



## City Council Staff Report

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

**Meeting Date: June 17, 2024**  
Staff Report: 2404-2842

### TITLE

PUBLIC HEARING & PROPOSITION 218 HEARING: Finance Committee Recommends Adoption of Six Resolutions: 1) Approving the Fiscal Year 2025 Wastewater Collection Utility Financial Plan, Including Approval of a Short-Term Loan From the Fiber Optics Fund Reserve to the Wastewater Collection Fund Operations Reserve for Fiscal Year 2024, and Amending Wastewater Collection Rate Schedules S-1, S-2, S-6 and S-7; 2) Approving the Fiscal Year 2025 Water Utility Financial Plan, and Amending Water Rate Schedules W-1, W-2, W-3, W-4, and W-7; 3) Approving the Fiscal Year 2025 Gas Utility Financial Plan, and Amending Gas Rate Schedules G-1, G-2, G-3 and G-10; 4) Approving the Fiscal Year 2025 Electric Utility Financial Plan and Accepting the 2024 City of Palo Alto Electric Cost of Service and Rate Study, and Amending Electric Rate Schedules E-1, E-2, E-4, E-4 TOU, E-7, E-7 TOU, E-14, E-EEC-1, E-NSE-1, E-2-G, E-4-G and E-7-G; 5) Amending Utility Rate Schedules EDF-1 and EDF-2 to Increase Dark Fiber Rates 2.6 Percent; 6) Amending Utility Rate Schedule D-1 Increasing the Storm Water Management Fee by 2.6 Percent per Month per Equivalent Residential Unit for FY 2025; CEQA Status: Not a project under CEQA Guidelines Sections 15378(b)(4) and (5) and Exempt Under Section 15273(a)

### RECOMMENDATION

*Note: Resolutions are included in the packet as Attachments A – F, Attachment G reflects the Table of URLs for the Exhibits to Attachments A – F.*

The Finance Committee, the Utilities Advisory Commission and staff recommend that the City Council adopt the following;

1. For the Wastewater Collection Utility, a Resolution (Attachment A):
  - a. Approving the Wastewater Collection Utility Financial Plan for Fiscal Year (FY) 2025, including approval of a short-term loan from the Fiber Optics Fund Reserve to the Wastewater Collection Fund Operations Reserve not to exceed \$3,000,000 for FY 2024; Amend the Fiscal Year 2024 Budget Appropriation Ordinance: In the Wastewater Collection Fund:

- i. Increase the Transfer In from the Fiber Optics Fund by \$3.0 million
    - ii. Increase the Ending Fund Balance by \$3.0 million; and
  - b. Amending the following Wastewater Collection Utility Rate Schedules to reflect increases effective July 1, 2024 (FY 2025):
    - i. S-1 (Residential Wastewater Collection and Disposal),
    - ii. S-2 (Commercial Wastewater Collection and Disposal),
    - iii. S-6 (Restaurant Wastewater Collection and Disposal), and
    - iv. S-7 (Commercial Wastewater Collection and Disposal – Industrial Discharger);
- 2. For the Water Utility, a Resolution (Attachment B):
  - a. Approving the FY 2025 Water Utility Financial Plan; and
  - b. Amending the following Water Rate Schedules to reflect increases effective July 1, 2024 (FY 2025):
    - i. W-1 (General Residential Water service),
    - ii. W-2 (Water Service from Fire Hydrants),
    - iii. W- 3 (Fire Service Connections),
    - iv. W-4 (Residential Master-Metered and General Non- Residential Water Service), and
    - v. W-7 (Non-Residential Irrigation Water Service);
- 3. For the Gas Utility, a Resolution (Attachment C):
  - a. Approving the Gas Utility Financial Plan FY 2025, which includes amending the Gas Utility Reserve Management Practices; and
  - b. Amending Gas Utility Rate Schedules FY 2025 to reflect increases effective July 1, 2024 (FY 2025):
    - i. G-1 Residential Gas Service,
    - ii. G-2 Residential Master-Metered and Commercial Gas Service,
    - iii. G-3 Large Commercial Gas Service, and G-10 Compressed Natural Gas Service); and
  - c. Transferring up to 14.5% of gas utility gross revenues received during FY 2023 to the General Fund in FY 2025.
- 4. For the Electric Utility, a Resolution (Attachment D):
  - a. Accepting the 2024 City of Palo Alto Electric Cost of Service and Rate Study;
  - b. Approving the Electric Utility Financial Plan FY 2025, which includes the following actions:
    - i. Amending the Electric Utility Reserves Management Practices, to direct staff to transfer to the CIP reserve, at the end of each fiscal year, any budgeted capital investment that remains unspent, uncommitted, and which is not proposed for reappropriation to the following fiscal year and to clarify how the Cap and Trade Program Reserve is adjusted each year.
    - ii. Approving the following transfers at the end of FY 2024:
      - 1. Up to \$20 million from the Electric Special Projects Reserve to the

