



City Council Agenda Item

City Council Meeting Date: August 6, 2024

TO: Dean Albro, City Manager

FROM: Christie Donnelly, Management Services Director
c_donnelly@ci.lompoc.ca.us

SUBJECT: Review of Draft Electric Cost of Service Study and Financial Projection Report for Purposes of Discussion and City Council Direction for Fully Developed Rate Design Structure

Recommendation:

Staff recommends the City Council consider and receive the attached Draft Electric Cost of Service Study and Financial Projection Report and provide input and direction to staff for use in the final Electric Rate Study report to be presented in September 2024.

Background:

In 2022, staff engaged Utility Financial Solutions (UFS) to begin an Electric Utility Cost of Service Study to be followed by an Electric Utility Rate Study. While that study was in its early stages, staff identified growing deficiencies in the revenue coverage of exponentially increased power supply costs. On April 18, 2023, the City Council adopted Resolution No. 6573(23) increasing Electric rates for all rate schedules of customers at all tiers in the amount of 30%, with that rate increase to be implemented effective starting May 1, 2023. The City Council also directed the rate increase to last until such time that a full cost of service study for the Electric fund could be completed and presented to the City Council for review. Prior to the increase, rates were the same as they had been in 2011, 12 years prior. Staff had projected that with the then-current pace of use of cash reserves and continuation of the 2011 rate structure that the Electric fund would likely deplete its cash reserves by May 2023, and could reach a zero cash balance by November 2023. The expectation was for the rate increase to serve as a stop-gap until the full cost analysis could be completed and a data-driven, fully analyzed rate structure with a permanent adjustment could be presented and implemented.

After the rate increase resolution was adopted, staff restarted its work with UFS to conduct the Electric Utility Cost of Service Study, followed by an Electric Utility Rate Study. From that time, the expectation was to present UFS's recommendations in time that they could be implemented by the beginning of Fiscal Year (FY) 2024-25, or by July 1, 2024. However, due to an unexpected requirement by the CA State Water Board for the City to conduct a Cost of Service study for the City's Wastewater Utility, and the resulting workload demand on both UFS and staff, the Electric Utility Cost of Service study was postponed until that Wastewater cost of service study could be completed. Once a draft version of the Wastewater Cost of Service study was completed, which

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occurred in March 2023, the Electric Utility study began again in earnest. The first step of the two phases of the study – the Draft Cost of Service study – was completed in May 2024 and is the subject of this staff report. The second and final phase – the rate structure design phase – will be completed directly after staff receives the requested discussion and input from City Council, at which time a final report with all facets of the study, including a completed rate design, will be presented in September 2024.

Discussion:

The Draft Electric Cost of Service Study and Financial Projection Report (Attachment 1) was prepared to provide a comprehensive examination of the City of Lompoc Electric Utility's existing rate structure by an outside party. It provides a full presentation and analysis of the parameters of the study and UFS's findings and recommendations. It is important to note that all projections in the report are based on the rates being charged in June 2024, which include the 30% emergency rate increase. In addition, all scenarios assume that \$4 million currently held in NCPA general operating reserve (GOR) is considered available operational cash.

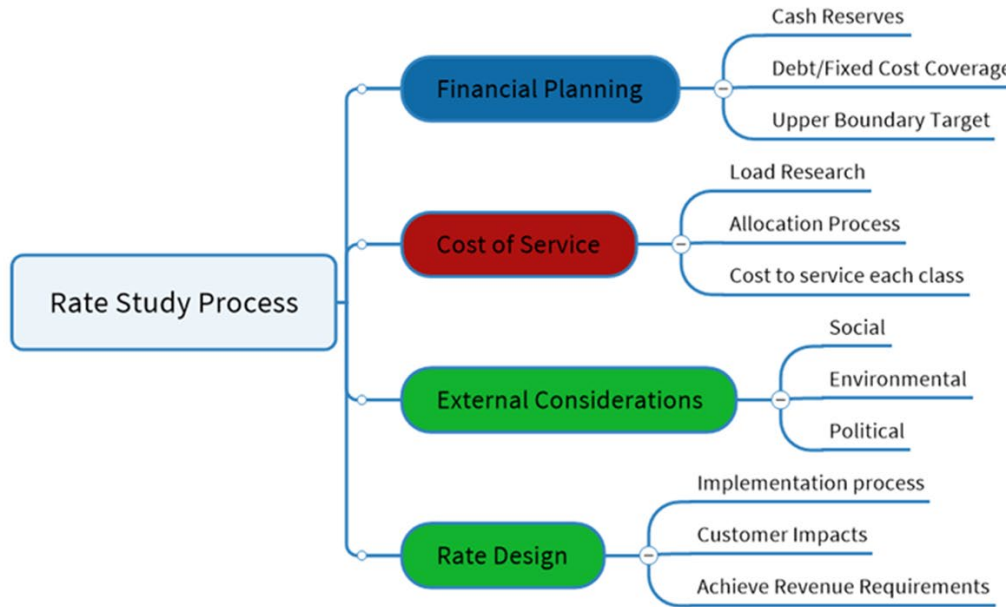
Purpose of the Study:

