



Finance Committee Staff Report

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

Meeting Date: April 15, 2025
Report #: 2412-3868

TITLE

Recommendation to the City Council to Adopt a Resolution Approving the FY 2026 Gas Utility Financial Forecast and Reserve Transfers, the Natural Gas Cost of Service and Rate Study, and General Fund Transfer; 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) and Implement a Climate Credit in FY 2026

RECOMMENDATION

The Utilities Advisory Commission and Staff request that the Finance Committee recommend that the City Council adopt a resolution (Attachment A):

1. Approving the Fiscal Year 2026 Gas Utility Financial Forecast shown in this staff report and attachments; and
2. Approving the transfer of up to \$1.5 million from the Gas Utility Operations Reserve to the Distribution Rate Stabilization Reserve at the end of FY 2025; and
3. Approving the Natural Gas Cost of Service and Rate Study (Attachment F); and
4. Transferring up to 18% of gas utility gross revenues received during FY 2024 to the General Fund in FY 2026; and
5. Amending Rate Schedules (Attachment B) effective July 1, 2025 (FY2026):
 - a. G-1 (Residential Gas Service)
 - b. G-2 (Residential Master-Metered and Commercial Gas Service)
 - c. G-3 (Large Commercial Gas Service)
 - d. G-10 (Compressed Natural Gas Service)

The Utilities Advisory Commission also recommends that the Finance Committee recommend that the City Council approve the use of approximately \$1.6 million of Cap-and-Trade allowance auction proceeds to provide a one-time flat climate credit of \$73.20 to each residential (G-1) customer only in FY 2026.

EXECUTIVE SUMMARY

The City of Palo Alto Utilities (CPAU) provides electricity, water, wastewater, natural gas, and fiber optic services to the Palo Alto community. The Public Works Department also provides

refuse collection and processing for recycling, compost and garbage, wastewater treatment and stormwater management. The City’s primary goals are to manage these services in a way that ensures continued safe, reliable, environmentally sustainable, and cost-effective operations. The City is proposing rate increases this year for electric, natural gas, wastewater and water services. As a locally owned municipal utility, CPAU’s rates by law, are designed to recover the costs of purchasing and delivering these utility services to customers. The City strives to be transparent with utilities customers about the reason for rate changes, including explaining the cost drivers, benefits to customers, what the City is doing to keep costs low for ratepayers, and the services and programs provided by the City to help customers keep utility bill costs low. Attachment E outlines CPAU’s plan for communicating rate changes to customers. Staff are presenting an overview of the financial forecast and rate change proposal for each utility service to the Utilities Advisory Commission (UAC) and Finance Committee prior to City Council review and approval in June 2025.

During the pandemic, the City kept overall Gas Utility rate increases to 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 were used to cover the difference between actual gas costs and the revenue generated by charging customers 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.

The FY 2025 financial plan forecasted an overall gas rate increase of 5% for FY 2026. In this financial forecast, staff proposes the same 5% overall rate increase, which is about an 8.7% increase to distribution rates, assuming no change in supply costs, effective July 1, 2025. Additionally, this forecast projects overall rate increases of 6% annually from FY 2027 through FY 2030 though the rate by customer class varies significantly. In recognition, of the significant impact on the specific residential customer class (G-1), a one-time climate credit is recommended to assist in smoothing the rate increase recommended.

Table 1: Current Year (FY2025) and Projected Overall Rate Trajectory from FY 2026 to FY 2030

Fiscal Year	2025	2026	2027	2028	2029	2030
Proposal	13%	5%	6%	6%	6%	6%
FY 2025 Plan	13%	5%	6%	6%	5%	-

The UAC recommended approval of this proposal with a 5-1 vote with one abstention. The UAC also recommended through a 6-1 vote to recommend to the Finance Committee and Council to approve the use of approximately \$1.6 million of Cap-and-Trade allowance auction proceeds to provide a one-time flat climate credit of \$73.20 to each residential (G-1) customer only in FY 2026.

BACKGROUND

This staff report provides the Finance Committee with a financial forecast for the Gas Utility, provides an overview of the utility's operations costs, capital costs, and debt and includes recommended rate adjustments required to maintain the utility's financial health. Attachment D contains a set of Reserves Management Practices describing the reserves. This work is done annually as part of the budget and rate-setting cycle.

ANALYSIS

Past Trends

The Gas Utility raised distribution rates on July 1, 2024, resulting in an estimated 12.5% increase in the overall system average gas rate, provided gas supply costs remained stable. For FY 2024, sales revenues were \$5.5 million below projections in the FY 2025 Financial Plan, mainly due to reduced revenues from lower gas commodity prices and decreased gas consumption. Other sources of funds were lower by \$0.4 million, largely due to lower connection fee revenues. On the expense side, supply costs were about \$4.6 million lower than projected, reflecting lower market commodity prices. Operational expenses were about \$0.9 million higher than projected, driven by higher operating and administrative charges. Total FY 2024 actual expenses were \$63 million, compared to the \$67 million projected in the FY 2025 Financial Plan. Table 2 summarizes the variances from forecast.

Table 2: FY 2024 Actuals vs. Prior Year's Forecast (\$000)

	Net Cost/ (Benefit) Variance	Type of Change
Sales revenues lower than forecast, Low Residential Tier 2 Consumption	5,479	Revenue Decrease
Lower connection fees revenues	358	Revenue Decrease
Supply purchases lower than forecast	(4,623)	Cost Decrease
Higher distribution costs (without CIP)	906	Cost Increase
CIP costs higher than forecasted	1,739	Cost Increase
Net Cost / (Benefit) of Variances	3,859	Net Cost Increase

Projections

Overview

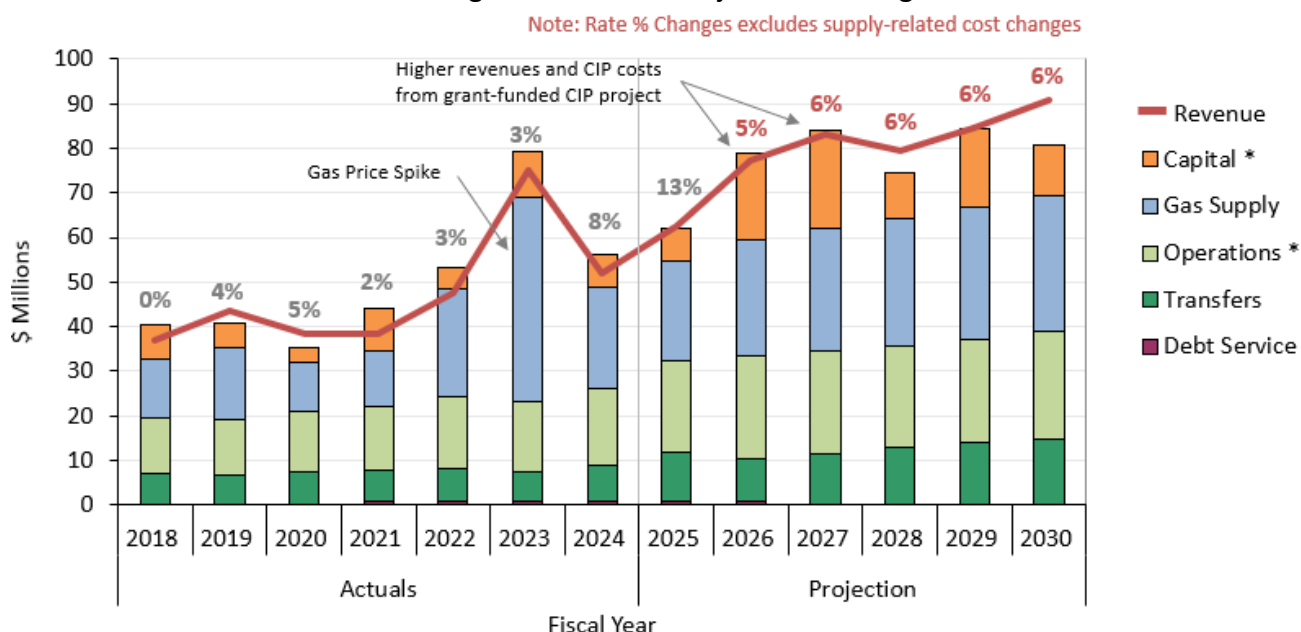
In the current year (FY 2025), sales revenues are projected to be about \$6.3 million, or 9% lower compared to last year's forecast, primarily due to lower projected gas consumption. On the expense side, supply purchases are expected to be about \$3.9 million, or 15% lower compared with last year's forecast, driven by lower than expected consumption and lower market-based commodity and carbon offset costs. However, operations costs are projected to rise by about \$2 million, or 6%, in FY 2025, mainly due to higher allocated charges and salaries and benefits expenses. Additionally, CIP costs are expected to decrease by about \$5 million, or 57%, in FY