- Supply Operations Reserve;
      - 2. Up to \$17 million from the Supply Operations Reserve to the Hydroelectric Stabilization Reserve;
      - 3. Up to \$58 million from the Supply Operations Reserve to the Distribution Operations Reserve; and
    - iii. Approving the following transfers in FY 2025:
      - 1. Up to \$26 million from the Distribution Operations Reserve to the Supply Operations Reserve;
      - 2. Up to \$30 million from the Supply Operations Reserve to the Electric Special Projects Reserve; and
      - 3. Up to \$5 million from the Distribution Operations Reserve to the CIP Reserve;
  - c. Amending the following Electric Utility Rate Schedules effective July 1, 2024 (FY 2025):
    - i. E-1 (Residential Electric Service), E-2 (Small Non-Residential Electric Service), E-4 (Medium Non-Residential Electric Service), E-4 TOU (Medium Non-Residential Time of Use Electric Service), E-7 (Large Non-Residential Electric Service), E-7 TOU (Large Non-Residential Time of Use Electric Service) and E-14 (Street Lights), each by varying percentages depending on rate schedule and consumption with an overall revenue increase of 0.5% effective July 1, 2024;
    - ii. Decreasing the Net Surplus Electricity Compensation (E-NSE-1) rate to reflect 2023 avoided cost, effective July 1, 2024; and
    - iii. Decreasing the Export Electricity Compensation (E-EEC-1) rate to reflect current projections of FY 2025 avoided cost, effective July 1, 2024;
    - iv. Updating the Residential Master-Metered and Small Non-Residential Green Power Electric Service (E-2-G), the Medium Non-Residential Green Power Electric Service (E-4-G), and the Large Non-Residential Green Power Electric Service (E 7 G) rate schedules to reflect modified distribution and commodity components, effective July 1, 2024.
5. A Resolution (Attachment E) Amend the Fiscal Year 2024 Budget Appropriation Ordinance: In the Fiber Optics Fund:
- i. Increase the Transfer Out to the Wastewater Collection Fund by 3.0 million
  - ii. Decrease the Ending Fund Balance by \$3.0 million; and amending Fiber Optic Utility Rate Schedules EDF-1 and EDF-2 to increase Dark Fiber Rates 2.6 percent effective July 1, 2024, consistent with the applicable Consumer Price Index;
6. A Resolution (Attachment F) amending Storm Water Management Fee Rate Schedule D-1 to increase the Storm Water Management Fee by 2.6 percent effective July 1, 2024, consistent with the applicable Consumer Price Index.

## EXECUTIVE SUMMARY

The rate changes described in this report will allow Palo Alto to invest in utility infrastructure, gradually increase reserves to guideline levels, and to support community goals. As utility infrastructure ages, investment is needed to maintain the reliability of the water, wastewater, electric and gas utilities. These rate increases will support the maintenance and replacement of infrastructure including rebuilding Palo Alto's wastewater treatment plant (Regional Water Quality Control Plant). Investment in modernizing the electric grid will allow the City to achieve the Council's Sustainability and Climate Action goals as well as to increase reliability of utility service to residents and businesses in Palo Alto. During the pandemic, the City of Palo Alto held rate increases to a minimum in order to limit the financial impacts to Palo Alto residents and businesses. However, holding down rates with rising commodity prices and drought means that utility reserves are now low; the reserves need to be replenished to provide fiscal responsibility for when unexpected events occur and more stable rate management overall.

From January 2024 through April 2024, the Utilities Advisory Commission (UAC) and Finance Committee reviewed preliminary and proposed rate changes recommended by staff for Fiscal Year 2025. This report summarizes the meetings, and incorporates UAC and Finance Committee recommendations into the staff recommendations for Council adoption. This comprehensive utility rates report includes separate sections for each of the Utilities: wastewater collection, water, gas, electric, dark fiber, and storm drainage and surface water. Estimates for retail revenue impacts are included in the FY 2025 budget assumptions. This report outlines the recommended actions and transmits the draft resolutions requested for City Council approval and adoption. Approval of this item would result in implementation of the finalized rates for FY 2025, beginning July 1, 2024.

The expected average residential utility bill changes are below, with the expected overall average utility bill for residential service to increase 9% in FY 2025.

- 15% increase for Wastewater Collection,
- 9.5% increase for Water,
- 12.5% increase for Gas,
- 9% for Electric,
- 2.6% increase for Dark Fiber rate schedules EDF-1 and EDF-2 and
- 2.6% increase for the Storm Water Management Fee.

In addition to the financial plans, the City engaged the services of a consultant to prepare a cost of service analysis (COSA) for the City's electric rates to ensure that electric rates continue to represent the Utility's cost to serve customers. The COSA, completed in April 2024, showed the need for different changes by customer class ranging from a 6% decrease for small non-residential customers (E-2) to a 2% increase for the residential class as a whole. However, recommended changes to the tier structure and the addition of a fixed charge result in a range of changes for residential customers depending on usage, with the median residential electric customer seeing a 9% increase. With the proposed rate increases, Palo Alto residential electric bills are projected to be approximately 50% lower than neighboring communities served by

PG&E.

## **BACKGROUND**

### Wastewater Collection

Utilities staff presented to the Finance Committee on April 23, 2024 and to the UAC on March 6, 2024 a recommendation that Council approve the Wastewater Collection Utility Financial Plan FY 2025, including approval of a short-term loan from the Fiber Optics Fund Reserve to the Wastewater Collection Fund Operations Reserve not to exceed \$3,000,000 for FY 2024 if short-term cashflow becomes negative. In addition, staff recommended increasing wastewater collection rates 15% by amending rate schedules S-1 (Residential Wastewater Collection and Disposal), S-2 (Commercial Wastewater Collection and Disposal), S-6 (Restaurant Wastewater Collection and Disposal) and S-7 (Commercial Wastewater Collection and Disposal – Industrial Discharger). See Staff Report 2402-2603<sup>1</sup> for more information.

The Finance Committee and UAC unanimously recommended approval of this proposal.

