Finance Committee
Staff Report

From: Kiely Nose, Assistant City Manager
Lead Department: Utilities

Meeting Date: March 21, 2023
Staff Report: 2302-0946

TITLE

Recommendation to the City Council to Adopt a Resolution Approving the Fiscal Year 2024 Gas Utility Financial Plan, Including Proposed Reserve and General Fund Transfers and Amending the Gas Utility Reserve Management Practices, and Increasing Gas Rates 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)

RECOMMENDATION

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

a. Approving the fiscal year (FY) 2024 Gas Utility Financial Plan[1]; and
b. Amending the Gas Utility Reserve Management Practices (Attachment B)
c. Transferring up to 18% of gas utility gross revenues received during fiscal year 2021 to the general fund in FY 2023;
d. Transferring up to ___% of gas utility gross revenues received during fiscal year 2022 to the general fund in FY 2024;
e. Transferring up to $3.82 million from the CIP Reserve to the Operations Reserve in FY 2023; and
f. Increasing gas rates 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) (Attachment C).

Staff is also seeking Finance Committee feedback on the FY 2024 general fund transfer before sending a final recommendation to Council, and has provided two general fund transfer alternatives which comply with the voter-approved Measure L[2]. For Item (d) above, the UAC

[1] FY24 Gas Utility Financial Plan https://www.cityofpaloalto.org/files/assets/public/agendas-minutes-reports/reports/city-manager-reports-cmrs/attachments/03-21-2023-id-2302-0946-gas-financial-plan.pdf
[2] Measure L Web Page https://www.cityofpaloalto.org/Departments/City-Clerk/Municipal-Elections/November-8-2022-Ballot-Measures

recommends transferring up to 15.5% of gas utility gross revenues received during fiscal year 2022 to the general fund in FY 2024.

EXECUTIVE SUMMARY

The FY 2024 Gas Utility Financial Plan includes projections of the utility's costs and revenues for FY 2023 through FY 2028. Gas utility costs are made up of supply-related costs (60 percent of costs in FY 2023), which are collected through a supply rate that varies monthly, and distribution-related costs (40 percent of costs in FY 2023), which are collected through a distribution rate that is typically adjusted annually. Distribution rates last increased on July 1, 2022, which resulted in a roughly 3 percent increase in the total system average gas rate (the supply rates plus the distribution rates). The UAC reviewed these plans and unanimously recommends the City Council adopt them at its March 1, 2023 meeting. Not included in this item is the review of gas rebates; per City Council direction, an item is scheduled for City Council review on March 27, 2023 to provide a rebate up to 20% of the highest month gas utility bills.

Gas market prices rose to unprecedented levels in FY 2023, leading to far higher gas costs than are projected for FY 2024 through FY 2028. Staff is proposing to increase the distribution component of the gas rates in FY 2024 to ensure the utility is recovering its costs of operations. Revenues were already below costs after keeping rate increases low through the pandemic, but construction inflation and other factors have driven costs up. The distribution rate increase is projected to increase overall customer bills approximately 8% if supply costs remain the same in FY 2024 as they were in FY 2023, though staff does not expect this. This 8% increase in customer bills results from increasing the distribution component of the rates 21% to fully recover distribution costs and avoid decreasing reserves further. Even with this distribution rate increase, staff expects average annual customer gas bills to decline 13% in FY 2024 compared to FY 2023 because gas supply costs were extremely high in FY 2023, particularly in the winter. FY 2024 annual gas supply costs are forecasted to be about 36% lower than FY 2023. Gas market prices are uncertain, however, and these forecasts can change.

The distribution rate increase is driven by two things: 1) the need to replenish reserves, which were depleted by significant losses due to FY 2023 commodity costs that were not be fully passed through to customers under the City's commodity rate cap of $4 per therm, and 2) continuing increases in capital and operating costs. Distribution rates have not kept up with these increased costs in past years as the City has minimized gas rate increases to minimize impacts to the community during the economic downturn associated with the COVID-19 pandemic.

The gas utility's transfer to the City's General Fund is another 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 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 the gross revenues of the gas utility,[3] though Council may choose to transfer a lesser amount. Staff is seeking Finance Committee feedback on the amount of the FY 2024 transfer before sending a final recommendation to Council. Two alternatives and their associated rate increases are shown in the section below titled "Alternative Gas Increase Plans." All post-FY 2023 rate and cost discussions in this staff report are based on Alternative 2, which involves transferring up to 18% of gas utility gross revenues in FY 2023, and projects 15.5% in FY 2024.

BACKGROUND

Every year staff presents the UAC with Financial Plans for its Electric, Water, Gas, and Wastewater Collection Utilities and recommends any rate adjustments required to maintain their financial health. These Financial Plans include a comprehensive overview of the utility's operations, both retrospective and prospective, and are intended to be a reference for UAC and Council members as they review the budget and staff's rate recommendations. Each Financial Plan also contains a set of Reserves Management Practices describing the reserves for each utility and the management practices for those reserves.

The City's gas is purchased from a variety of marketers who source gas from throughout the Western United States and Canada. The City pays Pacific Gas and Electric (PG&E) to transport the gas across its gas transmission system to Palo Alto, which is then delivered to customers through Palo Alto's gas distribution system.

