY 2030), projected increases in electric costs related to stricter resource adequacy requirements, increasing transmission costs, and capital investment and operational cost increases are expected to result in system average rate increases of 5% per year. Due to the positive net ending position in FY 2024 and CIP reappropriation, the electric utility is able to defer debt financing for grid modernization until FY 2026 and use existing balances for pay-go costs until financing is needed.

The current year (FY 2025) financial plan for the Electric Utility (approved June 17, 2024) is available at: <https://www.cityofpaloalto.org/files/assets/public/v/2/agendas-minutes-reports/reports/city-manager-reports-cmrs/attachments/2024-rates/electric-utility-financial-plan-fy25.pdf>

Gas

Gas fund expenses are typically one-third supply-related and two-thirds distribution system-related. Supply costs are market driven, change monthly according to market conditions, and are passed through to customers. Distribution costs include distribution operations and maintenance, capital investment, and the general fund transfer.

During the pandemic, the City kept overall gas utility rate increases at 2% to 3% annually and utilized reserve funding to cover costs. In the winter of 2022-23, surging gas prices depleted the gas utility reserves, which covered the gap between actual gas costs and the Council-approved maximum gas commodity charge. Reserves need to be replenished over time to ensure funds are available for safety and reliability needs, while managing ongoing cost inflation. In the FY 2025 financial plan, a gas rate increase of 5% was forecasted for FY 2026. However, due to FY 2024 year-end financials which resulted in lower sales revenues and higher operations and overhead costs, staff preliminary forecasts a 6% overall rate increase for the Gas Utility effective July 1, 2025.

On May 9, 2024, the Gas Utility received a recommendation letter from the U.S. Department of Transportation Pipeline and Hazardous Materials Safety Administration (PHMSA) for the FY 2023 Natural Gas Distribution Infrastructure Safety and Modernization (NGDISM) Grant. Staff expects this grant to provide approximately \$16.5 million for capital-related work that is additional to the utility's already-planned capital work over the next five-year period. The Gas Utility's transfer to the City's General Fund is a component of the City's gas rates. This transfer was first authorized by voters in 1950 and reaffirmed in November 2022 with the passage of Measure L which authorizes a transfer amount up to 18% of the gross revenues of the gas utility. The preliminary forecast assumes a transfer based on 18% of estimated gross revenues from FY 2024, to be \$9.735 million in FY 2026. This transfer of 18% is in alignment with the assumptions in the FY 2025 Adopted Budget process.

The current year (FY 2025) Financial Plan for the Gas utility (approved June 17, 2024) is available at: <https://www.cityofpaloalto.org/files/assets/public/v/2/agendas-minutes-reports/reports/city-manager-reports-cmrs/attachments/2024-rates/gas-financial-plan-fy25.pdf>

Water

The FY 2025 Financial Plan projected a distribution rate increase in FY 2026 of 17%, which is equivalent to a 9% overall system average increase. However, given lower reserves and higher expected ongoing costs going forward, preliminary forecasts reflect a 26% increase to the distribution rates, which is equivalent to a 14% overall system average increase on customer's water rates. This preliminary rate increase is necessary to pay for inflationary cost increases and continued lower water sales, while performing the necessary maintenance and replacement activities that contribute to the safe and reliable provision of high-quality water to Palo Alto residents and businesses.

Water usage and revenues declined in FY 2022 and FY 2023 as customers successfully conserved water in accordance with local, regional and state calls for water conservation. When the drought ended in FY 2024, water usage and sales revenue began to increase gradually. Some of the water conservation achieved during the drought will be permanent, and staff expects water sales will continue to gradually rebound before resuming a long-term decline. The lower revenue has been managed using \$5 million from the water rate stabilization reserve in FY 2023 and FY 2024 and approximately \$7 million from the water operations reserve from FY 2022 through FY 2024 to cover the utility's costs. By taking this approach of drawing down reserves, the City has only increased the distribution portion of the water rate by an average of 4% annually from FY 2021 to FY 2025. The Finance Committee reaffirmed its support for this approach on April 23, 2024 when it voted unanimously to limit the overall system average water rate increase to 9.5% in FY 2025 while reducing reserve funds available in FY 2026 and future years.¹

At the end of FY 2024, the operations reserve was approximately \$2 million below projected levels with a balance of \$7.1 million, which is below the minimum guideline level of \$8.4 million. While revenues were \$2.3 million higher than forecasted (sales revenue, capacity and connection fees), operating and capital expenses were \$4.4 million higher than forecasted. Many of the cost increases are ongoing and

¹ Finance Committee April 23, 2024, Action Minutes

<https://cityofpaloalto.primegov.com/Public/CompiledDocument?meetingTemplateId=15050&compileOutputType=1>

the utility will need to continue to pay them annually. The rate stabilization reserve at the end of FY 2024 has \$4 million remaining and the financial forecast plans to use all of that remaining funding to cover costs in FY 2025 and 2026.