### Water

Utilities staff presented to the Finance Committee on April 23, 2024 and the UAC on March 6, 2024 a recommendation that Council approve the Water Utility Financial Plan FY 2025. In Staff Report 2402-2604,<sup>2</sup> staff originally recommended a 13% water distribution rate increase and reflected a 6.5% water commodity rate increase based on preliminary estimates from the SFPUC. However, on April 12, 2024, SFPUC provided its rate notice to Palo Alto with an 8.8% water commodity rate increase. To mitigate the overall bill impact to customers, the Finance Committee voted unanimously on April 23<sup>rd</sup> to lower the distribution rate increase to maintain an overall expected bill impact of 9.5% through the use of additional rate stabilization reserve funds in FY 2025, bringing the Operations and CIP Reserves below the minimum guideline ranges during the forecast period. Staff updated the Resolution (Attachment B) and all Exhibits to Attachment B to reflect the Finance Committee's direction: a 10% water distribution rate increase in combination with the 8.8% water commodity rate increase resulting in an overall 9.5% rate increase.

Staff recommends increasing water distribution rates 10% by amending rate schedules W-1 (General Residential Water service), W-2 (Water Service from Fire Hydrants), W-3 (Fire Service Connections), W-4 (Residential Master- Metered and General Non-Residential Water Service), and W-7 (Non-Residential Irrigation Water Service). The SFPUC is increasing its wholesale water rates by 8.8% due to the drought and related water-purchase cutbacks, resulting in an overall water rate increase for City customers of about 9.5%.

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1 Staff Report 2402-2603 (April 23, 2024 Finance Committee);

<https://cityofpaloalto.primegov.com/api/compilemeetingattachmenthistory/historyattachment/?historyId=90274720-d4f9-47c2-964a-5c722c99d7d8>

2 Staff Report 2402-2604 (April 23, 2024 Finance Committee);

<https://cityofpaloalto.primegov.com/api/compilemeetingattachmenthistory/historyattachment/?historyId=29e7b9c3-6b38-4c11-8032-8f921445fdac>

On April 29, Staff mailed a Prop 218 notice<sup>3</sup> to all utility customers, outlining proposed adjustments to the water and wastewater rates. Due to the timing of the Finance Committee meeting on April 23, 2024, which occurred after the deadline for finalizing the Prop 218 notice, the notice specified a 13% increase in distribution rates for water, alongside an 8.8% increase in water commodity rates. Consistent with the Finance Committee's direction, staff lowered the proposed water distribution rate increase from 13% to 10% in the FY 2025 Water Utility Financial Plan and related Water Rate Schedules. Consequently, the staff proposal for the water distribution rates recommended for Council approval in this report is lower than indicated in the Prop 218 notice.

### Gas

Utilities staff presented to the Finance Committee on April 23, 2024 and UAC on March 6, 2024 a recommendation that Council Adopt a Resolution approving the FY 2025 Gas Utility Financial Plan, which includes amending the Gas Utility Reserve Management Practices. At that time, staff's preliminary recommendation was to increase gas rates overall by 9% (a 15% distribution rate increase). The Finance Committee unanimously recommended approval of this proposal (see Staff Report 2402-2605<sup>4</sup> for more information).

However, based upon a discussion of the City's budget on May 8, 2024, the Finance Committee referred several items to the Council for discussion, including changing the Gas General Fund Transfer from 11.9% to 14.5% of FY 2023 gross revenue transferred in FY 2025, and 18% of FY 2024 gross revenue transferred in FY 2026. Staff updated its recommendation consistent with the Finance Committee's May 8, 2024 referral to the Council. Attachment C and associated exhibits reflect this updated recommendation.

Staff recommends increasing gas rates overall by 12.5% (this equates to a 20.9% distribution rate increase and assumes gas supply-related costs remain unchanged) by amending rate schedules G-1 (Residential Gas Service), G-2 (Residential Master- Metered and Commercial Gas Service), G-3 (Large Commercial Gas Service), G-10 (Compressed Natural Gas Service).

### Electric

Utilities staff presented to the UAC on March 6, 2024 and the Finance Committee on April 23, 2024 a recommendation that Council Adopt a Resolution (Attachment D):

1. Accepting the 2024 City of Palo Alto Electric Cost of Service and Rate Study
2. Approving the FY 2025 Electric Financial Plan, which includes the following actions:
  - a. Amending the Electric Utility Reserves Management Practices, to direct staff to transfer to the CIP reserve, at the end of each fiscal year, any budgeted capital investment that remains unspent, uncommitted, and which is not proposed for

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3 Prop 218 Notice; [https://www.cityofpaloalto.org/files/assets/public/v/1/utilities/rates-schedules-for-utilities/prop-218-notice-FY 2025-final.pdf](https://www.cityofpaloalto.org/files/assets/public/v/1/utilities/rates-schedules-for-utilities/prop-218-notice-FY%2025-final.pdf)

4 Staff Report 2402-2605 (April 23, 2024 Finance Committee);  
<https://cityofpaloalto.primegov.com/api/compilemeetingattachmenthistory/historyattachment/?historyId=d5e65956-71ef-419d-b758-2a841ff14bef>

reappropriation to the following fiscal year and to clarify how the Cap and Trade Program Reserve is adjusted each year.