2025, reflecting a deferral of a rate-funded Gas Main Replacement project construction (from FY 2025 to FY 2027 and FY 2029), to be replaced by a federally grant-funded project.¹

Looking ahead to the five-year forecast period from FY 2026 to FY 2030, supply-related costs are expected to increase at an average annual rate of 6%, with commodity prices projected to grow by 3% annually. Furthermore, distribution expenses are forecasted to rise by an average of 7% annually.

Figure 1 shows the actual overall system average rate percentage change from FY 2018 through FY 2025 (grey) and the projected overall system average rate change for FY 2026 through FY 2030 (red), excluding supply-related rate changes. The rate increases shown in Figure 6 include the needed increase for the distribution rate as a percentage of the base Gas Utility sales revenue.

Figure 1: Gas Utility Expenses, Revenues, Rate Changes Excluding Supply-Related Changes
Actual Costs through FY 2024 and Projections through FY 2030



*FY25 Commitments and Reappropriations reserves balances for Operations and Capital Investment are anticipated to be utilized in FY 2026 and FY 2027.

Note: Revenues and Expenses exclude Cap-and-Trade auction sales revenue, which goes directly to the Cap-and-Trade reserve.

¹ Staff Report 2411-3777, February 3, 2025;

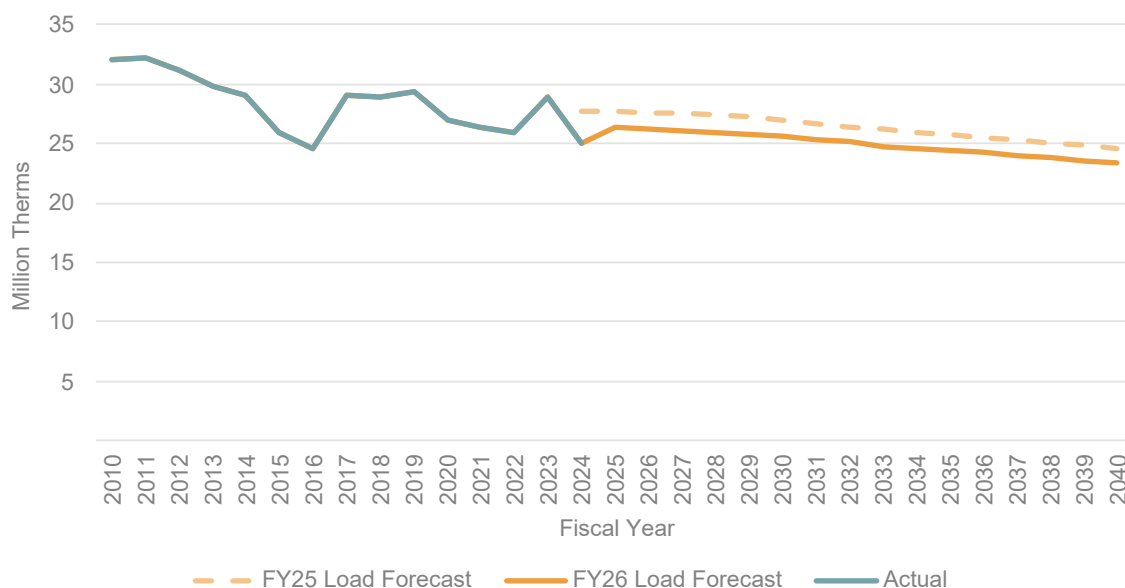
<https://portal.laserfiche.com/Portal/DocView.aspx?id=134447&repo=r-704298fc> Council unanimously voted to authorize the City Manager or their Designee to Execute an Assistance Agreement with the United States Department of Transportation Pipeline and Hazardous Materials Safety Administration (PHMSA) in the amount of \$16,519,879 through January 31, 2030.

Load Forecast

Gas usage in Palo Alto declined from FY 2020 to FY 2022, mainly due to the impacts of the COVID-19 pandemic. However, FY 2023 saw an increase in gas usage, likely driven by a modest recovery from COVID-19 effects and colder than average winter temperatures. However, similar to previous declines in gas usage due to economic factors, it is unlikely that consumption will return to pre-conservation or pre-pandemic levels. Instead, a long-term decline in gas usage is expected. Further changes, such as the voluntary replacement of gas appliances with electric appliances and building electrification are also expected to lower long run usage. Staff will conduct strategic planning and financial analysis separately from this financial forecast to develop a financial and infrastructure strategy for the Gas Utility as the community electrifies. Any insights from that analyses will be integrated into future financial forecasts.

Staff worked with a consultant to assist in the development of an updated gas load forecast, which included statistically adjusted end-use (SAE) modeling, weather-normalized modeling, economic factors, and an electrification assumption. The result, shown in Figure 2, projects gas supply load for FY 2026 at 26,172,070 therms, about 5% lower than prior year's forecast. Projections for subsequent years have also been adjusted downward by about 5% compared with last year's forecast. This reduction reflects decreased consumption in FY 2024, which has slightly shifted the long-term trend. Over time, declining gas consumption is expected to increase pressure on rates, as rising and fixed costs for gas operations and distribution will need to be allocated across fewer units sold.

Figure 1: Gas Supply Load Forecast



Revenues

This financial forecast bases sales revenue projections on the load forecast. Except where stated otherwise, these load forecasts are based on normal weather. Weather can vary substantially, however, and this can affect revenues substantially. Changes in customer behavior, improvements to gas appliances efficiency, and electrification all impact gas usage. Staff regularly monitor emerging trends and make updates to forecasts as needed.

Expenses

The Gas Utility's costs fall into two main categories: gas supply costs and distribution-related costs. Gas supply costs encompass the cost of the gas itself, its transmission to Palo Alto, and associated environmental expenses. These supply-related costs vary with the market or are set by other entities and are passed through to customers. Distribution-related costs cover the operation of the distribution system, capital improvement, and overall business operations and are collected through a distribution rate adjusted annually.

Table 3 shows total Gas Utility costs. The operations and capital costs are considered distribution costs. Current projections show distribution costs increasing 7% on average from FY 2025 through FY 2030.

