



TO: Mayor and Council Members
FROM: Marc A. Ott, City Manager
DATE: April 5, 2010
SUBJECT: Austin Energy Financial Planning Action Plan

As you are aware, a number of challenges facing Austin Energy were presented to Council this past November at a work session. Let me emphasize that our guiding principle in responding to all these issues will be to ensure the financial stability and sustainability of Austin Energy. We will always present recommendations that focus on preserving Austin Energy's stellar financial standing...as you know Austin Energy currently has A1 and A+ bond ratings. We will do everything we can to maintain and even improve those ratings.

In that light, I wanted to share the plan that I've given staff that will develop both short and long term recommendations to address the challenges facing Austin Energy. As a reminder, these issues include:

CHALLENGES

- **Funding** for power generation, as well as general improvements for our utility infrastructure.
- The **General Fund transfer policy** needs to be evaluated in conjunction with the review of our electric rates.
- We need to recover **increasing transmission costs** related to ongoing costs of the Texas Transmission Construction Program.
- Over a longer planning horizon, changes in the electric industry will require us to evaluate and begin planning for adjustments to our **business model** to competitively position us for the future state of the industry.

ACTION PLAN

We will address several of these issues in the short term, while others are longer term issues dependent on future market conditions and technology improvements. We are developing strategies and work plans to address each of these issues in a holistic and systematic manner. I've listed each "challenge" with a specific action plan below.

Funding

There are both short term and long term issues to deal with on the “funding” issue. In the short term, we need to evaluate our current financial position and benchmark costs compared to other comparable utilities. Austin Energy is clearly at a cross roads in terms of funding. In order to make prudent recommendations regarding the challenges facing Austin Energy, I need to spend some time determining “existing conditions” or more simply put determine “where are we now?” We plan to procure the services of several outside firms to provide expertise, knowledge of best practices, and an objective/independent perspective. I’ve divided this financial assessment work into two separate phases, although both efforts will feed into our recommendations. The preliminary scope of work for each phase is detailed at the end of this memo.

General Fund Transfer

As you know, the rating agencies have a favorable view of the City’s existing transfer policy largely due to the historical stability of the annual transfer policy (methodology and percentage transfer). The rating agencies have been particularly pleased to see that as General Fund revenue has increased over time, the relative amount of the transfer has remained fairly constant. This is a vitally important factor in the financial stability for both the General Fund and Austin Energy that we must keep in mind as we move forward with an in-depth look at the transfer policy.

The General Fund transfer policy is an integral part of the planned electric rate review and may ultimately help to address some of the challenges presented by changes in the business model. Our strategy will balance the utility’s long term financial sustainability while preserving the appropriate transfer level to the General Fund.

The first look at the General Fund Transfer policy will take place during Phase 1 (see below), where we will direct our consultant to assess the General Fund transfer methodology and review best practices across the country. The development of potential modifications will occur during Phase 2 as we work through the rate case implications.

Addressing the Rising Costs of Transmission

As we mentioned during the 2010 budget development process, Austin Energy’s transmission expense is growing faster than its transmission revenue. Transmission expense is the cost of moving high-voltage electric energy over the regional electric grid operated by the Electric Reliability Council of Texas (ERCOT) from the power supply to the local lower-voltage distribution system. Transmission expense is paid to other utilities for the use of their transmission wires by Austin Energy. Our transmission expense is projected to increase by over \$125 million in the 2010-2014 forecast due to the ongoing Texas electric transmission grid build-out.

As a short term solution, Austin Energy will include a proposed transmission rider to begin cost recovery of increasing transmission expense in its 2011-2015 financial forecast and in the proposed 2011 budget. A long term solution will be evaluated and proposed during Phase 2.

New Business Model

The rate review is a key step in the development and implementation of what has become known as the “new business model.” One component of the rate review will likely involve unbundling Austin Energy’s costs into functional components (generation, distribution, and transmission) and consideration of alternative rate designs. These new

rate design alternatives are fundamental to the long-run evolution of the new business model and the utility's continued ability to recover its costs and remain financially sustainable.

Austin Energy's business model challenges are related to electric industry changes that may develop over an extended period of time, such as increased reliance on distributed generation and solar and energy efficiency. The timing of the impacts of these changes depends on external factors, such as market penetration and/or saturation affected by technology changes which may significantly reduce solar costs stimulating earlier adoption. In other words, the "business model" work needs to begin (as it will in Phase 2) but this will be an ongoing, long term effort.

Financial Assessment Plan

Phase 1 – Initial financial analysis and affordability benchmarking

The scope of work for this initial financial analysis will include such elements as:

- An independent evaluation of Austin Energy's financial position given the current economic and industry conditions and outlook. This evaluation will include a review of the adequacy of fund balance levels, as well as an analysis of the ability to ensure ongoing compliance with current bond ordinances that define debt service coverage and utility rate requirements,
- Benchmarking of electric utility costs compared to other comparable utilities, which will also complement the work being completed as part of the Resource and Climate Protection Plans,
- A comprehensive review of all Austin Energy programs to determine whether they support the achievement of long-range goals outlined in Austin Energy's strategic plan and to help maximize program efficiencies,
- Assistance with an assessment of the General Fund transfer methodology that incorporates a review of best practices across the country, and
- Development of a financial model that will provide the tools Austin Energy financial staff need to prepare projections in preparation for changes in the business environment and to help provide the analysis needed by management to chart the optimal course.

I believe that the resulting product will provide the future General Manager with much of the analysis he or she will need to hit the ground running. We are in the process of developing a specific scope of work for this effort and expect to bring forward a consultant contract for this initial review for your consideration in April.

Phase 2 – Review Austin Energy's rate structure

At the November 2009 presentation, we apprised Council of the need for a rate review during fiscal year 2012 with a rate increase becoming effective at the beginning of fiscal year 2013. There is a long planning and preparation process for an electric rate review. Planning began in fiscal year 2010 and work is underway to hire the third party expertise needed to assist in the planning and analysis that must be accomplished over the next two years. These consultants will assist with cost of service studies, cost analysis, rate comparisons, the design and implementation of a public involvement process, and rate design.

While the first priority of the rate review is to assure revenue sufficiency of the utility, several other business and strategic objectives will be addressed in that process. The rate review will address the appropriate balancing of rates across customer classes. The financing needs of the generation plan will be considered, as well as the implications of the increased goal for energy efficiency. Setting the stage for the new business model will also be a critical element of the review.

One of the key challenges of the rate review will be striking the proper balance among those objectives. Achieving that balance may necessitate that the recommended rate changes be implemented in stages over several years—fulfilling some objectives in the near term, while others are initially deferred. In planning for the rate review, Austin Energy will develop and recommend a long-run strategy for adjusting electric rates to satisfy these multiple objectives.

We expect to launch the RFP process in April for the “rate case” consultant with the ultimate selection of the consultant for your consideration in August.

In conclusion, I hope this memo conveys that we do indeed have financial challenges facing Austin Energy. I also hope the Action Plan detailed above confirms that we have launched our work to address each and every one of these issues head on. I look forward to working with you as we develop and implement plans and strategies to position our electric utility for the future.

xc: Robert Goode, Interim Austin Energy General Manager
Leslie Browder, Chief Financial Officer