



City of Anaheim
PUBLIC UTILITIES DEPARTMENT

DATE: OCTOBER 26, 2011
TO: CITY MANAGER/CITY COUNCIL/ PUBLIC UTILITIES BOARD
FROM: PUBLIC UTILITIES GENERAL MANAGER *Me*
SUBJECT: MODIFICATIONS TO ELECTRIC RATES

This item is for information only.

Summary

On November 9, 2010, the City Council adopted revisions to electric rate schedules, with electric base rates increasing by five percent effective December 1, 2010, and another five percent effective December 1, 2011, for all customer classes. In preparation for the implementation of the upcoming electric rate change, which is approximately one month away, we are providing this memo for your information.

Background

As customary in the electric industry, Anaheim electric revenues are based on the amount of energy consumed by its customers. The economic recession that began in late 2007 has reduced the amount of energy customers consumed by approximately nine percent. As demand fell, the Electric Utility (Utility) had limited flexibility to lower its expenses as a short-term response since its power portfolio is structured with long-term contracts that secure approximately 90% of Anaheim's electric needs. Under normal conditions, this long term approach protects Anaheim from the volatility of wholesale markets and has served the Utility's customers well over the past 10 years. In fact, this approach is the primary reason why Anaheim customers have saved, in total, over \$860 million since 2001 in their cost of electricity as compared to what they would have paid in a neighboring community. However, in a swift and prolonged downturn that is global in nature, this protection leaves the Utility with fixed costs that are difficult to recover.

The Utility didn't sit idle, however, as its revenues began to fall. Management was able to offset declining revenues by implementing aggressive strategies including cost cutting measures with a modest reliance on cash reserves, to forestall rate increases while continuing to provide unparalleled service. Since the start of the recession, the Utility has cut \$30 million (7.5%) from its budget by eliminating most hiring, cutting management salaries, deferring non-essential programs, deferring capital expenditures, and largely eliminating discretionary spending (training, new tools, printing, etc.).

It's important to note that labor costs only make up approximately 7% of the Utility's operating costs, with a relatively small workforce that is well below key industry standards as measured by customers per employee and administrative costs per customer. Having made discretionary spending cuts and with labor costs accounting for a small portion of the

Utility's costs, the majority of the remainder of the Utility's approximately \$400 million budget is fixed by contract, legislation, or City Charter. These fixed costs include power supply, fuel, debt service, General Fund Transfer, City Right-of-Way charges, infrastructure maintenance, placing overhead electric lines underground, and legislatively mandated conservation and efficiency measures. Required expenditures left the Utility with very little else to cut when revenues fell below their historically normal levels and the only programs left to cut were those that would reduce service and reliability levels for all customers.

By the fall of 2010, the Utility believed its cash reserves had fallen to a level that would be considered risky by the municipal bond rating agencies, and to levels that would not provide sufficient protection should an adverse operating event occur, such as the long-term loss of a power plant or a significant earthquake. Therefore, the Utility believed that if it did not increase revenue to replace spent cash reserves, it would most certainly face the following consequences:

- Credit rating downgrade, which would increase future borrowing costs by millions of dollars. For perspective, the Canyon Power Project was financed at record low interest rates, saving millions of dollars in borrowing costs, precisely because of the Utility's AA- rating.
- Purchased power cost increases on the wholesale market as potential counterparties would consider the Utility a bigger credit risk and require higher prices as a risk premium.
- Inability to withstand a significant adverse event without curtailing electric service to customers. If the Utility did not have the cash on hand to remedy an event such as a major unplanned outage or impact to system infrastructure from a major earthquake, then its customers might experience significant service interruptions as attempts to secure financing were made.

It was apparent that a base rate increase was necessary.

Results

While it was a difficult decision, the City Council understood that if the proposed rate actions were not approved, the Utility would, in all likelihood, have its credit rating downgraded, be required to continue to use reserves to fund operations, and make relatively drastic cuts to customer and reliability programs. It was not fiscally prudent to utilize reserves any further to fund operations as this approach would negatively impact the Utility's credit rating and severely curtail its flexibility in the event that rapid and high unforeseen cost increases arose, such as those that occurred during California's electricity market in 2001 or during times of natural disaster.

The Utility strives to maintain a strong financial position, which benefits ratepayers in the form of lower and more stable electric rates over the long run. Specifically, the Utility strives to achieve the following: 1) maintain our bond credit rating, 2) generate sufficient cash flow to cover projected expenditures, 3) maintain minimal cash reserve balances in order to respond to market and other changes, 4) maintain reserves to stabilize rates under volatile market conditions, and 5) reduce risk exposure.

In order for the Utility to continue to provide reliable, customer focused service and recover long-term, structural costs, the City Council approved a two-phase approach to increasing electric rates, which would increase rates gradually thereby mitigating the impact to customers. The second of the two five percent rate increases takes effect on December 1, 2011.

Even with this increase, Anaheim residents will continue to enjoy the lowest electric rates and most reliable service in Orange County. The recent power outage affecting the Southwest United States from Arizona to San Diego to Mexico was a reminder of how disruptive an unreliable system can be to our customers, and how beneficial a utility under local control is to a community.

In addition, the affirmation of the Utility's AA- rating by Fitch Ratings and Standard & Poor's was largely credited to the City Council's approval of this rate increase. It is important to note, however, that the Utility will continue to accrue significant increases in its costs through State and Federal mandates. These mandates include the procurement of more expensive renewable power, installation of costly emission conversion equipment on power plants and mandatory reductions in its emissions. These mandates will continue to burden Anaheim's electric ratepayers with increasing rates within the next 3-10 years.

The Department is well prepared to answer any questions and you may refer those questions to Marcie Edwards, City of Anaheim Public Utilities General Manager, at 714-765-4590.

