Agenda Report

September 17, 2018

TO: Honorable Mayor and City Council

THROUGH: Municipal Services Committee (August 28, 2018)

FROM: Water and Power Department

SUBJECT: **AUTHORIZE UTILIZATION OF THE STRANDED INVESTMENT RESERVE TO OFFSET THE STRANDED COSTS ASSOCIATED WITH INTERMOUNTAIN POWER PLANT AND MAGNOLIA POWER PLANT**

RECOMMENDATION:

It is recommended that the City Council:

1. Find that the proposed action is exempt from the California Environmental Quality Act ("CEQA") pursuant to State CEQA Guidelines Section 15061(b)(3) (General Rule); and
2. Authorize the withdrawal of $7 million per year beginning fiscal year 2019 through fiscal year 2022 from the Stranded Investment Reserve ("SIR") and the deposit of the funds into the Energy Services Charge Reserve to offset the stranded costs associated with the Intermountain Power Plant and Magnolia Power Plant projects.

MUNICIPAL SERVICES COMMITTEE RECOMMENDATION:

On August 28, 2018, the Municipal Services Committee approved staff recommendation and directed staff to present updates on the SIR to the Municipal Services Committee and the City Council on an annual basis or more frequently as may be necessary. The Committee also requested that staff determine whether SIR funds could be used for removal of local generation units that have been decommissioned.

Staff has determined that Pasadena Municipal Code ("PMC") Section 13.04.175 does not allow for the use of SIR funds for the removal of decommissioned local generating units such as Broadway units 1, 2 and 3.

EXECUTIVE SUMMARY:

The Pasadena Water and Power Department ("PWP") maintains a SIR that was established to mitigate future exposure of above market cost of energy from PWP's generation-related assets and obligations and maintain PWP's competitiveness in a deregulated electricity market. The current balance in the SIR is about $69 million, excluding the balance of the subordinated notes held by the Intermountain Power Agency ("IPA"). PWP is proposing to withdraw $7 million per year beginning fiscal year 2019 through fiscal year 2022 from the SIR Fund and deposit the funds into the Energy Services Charge Reserve to offset the stranded costs associated with the IPP and Magnolia Power Plant ("Magnolia") projects, and potential increases in power costs to customers. The total withdrawal of $28 million over the four-year period is equal to the combined SI incurred for both IPP and Magnolia for fiscal year ("FY") 2015 through FY 2017.

BACKGROUND:

The SIR Fund is a reserve fund that was established in September 1996 to collect and receive funds to be used in the future to ensure that PWP could sell the energy it receives from its generation-related assets and obligations at prevailing market prices when the cost of energy from those resources is above the market price of energy. The SIR was funded from a variety of sources from 1996 through 2001 and the SIR Fund was deemed adequate to cover all future Stranded Investments as of July 2001. Pursuant to PMC Section 13.04.175, the use of the SIR Fund is strictly limited to offsetting SI associated with generation resources, long term energy resources, authorized electric industry restructuring related costs, and no other purpose.

In November 2006, the City Council approved a SIR Utilization Plan ("Plan") which directed PWP to use the existing SIR balance (at that time) of approximately $145 million for the following purposes:

A. **Direct Defeasance**: Commit $80 million to offset debt service requirements for IPP bonds from FY 2008 through FY 2023;
B. **Contingent Mitigation**: Retain approximately $50 million in the SIR to mitigate variable and unexpected future Stranded Investment; and
C. **Refund Excess Funds**: Transfer the remaining $15 million from the SIR to the Energy Services Charge Reserve (formerly referred to as the Power Cost Adjustment Charge Fund), to offset potential energy rate increases in FY 2007 and FY 2008.

In FY 2009, PWP completed the implementation of the Plan.

Direct Defeasance:
To implement the Direct Defeasance, PWP transferred approximately $80 million to IPA to purchase U.S. Treasury Securities on its behalf during FY 2009. In return, IPA issued corresponding subordinated notes to PWP and agreed to make debt service payments to PWP. Since the completion of the defeasance process, PWP has received the scheduled debt service payments from the subordinated notes and deposited the payments in the Energy Services Charge Reserve. In total, PWP has received about $66.3 million from IPA and expects to receive an additional $26.9 million through 2023 from IPA, which will be used to offset potential energy rate increases and maintain competitive energy rates.

Contingent Mitigation:
As set forth in the "Contingent Mitigation" plan, PWP retained about $50 million in the SIR to be used to offset potential future Stranded Investment amounts. As of June 30, 2018, no additional funds have been withdrawn to offset Stranded Investment and the SIR balance has grown to about $69 million as a result of interest earnings and unrealized market gain/losses that have accrued since then.

