December 2, 2015

TO: Manufacturing Industrial Council

FROM: Energy Strategies

RE: SCL Financial Policy Recommendation

Background

In 2010, the City of Seattle adopted legislation that brought about a number of changes to the Seattle City Light (SCL) financial policies. The most significant of these was the establishment of a Rate Stabilization Account (RSA) that creates a cash reserve that is used to "buffer the utility from uncertainty in wholesale energy revenue."[1].

SCL financial policies target $100 million to $125 million to be held in the RSA. An automatic surcharge is triggered if the cash balance drops below specific thresholds. The quarterly surcharge is 1.5% if the RSA is less than $90 million, 3.0% if the RSA is less than $80 million and 4.5% if the RSA is less than $70 million. Action by the City Council is initiated if the fund drops below $70 million.

The legislation also established:

- A requirement to maintain a Debt Coverage Ratio (DCR) of 1.8 beginning in 2010 (down from the previous 2.0) based on the reduced risk created by the RSA.
- A six-year "Strategic Plan" which SCL must use to forecast capital expenditures.
- A method for forecasting the net wholesale revenue (NWR) using a simple average of NWR realized over all years beginning in 2002 and ending with the last prior year that SCL has complete information. This NWR forecast can also be amended if the City Council finds reason to do so.

As part of the 2015-2020 Strategic Plan, SCL has proposed a dramatic reduction in the NWR forecast (totaling $69 million), from 2014 to 2020. The removal of these dollars from the revenue requirement forecast means that the $69 million must be collected from ratepayers in the form of higher rates.

Such rate increases are planned for implementation through 2020[2]:

Planned Rate Increase	2015	2016	2017	2018	2019	2020
Average System Rate Increase	4.2%	4.9% (6.1% for High Demand customers)	5.0%	3.9%	3.6%	4.9%

[1] SCL October 2, 2015 Financial Report to Mayor Murray, Page 4

[2] March 30, 2015, Presentation by Tony Kilduff to Energy Committee, Page 1

SCL acknowledges that the RSA “significantly mitigates”[3] SCL’s financial risk associated with wholesale sales revenue, while the “customers are exposed in part to the wholesale revenue risk via RSA surcharges”[4] explained above.

Discussion

As previously noted, SCL’s financial policies require it to set rates sufficient to cover debt service 1.8 times after all required operating expenses are paid. Therefore, changes in debt service have 1.8 times the impact that regular expenses have on the revenue requirements.[5] In its most recent financial report to Mayor Murray on October 29, 2015, SCL indicated that although it expects to achieve significantly less NWR ($29.9 million) in 2015 than the financial plan projects, the utility’s DCR is at 1.7, which it expects to maintain through the end of 2015. Despite this lower DCR, there has been no discussion or remedial actions taken by the City Council to increase the DCR to the required 1.8.

In addition, the following mechanisms significantly reduce SCL’s risk exposure:

- The RSA ensures that any shortfall in NWR can be immediately covered.
- Customers pay higher rates to allow for a lower NWR forecast in the revenue requirement.
- SCL also maintains $63.6 million in its Bond Reserve, which is funded by bond proceeds and interest earnings, and has grown by almost $40 million in the last few years. It is forecasted to grow to $73.6 million at year end.[6]
- Financial policies require that the City of Seattle set electric rates at levels that will “ensure that net revenue available to fund capital requirements each year will be positive with a probability of at least 95%."[7]

Due to the reduced risk these mechanisms provide to SCL, and in light of SCL’s ability to maintain a 1.7 DCR in 2015 without any action being taken by ratings agencies despite very low NWR, we believe it is reasonable for the target DCR to be relaxed from 1.8 to 1.6 in SCL’s financial policies.

At this time, the key line of demarcation appears to be a DCR of 1.5, as evidenced by statements by Moody’s. For example, when assigning a stable outlook to SCL in its June 9, 2015, ratings outlook, Moody’s stated that the rating is based on “the benefit of the RSA mechanism…..and an adjusted debt service coverage ratio north of 1.5”[8]. Moody’s further reinforced the significance of a 1.5 DCR when stating that SCL’s ratings could *potentially* drop if the DCR falls *below* 1.5[9] (along with other financial actions). A target DCR of 1.6 would keep SCL safely above the 1.5 DCR called out by Moody’s.

Further, as shown in the table below, SCL continues to have the highest target DCR amongst its peer public utilities in the west, while also having the largest reserve fund requirement.

[3] SCL Risk Oversight Status Report to Mayor Murray, Page 4
[4] IBID
[5] Adopted Revenue Requirements Analysis 2013-2014, Page 8
[6] SCL October 29, 2015, Financial Update to Mayor Murray, Page 1
[7] SCL Financial Policies
[8] Moody’s Ratings Outlook, June 9, 2015
[9] IBID

Utility	Rate Stability Mechanism	Required Amt	Funding Mechanism	Current Funds	Target DCR
SCL	Yes	$100 M	Contingency Reserve, CIP funds, retail rates	$97.8 M (9/15)	1.8
Chelan County	Yes	$50 M	Set in annual budget	$50 M (12/14)	1.25
Clark County	Yes	No set amt	Net sales margin	$50 M (3/15)	1.25
Cowlitz County	Yes	No set amt	Net sales margin	$110 (5/15)	1.5
Grant County	Yes	$12 M	Contingency Reserve	$121.7 M (12/14)	1.25
LADWP	Yes	NA	Set in actual budget	$174 M (6/14)	1.7
Snohomish	Yes	NA	NA	$115 M (10/14)	1.75
Tacoma Power	Yes	$36 M	Set in annual budget	$48 M (12/14)	1.5

Note that in a 2009 financial policy "working paper", SCL proposed changing the financial policies by reducing the DCR to 1.6, 1.7 and 1.8, respectively, in 2010, 2011 and 2012, in combination with an automatic rate adjustment mechanism (the RSA)[10].

SCL also has greatly reduced its debt over the last five years; thus, the amount of revenue needed for the debt service coverage has decreased as well.

Recommendation:

Because so much of the overall risk has been reduced for SCL through the creation of the substantial RSA and the growing bond reserve, we recommend that the target DCR be reduced from 1.8 to 1.6 in the financial policies, to reduce over-collection of revenue from customers.

The table below illustrates the amount the revenue would be reduced for the total service territory based on changing the DCR:

Revenue Savings ($M) - Total System (Residential + Non-Residential)						
Service Territory Savings	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
Debt Service Ratio (1.75x)	9.7	10.2	10.9	11.3	11.6	12.2
Debt Service Ratio (1.7x)	19.4	20.5	21.7	22.7	23.2	24.5
Debt Service Ratio (1.65x)	29.1	30.7	32.6	34.0	34.8	36.7
Debt Service Ratio (1.6x)	38.8	40.9	43.4	45.4	46.5	48.9

Source: 2014 Strategic Plan Financial Assumptions 2015-2020

[10] Review of Seattle City Light's Financial Policies Fall 2009 Working Paper, Page 1