The specific purpose of this cost of service study is to:

- Determine electric utility's revenue requirements for FY 2025-26;
- Identify cross-subsidies that may exist between rate classes;
- Identify cost-based power supply and distribution rates by unbundling the components of customer costs to identify the cost of each component for the purpose of restructuring and understanding the cost structure;
- Identify the appropriate monthly customer charge for each customer class; and
- Recommend rate adjustments needed to meet targeted revenue requirements.

Study Process:

This useful flow chart summarizes the process followed when conducting a rate study. The discussion tonight is the 3rd step in the process: External Considerations.



Financial

Indicators Reviewed & UFS Conclusion/Recommendation:

Financial indicators are reviewed in the report, and the summary conclusion of each are bulleted here. Please refer to the draft report for further discussion and detail.

- Projected Cash Flow: The projection shows cash balances decreasing throughout the projection. Initial cash balances are low as Lompoc has been using reserves to offset power supply charges that have been higher recently than historical levels. UFS recommends Lompoc implement a Power Supply Adjustment (PCA) mechanism that allows the utility to recover or refund any variation in power costs from an established base.
- *Minimum Cash Reserve: Projected cash balances are below the recommended minimums for the projection period without rate adjustments.*
- Debt Coverage Ratio: Debt coverage falls below the minimum in the projection period without rate adjustments.
- Rate of Return: Operating Income is below the optimal operating income for each year. The optimal operating income is an upper boundary in establishing a rate track.
- Debt to Equity Ratio: Lompoc is projected at 60% Debt to Equity Ratio in 2029, exceeding the average across the United States between 30% and 35%. This is due to substantial capital expenditures on infrastructure related to electrification.
- Age of Infrastructure: Lompoc’s system age indicates it will remain in the lower to average ranges of infrastructure age.

- Projected Rate Track: The recommended rate track ensures debt coverage is adequate, operating income remains healthy, the projected cash balance remains steady through FY 2029-30, and recommended minimum cash is attained by FY 2029-30. Due to cost changes, inflationary factors, and growth, financial projections should be reviewed on an annual basis. Depending on the system improvement timetable, additional changes may be needed throughout the projection period.

Projected Rate Track:

Adjusting system revenue requires balancing the financial health of the utility with the financial impact on customers and cost of service results. Table 1 in the report is the summary financial projection without any rate changes. Cash balances, operating income and the debt coverage ratio fall to critical levels without any rate change.

Table 1 – Summary of Financials without Rate Adjustment

Fiscal Year	Projected Rate Adjustments	Additional Staffing costs not Included in 2025 Budget	Debt Coverage Ratio	Adjusted Operating Income	Optimal Operating Income	Projected Operational Cash Balances	Recommended Minimum Cash
2025	0.0%	\$ -	2.54	\$ 434,655	\$ 2,300,512	\$ 3,273,604	\$ 4,652,604
2026	0.0%	-	1.05	43,957	5,159,451	2,854,029	4,922,294
2027	0.0%	-	0.66	(467,554)	6,579,930	804,514	5,826,606
2028	0.0%	-	0.47	(959,150)	7,790,021	(2,757,180)	6,625,423
2029	0.0%	-	0.36	(1,439,109)	8,882,265	(7,674,908)	7,372,390

The study identifies increasing current revenues to meet financial targets. Table 2 details a summary of the financial results detailing the projected revenue adjustments. Three scenarios are presented for the discussion process.