The Gas Utility's costs are divided into two main categories: gas supply costs and gas distribution costs. Supply costs include the cost of the gas itself, the cost of transmitting the gas to Palo Alto, and environmental costs[4] and distribution costs include the costs of operating the distribution system. As noted above, gas supply costs are passed through to customers through four gas supply rate components. The commodity rate is the largest gas supply rate component and it varies monthly, while transportation and environmental pass-through rates change less frequently.

ANALYSIS

Staff's annual assessment of the financial position of the City's gas utility is completed to ensure adequate revenue to fund operations, including reserves, and to ensure that the City's rates comply with cost-of-service requirements set forth in the California Constitution and applicable statutory law. The assessment includes making long-term projections of market conditions, of costs associated with the physical condition of infrastructure, and of other factors that could affect utility costs. Rates are then proposed that will be adequate to recover projected costs.

<u>Proposed Actions for FY2023 and FY 2024:</u>

[3] 18% of the gross revenues of the gas utility received "during the fiscal year two fiscal years before the fiscal year of the transfer." (Palo Alto Municipal Code Section 2.28.185).

[4] These are the costs of complying with the State's Cap and Trade regulations and procuring offsets under the City's Carbon Neutral Gas program.

The FY 2024 Gas Utility Financial Plan includes the following proposed actions:

a. Approve the FY 2024 Gas Utility Financial Plan (Linked Document); and
b. Amend the Gas Utility Reserve Management Practices (Attachment B); and
c. Transferring up to 18% of gas utility gross revenues received during fiscal year 2021 to the general fund in FY 2023;
d. Transferring up to ___% of gas utility gross revenues received during fiscal year 2022 to the general fund in FY 2024;
e. Transfer up to $3.82 million from the CIP Reserve to the Operations Reserve in FY 2023; and
f. Amend gas rate schedules (Attachment C) to increase distribution rates by 21.4 percent, (for an estimated 8 percent increase to total rates in FY 2024).

These proposed actions are described in more detail below and in the FY 2024 Gas Financial Plan (Linked Document). Staff is seeking Finance Committee feedback on the General Fund transfer in item (d) above before sending a final recommendation to Council and has provided two alternatives for determining the amount of the transfer, both of which comply with the voter-approved Measure L. Both options are described in the section below titled "Alternative Gas Increase Plans." The UAC, at its March 1, 2023 meeting, recommended transferring up to 15.5% of gross gas utility revenues, alternative 2.

<u>Overview of Cost and Rate Projections and Drivers</u>

The Financial Plan projects overall gas costs to increase from FY 2022 actuals through FY 2028 at about 5.1% per year on average. Although it is not possible to precisely predict commodity rates, staff monitors market prices monthly and automatically incorporates market prices into monthly supply rate adjustments, which are passed directly to customers as a line item on their utility bills. Staff projects commodity prices to decline in FY 2024. Beyond FY 2024 the forecast assumes (consistent with current gas market forecasts from various sources, including forward gas contracts on exchanges, forecasts from suppliers, and the Federal Energy Information Administration) overall supply costs will increase gradually from FY 2025 through FY 2028, remaining higher than historical gas prices.

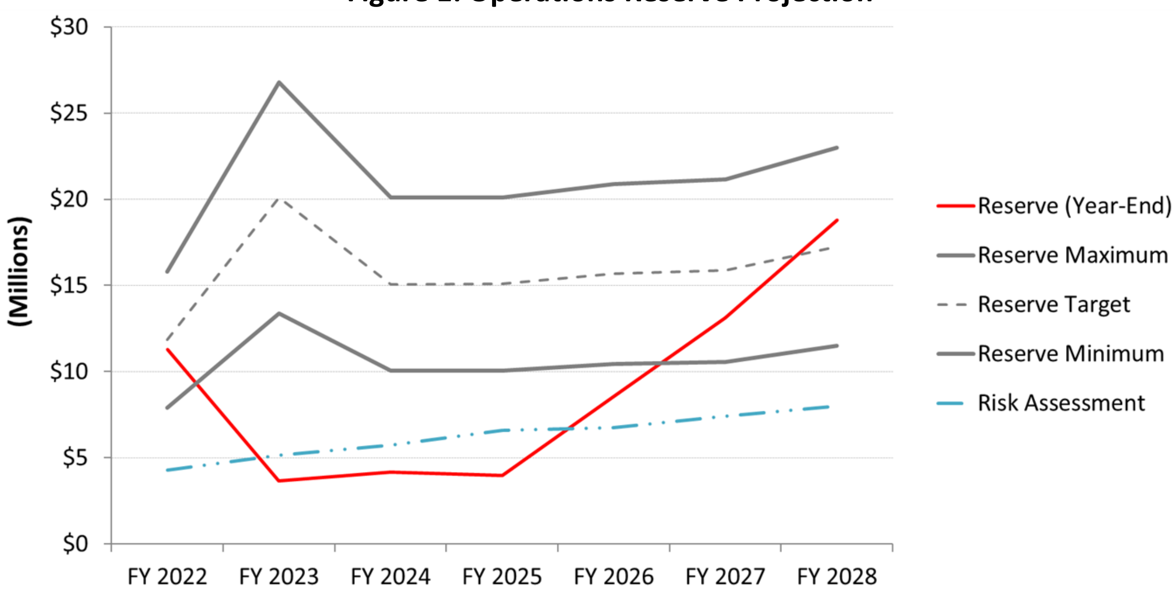
Total gas supply costs (which include gas commodity, transportation, and environmental charges) were $0.4 per therm to $0.6 per therm before FY 2022, but are projected to be between $1.0 per therm and $1.3 per therm for the rest of the forecast period. This is partially due to projected increases in environmental and transportation charges, but also higher projected western gas prices going forward. However, gas commodity prices are highly variable, and weather or economic factors could shift this forecast rapidly, in which case any savings or additional costs would be passed through to customers via the monthly varying commodity rate adjuster.