The Water Utility needs to plan for large capital projects in the five-year budget, including two reservoir replacements or rehabilitations and a large main replacement every other year. This revised proposal defers the reservoir work by two years from FY 2027 and FY 2028 to FY 2029 and FY 2030. The Water Utility has used or planned for the use of all possible reserve funds to offset costs and set rates at a level that is below the utility's actual costs throughout the pandemic and drought. However, the reserves have now reached a point where rate increases are needed to pay for distribution system costs.

In the April 12, 2024 rate notice from the City's water supplier, the San Francisco Public Utilities Commission (SFPUC), estimated no rate increase for wholesale water rates in FY 2026. Consistent with this rate notice, the preliminary forecast assumes that in FY 2026 SFPUC does not increase the wholesale water rate during FY 2026 from its current level of \$5.67/CCF. Projections for FY 2027 – FY 2030 assume annual increases of 3.4% in FY 2027, 7.5% in FY 2028, and 5.4% in FY 2029 on SFPUC's wholesale rate in accordance with SFPUC's April 12, 2024 wholesale water rate notice. However, SFPUC's wholesale rate projection is subject to change and highly uncertain.

The current year (FY 2025) financial plan for the Water Utility (approved June 17, 2024) is available at: <https://www.cityofpaloalto.org/files/assets/public/v/1/agendas-minutes-reports/reports/city-manager-reports-cmrs/attachments/2024-rates/water-financial-plan-fy25.pdf>

Wastewater Collection

Preliminary rate calculations reflect a needed 18% rate increase for FY 2026, which is equivalent to approximately \$10 per residential customer per month. With this increase, Palo Alto's rate will be approximately 6% below neighboring cities, assuming that neighbor rates remain at current levels though rate increases are likely for those partners with the Regional Water Quality Control Plant. The additional funding to be generated by this rate increase is required to pay for the ongoing wastewater treatment charges, operations, and capital improvement; and deferral of some capital costs to manage the magnitude of the rate increase needed.

In FY 2024 the Wastewater Operating Reserve level was about \$1.2 million lower than expected due to treatment costs being \$1.4 million higher than forecasted, driven by higher Palo Alto flow share, and higher operating expenses than initially forecasted. The Operations Reserve ended the year with negative \$1 million. The utility's overall cash balance was positive \$0.34 million at the end of FY 2024 due to the \$3 million short-term loan that Council approved from the Fiber utility to the Wastewater Collection Utility in FY 2024. The short-term loan is expected to be paid in FY 2026.

Looking ahead, from FY 2026 to FY 2030, staff updated the operating cost projection based on the most recent recorded costs and rates of cost increase. Relative to last year's financial forecast, this increased the total operating costs by \$6.2 million or 14% over the five-year forecast. Over the five-year forecast, treatment costs are approximately \$14.2 million higher due to additional minor CIP expenses and

Section 115 Pension Trust expenses inadvertently excluded from the RWQCP's forecast. To address these challenges, the Wastewater Collection Utility preliminary forecast assumes deferral of the next sewer main replacement budget to FY 2028 and reflects investments in minimally necessary projects to allow the Wastewater Collection fund to recover and mitigate an even higher rate increase. This assumption would defer the more aggressive replacement cycle adopted in the FY 2024 financial plan to increase replacement from 1 miles to 2.5 miles of pipe annually starting in FY 2026.

The most recent (FY 2025) financial plan for the Wastewater Collection Utility (approved June 17, 2024) is available at:

<https://www.cityofpaloalto.org/files/assets/public/v/2/agendas-minutes-reports/reports/city-manager-reports-cmrs/attachments/2024-rates/wastewater-financial-plan-fy25.pdf>

FISCAL/RESOURCE IMPACT

Based on the preliminary rate increases as shown, the estimated revenue impacts in FY 2026 would be an increase of \$7.8 million in the Water Fund, \$4.4 million in the Wastewater Collection Fund, \$3.1 million in the Gas Fund and an increase of \$8 million in the Electric Fund. Utility rate increases impact the general fund because the City is a utilities customer. The impact to the general fund of these preliminary rate increases is a \$0.86 million expense increase.

STAKEHOLDER ENGAGEMENT

The Utilities Advisory Commission (UAC) will review the preliminary financial forecasts at its December 4, 2024 meeting. Staff will summarize feedback from the Finance Committee verbally during the UAC meeting. An excerpt of the minutes from the UAC's December 4, 2024 meeting will be located at the Utilities Advisory Commission website.

The UAC is scheduled to review the long-term Financial Forecasts and proposed rate adjustments for the Electric, Water, Wastewater and Gas Utilities in March. The Finance Committee is tentatively scheduled to review the long-term Financial Forecasts and proposed rate adjustments in Spring 2025. In late April or early May, notification of any recommended Water and Wastewater Collection rate adjustments will be sent to customers, giving them the opportunity to protest the proposed changes as required by Article XIID of the State Constitution (added by Proposition 218). The Financial Forecasts and proposed new rate schedules will be considered by the City Council with the FY 2026 budget, at which time the public hearing required by Article XIID of the State Constitution will be held.

ENVIRONMENTAL REVIEW

The Finance Committee's review of the preliminary financial projections does not meet the definition of a project, pursuant to Section 21065 of the California Environmental Quality Act, thus no environmental review is required.

APPROVED BY:

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