



Finance Committee Staff Report

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

Meeting Date: February 21, 2024
Staff Report: 2312-2468

TITLE

Discussion and Update on the Fiscal Year 2025 Preliminary Utilities Financial Forecast and Rate Projections

RECOMMENDATION

This item is for discussion, and no action is requested. Staff will use input from the Finance Committee on these preliminary rate projections for the Electric, Gas, Water and Wastewater Collection Utilities to finalize its recommended FY 2025 Financial Plans and proposed rate changes for each utility.

EXECUTIVE SUMMARY

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 effects. In 2023, the Council approved the first in a series of rate adjustments to manage some notable and unprecedented trends:

- During the winter of 2022-2023, energy prices increased to unprecedented levels;
- A drought from 2021 through 2023 impacted electric supply costs, wholesale water costs, and customer demand;
- The drought abruptly ended when thirty-one atmospheric rivers from mid-December 2022 to the end of March 2023 established a near-historic snowpack in the Sierra Nevada; and
- Relatively cool and wet weather patterns persisted locally in 2023 and water conservation habits established during the drought together contributed to lower customer water use.

Reserve funds were drawn down during the last three years, and the preliminary projections shown in Table 1 provide a path to steadily restore those reserve levels during the five-year planning period. This series of rate adjustments is necessary to restore reserves to within guideline ranges within the 5-year planning period, sustain operations given inflationary cost increases, and enable ongoing capital work necessary to provide safe, reliable, and sustainable utilities.

Staff is also requesting feedback from the Finance Committee on the amount of the General Fund transfer for the Gas Utility. City voters first authorized the transfer in 1950, and in November 2022 voters approved Measure L, affirming the continuation of this practice by adding section 2.28.185 to the Municipal Code. Each year the City Council may transfer from the Gas Utility to the General Fund an amount up to 18% of gas utility gross revenues, though Council may choose to transfer a lesser amount. For the FY 2024

transfer, the Council approved a transfer from the gas utility to the General Fund of 15.5% of the gross revenues (Resolution 10101). The proposed transfer for FY 2025 aligns with the Council's previous guidance, suggesting an 11.9% or \$8.96 million transfer from the gas utility to the General Fund.

At the meeting, staff will provide a presentation describing the preliminary rate projections for the Electric, Gas, Water and Wastewater Collection utilities. A similar presentation was provided to the Utilities Advisory Commission (UAC) at its January 3, 2024 meeting. The presentation will be available online prior to the meeting.

BACKGROUND

Table 1 shows the preliminary retail rate forecast over the next five fiscal years and the overall impact to the median residential bill. The rate changes shown 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 Electric Utility is expected to be completed in early 2024 and will be factored into proposals for FY 2025. Cost of service studies for the Water and Gas Utilities were completed in 2019, and one for the Wastewater Utility was completed in 2021.

Staff's preliminary system average rate adjustment recommendations are

- 5% increase for electric
- 9% increase for gas
- 9% increase for water (this assumes SFPUC increases the wholesale rate at the low end of its proposed range, however a 13% increase for water is expected if SFPUC increases the wholesale rate at the high end of the range)
- Storm drain rates increase annually by the calendar year change in the Consumer Price Index (CPI) which is 2.6% for FY 2025 and Table 1 estimates the same CPI for future years
- Wastewater, staff originally proposed a 9% increase as shown in Table 1. In response to UAC Commissioner feedback to consider a higher rate increase to avoid deferring sewer infrastructure investment, staff recommends a 15% increase and presents both alternatives in the analysis section below for the Finance Committee's consideration.
- Rates for fiber optic services established prior to September 18, 2006 will also increase by the CPI rate.

Table 1: Projected Residential Rate Changes

	FY 2024 (effective July 1, 2023)	FY 2025 (Projected)	FY 2026	FY 2027	FY 2028	FY 2029
Electric Utility ⁽¹⁾	-\$5.80 -5%	\$4.00 5%	\$4.40 5%	\$4.60 5%	\$4.90 5%	\$5.10 5%
Gas Utility ⁽²⁾	\$5.20 8%	\$6.30 9%	\$5.40 7%	\$5.70 7%	\$5.20 6%	\$5.60 6%
Wastewater	\$4.00 9%	\$7.30 15%	\$5.00 9%	\$5.50 9%	\$5.30 8%	\$5.00 7%
Water Utility	\$5.20 5%	\$9.3 - \$13.5 9% - 13%	\$10.2 - \$10.5 9%	\$12.3 - \$12.8 10%	\$12.2 - \$12.6 9%	\$7.4 - \$7.7 5%
Refuse	\$0.00 0%	\$0.00 0%	\$1.50 3%	\$1.50 3%	\$1.60 3%	\$1.60 3%
Storm Drain ⁽³⁾	\$0.80 5%	\$0.40 3%	\$0.40 3%	\$0.50 3%	\$0.50 3%	\$0.50 3%
Monthly Bill Change ⁽⁴⁾	\$9.40 3%	\$28.3 - \$32.7 7% - 9%	\$27.9 - \$28.3 7%	\$31.3 - \$31.8 7%	\$30.8 - \$31.3 7%	\$26.1 - \$26.4 5%