Table 3: Gas Utility Costs for FY 2024 to FY 2030 (\$000)

Expenses	Actual	Projected					
	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029	FY 2030
Supply Costs	22,772	22,395	26,091	27,560	28,607	29,578	30,608
Commodity	11,789	10,087	12,487	12,838	12,640	12,153	11,803
Transportation	4,418	6,836	7,370	7,638	8,106	8,593	9,092
Carbon Offset	2,705	1,616	1,855	2,151	2,343	2,701	2,950
Cap-and-Trade	3,860	3,857	4,380	4,933	5,518	6,131	6,763
Distribution Costs	40,097	38,525	52,467	60,243	50,125	59,270	54,776
Operations	32,873	34,843	36,692	38,123	39,554	41,562	43,597
Capital	7,225	3,682	15,775	22,120	10,571	17,707	11,179
TOTAL	62,869	60,921	78,559	87,803	78,731	88,848	85,384

Supply Costs

Supply costs consist of the commodity cost of natural gas, gas transmission charges, and environmental compliance costs. These costs are passed directly to customers and are shown as line items on their utility bills.

Overall, supply expenses are projected to increase by an average of about 6% per year from FY 2025 through FY 2030. Gas commodity costs, which are the most variable component, account for the largest share of overall costs. Although market forecasts currently indicate that gas prices will remain relatively steady over the next several years, those forecasts are highly uncertain. The

financial forecast assumes that gas prices increase by an average of about 3% annually during the forecast period.

Transportation and environmental compliance costs are also expected to rise gradually over the forecast period. PG&E's local transportation rates, which have experienced steady increases in recent years, are expected to rise by an average of 6% per year throughout the forecast period².

Because the Gas Utility is regulated under California's greenhouse gas (GHG) regulations, the Gas Utility incurs Cap-and-Trade compliance costs. The regulation requires Palo Alto to purchase allowances based on actual gas load. Staff estimates that Cap-and-Trade allowance costs will increase on average by 12% annually over the forecast period.³

The Gas Utility also generates revenue from the sale of free allocated allowances. In FY 2024 and in accordance with Council-approved Cap-and-Trade revenue uses (Council Resolution 10077⁴) and Council's goal of reducing GHGs 80% by 2030, Palo Alto began allocating Cap-and-Trade reserves to support programs such as the Full-Service Heat Pump Water Heater Program.

The City also has a Carbon Neutral Natural Gas plan (Staff Report 7441⁵), which involves purchasing carbon offsets equivalent to the emissions generated by the community's natural gas use. These high-quality offsets fund projects that reduce GHG emissions, such as forest conservation or methane capture from dairy farms. While purchasing carbon offsets is an important initial step in reducing carbon emissions, the long-term goal is to decrease the community's natural gas usage by maximizing efficiency and transitioning to high-efficiency electric appliances where feasible. Carbon offset costs are projected to rise by 13% annually through the forecast period.

In response to the dramatically high natural gas prices that occurred during winter 2022-23 and to mitigate the impact of short-term price spikes, staff implemented a gas hedging program effective beginning winter 2023-24. The program currently calls for the inclusion of a gas price mitigation adder in the gas commodity charge to customers while maintaining the practice of purchasing gas at market prices. Funds collected from the gas price mitigation adder will accrue in the Gas Distribution Rate Stabilization Reserve and be used to offset the impact of a potential gas market price spike above the maximum gas commodity charge to customers.

Operations

Operations costs are projected to increase by about 4% annually on average from FY 2025 to FY 2030, primarily due to higher allocated charges and salary and benefit expenses. The operations

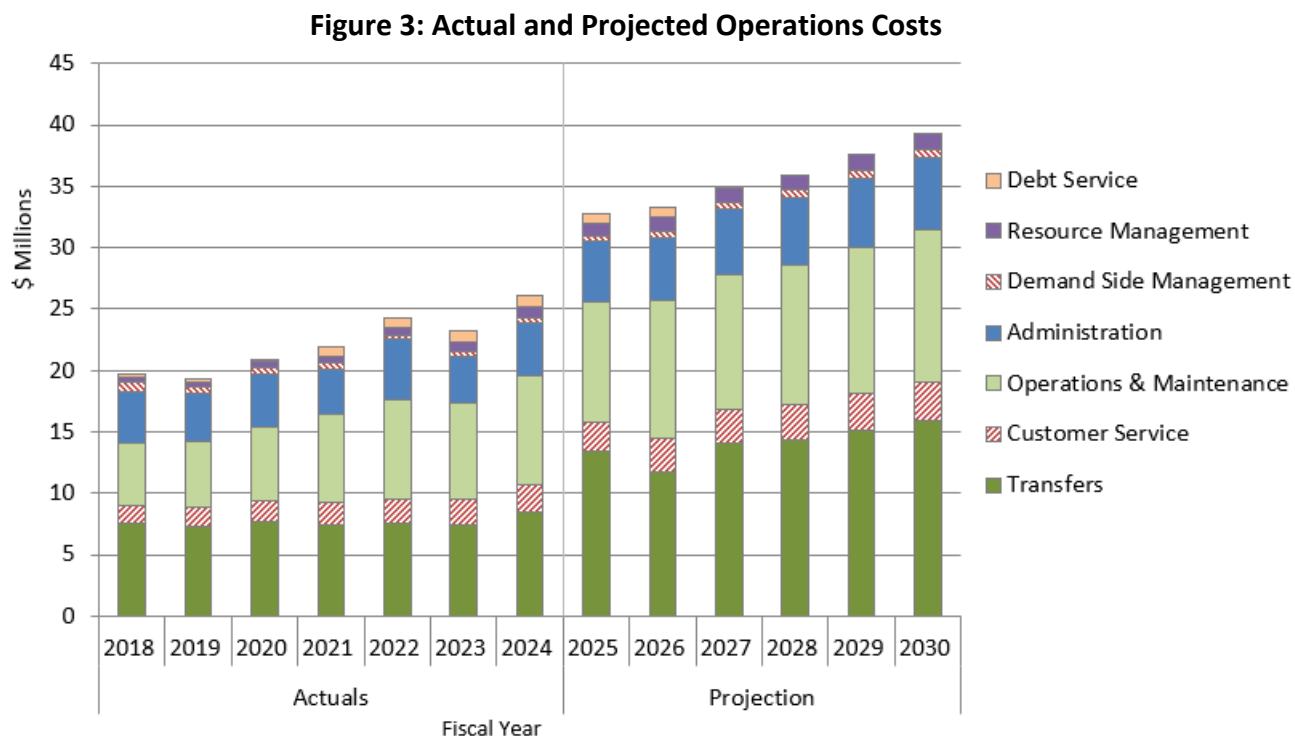
² The transportation rates for calendar years 2023-2026 reflect the rates in the December 15, 2021 prepared testimony (A.21-09-018) regarding PG&E's 2023 Gas Transmission & Storage (GT&S) Cost Allocation and Rate Design (CARD), afterward a 3% escalation rate is applied.

³ Based on allowance broker quotes.

⁴ Council Resolution 10077 <https://portal.laserfiche.com/Portal/DocView.aspx?id=38224&repo=r-704298fc&searchid=a464f6a9-e18c-49c1-923b-40260cb517d4>

⁵ Staff Report 7441; <https://portal.laserfiche.com/Portal/DocView.aspx?id=51422&repo=r-704298fc>

costs in this forecast include \$0.7 million for the cross-bore program in FY 2026. The safety program ensures that gas pipelines have not crossed through sewer laterals, which is rare but possible during trenchless installation. This "cross-bore" configuration poses a risk of gas leaks as due to accidental cut by a plumber using a cutting tool to clear a sewer line. While a majority of sewer laterals have been inspected, staff has come across several services which are unable to be scoped, due to either infiltration by roots or broken/collapsed pipe segments. Figure 3 shows the actual operations costs through FY 2024 and projected operations costs for the Gas Utility from FY 2025 through FY 2030.



Capital Improvement Program

Staff anticipates annual capital expenditures will vary during the forecast period due to plans for larger main replacement projects every other year, instead of smaller projects every year. This main replacement schedule allows the Gas Utility to meet its main replacement needs while addressing challenges in the current construction market and optimizing current staffing resources. Overall CIP costs are expected to increase by around 6% on average annually from FY 2025 through FY 2030.