The gas utility last increased distribution rates on July 1, 2022, which resulted in about a 3% increase in the total system average gas rate (the supply rate plus the distribution rate). This Financial Plan includes an increase in distribution rates effective July 1, 2023 that will result in about an 8% increase to the total system average gas rate if supply costs remain the same in FY 2024 as they were in FY 2023, though staff does not expect this. This 8% increase in customer bills results from increasing the distribution component of the rates 21% to fully recover distribution costs and avoid decreasing reserves further. This Financial Plan includes additional 5-7% increases to the total system average gas rate annually over the subsequent four years.

The unprecedented and extremely high gas prices in FY 2023 impacted the gas utility's reserves significantly, and very high double-digit rate increases in the total system average gas rate would be required to return the Operations Reserve to a level within guidelines. Due to the market price dynamics described above and commodity rate cap limits, the utility did not recover the full supply purchase costs from customers. Specifically, the commodity rate limit was $4/therm in January, but about 50% of the City's gas was purchased at $5/therm, leading to significant additional costs being absorbed from the Operations Reserve instead of being passed through to customers.

The rate increases in the attached Financial Plan partially replenish the gas utility's reserves over the next several years. However, Staff is also proposing to allow the Gas Operations Reserve to be below the risk assessment levels for two fiscal years (FY 2024 and FY 2025) and below the minimum guideline for three fiscal years (FY 2024 through FY 2026) to mitigate required rate increases. The Gas Utility Reserves Management Practices (Attachment B) require returning reserves to within minimum guidelines (60 days of O&M and commodity expense) within one year unless an alternative plan is approved by Council.

Figure 1: Operations Reserve Projection



In addition to replenishing gas utility reserves, distribution rate increases are needed to pay for increasing operations costs and Capital Improvement Project (CIP) expenditures in the distribution system. Distribution system operations costs are increasing primarily due to salary and benefit increases both in the gas utility and for administrative functions provided by the City's General Fund staff.

The priority for the City's gas utility is operating the system safely, which requires the replacement of higher risk PVC and steel mains on a reasonable timeline. The cost of gas main replacement continues to rise. For this reason, failing to increase the gas main replacement program budget steadily would result in a reduction of the rate of main replacement over time. This Financial Plan addresses these challenges in a way that will allow CPAU to meet its main replacement needs by increasing the main replacement budget beginning in FY 2025 and including a 3% annual construction inflationary increase thereafter. Staff is also controlling costs by applying for grant funding for the upcoming main replacement project and is currently awaiting a response regarding a Natural Gas Distribution Infrastructure Safety and Modernization grant opportunity. In addition, with the ongoing discussions and direction from City Council related to electrification of homes and neighborhoods throughout the City and transitioning away from natural gas, the City may be able to retire some PVC and steel mains through aggressive electrification in neighborhoods with these types of mains. Staff is working to develop an efficient phasing plan for electrification and the scaling back of the gas infrastructure.

The City's natural gas rates are based on the 2019 Natural Gas Cost of Service and Rates Study, updated with current and proposed operating costs. During the COVID-19 pandemic, usage amongst customer classes dropped to reflect people working and staying at home rather than going to the workplace. Similarly, businesses operated at minimum staffing conditions or fully remote. Cost projections for CIP and operation of the distribution system as well as supply costs are increasing.

The overall rate changes (gas supply plus distribution) referenced in this report are based on current gas market forecasts that indicate that the commodity portion of the overall rate is unlikely to continue increasing at the unprecedented level observed in FY 2023. Current gas market forward prices indicate that average annual commodity costs are likely to decline 36% FY 2024 from FY 2023. This is consistent with current gas market forecasts from various sources, including forward gas contracts on exchanges and forecasts from suppliers, but staff cautions that these forecasts can change rapidly due to changing weather, economic factors, or gas supply constraints.

Staff recommends increasing the distribution component of the rates by 21.4%, which equates to an 8% increase to total rates, if commodity rates remain unchanged from FY 2023 (which, as noted above, staff does not project to be the case). Table 3 below shows both the proposed increase in distribution rates (about 21%) and the net impact on rates including commodity costs (about 8% overall, as distribution is about 40% of total rate revenue in FY 2023). From FY 2023 to FY 2024, the distribution portion of customer gas bills will increase 8%, and the commodity portion of the bill is projected to decline 22%. The result is that customers should see a 13% overall **decrease** in their bills in FY 2024 over the prior year, if, as forecasted above, commodity rates drop 36% from FY 2023 to FY 2024.