- 1) Preliminary projection pending completion of a cost of service analysis.
- 2) Based on General Fund transfer of 11.9% of gross revenue in FY25; gas rate changes shown with commodity rates held constant; actual gas commodity rates vary monthly
- 3) Storm Drain fees increase by CPI index annually per approved 2017 ballot measure (2.6% in FY 2025)
- 4) Based on an FY 2023 monthly residential bill of \$369

For the Water Utility, this preliminary projection allows the operations reserve to remain within the guideline range. For the Electric and Wastewater Utilities, the distribution operations reserves dropped below guideline ranges at the end of FY 2023, and staff projects the Gas distribution operations reserve will drop below the guideline range by the end of FY 2024. This proposal would restore the Electric distribution operations reserves to within the guideline range by the end of FY 2025, and for the Gas and Wastewater Utilities by the end of FY 2026.

ANALYSIS

Staff seeks input from the Finance Committee prior to finalizing the Utilities Financial Plans and developing recommendations for rate changes that would be effective July 1, 2024. The proposed rate adjustment recommendations, along with each utility's Financial Plans, are currently scheduled to be presented to the Finance Committee in April.

Every year presentations are provided to the UAC and Finance Committee with financial forecasts for the Electric, Gas, Water, and Wastewater Collection Utilities and recommends any rate adjustments required to maintain their financial health. These forecasts are memorialized in Financial Plans that comprehensively discuss the outlook for each utility. Before providing recommended Financial Plans and rate changes, typically a preliminary forecast is completed to get early feedback.

Electric

In FY 2025 and FY 2026 the electric utility will benefit from significant one-time revenues offset by significant capital investment expenses. Electric supply purchase costs are anticipated to be lower mainly due to the amount of hydroelectric generation resulting from heavy rains in the winter of 2022/2023. Staff also expects substantially higher revenues from resource adequacy and renewable energy credit sales. On the expense side transmission costs continue to rise, and capital spending and distribution system maintenance spending is rising due to grid modernization and fiber-related investments and an upgrade to the Hanover Substation, some of which staff expects to recommend be offset with debt service. On balance, however, 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, especially the Hydro Rate Stabilization Reserve. This ensures that, in the event of a significant degradation in hydro conditions, the City will not need to use the Hydro Rate Adjuster to recover higher supply costs. In addition, an electric utility cost of service analysis is underway, which is conducted to ensure that the cost of running the utility is allocated to customer classes according to the cost to serve them. The cost study will incorporate the revenue and expense data described above to determine resulting rate impacts for all customer classes.

In the longer term (FY 2027 through FY 2029) projected increases in costs related to stricter resource adequacy requirements, increasing transmission costs, and capital investment and operational cost increases that are expected to result in system average rate increases of 5% per year. Projected rate changes for the median residential bill or any other customer may vary from this projection due to the cost of service analysis currently in progress.

The current year (FY 2024) financial plan for the Electric Utility (approved April 17, 2023) is available at:

<https://cityofpaloalto.primegov.com/meeting/attachment/1201.pdf?name=Attachment%20B%20-%20FY24%20Electric%20Utility%20Financial%20Plan>

Gas

Gas fund expenses are currently composed of about 60% supply and 40% distribution expenses. Most of the supply costs are market driven pass-through charges on customers' bills that change monthly according to market conditions. The long-term gas rate increases shown in Table 1 will go towards funding the distribution and capital investment costs of the Gas Utility. Throughout the pandemic, the City opted to cap rate increases at 2% to 3% per year. This decision aimed to minimize rate increases on customers while still aligning with reserve guidelines by scaling down the size of main replacement capital projects. In the winter of 2022 – 2023, gas supply prices spiked to unprecedented levels and Palo Alto's Gas Utility reserves were drawn down to cover the difference between the Council-approved maximum gas commodity charge and the City's actual cost of gas. The reserves need to be replenished over time and the Gas Utility needs to plan for a large main replacement project every other year to ensure safety and reliability while managing ongoing construction cost inflation. Last year, a gas rate increase of 7% in FY 2025 was forecasted. However, given the continuing increases in construction costs, salaries and benefits, overhead costs and reserve levels projected to be below minimum guideline levels at the end of the current fiscal year (FY 2024), staff recommends a 9% overall rate increase for the Gas Utility effective July 1, 2024.