Table 2 – Projected Revenue Adjustments

Rate Track 1 – (Additional Electrification staffing onboarded over 3 years)

Fiscal Year	Projected Rate Adjustments	Additional Staffing costs not Included in 2025 Budget	Debt Coverage Ratio	Adjusted Operating Income	Optimal Operating Income	Projected Operational Cash Balances	Recommended Minimum Cash
2025	7.0%	\$ -	4.17	\$ 2,519,391	\$ 2,300,512	\$ 5,358,340	\$ 4,652,604
2026	7.0%	2,250,000	2.33	3,686,141	5,159,451	7,089,338	5,005,513
2027	7.0%	250,000	2.07	5,454,298	6,579,930	9,291,484	5,921,568
2028	6.0%	2,750,000	1.79	6,301,134	7,790,021	9,256,343	6,824,947
2029	6.0%	-	1.80	8,075,177	8,882,265	10,009,729	7,656,588

Fiscal Year	Average Residential Monthly Impact	Lompoc Average Residential Bill	PGE Monthly Bill based on Lompoc Average Usage
2025	\$ 4.97	\$ 75.90	\$ 149.97
2026	5.31	81.21	149.97
2027	5.68	86.89	149.97
2028	5.21	92.11	149.97
2029	5.53	97.63	149.97

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Rate Track 2 – Additional Electrification staffing onboarded over 7 years:

Fiscal Year	Projected Rate Adjustments	Additional Staffing costs not Included in 2025 Budget	Debt Coverage Ratio	Adjusted Operating Income	Optimal Operating Income	Projected Operational Cash Balances	Recommended Minimum Cash
2025	5.5%	\$ -	3.82	\$ 2,072,662	\$ 2,300,512	\$ 4,911,611	\$ 4,652,604
2026	5.5%	750,000	2.15	3,186,450	5,159,451	7,175,049	4,950,034
2027	5.5%	750,000	1.79	4,262,766	6,579,930	8,919,734	5,882,917
2028	4.0%	750,000	1.54	4,926,302	7,790,021	9,661,346	6,711,164
2029	4.0%	750,000	1.43	5,649,460	8,882,265	9,684,089	7,488,442

Fiscal Year	Average Residential Monthly Impact	Lompoc Average Residential Bill	PGE Monthly Bill based on Lompoc Average Usage
2025	\$ 3.90	\$ 74.83	\$ 149.97
2026	4.12	78.95	149.97
2027	4.34	83.29	149.97
2028	3.33	86.62	149.97
2029	3.46	90.09	149.97

Rate Track 3 – No additional Electrification staffing

Fiscal Year	Projected Rate Adjustments	Additional Staffing costs not Included in 2025 Budget	Debt Coverage Ratio	Adjusted Operating Income	Optimal Operating Income	Projected Operational Cash Balances	Recommended Minimum Cash
2025	4.0%	\$ -	3.47	\$ 1,625,933	\$ 2,300,512	\$ 4,464,882	\$ 4,652,604
2026	4.0%	-	1.90	2,475,166	5,159,451	6,524,167	4,922,294
2027	4.0%	-	1.55	3,252,642	6,579,930	8,304,952	5,826,606
2028	4.0%	-	1.39	4,100,711	7,790,021	9,840,621	6,625,423
2029	4.0%	-	1.34	5,013,398	8,882,265	11,424,603	7,372,390

Fiscal Year	Average Residential Monthly Impact	Lompoc Average Residential Bill	PGE Monthly Bill based on Lompoc Average Usage
2025	\$ 2.84	\$ 73.77	\$ 149.97
2026	2.95	76.72	149.97
2027	3.07	79.79	149.97
2028	3.19	82.98	149.97
2029	3.32	86.30	149.97

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Cost of Service Summary Results are presented and discussed on pages 9-13 and Tables 10 – 14 of the Attachment 1. The following table is a compilation:

Customer Class	Cost of Service	Projected Rate Revenue	% Change	Sample Rate Adjustments
General Service (A-1)	\$ 11,124,081	\$ 9,557,342	16.4%	5.1%
Domestic Service (D-1)	20,426,918	11,626,188	75.7%	8.6%
Domestic Service - Mobile Home Park (D-2)	516,998	250,132	106.7%	8.6%
Street Lighting (LS-1)	862,462	682,080	26.4%	5.1%
Customer Owned Lighting (LS-2)	7,698	7,596	1.3%	1.3%
General Service Demand (A-12)	8,155,145	5,930,367	37.5%	7.0%
General Service Econ. Dev. (A-13)	2,524,574	1,728,247	46.1%	7.2%
Total	\$ 43,617,877	\$ 29,781,953	46.5%	7.0%

Additional Factors Evaluated:

Several additional pages in the report detail the analysis of the following items:

- Transmission
- Ancillary Service Charges
- Distribution
- Distribution Customer Types
- Customer-Related Services
- Administrative Services
- System Losses
- Unbundling Process
- Significant Assumptions
- Load Data

Summary, Considerations and Additional Information:

Lompoc Financial Considerations –

1. Lompoc is projected to require increases in rates charged to customers to meet or exceed all financial targets over the projection period. Three scenarios were considered.
2. Projected cash balances are below the recommended minimums throughout the projection period without change in rates.
3. Debt Coverage Ratio is below recommended minimum levels throughout the projection period without changes in rates.
4. Current rate-related revenues are projected to result in operating income below the optimal operating income for each year. Meeting the operating income target indicates current rates are fully funding system revenue requirements and future replacement cost of current infrastructure.