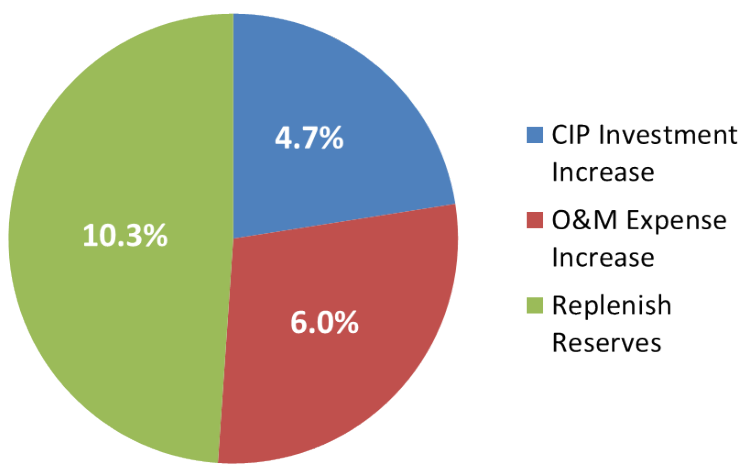
Table 1: Revenue and Rate Revenue Changes by Customer Class

Cost of Service Analysis FY 2024	Proposed Distribution Rate Increase	Assumed Commodity Rate Change	Net Change for Combined Commodity and Distribution Rate
G1 – Residential	21%	-36%	-13%
G2 - Small Commercial			
G3 - Large Commercial			
Total*			

* CPAU also has a G-10 Compressed Natural Gas Rate Schedule that currently does not have any customers but is retained for potential future use.

Figure 2 below shows the primary drivers for the proposed rate change, which are split between increasing operating and capital improvement expenses and replenishing reserves to work towards bringing reserves back to within guideline levels for the Operations Reserve set forth in the Reserve Management Practices (Attachment B). The attached FY 2024 Gas Financial Plan provides more detailed discussion.

Figure 2: Allocation of 21% Distribution Rate increase



<u>Proposed Gas Rates</u>

Staff proposes to adjust gas rates as shown in **Table 2** and **Table 3** below, effective July 1, 2023. These changes are projected to increase distribution rates by 21.4% resulting in a total system average gas rate (total of supply and distribution) by roughly 8 percent for all classes. These rate changes are included in the proposed amended rate schedules in (Attachment B).

Table 2: Current and Proposed Monthly Service Charges

Rate Schedule	Current (as of 1/1/23)	Proposed for FY 2024	Change ($)	Change (%)
G-1 (Residential)	$ 11.54	$ 14.01	$ 2.47	21.4%
G-2 (Small Commercial)	106.90	129.78	22.88	21.4%
G-3 (Large Commercial)	489.12	593.79	104.67	21.4%
G-10 (CNG)	72.30	87.77	15.47	21.4%

Table 3: Current and Proposed Gas Distribution Charges

	Current (as of 1/1/23)	Proposed for FY 2024	Change ($)	Change (%)
G-1 (Residential)				
Tier 1 Rates	$ 0.5607	$ 0.6807	$ 0.1200	21.4%
Tier 2 Rates	1.4338	1.7406	0.3068	21.4%
G-2 (Residential Master-Metered and Small Commercial)				
Uniform Rate	0.7365	0.8941	0.1576	21.4%
G-3 (Large Commercial)				
Uniform Rate	0.7292	0.8852	0.1560	21.4%
G-10 (CNG)				
Uniform Rate	0.0120	0.0145	0.0025	20.8%*

*Adjusted downward due to rounding

Bill Impact of Proposed Rate Changes

Table 4 shows the impact of the proposed July 1, 2023 rate changes on the median residential bill for representative average winter and summer bills, with average winter bills forecasted to be significantly lower and summer bills higher. The average annual gas bill for the median residential customer is projected to be 13% lower in FY 2024 than FY 2023. However, since customer gas usage varies and the price of commodities changes monthly, the actual change may vary. Table 4 shows a representative winter period (November thru March) and summer period (April through October) bill comparison.

Table 4: Impact of Proposed Gas Rate Changes on Residential Bills

Usage (Therms/month)	Bill under Current Rates	Bill under Proposed Rates	Change	
			$/mo.	%
Winter Commodity Prices based on:	Average Actual Commodity Cost Nov. 2022 – Jan. 2023	Average Forecast Commodity Cost Nov. 2023 – Jan. 2024		
30	$ 98.98	$ 66.53	$(32.45)	-33%
54 (median)	168.93	108.54	(60.39)	-36%
80	262.18	175.25	(86.92)	-33%
150	527.32	371.99	(155.34)	-29%
Summer (Based on May 2022 Commodity Prices)				
10	$ 27.41	$ 31.08	$ 3.67	13%
18 (median)	40.11	44.74	4.63	12%
30	67.89	75.83	7.94	12%
45	104.80	117.34	12.54	12%

Table 5 shows the impact of the proposed July 1, 2023 rate changes on various representative commercial customer bills. The overall increases for the G-2 and G-3 classes are projected to be about -13% on an annual basis, assuming gas commodity prices decline as described above.

