TO:               HONORABLE CITY COUNCIL
FROM:             CITY MANAGER              DEPARTMENT: UTILITIES
ATTENTION:       FINANCE COMMITTEE
DATE:            APRIL 17, 2007              CMR: 204:07
SUBJECT: UTILITIES ADVISORY COMMISSION RECOMMENDATION TO APPROVE A RESOLUTION ADOPTING A NATURAL GAS RATE INCREASE FOR FISCAL YEAR 2007-08, AND STAFF RECOMMENDATION TO APPROVE, IN CONCEPT, THE ADOPTION OF A NATURAL GAS RATE INCREASE FOR FISCAL YEAR 2008-09

RECOMMENDATION
Staff and the Utilities Advisory Commission (UAC) recommend that the City Council adopt the attached resolution to:

(a) Approve a 9.5 percent increase to gas retail rates, for Fiscal Year (FY) 2007-08, effective July 1, 2007, which will increase annual revenue by $4.9 million;

(b) Approve the changes to the Gas Utility Rate Schedules, as attached;

(c) Approve a monthly “Customer Charge” for all customer classes, irrespective of their monthly gas consumption, in order to collect a portion of the utility’s fixed operating costs.
In addition, for biennial budgeting purposes, staff recommends:

(d) Approval, in concept, of a 9.1 percent system average gas rate increase for FY 2008-09, which will increase annual revenue by an additional $4.5 million.

DISCUSSION
Revenue
The City Council approved a 20 percent gas rate increase for FY 2006-07. Gas sales and revenue forecasts were adjusted during the midyear budget process for FY 2006-07, with residential sales
approximately 5 percent lower than forecast during the first half of the year. Gas sales for FY 2007-08 are projected to be flat, although consumption can be weather-dependent.

Staff is recommending a 9.5 percent gas rate increase effective July 1, 2007. This represents an annual revenue increase of $4.9 million which will be applied to the distribution rates of all customer classes. Another 9.1 percent revenue increase, or $4.5 million, is proposed for FY 2008-09 to cover projected increases in commodity costs and to fund the Gas Supply Rate Stabilization Reserve (G-SRSR). Percentage increases for each customer class will be allocated by consumption patterns based on the cost of service study.

The key driving factors for the rate increases are the increased costs of commodity and the increased costs to operate maintain the gas distribution system as discussed in the attached Utilities Advisory Commission report.

For the past three fiscal years, average winter residential bills for Palo Alto customers have been between 26.9 to 31.5 percent lower than for PG&E customers, and annual residential bills have been lower by roughly 25 percent.

**Distribution Expenses**

Operating expenses for Gas Distribution and the Capital Improvement Program (CIP) continue to increase while sales are projected to be flat.

Continuing to draw down the Gas Distribution Rate Stabilization Reserve (G-DRSR) to fund the increased expenses for FY 2007-08 would significantly reduce the G-DRSR level to a negative (-) $1.4 million.

Staff proposes an increase of approximately $4.9 million in Gas Distribution Fund revenues for FY 2007-08. This will fund the increased costs of operating and maintaining the gas distribution system as well as funding the G-DRSR to raise its balance to an acceptable level. The “Annual Risk Assessment for Reserves” was performed for the Gas Distribution Fund based on loss of revenue due to reduced sales and unplanned capital projects. The proposed increase is projected to bring the FY 2007-08 ending balance for the G-DRSR above the Risk Assessment level of $3.3 million by $100,000, but it will be $600,000 below the Minimum Guideline level. To bring the G-DRSR balance to the Minimum Guideline level would require an additional 1.9 percent rate increase above the proposed rate increase. With the recommended two-year gas retail rate increase, the G-DRSR level is expected to exceed the Minimum Guideline at the end of FY 2008-09 by $700,000.

**Customer Charge**

In conjunction with the proposed revenue increase, staff is recommending the institution of a fixed monthly “Customer Charge” to collect some of the allocated distribution costs not currently being recovered from low consumption users. A natural gas fixed “Meter Charge” was eliminated in the 1970’s to encourage conservation. As loads and sales continued to grow, fixed
costs were spread across increasing sales volumes and full recovery was ensured. However, as sales decline, or fluctuate due to unanticipated weather patterns, this “volumetric pricing” methodology results in uneven revenue streams. It also results in artificial and unfair subsidization of the distribution costs of low-volume gas users by higher-volume users. An alternative to strict volumetric pricing is required to ensure the equitable capture of fixed expenses, such as meter reading and customer accounting.