Refund Excess Funds:
PWP refunded $15 million to customers by transferring this amount from the SIR to the Energy Services Charge Reserve between November 2006 and June 2008, offsetting energy rates by approximately 0.6 cents/KWh on average over a two year period.

Stranded Investment Calculation

Although SI could arise from above market costs associated with a number of resources or industry restructuring actions, the generation assets of IPP and Magnolia are currently the major sources of SI for PWP. Also, as a result of dramatic cost reductions in newer wind and solar generation resources, the contract prices for some of PWP's early commitments to renewable resources are significantly higher than the current prices for renewable resources. As shown in Table 1, the SI for IPP is the market value less its cost.

Table 1 - IPP Stranded Investment Calculation

	FY 2015	FY 2016	FY 2017	Total
Total Generation (MWh)	570,718	412,339	470,739	1,453,796
IPP Value				
Market Value of Generation	$22,213,859	$12,539,852	$16,334,085	$51,087,796
Proceeds from IPP Debt Defeasance	$ 6,830,720	$ 6,923,849	$ 7,033,459	$ 20,788,028
Resource Adequacy Value	$ 989,869	$ 957,163	$ 1,045,908	$ 2,992,940
Total IPP Value	$30,034,448	$20,420,864	$24,413,452	$74,868,764
Total IPP Cost	($35,923,828)	($30,167,189)	($30,578,933)	($96,669,950)
IPP Stranded Investment	**($5,889,380)**	**($9,746,325)**	**($6,165,481)**	**($21,801,186)**

IPP's market value consists of the value of energy produced and capacity utilized to meet "Resource Adequacy" requirements, plus the defeasance credit received from IPA. The Total IPP Cost reflects amounts billed for IPP generation, including all fixed and variable costs.

Another significant source of SI is Magnolia, a 242 MW natural gas-fired generating facility located in the City of Burbank which commenced commercial operations in September 2005. Magnolia is a Southern California Public Power Authority project and Pasadena has about 6.4% share of the project. Although Magnolia was not included in the previous SI analysis, it is a generation-related asset that is currently producing electricity at costs higher than market, thereby qualifying it as a stranded asset. The SI associated with Magnolia for FY 2015 through FY 2017 is shown in Table 2 below.

Table 2 – Magnolia Stranded Investment Calculation

	FY 2015	FY 2016	FY 2017	Total
Total Generation (MWh)	102,007	100,621	84,688	287,316
Magnolia Value				
Market Value of Generation	$2,689,201	$2,948,746	$2,753,231	$8,391,178
Resource Adequacy Value	$ 163,777	$ 154,481	$ 135,581	$ 453,839
Total Magnolia Value	$2,852,978	$3,103,227	$2,888,812	$8,845,017
Total Magnolia Cost	($5,353,663)	($5,063,331)	($4,633,257)	($15,050,251)
Magnolia Stranded Investment	**($2,500,685)**	**($1,960,104)**	**($1,744,445)**	**($6,205,234)**

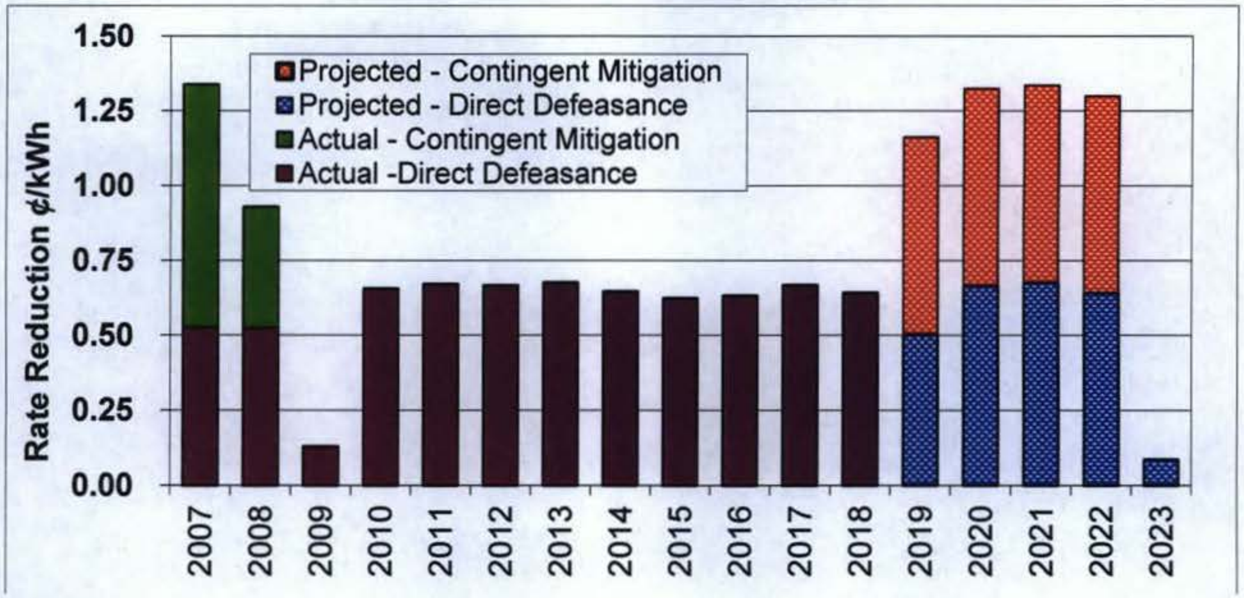
The Magnolia SI is the market value of energy produced from Magnolia plus the market value of the capacity utilized to meet "Resource Adequacy" capacity requirements less the fixed and variable costs billed to PWP for its share of Magnolia.