Table 5: Impact of Proposed Gas Rate Changes on Commercial Bills[5]

Usage (Therms/month)	Bill under Current Rates	Bill under Proposed Rates	Change
			%
500	$ 1,282	$ 1,146	-11%
5,000	11,855	10,295	-13%
10,000	23,604	20,460	-13%
50,000	117,609	101,802	-13%

FY 2024 Financial Plan's Projected Rate Adjustments for the Next Five Fiscal Years

Table 6 shows the projected rate adjustments over the next five years and their impact on the annual median residential gas bill (54 therms per month in winter, 18 therms per month in summer).

[5] Commodity prices for bills under current rates are based on the average actual commodity prices from July 2022 through February 2023 and projections for March 2023 to June 2023. Commodity prices for bills under the proposed rates are based on staff's forecast for July 2023 through June 2024.

Table 6: Projected Distribution Rate Adjustments, FY 2024 to FY 2028

	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028
Gas Utility	8%	7%	5%	5%	5%
Estimated Residential Bill Impact ($/mo)*	$ 6.43	$ 4.34	$ 3.10	$ 3.30	$ 3.49

* Estimated impact of distribution rate increases on median residential gas bill, which is currently $64.14 for FY 2023, assuming commodity rates are static.

Reserve Transfers

Table 7 below shows the reserve transfers from FY 2023 and projected through FY 2028.

Table 7: Operations, Rate Stabilization and CIP Reserve Starting and Ending Balances, Revenues, Transfers To/(From) Reserves, Capital Program Contribution To/(From) Reserves, and Reserve Guideline Levels for FY 2023 to FY 2028 ($000)

		FY 2023	FY 2024	FY 2025	FY 2026	FY 2027	FY 2028
	Starting Reserve Balances						
1	Operations Reserve*	11,300	3,666	4,169	3,983	8,536	13,101
2	CIP Reserve	3,820	-	-	-	-	-
3	Cap and Trade Reserve	6,732	8,834	11,908	15,395	19,294	23,623
4	Debt Service Reserve	434	434	434	434	-	-
	Revenues						
5	Total Revenues	70,468	63,223	65,479	68,993	72,516	76,622
6	Cap and Trade	2,102	3,074	3,487	3,898	4,329	4,776
	Transfers						
7	Operations Reserve*	1,718	(3,074)	(3,487)	(3,464)	(4,329)	(4,776)
8	CIP Reserve	(3,820)	-	-	-	-	-
9	Cap and Trade Reserve	2,102	3,074	3,487	3,898	4,329	4,776
10	Debt Service Reserve				(434)		
	Expenses						
11	Total Non-CIP Expenses	(71,704)	(55,684)	(55,318)	(57,374)	(57,800)	(59,122)
12	Planned Distribution CIP	(10,217)	(7,036)	(10,347)	(7,500)	(10,150)	(11,818)
	Ending Reserve Balances						
1+5+6+7+11+12	Operations Reserve*	3,666	4,169	3,983	8,536	13,101	18,784
2+8	CIP Reserve	-	-	-	-	-	-
3+9	Cap and Trade	8,834	11,908	15,395	19,294	23,623	28,398
4+10	Debt Service Reserve	434	434	434	-	-	-
	Operations Reserve Guidelines						
13	Minimum	13,394	10,044	10,055	10,450	10,575	11,504
14	Maximum	26,788	20,089	20,111	20,900	21,151	23,008
	CIP Reserve Guidelines						
15	Minimum	10,217	7,036	10,347	7,500	10,150	11,818
16	Maximum	17,253	17,383	17,847	17,650	21,968	26,261

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

Cost Trends

Figure 3 below illustrates the projected long run changes in the Gas Utility's costs. Cost increases over the FY 2019 to FY 2028 time period are mainly from supply costs, followed by operations and capital expenses.