- b. Approving the following transfers at the end of FY 2024:
  - i. Up to \$20 million from the Electric Special Projects Reserve to the Supply Operations Reserve;
  - ii. Up to \$17 million from the Supply Operations Reserve to the Hydroelectric Stabilization Reserve;
  - iii. Up to \$58 million from the Supply Operations Reserve to the Distribution Operations Reserve; and
- c. Approving the following transfers in FY 2025:
  - i. Up to \$26 million from the Distribution Operations Reserve to the Supply Operations Reserve;
  - ii. Up to \$30 million from the Supply Operations Reserve to the Electric Special Projects Reserve; and
  - iii. Up to \$5 million from the Distribution Operations Reserve to the CIP Reserve;
- 3. Amending the following rate schedules effective July 1, 2024 (FY 2025):
  - a. Changing retail electric rates E-1 (Residential Electric Service), E-2 (Small Non-Residential Electric Service), E-4 (Medium Non-Residential Electric Service), E-4 TOU (Medium Non-Residential Time of Use Electric Service), E-7 (Large Non-Residential Electric Service), and E-7 TOU (Large Non-Residential Time of Use Electric Service)<sup>5</sup> by varying percentages depending on rate schedule and consumption with an overall revenue increase of 0.5% effective July 1, 2024;
  - b. Decreasing the Net Surplus Electricity Compensation (E-NSE-1) rate to reflect 2023 avoided cost, effective July 1, 2024; and
  - c. Decreasing the Export Electricity Compensation (E-EEC-1) rate to reflect current projections of FY 2025 avoided cost, effective July 1, 2024;
  - d. Updating the Residential Master-Metered and Small Non-Residential Green Power Electric Service (E-2-G), the Medium Non-Residential Green Power Electric Service (E-4-G), and the Large Non-Residential Green Power Electric Service (E 7 G) rate schedules to reflect modified distribution and commodity components, effective July 1, 2024.

See Staff Report 2401-2497<sup>6</sup> for more information.

The Finance Committee unanimously recommended approval of this proposal.

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<sup>5</sup> UAC and Finance Committee did not review E-14 (Street Lights) rate as the cost of service analysis on this rate schedule was not yet complete at the time of those meetings

<sup>6</sup> Staff Report 2401-2497;

<https://cityofpaloalto.primegov.com/api/compilemeetingattachmenthistory/historyattachment/?historyId=1dbef9d4-c39e-4f1f-8944-442816a6d9f0>

### Dark Fiber

Since 2007, the EDF-1 and EDF-2 rates for Dark Fiber customers have increased annually by the annual December change in the Consumer Price Index for All Urban Consumers (CPI-U) in the San Francisco area, as stated in their dark fiber license agreements. Based on prior Utilities Advisory Commission and City Council direction, these rate changes are routinely included as part of the Budget adoption process rather than in a separate staff report, however this report ensures the CPI increase is published in the City's adopted rate schedules. This year's change in CPI-U was 2.6 percent, as reported by the Bureau of Labor Statistics.

### Storm Drain

On April 23, 2024, Public Works staff presented the Finance Committee with a recommendation that the City Council adopt a Resolution (Attachment F) amending Utility Rate Schedule D-1 (Storm and Surface Water Drainage) to implement a 2.6 percent rate increase consistent with the applicable Consumer Price Index, increasing the monthly charge per Equivalent Residential Unit by \$0.44, from \$16.76 to \$17.20. See Staff Report 2402-2614<sup>7</sup> for more information.

The Finance Committee unanimously recommended approval of this proposal.

### **ANALYSIS**

In January 2024 and February 2024, respectively, the UAC and Finance Committee received preliminary projections of rate increase needs for FY 2025. Based on their feedback and updated financial information, staff brought to the UAC on March 6, 2024 and the Finance Committee on April 23, 2024, recommendations for utility financial plans, transfer requests, and rate changes. The Finance Committee voted to unanimously approve each of staff's recommendations with the exception of the Water Utility rate proposal, where the Committee recommended a lower rate increase. Specifically, the Finance Committee recommended to increase the use of reserve funds in FY 2025 to limit the overall system average water rate increase to 9.5% while reducing reserve funds available in FY 2026 and future years.

In the May 8, 2024 budget meeting, the Finance Committee referred several items to the Council for discussion including changing the Gas General Fund Transfer from 11.9% to 14.5% of FY 2023 gross revenue transferred in FY 2025, and 18% of FY 2024 gross revenue transferred in FY 2026. An 11.9% Gas General Fund Transfer for FY 2025 is \$8.960 million and a 14.5% Gas General Fund Transfer for FY 2025 is \$10.917 million. A 14.5% General Fund Transfer will result in a 12.5% increase to overall gas rates in FY 2025 assuming gas supply-related costs remain unchanged, and staff will decrease the size of Gas Main Replacement 25 by \$0.735 million to limit the rate impacts to customers. This report and all attachments reflect the Finance Committee's May 8, 2024 referral. On May 13, 2024 the Council discussed this item at a Study Session and Council members

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<sup>7</sup> Staff Report 2402-2614;

<https://cityofpaloalto.primegov.com/api/compilemeetingattachmenthistory/historyattachment/?historyId=c05ba13f-1c8a-4376-87b7-7d127a501824>

discussed the transfer but did not reach consensus on the amount.

This report outlines the actions recommended, transmits the resolutions from these reviews, and requests City Council approval and adoption, as summarized below:

## **Proposed Rate Changes and Financial Plans**

### Wastewater Collection Proposal

The FY 2025 Wastewater Collection Utility Financial Plan includes projections of the utility's costs and revenues through FY 2029. The Financial Plan anticipates costs will rise over the forecast horizon due to increasing treatment costs related to capital improvements and operational costs at the Regional Water Quality Control Plant (RWQCP), as well as increasing collection system operational and Capital Improvement Program (CIP) costs.

