SEATTLE CITY COUNCIL
CENTRAL STAFF

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| **To:** | **Select Committee on 2016 Seattle City Light Strategic Planning** |
| **From:** | **Tony Kilduff**<br>**Calvin Chow** |
| **Date:** | June 22, 2016 |
| **Subject:** | Overview of Strategic Plan Update |

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Overview

On June 23rd the Select Committee will meet to begin consideration of the Mayor's proposed update to City Light's Six-year Strategic Plan (Plan). The Select Committee will meet again on June 30th and July 14th. At the end of its deliberations the Select Committee is expected to adopt a Resolution approving a Plan. In addition to adopting a Plan, the Resolution provides policy direction to City Light for future updates to the Plan, and requests that the utility submit a rate ordinance to the Council before the start of the next budget cycle establishing new rates for 2017 and 2018.

This memo will highlight some issues for the Select Committee. Later in the process, when the Select Committee has had time to review the proposal in depth, staff will work with the Select Committee and the utility to develop recommendations for the Select Committee's consideration.

Summary

1. Under the proposed Plan rates would increase by 5.6% in 2017 and by 5.6% in 2018.

2. The Plan assumes that retail sales of electricity will grow by 0.3% annually. Retail sales fell between 2011 and 2015, calling this assumption into question.

Context

Prior to the adoption of the first Plan in 2012, the Council's engagement with City Light had been episodic, centering mainly on crisis-driven rate increases such as a 58% increase in 2001, a 13.8% increase in 2010, and a 4.5% mid-year surcharge in that same year. The Council's frustration with the uncertainty around the utility's future led it to establish the City Light Review Panel in 2010. The Review Panel's mandate was to work with the utility to begin a rolling six-year planning and rate-setting process that would bring some order and predictability to City Light's strategic direction and rates.

The Council adopted the first Plan in 2012, covering the period 2013 to 2018. The Plan identified the spending the utility believed it would need to maintain services at their current levels over that period, plus new initiatives the utility believed would improve service delivery to its customers in the future, such as a new substation and deployment of modern meters capable of communicating directly with the utility.[1]

Although the Council only adopted rates for the first two years of the Plan, the document provided a roadmap for the future that City Light would update every two years and present to the Council for consideration. The first update was in 2014 and covered the period 2015 to 2020. The Council approved the proposed spending plan and established new rates for 2015 and 2016 to support it.

This will be the second update to the original Plan and covers the period 2017 to 2022. This update to the Plan continues the 26 ongoing initiatives of the original 38 approved in the first Plan (12 have been completed). There are two new initiatives in this update—transportation electrification and climate adaptation—however, the plan does not set aside any funding for them at this point.