Figure 3: FY 2019, FY 2024 and FY 2028 Cost Trends

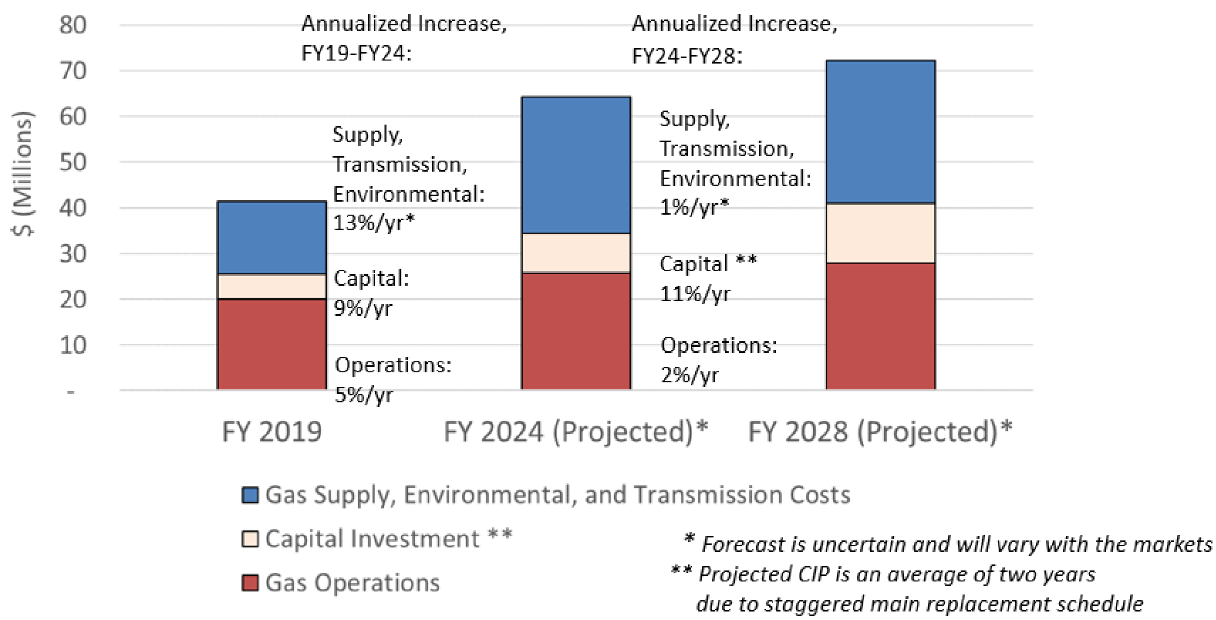


Figure 3 shows total gas supply costs, including commodity and transmission and environmental costs. Together these supply costs increased by 13% annually on average from FY 2019 to FY 2024. Gas commodity costs, a component of the supply costs in Figure 3, are the most variable component and represent the largest jump in costs from FY 2022 to FY 2023. Staff projects commodity costs to approximately double from FY 2022 to FY 2023 and then decline by FY 2024 (consistent with current gas market forecasts from various sources, including forward gas contracts on exchanges, forecasts from suppliers, and the Federal Energy Information Administration). For the remainder of the five-year forecast period from FY 2024 through FY 2028, these forecasts show gas market prices per therm expected to decrease gradually, though longer-term projections are even more uncertain.

Despite the projected gradual increase in FY 2024 – FY 2028 in gas market cost estimates, there are several smaller components of supply costs that are expected to increase significantly during that time period, leading to an overall gradual increase in total gas supply costs. Cap and Trade allowance costs are increasing by 15.7% annually from FY 2024 to FY 2028.[6] Staff projects

[6] Based on allowance broker quotes.

transmission costs to increase steadily at 4-6% annually from FY 2024 to FY 2028.[7] Carbon offset products are also increasing at 7% per year on average.[8] This leads to a gradual increase in gas supply costs over the forecast period, despite the projected decline in gas market prices (which itself is inherently uncertain).

Averaging the cost of CIP over the two-year main replacement cycles, staff expect costs to increase by around 11% on average annually from FY 2024 through FY 2028 as main replacement costs continue to rise. Capital Improvement Program (CIP) costs vary from year to year and staff projects the two-year average CIP costs to increase by about 10% on average over the forecast horizon. While CPAU has historically planned a new gas main replacement project every year, higher than expected bid proposals have required resizing and redesign of some projects. Since FY 2020, staff has been budgeting for a new, larger main replacement project every other year, and this revised main replacement schedule has allowed CPAU to reasonably meet its main replacement needs while addressing challenges in the construction market and optimizing staffing resources. However, replacement costs continue to rise and holding the gas main replacement program budget steady results in a reduction of the rate of main replacement over time. This Financial Plan addresses these challenges in a way that will allow CPAU to meet its main replacement needs by increasing main replacement budget beginning in FY 2025 and including a 3% annual construction inflationary increase thereafter.

Staff also projects operations costs to increase by about 2% annually on average from FY 2024 to FY 2028, primarily due to inflation and salary and benefit increases. Operations costs include funding for the cross-bore program. The cross-bore safety program ensures that gas pipelines have not crossed through sewer laterals, which is rare but possible during trenchless installation. This is referred to as a "cross-bore," and while they are very rare, if they exist, they pose a risk of gas leaks if a plumber uses a cutting tool to clear a sewer line and accidentally cuts the gas line. While a majority of sewer laterals have been inspected, staff has come across several services which are not able to be scoped, either due to infiltration by roots or broken/collapsed pipe segments. Staff has included $0.6 million to $0.8 million per year in additional funding between FY 2024 and FY 2028 to complete the inspections within the next 5 years.