In 2023, the Council approved the first in a series of wastewater collection rate increases which incorporated expected costs for the City to accelerate its rate of sewer main replacements from 1 mile to 2.5 miles per year by FY 2026 (implemented as a major sewer replacement project of 5 miles every other year). The accelerated rate of main replacement was calculated to replace all aging sewer mains within 8 years beyond 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 (Staff Report 2301-08081, May 8, 2023 approving contract for Sanitary Sewer Replacement Project 31, WC-19001 for \$8.36 million). However, in FY 2023, costs were higher than forecasted and revenues were lower than forecasted and the Operations Reserve ended the year with a negative balance of \$0.7 million.

In an effort to increase the currently low reserve levels, staff recommends a 15% rate increase in FY 2025, which is equivalent to \$7.29 per month per residential customer. This proposal would include proceeding with a reduced-size main replacement in FY 2026 of 1.25 miles instead of 5 miles due to the low reserve and revenue levels. This would allow the highest priority mains to be replaced while allowing the reserves to gradually replenish before the next major project. The 5-mile sewer main replacement every other year would resume with construction scheduled in FY 2028. With this schedule of main replacement, the last remaining sewer main would be 110 years old at the time it is replaced.

Given the low reserves, and the projected levels of revenue and expenses, there is a risk that the short-term need for cash will exceed available cash in FY 2024 and/or FY 2025. Both the staff recommendation and the alternative assume a potential short-term loan from the Fiber Optics Fund Reserve to the Wastewater Collection Fund Operations Reserve not to exceed \$3,000,000 for FY 2024.

During the April 23, 2024 Finance Committee meeting, Committee members had questions about how certain the Valley Water grant funding is and staff responded that there will be a staff report to Council soon and that the funding will be available to Palo Alto, but the total amount is

uncertain.<sup>8</sup> A Finance Committee member asked whether the loan from the Fiber optic utility is a loan or a line of credit and staff responded that it could be structured either way. After deliberating the proposal, the Finance Committee voted unanimously in favor of the 15% rate increase proposal put forth by staff and in favor of the one-time loan from the Fiber Optics Fund Reserve to the Wastewater Collection Fund Operations Reserve not to exceed \$3,000,000 for FY 2024.

### Water Proposal

Overall costs in the Water Utility are projected to rise on average by about 6% per year from Fiscal Year (FY) 2024 to 2029. Operations cost projections rise on average by about 4% annually from FY 2024 to 2029, excluding one-time transfers and debt service. Debt service is expected to decline by 4.5% during this time because one bond is to be retired in 2026. SFPUC's FY 2024 wholesale water rate is \$5.21 per CCF. On May 14, 2024, SFPUC held a public hearing and adopted the FY 2025 Wholesale Water Rate of \$5.67 per CCF.

Overall, this Water Financial Plan uses reserve funding (from the Operations Reserve, Rate Stabilization Reserve and CIP Reserve) together with rate increases to manage the decreased sales revenue and increasing costs from FY 2024 through FY 2029. While these rate increases can be perceived as decreasing the benefit of conservation, bills for customers who conserve will be lower in the future than they would have been without conservation.

By approving the attached resolution, the Council would approve the proposed FY 2025 Water Utility Financial Plan, which includes an increase in distribution rates of 10% for rate W-1 (General Residential Water service), W-2 (Water Service from Fire Hydrants), W-3 (Fire Service Connections), W-4 (Residential Master-Metered and General Non-Residential Water Service), and W-7 (Non-Residential Irrigation Water Service). The FY 2025 Water Utility Financial Plan also increases the Commodity rate for each CCF of water sold to the SFPUC Wholesale Water Rate of \$5.67. By approving the attached resolution (Attachment B), Council would also authorize the extension of Palo Alto's pass-through provision for the SFPUC wholesale rate increase for an additional five years, effective July 1, 2024.

During the April 23, 2024 Finance Committee meeting, Committee members asked about Palo Alto's residential rates being higher relative to neighboring agencies and non-residential rates being closer to the average of neighboring utilities. Staff explained that the process used to set the water rates is a detailed cost of service study using a standard method and outside expert consultant. One Committee member suggested comparing Palo Alto's water rates to neighboring utilities who also use 100% SFPUC for their potable water supply. After deliberating the proposal, the three members of the Finance Committee voted unanimously in favor of the staff proposal

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<sup>8</sup> Staff Report 2404-2877, June 3, 2024 requests approval from Council for a cost-sharing agreement with Valley water for Guiding Principle 5 Program funding for future projects at the Palo Alto Regional Water Quality Control Plant:

<https://cityofpaloalto.primegov.com/api/compilemeetingattachmenthistory/historyattachment/?historyId=03d85b35-0721-45f3-aa0e-d0a4d8360282>

as modified to reflect SFPUC's April rate increase notice and by increasing the use of water reserves 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.

### Gas Proposal

The FY 2025 Gas Utility Financial Plan includes projections of the utility's costs and revenues for FY 2025 through FY 2029. Staff recommends increasing the distribution component of the gas rates by 20.9% in FY 2025 to bring revenue up to a level closer to recovering the costs of operations and prevent further depletion of reserves. This distribution rate increase is projected to increase overall customer bills by about 12.5% in FY 2025, assuming gas supply-related costs remain unchanged. In FY 2021 and FY 2022, the Gas Utility maintained minimal rate increases, leading to revenues struggling to match the rising expenses, resulting in a significant depletion of reserves.