On May 9, 2024, the Gas Utility received a recommendation letter from the U.S. Department of Transportation's 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 for replacement of 4.8 miles of leak-prone steel pipe and purchase of leak survey equipment, that is additional to the utility's already-planned capital work over the next five-year period. This grant

will replace and provide the full funding for GMR 25 and this replacement will take place in FY 2026 and FY 2027. About \$3.7 million that was already reappropriated for this project from FY 2024 will return to the Operations Reserve. The original GMR 25 budget of \$9.8 million, initially scheduled for FY 2025, has been reallocated and split between GMR 26 and GMR 27, with construction now planned for FY 2027 and FY 2029, respectively. CPAU will continue to look for other grant opportunities to help fund the replacement of PVC and steel distribution mains in the gas system.

This financial forecast also includes transfers of about \$1 million and \$4 million each year in FY 2027 to FY 2030 from the Operations Reserve to gradually increase the currently depleted CIP Reserve to within the guideline range by end of FY 2028.

As residential and commercial buildings in Palo Alto are electrified, the City may be able to retire some PVC and steel mains in neighborhoods where these materials exist. Staff is developing an efficient phasing plan for electrification and the scaling back of the gas infrastructure, while assessing both operations and financial implications. Some decommissioning and electrification costs are included in the CIP budgets.

Table 4 shows the current status of these project categories and projected spending. In addition to the table shown below, CIP budgets include \$3 million annually in gas decommissioning costs from FY 2028 through FY 2030.

Table 4: Budgeted Gas CIP Spending (\$000)

Project Category	2025	2026	2027	2028	2029	2030
Gas Main Replacement	17,897,958	4,216,000	11,037,421	4,683,622	11,776,731	5,203,111
Gas Tools and Equipment	145,000	100,000	100,000	100,000	100,000	100,000
Ongoing Projects	500,000	1,516,820	1,000,000	1,000,000	1,000,000	1,000,000
Customer Connections	700,000	700,000	700,000	700,000	700,000	700,000
Total	19,242,958	6,532,820	12,837,421	6,483,622	13,576,731	7,003,111
*Includes unspent funds from previous years carried forward or reappropriated into the current fiscal year						

Debt Service

The Gas Utility currently makes debt service payments on one bond issuance. Table 5 shows debt service for this bond and debt service coverage ratio for the financial forecast period. Debt service on this bond will continue through FY 2026.

Table 5: Debt Service Coverage Ratio (\$000)

	FY 2025	FY 2026
Revenues	65,730	80,775
Expenses (Excluding CIP and Debt Service)	(44,163)	(50,179)
Net Revenues	21,568	30,597
Debt Service	799	802
Coverage Ratio	2,698%	3,817%

Reserves

The unprecedented and extreme gas prices experienced in FY 2023 depleted the Gas Utility's reserves. A series of multi-year rate increases to the distribution rates were planned to bring the reserves back within guideline levels. The rate increases in this financial forecast continue that plan to replenish the Gas Utility's reserves over the next several years. The FY 2025 Financial Plan proposed allowing the Operations Reserve to fall below the risk assessment levels for FY 2024 and FY 2025, with a plan to return to within the guideline range by the end of FY 2026. The Operations Reserve is now expected to be above minimum at the end of FY 2025. However, due to the CIP Reserve contributions starting in FY 2027, the Operations Reserve is expected to remain close to the minimum guideline levels: it is expected to be at target levels by FY 2030. Figure 4 shows the actual year-end balance in the Operations Reserve from FY 2018 to FY 2024 and projected from FY 2025 through FY 2030.

Figure 4: Operations Reserve Projection

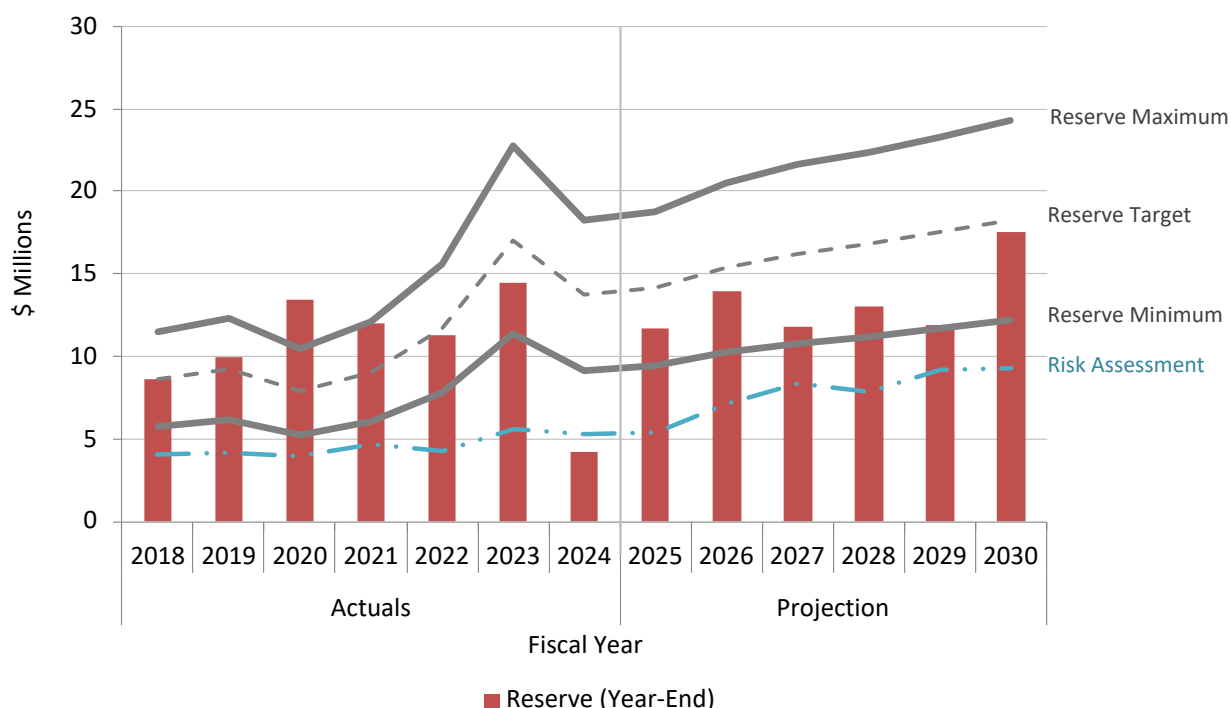


Table 6 summarizes the risk assessment calculation for the Gas Utility through FY 2030. The risk assessment is intended to be covered by the Operations Reserve and includes the revenue shortfall that could occur due to:

1. Maximum non-commodity revenue percentage variance from the previous ten years; and
2. An increase of 10% of planned system improvement CIP expenditures for the budget year.

Table 6: Gas Risk Assessment (\$000)

	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029	FY 2030
Total non-commodity revenue	36,754	41,131	45,295	49,599	54,285	59,344
Risk of Revenue Loss @14%	5,157	5,771	6,356	6,960	7,617	8,327
CIP Budget	2,068	14,070	20,375	8,784	15,877	9,303
CIP Contingency @10%	207	1,407	2,037	878	1,588	930
Total Risk Assessment value	5,364	7,178	8,393	7,838	9,205	9,257

Reserve Transfers

Staff estimates that the gas price mitigation adder in the gas commodity charge will collect about \$1.126 million in FY 2025 for the gas hedging program. Although these funds are initially collected in the Operations Reserve, they should be transferred to the Gas Distribution Rate Stabilization Reserve to be available to mitigate the impact of potential gas market price spikes exceeding the maximum gas commodity charge to customers. To support this objective, staff proposes transferring up to \$1.5 million from the Gas Utility Operations Reserve to the Gas Distribution Rate Stabilization Reserve at the end of FY 2025. The exact transfer amount will be determined at year end based on calculations aligned with the gas hedging program.