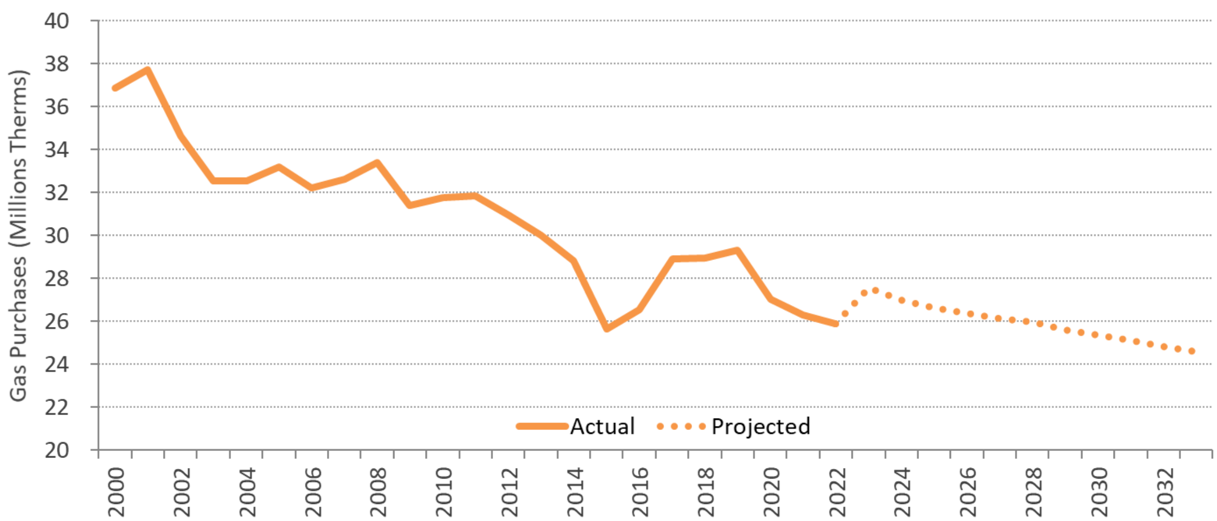
<u>Gas Purchases Forecast</u>
The ongoing pandemic recovery, as well as usage declines similar to what has been seen in the electric utility, leads to questions of how long the trend of reduced gas consumption will last. As seen with prior economic and drought-related gas usage declines, it is likely that consumption will not come back to pre-conservation/pandemic levels but will likely become a longer-run usage decline. Further changes, such as the voluntary replacement of gas appliances with electric appliances, building electrification of new construction as mandated by the 2019 Reach Code,

[7] The transportation rates for calendar years 2022-2026 reflect the rates in the September 30, 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.
[8] Based on carbon offset provider quotes.

and customer behavior are also expected to lower long run usage, and this forecast will be revised accordingly as more customers adopt these measures.

Based on billing data through the end of 2022, gas usage has shown modest recovery with the return of winter heating. It is too early in the winter heating season to tell what the trend will be for the whole season. However, long term declining gas consumption will put upward pressure on rates, as a generally increasing cost to operate and distribute gas will be spread across fewer units of sale. **Figure 4** shows the gas supply purchases actuals through the end of 2022 and projected for the next 10 years.

Figure 4: Gas Supply Purchases Forecast



<u>Gas Bill Comparison with Surrounding Cities</u>

Table 8 presents residential bills for Palo Alto and PG&E for Calendar Years 2021 and 2022 compared to winter months in 2022 – 2023 during the recent supply price spikes at median usage levels. The annual gas bill for the median residential customer for CY 2022 was $821, about 11% lower than the annual bill for a PG&E customer with the same consumption. PG&E's distribution rates for gas have increased to collect for needed system improvements for pipeline safety and maintenance.

The bill calculations for PG&E customers are based on PG&E Climate Zone X, an area which includes the surrounding communities.

Table 8: Residential Monthly Natural Gas Bill Comparison ($/month)

Year/Month	Median Usage (therms)[9]	Palo Alto	PG&E Zone X	% Difference
CY 2021	402	$ 631.28	$ 701.60	(14%)
CY 2022	402	821.33	868.62	(11%)
November 2022	32	62.64	76.93	(19%)
December 2022	69	175.06	171.96	2%
January 2023	76	393.57	217.25	81%

Historically, Palo Alto's residential gas bills have been competitive relative to PG&E. During January 2023, bills increased significantly relative to PG&E. Staff is looking into reasons why gas prices spiked this winter and why PG&E's gas rates did not rise as rapidly as Palo Alto's gas rates during the recent market price spikes. Governor Newsom has requested that the Federal Electric Regulatory Commission start an investigation of winter gas prices. The Mayor sent a letter to the Governor on February 7, 2023 expressing the City's support for pursuing these investigations. Similar investigations are underway by the California Public Utilities Commission (CPUC) in collaboration with the California Energy Commission and California Independent System Operator (CAISO). Staff is also in the process of doing a more extensive competitiveness review and will provide updates in the future.

<u>Alternative Gas Increase Plans</u>

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.

The attached Financial Plan proposes an 18% transfer, $7,191,000 for FY 2023, which aligns with the voter-approved changes codified in PAMC 2.28.185. Measure L authorized Council to make the transfer annually, and granted Council the ability to approve a lower amount. Although Council will formally direct the FY 2024 transfer amount next year, Staff provided preliminary projections for FYs 2024 – 2026 for the UAC and Finance Committee's consideration and feedback: Alternative 1 proposes transferring 18% of gross revenue as voters approved in Measure L, and Alternative 2 proposes a transfer between 15.5% and 11.1% annually through FY 2026.