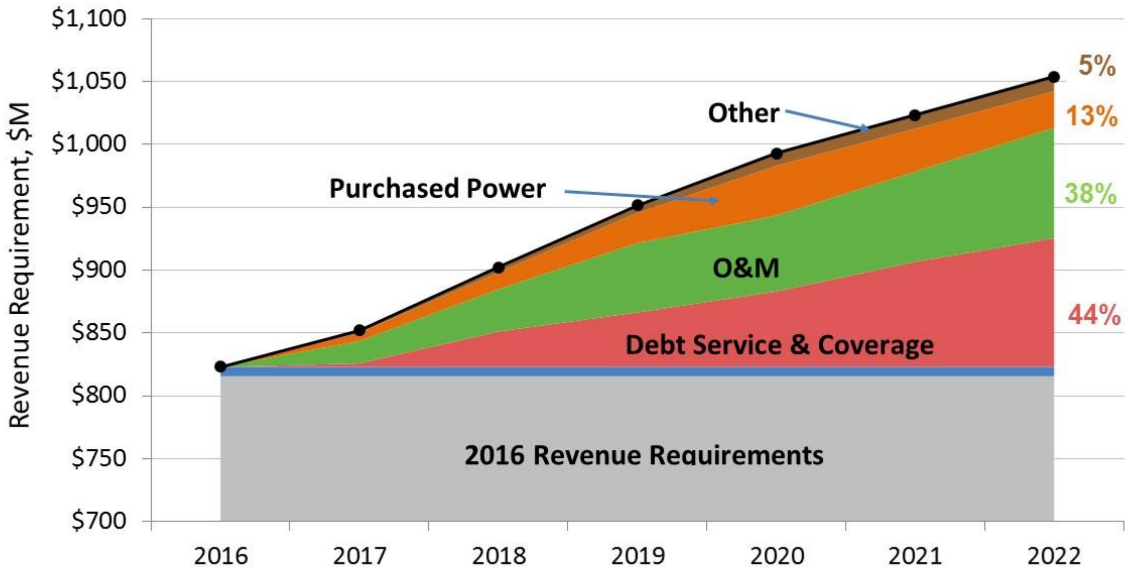
Elements of the Plan

At its core, City Light's Six-Year Strategic Plan is its six-year revenue requirements document. That is, a statement of how much the utility will need to collect from its retail customers over the period. This is not the same as the utility's budget. City Light has other sources of revenue than rate revenues and it borrows money each year to support its actual spending as shown in its budgets.

Figure 1 below shows what City Light expects to have to collect from its customers and what it intends to spend those revenues on. As the Figure indicates, the largest increases are in debt service coverage and O&M. The Council has twice endorsed the spending plan underlying this update.

[1] The 38 initiatives, grouped by topic, are detailed in Attachment A Ex2 on your agenda.

**Figure 1: Cost Drivers**




Underlying the O&M projections (which are predominantly labor-related) are the following assumptions about the growth in its main cost areas over the life of the Plan:

**Table 1: Assumed Growth Rates for O&M Components**

| | |
|---|---|
| Labor costs (direct) | 2.4% - 2.75% |
| Labor costs (benefits) | 5.0% |
| Non-labor O&M | 2.4% |
| Payments for City Services | 3.0% |
| Construction and Field Materials | 8.0% |

The growth in debt service is driven by City Light's debt issuance of approximately $200 million per year to support its capital spending program. This spending, which averages around $350 million annually, is largely unavoidable. City Light manages a large physical capital system that includes seven dams, 3,000 miles of distribution and transmission lines, 13 substations, 54,000 transformers, and 84,000 distribution poles. Failure to maintain these assets leads to increased costs later. Fortunately, with historically low interest rates, debt is cheaper now than it has been in the past.

In order to calculate an average rate,[2] City Light divides its total revenue requirement in each year by the total number of kilowatt-hours (kWh) it thinks it will sell to its retail customers in that year. Figure 2 below shows the forecast of its retail sales (usually called load) for the current Plan, and for reference the forecasts underlying the original Plan and the first update to it, and the actual load (the numbers are in gigawatt-hours, that is, millions of kWh).

**Figure 2: Actual and Forecasted Load**


City Light forecasts that it will sell 9,441 million kilowatt-hours in 2017, and 9,432 million in 2018. Dividing these into the revenue requirements for those years results in average systems rates of 9.03 and 9.54 cents/kWh respectively. These average rates represent a 5.6% increase in each of the two years. If the Plan is adopted as proposed, City Light would submit a rate ordinance for 2017 and 2018 reflecting these increases.

Staff Issue—Actual vs Planned Rates

This update to the Plan will take us to the end of the initial six-year planning period. It may be useful and informative to compare how rates grew with how the original Plan anticipated they would. Table 2 shows this comparison.

[2] No customer pays the average rate. Instead, City Light allocates its costs over its customer classes in proportion to the costs those classes impose on it, and calculates a rate specific to each class. The average rate is a convenient way to track changes in overall rates from year to year.

**Table 2: Actual and Original Plan Rate Increases**

| | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|
| **2012 Plan** | 4.4% | 5.6% | 4.1% | 4.8% | 5.3% | 3.9% |
| **Actual Rate Increases** | 4.4% | 5.6% | 4.2% | 4.9% | ***5.6%*** | ***5.6%*** |

The divergence is most marked in this update, especially for 2018. As we will see later, the failure of load to materialize as anticipated plays a large role in this.

Staff Issue—Load Growth and Rates

A striking feature of Figure 2 is how much different the forecasts are from what actually happened (the scale is truncated to exaggerate the differences). Load fell steadily from 2011 to 2015, recovering somewhat this year. In 2012, when City Light drafted the original Plan, it forecasted that load would grow by about 0.6% per year over the planning period. In reality it declined by about 1.3% over the first three years of the Plan.