Reserve Balances

Figure 5 shows the CIP Reserve balances from FY 2018 through FY 2030. The CIP Reserve is currently depleted; however, planned transfers in FY 2027 through FY 2030 will replenish the CIP Reserve to within guideline range. With these transfers, the CIP Reserve would reach the minimum guideline level by FY 2028. Per the Reserves Management Practices (Attachment D), Section 6, any rate plan that does not return CIP reserves above minimum levels within one year requires Council approval.

Figure 5: Gas CIP Reserve Levels for FY 2018 through FY 2030

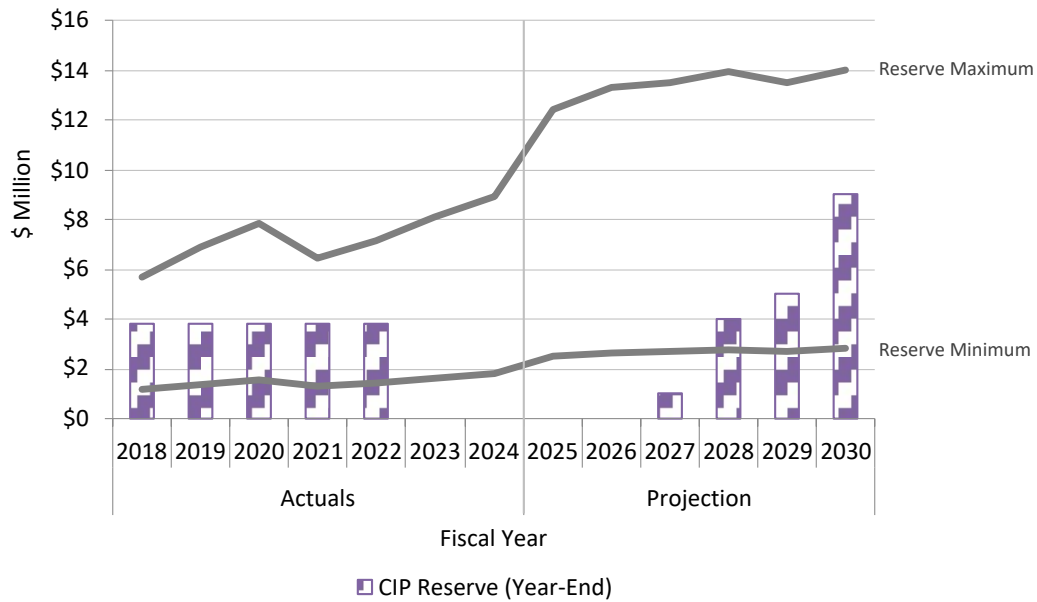


Figure 6 shows year-end reserve balance levels for each reserve from FY 2018 through FY 2030. Table 7 shows reserve starting and ending balances, revenues, transfers expenses, capital program contribution and operations reserve guideline levels from FY 2025 to FY 2030.

Figure 6: Gas Utility Reserves; Actual Reserve Levels for FY 2018 through FY 2024 and Projections FY 2025 through FY 2030

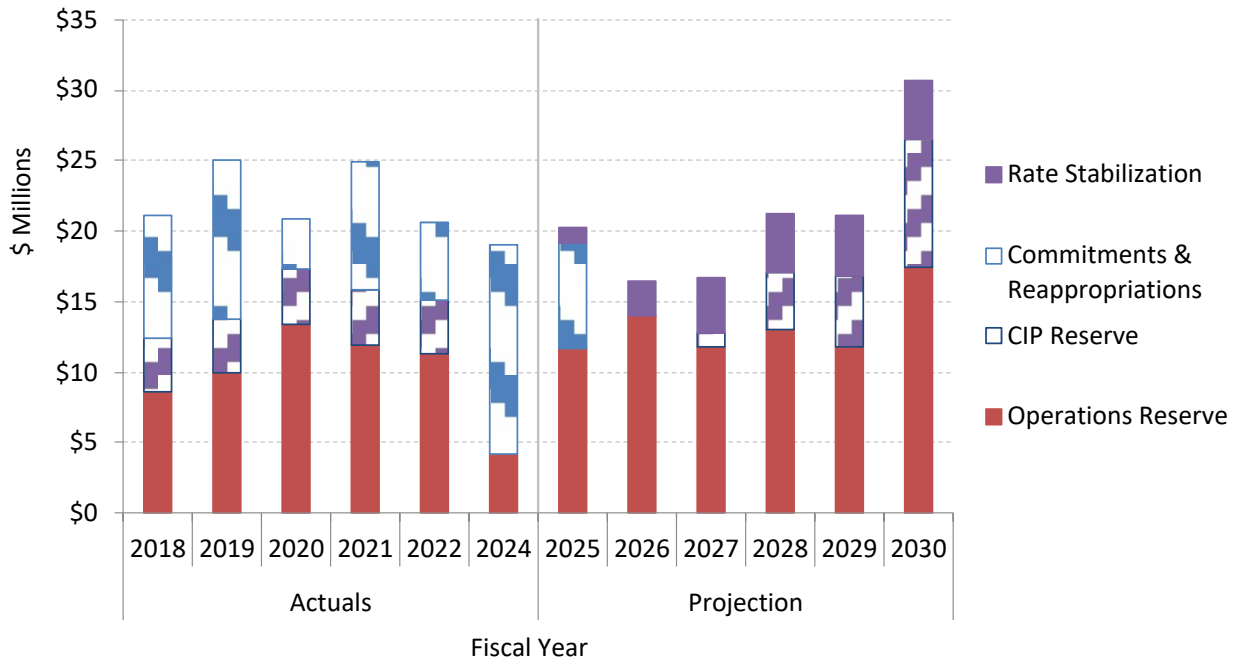


Table 7: Operations, CIP, Cap-and-Trade, and Debt Service Reserve Starting and Ending Balances, Revenues, Transfers To/(From) Reserves, Capital Program Contribution To/(From) Reserves, and Reserve Guideline Levels for FY 2025 to FY 2030 (\$000)

Fiscal Year		2025	2026	2027	2028	2029	2030
Starting Reserve Balances							
1	Operations Reserve*	4,257	11,733	13,959	11,997	13,453	12,452
2	Rate Stabilization	-	1,126	2,543	3,953	4,248	4,248
3	CIP Reserve	-	-	-	1,000	4,000	5,000
4	Cap-and-Trade	13,568	16,902	13,724	11,066	8,408	5,750
5	Debt Service Reserve	313	313	313	-	-	-
Revenues							
6	Total Revenues	62,590	77,360	83,237	79,528	84,852	90,456
7	Cap-and-Trade	3,141	3,416	3,690	3,959	4,221	4,470
Expenses							
8	Non-CIP Expenses	(55,191)	(59,358)	(62,393)	(64,500)	(67,146)	(69,940)
9	Planned CIP	(3,682)	(15,775)	(22,120)	(10,571)	(17,707)	(11,179)
10	Cap-and-Trade	(900)	(6,993)	(6,748)	(7,017)	(7,279)	(7,528)
Transfers							
11	Operations Reserve*	618	(3,416)	(4,377)	(6,959)	(5,221)	(8,470)
12	Rate Stabilization	1,126	1,418	1,410	295	-	-
13	CIP Reserve	-	-	1,000	3,000	1,000	4,000
14	Cap-and-Trade	4,233	3,816	4,090	4,359	4,621	4,870
15	Funds Restricted for Debt Service Obligations	-	-	(313)	-	-	-
Ending Reserve Balances/Restricted Funds							
1+6+7+8+9+11	Operations Reserve*	11,733	13,959	11,997	13,453	12,452	17,789
2+12	Rate Stabilization	1,126	2,543	3,953	4,248	4,248	4,248
3+13	CIP Reserve	-	-	1,000	4,000	5,000	9,000
4+10+14	Cap-and-Trade	16,902	13,724	11,066	8,408	5,750	3,093
5+15	Funds Restricted for Debt Service Obligations	313	313	-	-	-	-
Operations Reserve Guidelines							
16	Minimum	9,589	10,319	10,863	11,254	11,732	12,232
17	Maximum	19,177	20,638	21,726	22,507	23,463	24,464
CIP Reserve Guidelines							
18	Minimum	2,485	2,667	2,705	2,794	2,700	2,805
19	Maximum	12,425	13,335	13,527	13,969	13,502	14,025

*Operations Reserve represents the Gas Supply Fund Rate Stabilization Reserve and the Gas Distribution Fund Operations Reserve combined.