Although revenues exceeded costs in FY 2023, some costs associated with FY 2023 were paid in FY 2024. Specifically, carbon offset purchases from FY 2023 were made in FY 2024, and the transfer of prior years' Cap and Trade auction sales revenue from the Operations Reserve to the Cap and Trade reserve, which is a cost item, also occurred in FY 2024. Additionally, FY 2024 costs reflect the Council's adopted revised natural gas purchasing strategy for the 2023 – 2024 winter months to include commodity price insurance against very high market prices. A longer-term strategy for mitigating against potential future gas price spikes will be presented to Council for consideration prior to next winter.

Consequently, the Operations Reserve is projected to drop below the risk assessment level by the end of FY 2024. Overall distribution costs are expected to increase by 4% from FY 2024 to FY 2025 and by 5% on average annually from FY 2025 through FY 2029. This distribution cost increase is due to projected increases in operations costs as well as capital costs related to the safety and maintenance of gas pipelines in Palo Alto, as well as preparation for electrification-related costs. In addition, increased costs from prior years reduced reserve levels and rates need to be increased to bring reserves gradually back to within guideline ranges.

As part of the annual budget process, Council also determines the amount of the General Fund transfer for the Gas Utility in FY 2025. Each year, in accord with the voter-approved changes codified in PAMC 2.28.185, the City Council may transfer from the gas utility to the General Fund an amount up to 18% of the gross revenues of the gas utility, though Council may choose to transfer a lesser amount. The Finance Committee and staff recommends transferring 14.5% of FY 2023 gas utility gross revenue to the general fund for FY 2025, and 18% of gas utility gross revenue in FY 2026 and subsequent years. Alternatively, in alignment with PAMC 2.28.185, Staff also provided two other alternatives for FY 2025: transfer 11.9%, or \$8.96 million, or transfer up to 18%, or \$13.55 million.

The proposed FY 2025 Gas Utility Financial Plan includes an increase in distribution rates effective July 1, 2024 and will result in a 12.5 percent increase to the total system average gas rate,

assuming supply rates remain unchanged. This will be done by 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). Additional 5 to 6 percent increases per year to the total system average gas rate are projected over the next four years. See Attachment C and its exhibits for more information.

### Electric Proposal

The FY 2025 Electric Utility Financial Plan includes projections of the utility's costs and revenues through FY 2029. Rate changes are recommended that vary significantly by customer class but that in aggregate result in little change (around a 0.5% increase) to total electric utility revenue in FY 2025. To ensure that electric rates continue to represent the Utility's cost to serve customers, the City engaged the services of a consultant to prepare a cost of service analysis (COSA), which was completed in March 2024 (Attachment D, Exhibit 1.1). The COSA showed the need for different changes by customer class ranging from a 6% decrease for small non-residential customers (E-2) to a 2% increase for the residential class as a whole. However, recommended changes to the tier structure and the addition of a fixed charge result in a range of changes for residential customers depending on usage, with the median residential customer seeing a 9% increase.

Table 1: Revenue Allocation by Customer Class in FY2025

	Projected Revenues under Current Rates	Net Revenue Requirement	Projected Surplus/ (Deficiency) in Revenue Based on Current Rates	Revenue Increase/ (Decrease) Needed
<b>Residential E-1</b>	\$ 27,309,759	\$ 27,852,514	\$ (542,755)	2.0%
<b>Small Commercial E-2</b>	\$ 11,784,676	\$ 11,067,556	\$ 717,121	-6.1%
<b>Medium Commercial E-4</b>	\$ 67,707,023	\$ 65,186,601	\$ 2,520,422	-3.7%
<b>Large Commercial E-7</b>	\$ 59,295,683	\$ 58,473,708	\$ 821,975	-1.4%
<b>Street and Traffic Lighting</b>	\$ 2,224,184	\$ 2,006,759	\$ 217,425	-9.8%
<b>TOTAL</b>	<b>\$ 168,321,326</b>	<b>\$ 164,587,138</b>	<b>\$ 3,734,187</b>	<b>-2.2%</b>

Palo Alto residential electric bills are approximately 50% lower than neighboring communities served by PG&E.

As of the drafting of this report, precipitation for the 2023/2024 water year was still below average. However, reservoir conditions are good as a result of last year's rains, so staff is forecasting hydroelectric generation for FY 2025 and FY 2026 that is slightly higher than the baseline level assumed in its long-term projections. High one-time energy supply cost savings and surplus energy sales for FY 2024 are projected related to higher late summer 2023 hydroelectric generation resulting from the 2022/2023 winter rains. Other short term revenues include higher than average sales revenue for resource adequacy and renewable energy credits (RECs) in FY 2024 through FY 2026 due to favorable market conditions. Some of these revenues are being

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9 This differs slightly from the 0.5% increase stated above, due to a difference in how revenues are forecast in the long-range cost of service model and staff's annual financial modeling. The net revenue requirement under both models is the same: \$164.5 million.

used to replenish the hydroelectric stabilization reserve, reducing the chance that the City would need to activate the hydroelectric rate adjuster in the next few years, even if there is less snow and rain.

These one-time revenues are offset by significant capital investment costs associated with grid modernization (\$50 million in FY 2024 and FY 2025), a rebuild of the Hanover substation (\$15 million in FY 2024), and a new dark fiber backbone for the electric utility that will require some contribution from the electric utility (\$13 million in FY 2026). Current plans anticipate offsetting these capital investments by issuing municipal bonds. However, reserves will need to absorb some of the costs in FY 2024 until the first bonds can be issued in FY 2025. This is leading to large reserve transfers in FY 2024 and FY 2025 to manage this short-term cash flow issue.