When City Light proposed its first update to the Plan in 2014, it again forecasted that load would grow, but this time by about half (0.3%) of what had been assumed in the original Plan. Instead of growing in 2015, as anticipated, it fell again. This year may show some growth but it is too soon to say.

The current update to the Plan forecasts that load will grow, starting in 2017, by about 0.3% per year. The evidence since 2011 calls this projection into question. And even with the 0.3% assumption, load in 2018 will be almost 2% lower than load in 2011.

The failure of load to grow as forecast has implications for rates. As noted earlier, average rates are the result of dividing the revenue requirements by the number of kWh sold. Even if costs are fixed, rates will increase when load declines. To get a sense of the impact on rates of the failure of load to grow as predicted, if load *had grown* as originally forecasted in the 2012 Plan, the rate increase facing customers in 2017 would be 2.5% instead of the proposed 5.6%.

Table 3 below compares the growth in rates if load remains constant at the 2016 level throughout the Plan period. This is more conservative that City Light's assumption of 0.3% growth, but in light of recent experience with declining load, it may not be conservative enough

**Table 3: Rate Increases Assuming Flat Load**

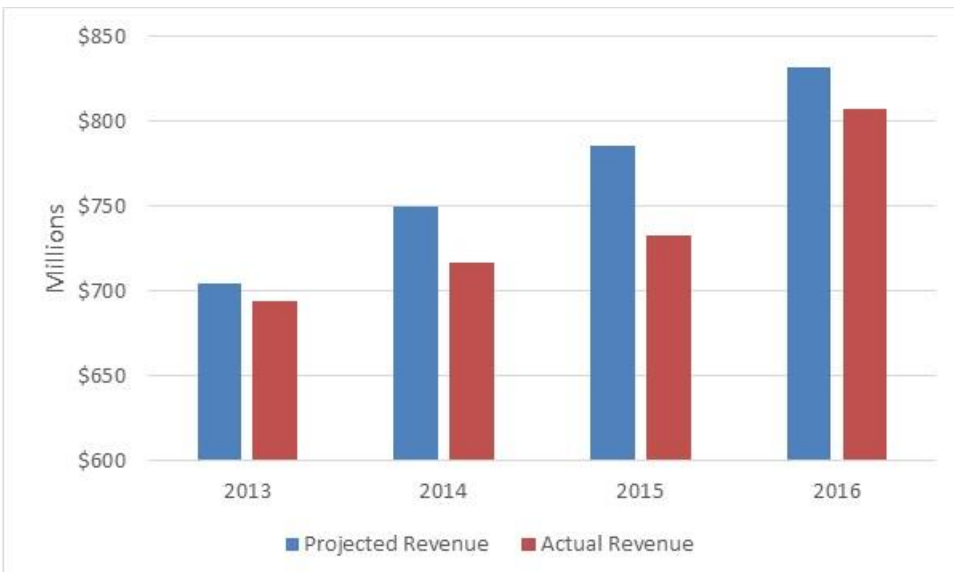
| | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|---|
| **Proposed Rate Increases** | 5.6% | 5.6% | 5.0% | 3.6% | 3.1% | 2.5% |
| **Increases with Flat Load** | 5.6% | 5.9% | 5.5% | 4.3% | 3.1% | 3.0% |

It is not clear at this time whether the observed decline in load reflects a structural shift for the utility or whether it is just an isolated episode. A structural shift would require a policy shift in how the utility recovers its costs.

Staff Issue—Load Growth and Revenue

Declining load has implications for revenue too. When the Council adopted the Plan in 2012 and reaffirmed the basic direction in the 2014 update, it established rates that it assumed would generate the revenue needed to support the Plan. However, as noted above, load did not grow as anticipated. As a consequence, City Light did not collect the revenue the Council had intended it to collect. The chart below shows planned versus actual revenue collection since the inception of the Plan (the scale is truncated to highlight the differences). Under-collection was marked in 2014 and 2015. 2016 is a forecast and the situation may yet improve. Over the last four years (including the best estimate for 2016), City Light's revenue collection is down by $121 million.