Natural Gas Cost of Service and Rate Study

The Gas Utility's rates are evaluated and implemented in compliance with cost-of-service requirements set forth in the California Constitution and applicable statutory law. Staff engaged the services of EES Consulting (EES) to review and revise the Gas Utility's Cost of Service (COS)

for FY 2026.⁶ A copy of the FY 2026 COS study titled “City of Palo Alto Natural Gas Cost of Service and Rate Study,” (Natural Gas Cost of Service and Rate Study), February 2025 is included as Attachment F to this report. The study examines and allocates the Gas Utility’s costs to each rate class to develop proposed FY 2026 distribution rates and includes a recommendation to refine the G-2 rate schedule as explained below. This financial forecast is based on staff’s assessment of the financial position of the Gas Utility using the methodology from the Natural Gas Cost of Service and Rate Study described above.

Refinement of G-2 (Residential Master-Metered and Commercial Gas Service) Rate Schedule

The Natural Gas Cost of Service and Rate Study recommends a refinement of the G-2 rate schedule. Based on its review of existing G-2 services’ meter capacities, associated costs and recorded sales, the study recommends 3 meter capacity groupings for G-2 by Standard Cubic Feet per Hour (scfh), with a higher monthly service charge for larger meter capacity. The G-2 customer class has a wide range of meter types and capacities. The larger meters require a higher cost to serve because generally they have higher average use, require larger service lines to connect the meter to the distribution system, and impose greater demand on the system. This meter capacity grouping refinement will better reflect customer-related fixed costs in the fixed monthly service charge. The volumetric distribution charge is the same for all G-2 customers.

Table 8 presents the meter capacity groupings recommended for G-2 monthly service charge application. Section 4.1.2 of the Natural Gas Cost of Service and Rate Study (Attachment F of this report) describes the recommended refinement in the development of Monthly Service Charge for G-2, including analysis of G-2 meter capacities, usage and allocated costs. EES analyzed average consumption for various meter capacities in the G-2 rate class, and developed 3 meter capacity ranges and customer-related costs for each range. The proposed G-2 Monthly Service Charge is higher for larger capacity meters to reflect higher fixed costs.

Table 8: G-2 Service by Maximum Meter Capacity⁷

G-2 Service by Maximum Meter Capacity	Range	# of Services
G-2: ≤ 220 scfh	Less than 220 standard cubic feet per hour (scfh)	1,134
G-2: > 220 and < 4,000 scfh	More than 220 scfh and less than 4,000 scfh	942
G-2: ≥ 4,000 scfh	4,000 scfh and above	116

Distribution Revenue Requirement

The Natural Gas Cost of Service and Rate Study contains gas sales forecasts and estimates for Gas Utility assets and expenses (including estimated contributions to reserves). The Natural Gas Cost

⁶ Since FY 2021, the City has adjusted its distribution rates annually based on the COS study for FY 2020, which was also conducted by EES.

⁷ Meter capacities in this staff report are all at an assumed pressure of 7 inches of water column (equivalent to 0.25 pounds per square inch).

of Service and Rate Study allocates these asset and expense estimates using updated classification and allocation factors to ensure that the Gas Utility's costs are properly assigned to each rate class.

For FY 2026, the Natural Gas Cost of Service and Rate Study estimates a \$41.3 million distribution revenue requirement⁸ – the amount to be recovered through distribution rates via G-1, G-2 and G-3 rate schedules. Current distribution rates (effective beginning July 1, 2024) at the same FY 2026 sales forecast would generate only \$38.0 million in revenue and result in a \$3.3 million revenue shortfall. Thus, an 8.7% overall increase in distribution rates is needed to generate sufficient revenue to cover FY 2026 distribution revenue requirement.

Table 9 below presents a comparison of estimated revenue at current distribution rates and the FY 2026 distribution revenue requirement. The Natural Gas Cost of Service and Rate Study's updates and adjustments to classification and allocation factors⁹ result in a revenue requirement distribution (among the rate schedules) that differs from the prior cost study. Thus, the percentage of revenue increase needed varies by rate schedule—ranging from 0% for G-2 to 15.6% for G-1. Tables 11 and 12 in the Proposed Rates section of this report present the current and proposed rates associated with the following COS revenue requirement estimates.

Table 9: COS Revenue Requirement and Revenue Increase

FY 2026	Total	G-1	G-2	G-3
Distribution Only				
Revenues at Current Rates	\$37,957,863	\$16,311,063	\$16,565,086	\$5,081,713
Allocated Revenue Requirement	\$41,268,342	\$18,853,368	\$16,568,614	\$5,846,360
Revenue Shortfall	(\$3,310,479)	(\$2,542,305)	(\$3,527)	(\$764,647)
% Revenue Increase Needed	8.7%	15.6%	0.0%	15.0%

Table 10 below presents revenue and revenue requirement results associated with the proposed G-2 meter capacity groupings. The Natural Gas Cost of Service and Rate Study uses these revenue requirements to develop the proposed monthly service charges and the uniform distribution charge for the G-2 rate schedule (presented in Table 12 of this report).

⁸ This includes distribution costs, certain supply costs that are not paid for by pass-through supply charges (such as administrative charges allocated to gas supply), and additional amounts required to restore the gas utility's operations reserve to within the guideline range in FY 2026.

⁹ For example: update in meter costs; adjustment to factor used to allocate General Fund Transfer to rate classes. See Natural Gas Cost of Service and Rate Study (Attachment F of this report) for more details.

Table 10: COS Revenue Requirement and Revenue Increase, G-2

FY 2026	G-2 Rate Schedule	G-2: ≤ 220 scfh	G-2: > 220 and < 4,000 scfh	G-2: ≥ 4,000 scfh
Distribution Only				
Revenues at Current Rates	\$16,565,086	\$2,948,824	\$7,685,399	\$5,930,863
Allocated Revenue Requirement	\$16,568,614	\$1,713,540	\$7,987,841	\$6,867,232
Revenue Shortfall	(\$3,527)	\$1,235,283	(\$302,442)	(\$936,369)
% Revenue Increase Needed	0%	-41.9%	3.9%	15.8%

Proposed Rates

Table 11 shows the current and proposed monthly service charges, while Table 12 shows the volumetric charges related to distribution for all rate schedules. As previously noted, supply-related charges are pass-through charges that update periodically. The latest charges are shown in the City's Rates website¹⁰. The proposed rates reflect the Natural Gas Cost of Service and Rate Study adjustments conducted this year, which recommends a refinement of the G-2 rate schedule by establishing three meter capacity groupings.

