



City Council Staff Report

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

Meeting Date: April 17, 2023
Staff Report: 2303-1219

TITLE

PUBLIC HEARING: Adoption of 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); CEQA status: exempt/not a project under Public Resources Code section 21080(b)(8)

RECOMMENDATION

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

- a. Approving the fiscal year (FY) 2024 Gas Utility Financial Plan (Attachment B);
- b. Amending the Gas Utility Reserve Management Practices (Attachment C);
- 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 15.5% 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 D).

The UAC and Finance Committee both recommend transferring 15.5% of gas utility gross revenues received during fiscal year (FY) 2022 to the General Fund in FY 2024, which is below the voter approved level of 18.0% (item (d) above). The UAC had one dissenting vote for reasons unrelated to the transfer and the Finance Committee had one dissenting vote specifically related to the transfer level.

EXECUTIVE SUMMARY

The Utilities Advisory Commission (UAC) and Finance Committee have reviewed the attached proposed Gas Utility Financial Plan and proposed rate changes recommended by staff for FY 2024. The UAC and Finance Committee recommend approval of the staff recommendation, which includes the transfers described in the Recommendation section above. The rate changes included in Attachment D are expected to result in an 8% increase in the customer bill (due to a 21% increase to the distribution component of the rates). The actual bill change customers would experience would vary due to various pass-through rate components related to gas supply costs, which vary as frequently as monthly. Approval of this item would result in implementation of the finalized rates for FY 2024, beginning July 1, 2023.

Staff is requesting that Council determine the amount of the General Fund transfer for the gas utility. This 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, though Council may choose to transfer a lesser amount. Two alternatives and their associated rate increases are shown in the section below titled "Alternative Gas Increase Plans." All rate and cost discussions in this staff report and the Financial Plan are based on Alternative 2, which involves transferring up to 18% of gas utility gross revenues in FY 2023 and 15.5% in FY 2024, as recommended by the UAC and Finance Committee.

BACKGROUND

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:

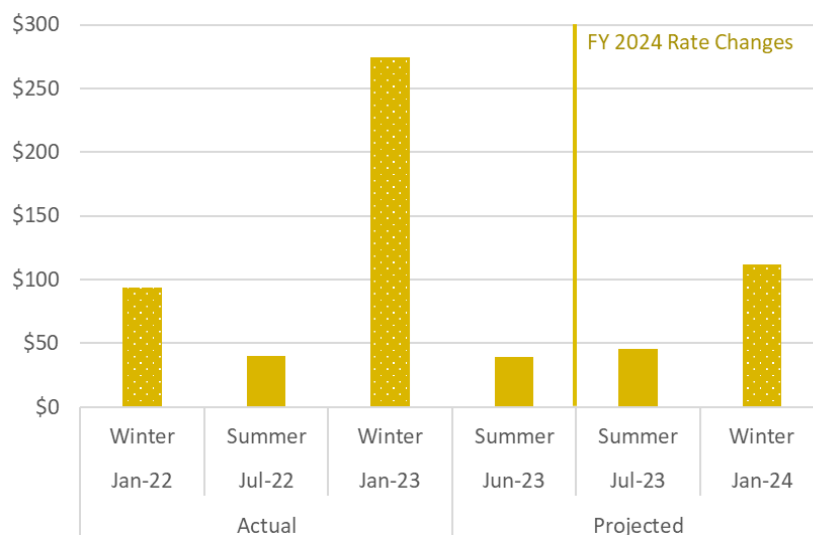
- gas supply costs (60 percent of costs in FY 2023), which represent the cost of buying gas and transporting it to Palo Alto and associated environmental charges, and
- distribution-related costs (40 percent of costs in FY 2023), which represent the cost of operating Palo Alto's gas distribution system, administration, customer service, and other day to day operations.

Gas supply revenues to cover gas supply costs are collected through four rate components (commodity, transmission, cap and trade, and Carbon Neutral Gas) that pass gas supply costs through directly to customers, and which change as frequently as monthly. Gas distribution revenues to cover gas distribution costs 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).

Gas market prices rose to unprecedented levels in FY 2023, leading to far higher gas supply costs for Palo Alto in FY 2023 than are projected for FY 2024 through FY 2028. As shown in Figure 1 below, customer gas bills spiked in the winter of 2022/2023 and are expected to decrease

significantly by June 2023, when this rate change would take effect, and are not currently forecasted (based on current forward market prices) to reach similar levels next winter, though these forecasts are uncertain.

Figure 1: Monthly Median Residential Gas Bill



ANALYSIS

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. In addition, the gas market price spikes in FY 2023, which were not fully passed through to customers, decreased reserves well below Council-approved minimums. The distribution rate increase is projected to increase overall customer bills approximately 8%, though changes to gas supply costs mean that the actual impact to customer bills may be higher or lower. 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, based on current market forecasts 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 did not keep up with these increased costs as the City pursued a Council policy to minimize rate increases during the economic downturn associated with the COVID-19 pandemic.

Additional detail on the staff proposal is available in the March 21, 2023 Finance Committee staff report (2302-0946).

Alternative Gas Increase Plans

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.

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 is projected to be 3% long term, though staff projects 5% CPI increases in FY 2024 and FY 2025. Table 1 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 1 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 2 below shows the distribution rate increases (as a percentage of the total bill, excluding supply cost changes) associated with each alternative.

**Table 1: Proposed / Projected General Fund Transfers
as % of Gross Gas Revenues Two FYs Prior¹**

| | Proposed | | Projected | |
|--|----------|---------|-----------|---------|
| | FY 2023 | FY 2024 | FY 2025 | FY 2026 |
| Gas Utility Gross Revenue Two Fiscal Years Prior (\$000) | | | | |
| Alternative 1 | 39,950 | 49,721 | 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 | | 7,707 | 8,080 | 8,565 |
| Change in Transfer from Prior Fiscal Year (%) | | | | |
| Alternative 1 | -1% | 24% | 46% | -8% |
| Alternative 2 | | 6% | 6% | 6% |

Table 2: 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% |

FISCAL/RESOURCE IMPACT

The resource impact of the recommendations summarized in this report is the continued financial solvency of the gas utility and, as the City is a ratepayer, an increase to General Fund expenses (due to the rate increases) and revenues (due to the General Fund transfer). Normal year sales revenues for the Gas Utility in FY 2024 are projected to increase by roughly 8 percent or \$5.7 million as a result of the proposed rate increases, not including fluctuations in commodity revenue/cost. General Fund utility bill costs are expected to increase by \$0.06 million as a result of these rate changes. The change in General Fund revenues from FY 2023 to FY 2024 would depend on the General Fund transfer alternative chosen by Council, as shown above in Table 1. Under Alternative 2, which was recommended by the UAC and Finance Committee, General Fund revenues would increase from \$7.191 million in FY 2023 to \$7.707 million in FY 2024, an increase of about \$516,000.

¹ 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.

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

These recommendations were reviewed by the UAC and Finance Committee in public meetings. Public communications of issues related to winter gas supply price spikes were done via social media, City newsletters, and other channels. The public will be notified of the final rate changes adopted by Council through various channels, including social media, the website, utility bill inserts, and City newsletters. Published in the Palo Alto Daily on April 7th and 14th, 2023.

ENVIRONMENTAL REVIEW

Adoption of the Financial Plans and budgeted transfers referenced in this report 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 gas 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 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: Gas Resolution FY24

Attachment B: Reserves Management Practices Redlined

Attachment C: Gas FY 2024 Financial Plan

Attachment D: Rate Schedule for FY2024

APPROVED BY:

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