The gas utility's transfer to the City's General Fund is a component of the City's gas rates. City voters first authorized the transfer in 1950, and in November 2022 voters approved Measure L, affirming the continuation of this practice by amending the Municipal Code. Specifically, section 2.28.185, "Natural Gas Utility Transfer" states:

Each fiscal year the City Council may transfer from the natural gas utility to the General Fund an amount equal to 18% of the gross revenues of the gas utility received during the fiscal year two fiscal years before the fiscal year of the transfer. At its discretion, the City Council may decide to transfer a lesser amount. The projected cost of the transfer shall be included in the City's retail natural gas rates as part of the cost of providing gas service.

Measure L authorized Council to make the transfer annually and granted Council the ability to approve a lower amount. On 4/17/2023 Council approved the transfer of up to 15.5% of gas utility gross revenues received during FY 2022 to the General Fund in FY 2024, or \$7,707,000. In the preliminary rate projection, the staff recommendation for the proposed FY 2025 transfer is 11.9% of the gas utility's gross revenues in FY 2023, or \$8,960,000, which aligns with the voter-approved changes codified in PAMC 2.28.185. Though the percentage reduced, the transfer amount remains in line with the guidance Council provided in the FY 2024 Budget Adoption. The percentage is an anomaly as the FY 2025 transfer is based on the unusual actual activities in FY 2023 which included the unprecedented spike in gas prices. Recommended beyond FY 2025 is the continuation of a gradual annual transfer increase to up to 18% of gross revenues by FY 2027. Note that revenues for FY 2026 (two fiscal years prior) and beyond are projected and will fluctuate depending on gas commodity market prices and other factors.

Table 2: Proposed/Projected and Alternate General Fund Transfers as % of Gross Gas Revenues Two FYs Prior

	Approved (Council Resolution 10101)	Proposed / Alternate	Projected	
	FY 2024	FY 2025	FY 2026	FY 2027
Gas Utility Gross Revenue Two Fiscal Years Prior (\$000)				
	\$49,721	\$75,291 ¹	\$61,032	\$70,414 ²
				\$73,618
Percent of gas utility gross revenue to transfer				
	15.5%	11.9%	16.5%	18%
		18%	18%	
Transfer amount (\$000)				
Transfer 11.9%	\$7,707	\$8,960	\$10,070	\$12,674
Transfer 18%		\$13,552	\$10,986	\$13,251
Change in Transfer from Prior Fiscal Year (%)				
	7%	16%	12%	26%
		76%	-19%	21%

Table 3: Summary of Distribution Rate Changes for Transfer Proposal and Alternatives

	FY 2024 (Approved)	FY 2025	FY 2026	FY 2027
Transfer 11.9%	8%	9%	7%	7%
Transfer 18%		15%	5%	5%

The current year (FY 2024) Financial Plan for the Gas utility (approved April 17, 2023) is available at:

<https://cityofpaloalto.primegov.com/meeting/attachment/1188.pdf?name=Attachment%20C%20-%20Gas%20FY2024%20Financial%20Plan>

Water

In FY 2023, customers successfully conserved water in accordance with local, regional and state calls for water conservation. Although the drought came to an end this past winter, the weather continued to be relatively cool and wet throughout the irrigation season and, together with continuing water conservation, this led to reduced water sales and lower revenue for the fiscal year. At the end of FY 2023, the transfer authorized by the City Council of \$3 million from the rate stabilization reserve to the operations reserve was completed. Despite this, the operations reserve was within the guideline range

¹ Represents actual gas utility gross revenues for FY 2023.