¹⁰ City's Rates Website <https://www.cityofpaloalto.org/files/assets/public/v/25/utilities/rates-schedules-for-utilities/residential-utility-rates/monthly-gas-volumetric-and-service-charges-residential-3.pdf>

Table 11: Current and Proposed Monthly Service Charges

Rate Schedule	Current Rates (as of 7/1/24)	Proposed Rates (effective 7/1/25)	Change (\$)	Change (%)
G-1 (<i>Residential</i>)	\$ 16.93	\$ 19.52	\$ 2.59	15.3%
G-2 (<i>Small Commercial</i>)				
G-2 (≤ 220 scfh)	156.90	29.06	(127.84)	(81.5%)
G-2 (> 220 and $< 4,000$ scfh)	156.90	94.94	(61.96)	(39.5%)
G-2 ($\geq 4,000$ scfh)	156.90	417.62	260.72	166.2%
G-3 (<i>Large Commercial</i>)	717.89	1,731.67	995.78	138.7%
G-10 (<i>CNG</i>)	106.11	115.34	9.23	8.7%

Table 12: Current and Proposed Gas Distribution Charges

Rate Schedule	Current Rates (as of 7/1/24)	Proposed Rates (effective 7/1/25)	Change (\$)	Change (%)
G-1 (<i>Residential</i>)				
Tier 1 Rates	\$ 0.8229	\$ 1.2274	\$ 0.4045	49.2%
Tier 2 Rates	2.1043	1.8972	(0.2071)	(9.8%)
G-2 (<i>Residential Master-Metered and Small Commercial</i>)				
Uniform Rate	\$ 1.0809	\$ 1.2616	\$ 0.1807	16.7%
G-3 (<i>Large Commercial</i>)				
Uniform Rate	\$ 1.0702	\$ 1.1616	\$ 0.0914	8.5%
G-10 (<i>Compressed Natural Gas</i>)				
Uniform Rate	\$ 0.0175	\$ 0.0190	\$ 0.0015	8.6%

Bill Impacts

Table 13 shows the impact of the proposed July 1, 2025 rate changes on the median monthly residential bill for representative average winter and summer bills, excluding supply-related cost changes. The annual gas bill for the median residential customer is projected to be 21% higher in FY 2026 than FY 2025. This increase is due to the overall 5% revenue increase needed system-wide together with the cost of service adjustments. The actual impact may be different because customer gas usage varies and commodity price changes monthly. Table 13 shows a representative winter period (November thru March) and summer period (April through October) bill comparison.

Table 13: Impact on Residential Monthly Bill due to Proposed Gas Rate Changes¹¹

Usage (Therms/month)	Bill Amount (Current Rates)	Bill Amount (Proposed Rates)	Change	
			\$/mo.	%
Summer				
10	\$ 33.75	\$ 40.38	\$ 6.64	19.7%
17 (median)	45.52	54.99	9.47	20.8%
30	79.70	86.50	6.80	8.5%
45	124.15	127.84	3.69	3.0%
Winter				
30	\$ 68.69	\$ 83.41	\$ 14.73	21.4%
51 (median)	104.92	128.14	23.22	22.1%
80	180.07	203.03	22.96	12.8%
150	390.54	399.00	8.47	2.2%
Annual Median	\$ 70.27	\$ 85.47	\$ 15.20	21.6%

Table 14 shows the impact of the proposed rate changes, effective July 1, 2025, on representative commercial customer bills, excluding supply-related cost changes. The G-2 usage levels listed below represent the median usage for the three G-2 rate class groupings, as recommended by the Natural Gas Cost of Service and Rate Study. G-2 customers with meter capacity within the lowest (proposed) capacity range and corresponding lower usage would see a significant reduction in monthly bill because of the proposed change in Monthly Service Charge (e.g., representative bill at 35 therms/month in Table 14 below reflects a reduction of \$127.84 in Monthly Service Charge, partially offset by the volumetric rate increase). For the G-3 rate class, the usage reflects a sample large commercial customer with an annual consumption of approximately 250,000 therms.

¹¹ Current rates are derived from actual commodity prices up to January 2025 and forecasted prices until June 2025. Proposed rates, while based on the same supply-related rates as current rates, incorporate adjustments solely in the increase of distribution rates.

Table 14: Impact on Commercial Monthly Bill due to Proposed Gas Rate Changes¹²

Usage (Therms/month)	Bill Amount (Current Rates)	Bill Amount (Proposed Rates)	Change	
			\$/mo	%
G-2 (Residential Master-Metered and Small Commercial)				
35	\$ 226.51	\$ 105.07	\$ (121.44)	-54%
280	706.04	694.62	(11.42)	-2%
2,648	5,356.93	6,096.22	739.29	14%
G-3 (Large Commercial)				
20,834	\$ 41,287.45	\$ 44,187.46	\$ 2,900.01	7%

Bill Comparisons/Competitiveness

Table 15 presents the median residential bills for Palo Alto and PG&E customers from FY 2022 to FY 2026. The bill calculations for PG&E customers are based on PG&E Climate Zone X, an area which includes Palo Alto's surrounding communities.

In FY 2023, the annual gas bill for the median Palo Alto residential customer was about \$892, or 6% higher compared to a PG&E customer with equivalent consumption. This is attributed to the gas price spike during the winter of 2022/2023, which impacted all California utilities except PG&E, which avoided exceptionally high gas prices.

In FY 2025, the estimated annual gas bill for the median Palo Alto residential customer is projected to be about 16% lower than that of a PG&E customer with equivalent consumption. With the implementation of the Natural Gas Cost of Service and Rate Study adjustment and the proposed rate increases, Palo Alto median residential bills are expected to be about 3% lower than PG&E bills in FY 2026. It is important to note that this 3% difference is likely understated, as this projection assumes PG&E does not implement additional rate increases between now and July 2026.

Table 15: Residential Annual Natural Gas Bill Comparison (\$/year)

Time Period	Median Usage	Palo Alto	PG&E Zone X	% Difference
FY 2022	Annual (374 Therms)	\$ 657.83	\$ 724.24	(9%)
FY 2023		891.89	845.03	6%
FY 2024		753.28	764.70	(1%)
FY 2025*		843.26	1,008.72	(16%)
FY 2026 **		1,025.62	1,052.11	(3%)

*Calculated based on actual and projected rates

**Calculated based on projected rates

¹² Current rates are derived from actual commodity prices up to January 2025 and forecasted prices until June 2025. Proposed rates, while based on the same supply-related rates as current rates, incorporate adjustments solely in the increase of distribution rates.

Table 16 presents the median commercial bills for Palo Alto and PG&E customers from FY 2022 to FY 2026. Palo Alto bills have been higher than PG&E's bills over the years, mainly due to higher customer charges. With this COS adjustment, commercial customer charges have been adjusted downward for the majority of commercial customers, making bills more competitive with PG&E. With the implementation of the COS adjustment and the proposed rate increases, Palo Alto median commercial bills are expected to be about 24% higher than PG&E bills in FY 2026, assuming PG&E does not implement additional rate increases.