[9] Median usage data based on CY 2022

Staff prepared Alternative 2's lower transfer percentages in response to recent increases in gas distribution rates and supply costs; this alternative is projected to create FY 2024 - 2026 transfers similar to the annual 2% to 3% growth rate in the transfer prior to Measure L. To illustrate, Alternative 2 links the FY 2024 – 2026 transfers to the Consumer Price Index (CPI). CPI**Error! Reference source not found.** is projected to be 3% long term, though staff projects 5% CPI increases in FY 2024 and FY 2025. **Table 9** shows a 6% per year projection as the maximum proposed increase under Alternative 2; actual increases for the years shown would be capped at 6% or CPI, whichever is less.

Table 9Error! Reference source not found. shows the amount of the transfer both in dollars and as a percentage of utility revenue for each fiscal year, as well as the projected rate of annual growth in the transfer. **Table 10** below shows the distribution rate increases (as a percentage of the total bill, excluding supply cost changes) associated with each alternative.

Table 9: Proposed / Projected General Fund Transfers as % of Gross Sales Revenues Two FYs Prior[10]

	Proposed		Projected	
	FY 2023	**FY 2024**	**FY 2025**	**FY 2026**
Gas Utility Gross Sales Revenue Two Fiscal Years Prior ($000)				
Alternative 1	39,950	49,634	72,570	66,927
Alternative 2				66,269
Percent of gas utility gross revenue to transfer				
Alternative 1	18.0%	18.0%	18.0%	18.0%
Alternative 2		15.5%	11.1%	12.9%
Transfer amount ($000)				
Alternative 1	7,191	8,934	13,063	12,047
Alternative 2		7,622	8,080	8,565
Change in Transfer from Prior Fiscal Year (%)				
Alternative 1	-1%	24%	46%	-8%
Alternative 2		6%	6%	6%

Table 10: Summary of Distribution Rate Changes for Transfer Proposal and Alternatives

	FY 2023	FY 2024	FY 2025	FY 2026
Alternative 1	4%	9%	10%	8%
Alternative 2		8%	7%	5%

COMMISSION REVIEW

The Utilities Advisory Committee reviewed the FY 2024 Gas Financial Plan on March 1, 2023 and voted 6-1 (Metz no) to recommend the staff recommendation with a General Fund transfer of up to 15.5% of gross gas utility revenues in FY 2024 (based on FY 2022 revenue), which

[10] Measure L authorizes a transfer based on 18% (or a lesser percentage if approved by Council) of the revenue for two fiscal years prior, so the FY 2024 transfer is based on FY 2022 revenue.

corresponds to Alternative 2 in Tables 11 and 12 above. The Commissioner who voted no said he wanted to see the reserves structure and transfers improved in the plan before approving it (for example, to have separate supply and distribution reserves and to avoid transfers from a reserve for a purpose different from the one that reserve typically serves). Commissioners expressed concern about keeping reserves below the minimum guidelines for as long as the plan proposes to do. There were several comments acknowledging how important it was to raise distribution rates to cost recovery right away given the condition of the reserves. There was some discussion of possible alternatives to raising rates right now and acknowledgement that it would require cuts to safety-related investments and the cross-bore program, ending the Carbon Neutral Gas program, or other cuts to core operations. Some Commissioners noted that the community had received a benefit during the pandemic by keeping gas prices low, which had been appropriate during the pandemic, but that the current rates could not be sustained. Several Commissioners emphasized the uncertainty in future gas prices and that there was not guarantee FY 2024 gas prices would be lower than FY 2023. They expressed interest in exploring alternatives for hedging against future gas price spikes.

TIMELINE

The City Council will consider adopting the Financial Plan and rate adjustments as part of the FY 2024 budget review and adoption process. If Council approves the proposed rate changes, they will become effective July 1, 2023.

FISCAL/RESOURCE IMPACT

Normal year sales revenues for the Gas Utility are projected to increase by roughly 8 percent or $5.7 million as a result of the proposed rate increases. If commodity costs decline 36% as forecasted, total supply revenue is projected to decrease by 36% as well. Commodity costs are uncertain, but any changes in costs from these forecasts would be passed through to customers via the monthly varying rate adjuster. The FY 2024 Budget is being developed concurrent with these rates and, depending on the final rates, adjustments to the budget may be necessary at a later time. See the attached FY 2024 Gas Financial Plan for a more comprehensive overview of projected cost and revenue changes for the next five years.

POLICY IMPLICATIONS

The proposed gas rate adjustments are consistent with Council-adopted Reserve Management Practices that are part of the Financial Plan and were developed using a cost-of-service study and methodology consistent with the California constitution and industry-accepted cost of service principles. As noted in the Reserves Management Practices (Attachment B), 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.

STAKEHOLDER ENGAGEMENT

Staff, the UAC's, and the Finance Committee's recommendation on the FY 2024 gas rate increases and proposals in this report will go to City Council in June during the budget adoption process.

ENVIRONMENTAL REVIEW

The Finance Committee's review and recommendation to the City Council on the FY 2024 Gas Financial Plan 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: Gas Resolution FY24
Attachment B: Reserves Management Practices
Attachment C: Rate Schedule

Approved by:
Dean Batchelor, Director of Utilities
Staff: Jonathan Abendschein, Assistant Director of Utilities Resource Management