² There are two values for gross revenue in FY 2027 because there are two possible rate trajectories shown in Table 3 that would impact the forecasted revenue for FY 2025 (two fiscal years prior to FY 2027); the first would increase rates by 9% in FY 2025 leading to forecasted revenues of \$70.414 million and the second would increase rates by 15% in FY 2025 leading to forecasted revenues of \$73.618 million.

but near the minimum guideline level at the end of FY 2023. Expenses were higher than forecasted due to transfers out, accounting adjustments and capital related costs. The Water Utility needs to plan for some large capital projects in the five-year budget including two reservoir replacements and a large main replacement every other year. A 13% increase on the distribution rates, which is equivalent to a 7% overall system average increase on customers water rates is needed to accommodate inflating construction costs, increases in salaries and benefits and overhead costs, and updated revenue estimates that incorporate ongoing conservation in the short-term. On January 17, 2024, the City's water supplier, the San Francisco Public Utilities Commission (SFPUC), estimated a rate range for its July 1, 2024 rate increase between 4.5% and 13.1%, an increase from the current rate of \$5.21/CCF to between \$5.43/CCF and \$5.89/CCF. The three main drivers of the SFPUC rate increase are cost increases, water sales volume decreases, and funds owed on the wholesale customer balancing account. The overall system average water rate increase including both the wholesale rate increases together with proposed distribution rate increases, is between 9% to 13% in FY 2025. Projections for FY 2026 – FY 2029 assumes inflationary increases of 3% on SFPUC's wholesale rate in each subsequent year.

The current year (FY 2024) financial plan for the Water Utility (approved June 19, 2023) is available at: <http://cityofpaloalto.org/civicax/filebank/documents/76983>

Wastewater Collection

Last year, the Council approved the first of a series of rate increases with the understanding that the City would accelerate the rate of sewer main replacements from 1 mile to 2.5 miles per year by FY 2026. This is a sustainable rate of main replacement needed to replace sewer mains within, or as close as possible to, their 100 year life expectancy. Additionally, in FY 2023 the Wastewater Utility accelerated by a year the most expensive sewer main replacement that the utility has ever completed. This project is double the cost of the second largest project in 2021. It was important to coordinate the work with Caltrans to limit or avoid digging into newly-paved street on El Camino. Council approved transfers of all funds from the CIP Reserve (\$3.178 million) and from the Rate Stabilization Reserve (\$0.34 million) to the operations reserve to utilize all available funds. Staff projected that this project would bring the operations reserve temporarily down to the minimum guideline range.

However, in FY 2023 costs were higher than forecasted, primarily for CIP-related costs and transfers out to capital projects, and revenue was lower than forecasted (primarily capacity fee revenue, which varies from year to year) and the operations reserve ended the year with negative \$0.7M. Additionally, in the current year, non-residential revenues are declining instead of increasing as a result of wet weather and reductions in winter water usage.

Under consideration is deferring the five-mile main replacement planned for FY 2026 due to the low reserve and revenue levels and the inflationary costs.

It is still important for the sustainable management of sewer main replacement to achieve replacing 2.5 miles per year. However, given the current reserve levels and revenue impacts, it will take more time than initially projected last year in order to reach the sustainable replacement rate. If the City replaces the last 138 miles of the sewer main over the next 60 years and executes the five-mile project in FY 2026, the final main would be replaced at the age of 108, which is 8 years past its useful life. By postponing the FY 2026

project and adding a new one at the end of the 60-year period, the last main would be replaced at around 111 years old, exceeding its useful life by 11 years.

This will allow time for the Wastewater Utility revenues to increase in line with expected costs and for the reserves to return to within the guideline range by the end of FY 2026. However, by deferring sewer main replacement planned for FY 2026 to the end of the ~60 year cycle, construction cost inflation will mean that customers have to pay market prices at that time, and the total costs may be much higher.

Wastewater treatment costs are projected to rise over the next several years due to higher capital improvement project costs and debt service or loan repayments at the Regional Water Quality Control Plant (RWQCP). A series of large increases in treatment costs are planned during the next five years to address aging infrastructure at the treatment plant.

During the UAC's January 3, 2024 meeting, a 9% rate increase in FY 2025 for the Wastewater Utility was presented. Based upon feedback from the UAC Commissioners during the meeting, a scenario with a 15% rate increase in FY 2025 has been molded that allows a sewer replacement project of a reduced size to continue in FY 2026, while each option resumes the 2.5 miles per year of sewer main replacement in FY 28.