Total costs for the Electric Utility are projected to increase steadily through the forecast period. The largest contributors to these cost increases are increasing transmission costs, reduced sales revenue from surplus RECs and resource adequacy rights, and increasing debt service associated with grid modernization. The financial plan projects the need for 5% per year rate increases through the forecast period. However, the electricity consumption projections in this report are conservative and increased load from electrification and any new large customer loads could reduce these projections. On the other hand, if the costs for grid modernization or other capital investment end up being higher than forecasted, as often occurs, those costs could offset the benefit of new customer loads.

#### Dark Fiber

Since 2007, the EDF-1 and EDF-2 rates for Dark Fiber customers have increased annually by the annual December change in the Consumer Price Index for All Urban Consumers (CPI-U) in the San Francisco area, as stated in their dark fiber license agreements. Based on prior Utilities Advisory Commission and City Council direction, these rate changes are routinely included as part of the Budget adoption process rather than in a separate staff report. This year's change in CPI-U was 2.6 percent, as reported by the Bureau of Labor Statistics. The City has five customers remaining on the EDF-1 rate schedule. All other dark fiber customers are on the EDF-3 rate schedule.

#### Storm Water and Surface Water Drainage

On April 11, 2017, a majority of Palo Alto property owners approved a ballot measure approving a monthly Storm Water Management Fee. This fee funds thirteen storm drainage capital improvement projects listed in the ballot measure, enhanced maintenance of the storm drainage system, and a variety of stormwater quality protection programs. The approved ballot measure allows for an annual adjustment based on the Consumer Price Index (CPI) or six percent, whichever is less. The Storm Water and Surface Drainage Rate will increase 2.6 percent, increasing the monthly charge per Equivalent Residential Unit by \$0.44, \$16.76 to \$17.20 for Fiscal Year 2025, effective July 1, 2024, to reflect the annual CPI change. See Staff Report 2402-2614<sup>10</sup> for more information.

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<sup>10</sup> Staff Report 2402-2614;

## Timeline

### Water and Wastewater Collection Rates

After the June 17th Public Hearing is opened and testimony from members of the public accepted, City Council may choose to:

1. Close the hearing and take action; or
2. Close the hearing and defer action until the close of the Budget Adoption Hearing on June 17th; or
3. Continue the hearing until the end of the Budget Adoption Hearing (should the Budget Adoption Hearing be continued to another Council meeting), and then reconvene the hearing, take any additional water and wastewater collection rate testimony, close the hearing, and take action.

The latter option has been used in prior years when the Budget Adoption process has spanned multiple City Council meetings. It is customary in such circumstances to continue to accept written protests up until the hearing is closed. Unless written protests are filed by a majority of affected water and wastewater customers, Council may vote on the proposed rate actions. If approved, the water and wastewater rates will become effective July 1, 2024. The City Council will also consider changes to the Financial Plans for the wastewater collection and water utilities, and should they take action to approve these plans, they will also become effective July 1, 2024.

### Electric, Gas, Dark Fiber and Storm Water rates, as well as Utility Financial Plans

The electric, gas, dark fiber and storm drainage rates will be considered at the June 17, 2024 public hearing. Should the City Council take action to approve any or all of these rates, they will become effective July 1, 2024. The City Council will also consider changes to Financial Plans and/or Reserve Management Policies for the electric and gas utilities, and should they take action to approve any or all of these Plans and/or Policies, they will also become effective July 1, 2024.

## **FISCAL/RESOURCE IMPACT**

The resource impact of the recommendations summarized in this report is the continued financial solvency of the various utilities through the revenue increases described below. Following are the estimated FY 2025 revenue impacts of the recommendations in this report relative to projected revenue for FY 2025 without changing utility rates:

- Staff anticipates normal year revenues for the Wastewater Collection Utility will increase by approximately \$3.3 million in FY 2025 as a result of a 15% rate increase;
- Estimated revenue for the Water Utility in FY 2025 is projected to increase approximately 9.5% or \$4.6 million as a result of the proposed rate increases;
- Normal year sales revenues for the Gas Utility in FY 2025 are projected to increase by roughly 12.5% to overall rates, with a projected distribution revenue increase of \$7 million as a result of the proposed rate increases, not including fluctuations in commodity revenue/cost. The change in General Fund revenues from FY 2024 to FY 2025 would

depend on the General Fund transfer alternative chosen by Council. Under the 14.5% transfer in FY 2025 alternative, which was supported by the Finance Committee during their discussion of the City annual budget in May 2024, the General Fund transfer would increase from \$7.707 million in FY 2024 to \$10.917 million in FY 2025, an increase of about \$3.210 million.

- FY 2025 revenues for the Electric Utility are projected to remain very close to FY 2024 levels if Council adopts this report's recommendations. The City is a non-residential utility customer and can expect a decrease in estimated City utility expenses of about \$160,000, approximately \$85,000 of that being in the General Fund. Streetlight expenses (which are paid from the General Fund) are projected to decrease by about \$180,000.

Resource impacts to City departments and funds of the recommended rate adjustments are programmed in the FY 2025 Proposed Operating Budget. If the final rates adopted by Council in June differ from those proposed in this report, further adjustments may be brought forward as part of the annual budget process.

