Legislative Department
Seattle City Council
Memorandum

Date: March 30, 2015

To: Energy Committee

From: Tony Kilduff (4-3580)
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Subject: **Staff recommendation on proposed change to City Light rate design**

Background

In early 2014, City Light proposed the first update to its Strategic Plan, covering the period 2015-2020. To support the updated Plan, it also proposed the following average system rate increases for the period:

	2015	2016	2017	2018	2019	2020
Planned Rate Increases	4.2%	4.9%	5.0%	3.9%	3.6%	4.9%

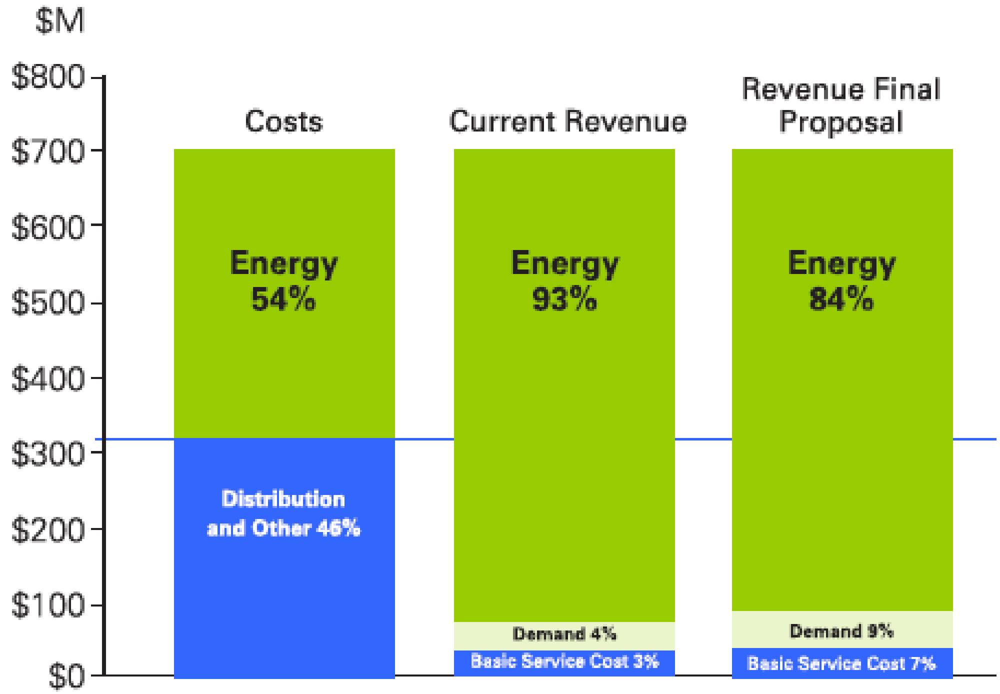
In addition to the proposed rate increases, the utility also proposed a change in the rate design for all of its customer classes that would result in less of the revenue from each class being recovered through charges related to the amount of electricity consumed, and more through other charges. To be clear, the proposed changes to rate design would have had no impact on the amount recovered from each class, only how it would have been collected.

In June 2014, the Council endorsed the proposed 2015-2020 Strategic Plan through Resolution 31529, and requested that the Executive propose electricity rates for 2015 and 2016 to support the first two years of the Plan, and also a biennial budget for the utility consistent with the Plan and the rates.

The Resolution made it clear that the Council did not approve City Light's proposed changes to rate design and asked that the Executive develop the rates under the extant rate design. The Resolution further noted the Council's intent to review the utility's proposal and to provide guidance on any changes to rate design for the future by the end of April, 2015.

Problem Statement

City Light proposed the change in rate design because of what it considers an imbalance between the way it incurs costs and the way it recovers revenue to cover those costs. The following graphic depicts the imbalance that is of concern to the utility.



The leftmost bar shows the division of City Light's costs between energy and distribution and other costs.

The cost of energy (kilowatt-hours purchased) clearly varies with retail consumption. On the other hand, the costs to maintain the distribution system and to provide all of the business support systems necessary to run the utility typically do not change with the amount of energy consumed. Thus, almost half of City Light's costs (45%) are fixed in the near term and do not vary with the level of energy demand in the service territory.

In contrast, City Light's rate structure is such that it recovers nearly all of its costs (93%—middle bar) through charges on the amount of electricity it sells to its customers. City Light's perspective is that this situation is essentially untenable in the long run. The utility has an active program to reduce the number of kilowatt-hours consumed, and to the extent that has been effective over the years, it requires ever higher rates for energy to recover not just the variable energy costs, but the fixed costs as well.

In the extreme, the utility sees the possibility of a "death spiral" in which declining consumption forces rates per kilowatt-hour up in order to recover costs, thus encouraging even lower consumption and forcing rates even higher. City Light's concern about this possibility was sharpened by the fact that load growth in the service territory has been declining in recent years and now stands at about a third of a percent per year, down from about one percent ten years ago.

(Also, certain utilities in Germany are experiencing something akin to this death spiral phenomenon; however, circumstances there are quite unusual and government actions in the last dozen years have exacerbated the situation for many investor-owned utilities.)

City Light's proposal to address this concern is to increase the amount of revenue it collects from customers through fees and charges *unrelated* to the amount energy they consume (rightmost bar). Although the extent of the change it proposed for 2015 was relatively modest, it was intended to be just the first step in a more significant shift away from cost recovery through energy charges. By 2022, at the end of the next Strategic Plan horizon, the utility envisioned the amount of cost recovery from energy charges declining from the current 93% to 67%, and the amount recovered through other charges to rise from 7% to 33%.

Staff Analysis and Recommendation

Staff recommended that the Council reject the utility's proposal to change rate design for the 2015-2016 rate period for three reasons:

- The problem identified by the utility was not articulated clearly enough to warrant action by the Council to change a long-standing policy. The likelihood of City Light experiencing a death spiral seems remote given that the City Council is its regulator, and the Council is unlikely to allow it to fail financially for lack of action;
- The utility did not provide a clear enough sense of the urgency of the problem. For example, its own forecast indicated that load, far from declining, would continue to grow at around a third of a percent for at least the next six years even in the face an average growth in rates of 4.6% per year; and
- Finally, the utility's proposed solution was one-dimensional: it did not present the Council with a variety of options for mitigating the problem.

Those same three reasons still apply: the problem is still ill-defined; its urgency is unclear; and the utility has not offered other ways to mitigate it.

At the Council's request, City Light will engage the City Light Review Panel in a discussion of trends in the U.S. utility industry that may impact the City Light in the future. That review, which should be complete by mid-2016, will help to frame this and will provide the Council with a clearer sense of the nature of the challenges the utility is likely to face in the next five to 10 years.

That discussion will also focus on alternative ways the utility might avoid declining retail demand for electricity. If these challenges truly are industry wide, it is likely that there will be pressure throughout the industry to change federal and state regulation to allow utilities the flexibility to respond. For example, under state law City Light cannot encourage the consumption of electricity, even if doing so would reduce greenhouse gases (through electrification of the transportation system, for example). It may be possible to change that in the future if utilities throughout the NW face similar challenges. There may also be other mechanisms to protect City Light from declining demand that are fully within the Council's purview today. The Council could authorize the utility to make up lost retail revenue in any given year through flat surcharges in subsequent years. And there may be yet other ways to address the problem.

Staff recommend that the Council not make any changes to rate design until the utility and the Review Panel have had an opportunity to explore the challenges facing the utility, determine their urgency, and present a menu of options to the Council for consideration.