- 15% rate increase in FY 25 (\$7.29 per residential customer per month)
 - 7-9% per year rate increases in FY 26 – FY 29
 - Continue with planned sewer replacement with \$1M in FY 25 and \$2M in FY 26
 - \$2M Pump station retrofit in FY 28

Table 4 shows the projected residential bill impact and each rate increase trajectory together with estimated monthly bill and net difference in monthly bills from FY 2025 through FY 2029. The difference between the 15% and 9% alternatives is \$2.92 in FY 2025 and ranges from \$1.96 to \$3.46 per month for residential customers in each subsequent year.

Table 4: Projected Residential Bill Impact, Rate Increase Percentage, Estimated Monthly Sewer Bill, and Net Difference in Monthly Bills FY 2025 to FY 2029

	Alternatives	FY 2025	FY 2026	FY 2027	FY 2028	FY 2029
Estimated Bill Impact for Residential Customers (\$/mo.) and Rate Increase Percentage (1)	Proposal: 15% in FY 2025	7.29	5.03	5.48	5.31	5.02
		15%	9%	9%	8%	7%
	Alternative: 9% in FY 2025	4.37	4.77	5.20	5.66	6.17
		9%	9%	9%	9%	9%
Estimated Monthly Sewer Bill (\$)	Proposal: 15% in FY 2025	55.93	60.96	66.44	71.75	76.77
	Alternative: 9% in FY 2025	53.01	57.78	62.98	68.64	74.81
Net Difference in Monthly Bills (\$)	15% vs. 9% in FY 2025	2.92	3.18	3.46	3.11	1.96

(1) estimated impact on residential wastewater monthly bill, which is currently \$48.64

The most recent (FY 2024) financial plan for the Wastewater Collection Utility (approved June 19, 2023) is available at:

<https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/reports/city-manager-reports-cmrs/attachments/03-07-2023-id-2302-0944-ww-financial-plan-lisa.pdf>

FISCAL/RESOURCE IMPACT

Based on the preliminary rate increases as shown, the estimated distribution revenue impacts in FY 2025 would be an increase of \$4.4 million in the Water Fund if the SFPUC increases the wholesale water rate to \$5.43/CCF (up to \$6.3 million in the Water Fund if the SFPUC increases the wholesale water rate to \$5.89/CCF), an increase of \$3.3 million in the Wastewater Collection Fund at the 15% rate increase level in FY 2025 (\$2.0 million in the Wastewater Collection Fund at the 9% rate increase level in FY 2025) and \$5.1 million in the Gas Fund. For the Electric Fund, the revenue change for FY 2025 is uncertain but is not expected to increase significantly despite the rate changes. This is due to various factors, including forecasted load reduction in FY 2025 and the implementation of the cost of service analysis, which is expected to yield higher rate changes for some customer classes than others.

STAKEHOLDER ENGAGEMENT

The UAC reviewed the preliminary financial forecasts at its January 3, 2024 meeting. Input from Commissioners was sought regarding the preliminary rate adjustment recommendations and the transfer amount from the gas utility to the general fund for FY 2025. Commissioners asked about the effect on Palo Alto customers from PG&E electric transmission cost increases, the marginal cost of electric transmission, how much surplus energy Palo Alto has, and they asked for more information about each of the electric reserve transfers. One Commissioner commented that there should be a separate fund within each utility by cost category with no loans between funds and we should use root-cause analysis. Commissioners asked questions about the ongoing cost of service study work on the Electric Utility. Commissioners agreed with the recommendation to transfer 11.9% instead of 18% of Gas Utility gross revenue to the General Fund for FY 2025. A water rate trajectory with 5% overall increases in each year from FY 2025 through FY 2029 was presented. Some Commissioners commented that staff should consider proposing a higher water rate increase in order to replenish reserves faster and build up CIP reserves for future One Water Plan CIP recommendations. The water rate proposal included in this preliminary rate report and presentation was revised. One Commissioner asked for more detail on operating cost components. For the Wastewater Collection Utility, Commissioners suggested staff consider a higher rate increase to avoid deferring sewer infrastructure investment, especially given the City's favorable rates compared to neighboring agencies. Two alternative rate increases for discussion with the Finance Committee have been prepared. An excerpt of the minutes from the UAC's January 3, 2024 meeting is located at the Utilities Advisory Commission website.

The UAC is scheduled to review the long-term Financial Plans 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 Plans and proposed rate adjustments in April. Once the Finance Committee has provided its recommendation, 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 Plans and proposed new rate schedules will be considered by the City Council with the FY 2025 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.

ATTACHMENTS

No Attachments

APPROVED BY:

Dean Batchelor, Director of Utilities

Staff: Lisa Bilir, Senior Resources Planner