**Figure 3: Actual and Forecasted Retail Revenue**




Given how little flexibility the utility has in adjusting its costs—it must, after all, continue to provide electricity to its customers—such a shortfall in revenues could have significantly weakened the utility's financial situation. Fortunately, over the same period its costs were about $100 million less than expected, due mainly to lower interest rates and lower purchased power costs. As a result, the net shortfall was not as great and the utility was able to continue to operate without significant disruption. However, in 2015 City Light did not meet the debt service coverage target (1.8) established in financial policies adopted by the Council, and will likely fail to meet it again this year.

City Light borrowed more for its capital program than planned in part because it had less cash from operations than anticipated, and in part because several large capital projects—the Denny Substation, the New Customer Billing System, and the Seawall Project—are coming in significantly above the cost estimates in the original 2012 Plan. In addition, City Light has deferred several major capital projects that were part the original Plan to accommodate the cost overruns and revenue shortfall. This will have a bow-wave effect in future Plans.

Staff Issue—Load Growth and Customer Bills

Since falling load increases pressure on rates, it may be useful to consider the impact to customer bills. Figure 4 plots the average rate, average residential customer bill, and inflation all set to 100 in 2011 for comparison.

**Figure 4: Bills Versus Rates**

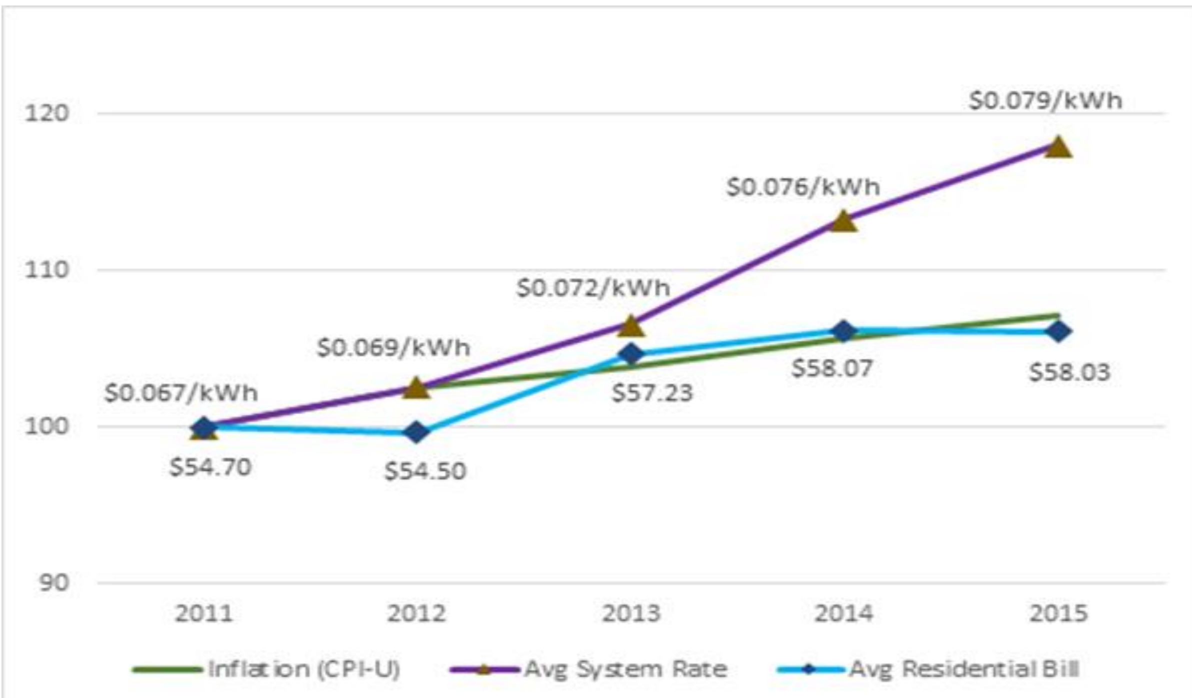



Figure 4 shows that although the average rate increased by 18% over five years from 2011 to 2015, average residential bills increased by only 6% because of reduced residential consumption. That is roughly in line with inflation over the period. While it is important to note that individual customers' bills will vary from the average residential bill, the graphic shows that residential customers as a class faced lower bill increases than the rates would suggest.