Table 16: Commercial Annual Natural Gas Bill Comparison (\$/year)

Time Period	Median Usage***	Palo Alto	PG&E Zone X	% Difference
FY 2022	Annual G-2 (3,356 Therms)	6,507.57	5,602.19	16%
FY 2023		8,844.11	6,506.91	36%
FY 2024		7,426.78	6,022.59	23%
FY 2025*		8,472.51	6,523.21	30%
FY 2026**		8,335.42	6,727.68	24%

*Calculated based on actual and projected rates

**Calculated based on projected rates

***Calculated based on G-2 with meter capacity of >220 and <4,000 scfh

Climate Credit Option

As shown in Table 13 above, median residential gas bills are expected to increase by about 21.6% (approximately \$15.20 per month or \$182.40 per year) in FY 2026, compared with FY 2025. The Gas Utility is a covered entity under California's Cap-and-Trade program. CARB's Cap-and-Trade regulations authorize utilities to distribute Cap-and-Trade auction proceeds to some or all ratepayers in a non-volumetric manner. Thus, Council may authorize staff to distribute approximately \$1.6 million in Cap-and-Trade reserve funds to provide a one-time flat \$73.20 climate credit to each residential gas customer in FY 2026,¹³ lessening the rate increase impact to the median residential customer from approximately \$182.40 to \$109.20 for FY 2026. While the credit only applies to gas customers, the \$73.20 credit would be the equivalent of reducing an overall utility median bill increase for electric, gas, water, wastewater, refuse, and stormwater from 11% to 9% for FY 2026. Cap-and-Trade revenues are earmarked for the benefit of retail natural gas ratepayers and for GHG emission reduction activities, and subject to any limitations imposed by Council. For context, \$1.6 million is approximately the cost to fully electrify 182 homes.

¹³ In accordance with the California Cap-and-Trade Program, specifically California Code of Regulations, Title 17, Section 95893(d)(3)(C) https://ww2.arb.ca.gov/sites/default/files/2021-02/ct_reg_unofficial.pdf, utilities are authorized to distribute Cap-and-Trade auction proceeds to some or all ratepayers in a non-volumetric manner.

Cap-and-Trade Reserve Transfer

In accordance with Section 11 of the Gas Reserve Management Practices and Council-approved Cap-and-Trade revenue uses (Council Resolution 10077¹⁴), staff is authorized to transfer revenues from allocated allowance auction proceeds to the Cap-and-Trade Reserve at the end of each fiscal year. Additionally, staff may utilize funds from the Cap-and-Trade Reserve to support greenhouse gas (GHG) reduction programs by transferring funds from the Cap-and-Trade Reserve to the Operations Reserve.

Under the Cap-and-Trade Regulation, interest earned on allocated allowance auction proceeds is considered value derived from the allocation of allowances and is subject to the same distribution requirements. Staff has determined that the accumulated interest amounts to \$1,092,855.17 from Calendar Year (CY) 2015 to CY 2024. Therefore, staff will transfer this amount from the Operations Reserve to the Cap-and-Trade Reserve in addition to the annual transfers of allocated allowance revenue and program expenses. Going forward this calculation and transfer will be done annually.

General Fund Transfer

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. This financial forecast proposes a transfer of \$9.735 million in FY 2026, 18% of FY 2024 gross revenues. This transfer of 18% is in alignment with the assumptions in the FY 2025 Adopted Budget process.

Next Steps

Staff will incorporate the Finance Committee's recommendations into the draft financial forecast and attachments and bring those to the City Council in June. The City Council will consider the proposed financial forecast and rate schedules with the FY 2026 budget review and adoption process in June 2025. If Council approves the proposed rate changes, the rates will become effective July 1, 2025.

FISCAL/RESOURCE IMPACT

The resource impact of the recommendations summarized in this report is the continued financial solvency of the Gas Utility and, as the City is a ratepayer, an increase to General Fund expenses (due to the rate increases) and revenues (due to the General Fund transfer).

Based on the proposed rates increase as shown, the estimated revenue impacts in FY 2026 would be an increase of \$3.3 million in the Gas Fund, not including fluctuations in commodity

¹⁴ Council Resolution 10077 <https://portal.laserfiche.com/Portal/DocView.aspx?id=38224&repo=r-704298fc&searchid=a464f6a9-e18c-49c1-923b-40260cb517d4>

revenue/cost. Utility rate increases impact the general fund because the City is a customer of the Gas Utility. The impact to the general fund from the proposed rate increases is a \$0.17 million expense increase. Additionally, the change in General Fund revenues from FY 2025 to FY 2026 would decrease from \$10.917 million in FY 2025 to \$9.735 million in FY 2026, a decrease of about \$1.183 million. The FY 2025 transfer was unusually high because it was based on FY 2023 revenue, which was elevated due to the gas price spike during the winter of 2022-23.

POLICY IMPLICATIONS

The proposed Gas Utility rate adjustments are consistent with Council-adopted Reserve Management Practices (Attachment D) and were developed using a cost-of-service study and methodology consistent with the California constitution and industry-accepted cost of service principles. If reserves fall below the minimum guidelines, Council approval is required for a rate plan that requires more than one year to return reserves to within guideline levels. This staff report serves as the required plan.

STAKEHOLDER ENGAGEMENT

Staff presented preliminary rate proposals to the Finance Committee on December 3, 2024¹⁵ for discussion only. One Committee member asked about the impact of population changes and one Committee member said that demographic changes should be included. Staff explained that the projection assumes lower gas sales due to electrification and we are considering population and factoring in electrification.

Staff presented preliminary rate proposals to the UAC on December 4, 2024¹⁶ for discussion only. One Commissioner asked about how electrification was incorporated in the forecast and staff explained that an outside consultant performed a regression with an electrification scenario that was used for the gas purchase forecast. Commissioners asked about reserve guidelines and reserve levels. One Commissioner expressed interest in the true cost of gas, considering the environmental externalities.

On April 2, 2025, staff presented rate proposals to the UAC. The UAC recommended approval of this proposal with a 5-1 vote with one abstention. The Commissioner who voted against the staff proposal expressed concern about the cost of service study results and in particular the increase in rates for the residential (G-1) customer class. The UAC also recommended through a 6-1 vote to recommend to the Finance Committee and Council to approve the use of approximately \$1.6 million of Cap-and-Trade allowance auction proceeds to provide a one-time flat climate credit of

¹⁵ December 3, 2024 Finance Committee Meeting, Staff Report
<https://portal.laserfiche.com/Portal/DocView.aspx?id=111748&repo=r-704298fc>, Minutes
<https://portal.laserfiche.com/Portal/DocView.aspx?id=117363&repo=r-704298fc>, Video
<https://www.youtube.com/watch?v=tshOdaDA3A%3Ffeature%3Dshare>

¹⁶ December 4, 2024 Utilities Advisory Commission, Staff Report
<https://cityofpaloalto.primegov.com/Portal/viewer?id=0&type=7&uid=d7cd6030-1d05-412e-a96b-cabd33557bc1>, Minutes
<https://portal.laserfiche.com/Portal/DocView.aspx?id=123724&repo=r-704298fc>, Video
<https://www.youtube.com/watch?v=tfznidSYXiU%3Ffeature%3Dshare>

\$73.20 to each residential (G-1) customer only in FY 2026. The Commissioner who voted against the climate credit option said that green funds should not be used to subsidize the use of fossil fuels. The video of the meeting is available on the City's website at the following link: <https://www.youtube.com/watch?v=021zJQHLADI>

Attachment E contains examples of CPAU's communication and outreach methods including the use of the utilities website, utility bill inserts, messaging on utility bills, and MyCPAU online account management platform, email newsletters, print and digital ads in local publications, social media, and community messaging platforms.

ENVIRONMENTAL REVIEW

The Finance Committee's review and recommendation to the Finance Committee on the FY 2026 Gas Utility financial forecast and rate adjustments does not meet the California Environmental Quality Act's definition of a project, pursuant to Public Resources Code Section 21065, thus no environmental review is required.

ATTACHMENTS:

Attachment A: FY26 Gas Resolution
Attachment B: FY26 Gas Rate Schedules
Attachment C: FY26 Gas Utility and CIP Financial Details
Attachment D: FY26 Gas Reserve Management Practices
Attachment E: FY26 Gas Communications Plan and Samples
Attachment F: Natural Gas Cost of Service and Rate Study
Attachment G: Natural Gas Cost of Service Schedules

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