To avoid a sudden negative financial impact on the smaller gas user, staff recommends that the customer charge initially be set at a level that does not fully collect all fixed costs, but rather a portion of those costs. For example a $5.25 monthly charge is proposed for most of the residential customers, which represents 45 percent of the fully allocated monthly cost-of-service of $9.50. Incremental changes will be made over time in order to achieve the 100 percent fully allocated level. For larger customers, the monthly charge, based on meter size, will immediately collect the fully allocated customer costs. The expected revenue collected from the proposed monthly fixed charges is approximately $2.3 million. The commercial Customer Charge will range from $5.25 to $311.

Supply Expenses
Gas supply costs have generally stabilized. While the Gas Supply Rate Stabilization Reserve (G-SRSR) balance is projected to be below Minimum Guideline levels, it exceeds the target established by the “Annual Risk Assessment for Reserves” for FY 2007-08, by $500,000 and a gas supply revenue increase is not recommended at this time. For FY 2008-09, a projected $4.5 million revenue increase will be applied, in entirety, to the Gas Supply Fund to offset increased supply costs and further fund the G-SRSR.

UTILITIES ADVISORY COMMISSION REVIEW AND RECOMMENDATIONS
On April 4, 2007, the UAC voted 4 to 0, with one absent, to recommend that the City Council:

(a) Approve a 9.5 percent increase to gas retail rates, for Fiscal Year (FY) 2007-08, effective July 1, 2007, which will increase annual revenue by $4.9 million;

(b) Approve a monthly “Customer Charge” for all customer classes, irrespective of their monthly gas consumption, in order to collect a portion of the utility’s fixed operating costs.

The UAC voted to withhold recommending approval, in concept, of a 9.1 percent system average gas rate increase, or $4.5 million revenue increase, for Fiscal Year 2008-09, feeling that future costs were too uncertain at this time. The UAC also suggested that recommendation for approval of the specific rate schedules be sought during the approval process.

ALTERNATIVES
Staff also evaluated the impact of alternative rate proposals to the proposed rate increase of 9.5 percent. Any smaller rate increase would require reducing some combination of the operating
budget, Capital Improvement Program (CIP), or the combined Gas Supply and Distribution Rate Stabilization Reserves. Such a reduction to the operating budget would hinder the ability to purchase adequate future gas supplies under the current laddering strategy. Reducing the CIP would cancel a number of gas main replacement projects, where the infrastructure has exceeded its system design life. Reducing the G-DRSR and the G-SRSR would leave them further below the Minimum Guidelines and could necessitate an unplanned rate increase request in the event of an infrastructure failure or rise in market costs for gas supply.

**RESOURCE IMPACT**
Approval of this proposed rate increase will increase the Gas Fund sales revenues by $4.9 million for FY 2007-08. This 9.5 percent revenue increase will be applied entirely to gas distribution. This will result in a projected end-of-year balance for FY 2007-08 of $3.4 million in the Gas Distribution Rate Stabilization Reserve, which is $5.8 million below the Minimum Guideline Level of $9.2 million and slightly above the Risk Assessment target of $3.3 million.

The 9.1 percent rate increase, a $4.5 million revenue increase, proposed for FY 2008-09 will be allocated to gas supply. This will result in a projected end-of-year balance of $6.4 million in the Gas Supply Rate Stabilization Reserve, which will be above the Risk Assessment target of $3.8 million, but below the Minimum Guideline Level of $9.6 million.

**POLICY IMPLICATIONS**
This proposed rate increase meets the Utilities Strategic Plan objective of providing superior financial performance to the City and competitive rates to customers. These recommendations do not represent a change in current City policies.

**ENVIRONMENTAL REVIEW**
The adoption of the resolution does not constitute a project under the California Environmental Quality Act. Therefore, no environmental assessment is required.

**ATTACHMENTS**
A: Resolution  
B. Gas Rate Schedules G-1, G-2, G-3, G-4, G-6, G-10, G-11, and G-12  
C. Report to the UAC for its April 4, 2007 meeting: Proposed FY 2007-08 and FY 2008-09 Natural Gas Rate Increase  
D. Minutes of the UAC meeting of April 4, 2007

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