5. Infrastructure of Lompoc is comparable to the national average. The infrastructure in total is approximately 54% depreciated compared with the national average between 50% – 55%.
6. Lompoc **Error! Reference source not found.** system losses are similar to national averages. The average system losses and unaccounted for energy for Lompoc are approximately 5.4% compared to typical municipal system losses of approximately 5.4%.

Rate-related Considerations –

1. The City of Lompoc does NOT have a cost-based residential customer charge currently representing the fixed cost of delivery of electricity.
2. Revenue recovered by each major class of customers indicates subsidization between classes which is not allowed in the State of California.
3. Customer charges are under-recovering and energy rates are over-recovering for most customer classes. The table below compares the current customer charges with a cost-based customer charge. It is recommended that movements toward the cost-based customer charge occur with the additional revenue used to lower the energy rates for customers in their respective classes.

Customer Class	COS Customer Charge	Current Average Customer
General Service (A-1)	\$ 50.07	\$ -
Domestic Service (D-1)	31.95	-
Domestic Service - Mobile Home Park (D-2)	58.36	-
Street Lighting (LS-1)	264.02	-
Customer Owned Lighting (LS-2)	2.64	-
General Service Demand (A-12)	308.57	151.57
General Service Econ. Dev. (A-13)	308.57	143.96

4. The study assumes adoption of a Power Cost Adjustment (PCA) to pass through increases and decrease in power cost. The PCA is projected to be set at \$0.00 initially. The PCA, as stated above, is a major factor in assuring the current and future financial stability of the utility. However, the PCA needs to be periodically trued up and placed back into the rates charged to customers to operate effectively. Power supply costs consist of two components; a demand related charge and energy related charge. The PCA is charged to customers entirely on energy use resulting in high load factor customers subsidizing low load factor customers if not periodically trued up to zero.

5. Lompoc may consider movements toward cost of service in its rate design. The cost of service study indicates a variance exists between revenues and costs for certain rate classes. The study results are listed below:

Customer Class	Cost of Service	Projected	
		Rate Revenue	% Change
General Service (A-1)	\$ 7,258,768	\$ 9,557,342	-24.1%
Domestic Service (D-1)	14,731,524	11,626,188	26.7%
Domestic Service - Mobile Home Park (D-2)	324,842	250,132	29.9%
Street Lighting (LS-1)	761,068	682,080	11.6%
Customer Owned Lighting (LS-2)	4,684	7,596	-38.3%
General Service Demand (A-12)	5,003,224	5,930,367	-15.6%
General Service Econ. Dev. (A-13)	1,585,225	1,728,247	-8.3%
Total	\$ 29,669,336	\$ 29,781,953	-0.4%

Negative % changes indicate the classes’ current rates are in excess of the rates necessary to support that class. Positive % changes indicate the classes’ current rates are below the rates necessary to support that class – i.e. subsidized. Subsidization of one class of customer by another class of customer is not permitted in the State of California.

Fiscal Impact:

There is no immediate direct fiscal impact from receiving and discussing the Draft Electric Cost of Service Study and Financial Projection Report. The discussion and direction given by the City Council will inform the final phase of the development of the rate design and final report, and implementation of any recommendations in that final report could have a fiscal impact to Electric Utility customers. Any potential fiscal impact of the discussion and direction as it relates to this report will be brought back to City Council for consideration and further discussion at a future date.

Conclusion:

Receiving, discussing, and providing feedback and direction on the attached Draft Electric Cost of Service Study and Financial Projection Report will allow staff to receive input for the purposes of completing the final Electric Rate Study report to be presented in September 2024.

Respectfully submitted,

Christie Donnelly, Management Services Director

APPROVED FOR SUBMITTAL TO THE CITY COUNCIL:

Dean Albro, City Manager

Attachment: Draft Electric Cost of Service Study and Financial Projection Report