Utility	Systemwide Residential Average Rate Increase	FY 2025 Estimated Overall Revenue Impact
Electric	9%	\$0.8 million
Gas	12.5%	\$7.0 million
Water	9.5%	\$4.6 million
Wastewater Collection	15%	\$3.3 million
Stormwater Management	2.6%	\$0.2 million

Staff estimates the Fiber Optics rate increase will increase revenue \$14,768 from the five remaining customers on the EDF-1 rate schedule.

### Policy Implications

Policy implications related to the proposed wastewater collection, water, gas, electric, dark fiber and storm water management fee rate actions are detailed fully in the attached Resolutions and associated exhibits.

### STAKEHOLDER ENGAGEMENT

The UAC reviewed preliminary financial forecasts for the Electric, Gas, Water and Wastewater Collection utilities at its January 3, 2024 meeting (Staff Report 2309-2080<sup>11</sup>), and the Finance Committee reviewed those utilities' preliminary forecasts at its February 21, 2024 meeting (Staff Report 2312-2468<sup>12</sup>).

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11 Staff Report 2309-2080 (UAC January 3, 2024);

<https://cityofpaloalto.primegov.com/Portal/viewer?id=0&type=7&uid=73e00809-8d00-449b-9e3e-b3dc0b0a44dd>

12 Staff Report 2312-2468 (UAC February 21, 2024);

<https://cityofpaloalto.primegov.com/Portal/viewer?id=0&type=7&uid=bfccaf4e-7ad7-49ab-9da2-5d728220f433>

The UAC reviewed staff's final recommendations for the Wastewater Collection, Water, Gas, and Electric utilities at its March 6, 2024 UAC meeting<sup>13</sup>, which were all passed unanimously.

The Finance Committee reviewed staff's proposals for the following utilities at its April 23, 2024 Finance Committee meeting<sup>14</sup>, which were all passed unanimously (3-0):

1. Wastewater Collection (Staff Report 2402-2603<sup>15</sup>)
2. Water (Staff Report 2402-2604<sup>16</sup>)
3. Gas (Staff Report 2402-2605<sup>17</sup>)
4. Electric (Staff Report 2401-2497<sup>18</sup>)
5. Stormwater Management (Staff Report 2402-2614<sup>19</sup>)

The Finance Committee voted on additional changes for the Gas Utility General Fund Transfer on May 8, 2024 and the Council discussed those changes on May 13, 2024 during a budget study session. This report discusses those changes above and the attached resolutions reflect the Committee's direction. The FY 2025 Budget is being developed concurrent with these rates and, depending on the final rates, adjustments to the budget may be necessary.

Note that there were no specific stakeholder engagement meetings on Dark Fiber rates because there are only a few impacted customers and the rate is increasing by CPI consistent with past practice.

## ENVIRONMENTAL REVIEW

Adoption of the attached Financial Plans and budgeted transfers does not meet the California Environmental Quality Act's definition of a project, pursuant to Public Resources Code Section 21065 and CEQA Guidelines Section 15378(b)(4) and (5), because it is a governmental fiscal and administrative activity which will not cause a direct or indirect physical change in the environment. Adoption of the proposed wastewater collection, water, gas, electric, storm water management fee, and dark fiber rates to meet operating expenses, purchase supplies and materials, meet financial reserve needs and obtain funds for capital improvements necessary to maintain service is not subject to the California Environmental Quality Act (CEQA), pursuant to

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13 March 6, 2024 UAC meeting; <https://cityofpaloalto.primegov.com/Portal/Meeting?meetingTemplateId=13458>

14 April 23, 2024 Finance Committee meeting;

<https://cityofpaloalto.primegov.com/Portal/Meeting?meetingTemplateId=15049>

15 Staff Report 2402-2603; <https://cityofpaloalto.primegov.com/Portal/viewer?id=0&type=7&uid=90274720-d4f9-47c2-964a-5c722c99d7d8>

16 Staff Report 2402-2604; <https://cityofpaloalto.primegov.com/Portal/viewer?id=0&type=7&uid=29e7b9c3-6b38-4c11-8032-8f921445fdac>

17 Staff Report 2402-2605; <https://cityofpaloalto.primegov.com/Portal/viewer?id=0&type=7&uid=d5e65956-71ef-419d-b758-2a841ff14bef>

18 Staff Report 2401-2497; <https://cityofpaloalto.primegov.com/Portal/viewer?id=0&type=7&uid=83d9b5c9-f71e-4d48-8322-665a9b4754a9>

19 Staff Report 2402-2614; <https://cityofpaloalto.primegov.com/Portal/viewer?id=0&type=7&uid=c05ba13f-1c8a-4376-87b7-7d127a501824>

California Public Resources Code Sec. 21080(b)(8) and Title 14 of the California Code of Regulations Sec. 15273(a). After reviewing the staff report and all attachments presented to Council, the Council incorporates these documents herein and finds that sufficient evidence has been presented setting forth with specificity the basis for this claim of CEQA exemption.

**ATTACHMENTS**

Attachment A: Resolution for the Wastewater Collection Utility FY 2025

Attachment B: Resolution for the Water Utility FY 2025

Attachment C: Resolution for the Gas Utility FY 2025

Attachment D: Resolution for the Electric Utility FY 2025

Attachment E: Resolution for the Fiber Optic Utility FY 2025

Attachment F: Resolution for the Storm Water Management Fee Rates FY 2025

Attachment G: Table of URLs for Exhibits to Attachments A - F

**APPROVED BY:**

Dean Batchelor, Director of Utilities