SIR Utilization

Under the SIR Utilization Plan approved in 2006, it was anticipated that the remaining SIR funds plus interest earnings would be needed to stabilize rates and maintain the required Energy Service Charge Reserve requirement from FY 2009 through FY 2015. It was also anticipated that the annual Stranded Investment associated with IPP would be mitigated by periodic withdrawals from the SIR and depositing the same amount into the Energy Service Charge Reserve to defer potential rate increases during this period. However, due to lower power and natural gas costs and the adequacy of the Energy Service Charge Reserve during the period, PWP has maintained relatively stable rates for the energy charge without drawing down the Contingent Defeasance since 2009.

As indicated in Tables 1 and 2, the combined SI incurred for both IPP and Magnolia for FY 2015 through FY 2017 is about $28.0 million. PWP proposes to drawdown the SIR per the Contingent Mitigation plan by $7 million per year beginning FY 2019 through FY 2022 to offset the SI associated with IPP and Magnolia, and to transfer this amount to the Energy Services Charge Reserve. These transfers will offset potential increases in power costs to customers. The retail electric rate benefits of the SIR Plan are shown in Figure 1.

Figure 1 - Retail Electric Rate Benefits of SIR Plan



With the proposed transfers, a typical residential customer using 500 KWh per month will avoid a potential increase of approximately $3.00 per month between FY 2019 and FY 2022.

SIR Future Use

PWP estimates that the balance in the SIR at the end of FY 2022 will be about $42 million, after the transfers planned for FY 2019 through FY 2022, and after accounting for interest earnings and unrealized market gain and/or losses as shown below.

Estimated SIR Balance	
SIR Balance as of 6/30/2017	$ 69 million
Interest Earnings and Unrealized Market Gain/Losses	$ 1 million
Transfers Planned for FY 2019 through FY 2022 ($7 million per year for 4 years)	$ 28 million
Projected Balance - 6/30/2022	**$ 42 million**

The balance in the SIR will be used to mitigate SI as defined in the Pasadena Municipal Code, including above market energy costs from long term energy contracts ("obligations") and other potential costs related to energy market restructuring. PWP plans to perform regular review of the SI associated with IPP and Magnolia projects as well as other long term energy contracts and recommend withdrawals from the SIR as may be required for FY 2018 and beyond.

COUNCIL POLICY CONSIDERATION:

This action supports the City Council's strategic goal to maintain fiscal responsibility and stability.

ENVIRONMENTAL ANALYSIS:

The utilization of the SIR to offset the SI associated with IPP and Magnolia projects has been determined to be exempt from the CEQA process pursuant to State CEQA Guidelines Section 15061(b)(3), the general rule that CEQA applies only to projects which have the potential for causing a significant effect on the environment. Where it can be seen with certainty that there is no possibility that the activity in question may have a significant effect on the environment, the activity is not subject to CEQA. The utilization of the SIR is an administrative action that does not involve any direct or indirect changes to the physical environment. This action does not have the potential for causing a significant effect on the environment and is therefore exempt from CEQA per Section 15061(b)(3) (General Rule).

FISCAL IMPACT:

There is no direct fiscal impact as a result of this action and it will not have any indirect or support cost requirements. The effect of this action will be to transfer funds from the SIR to the Energy Services Charge Reserve. The authorization to withdraw $7 million per year beginning fiscal year 2019 through fiscal year 2022 from the SIR and deposit the funds into the Energy Services Charge Reserve will enable PWP to offset the stranded costs associated with the IPP and Magnolia projects, and potential increases in power costs to customers.

Respectfully submitted,

GURCHARAN S. BAWA
General Manager
Water and Power Department

Prepared by:

Shari M. Thomas
Assistant General Manager
Water and Power Department

Concurred by:

MATTHEW E. HAWKESWORTH
Director of Finance
Department of Finance

Approved by:

STEVE MERMELL
City Manager