

SUMMARY OF AUSTIN ENERGY'S RESERVE FUNDS

Austin Energy
Austin, Texas



PREPARED BY:

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EXECUTIVE SUMMARY

Municipally Owned Utilities (“MOUs”) like Austin Energy (“AE”) are cash driven enterprises. To ensure financial stability over the long-run, a MOU’s primary concern is to have enough cash, after operating requirements, to meet debt service and infrastructure investment requirements. This financial objective is directly related to the ownership structure of a MOU and is very different from that of an Investor Owned Utility (“IOU”). IOUs are owned by stockholders and are concerned with maximizing their return on investment. When in need of cash, IOUs have access to equity and debt capital markets. By contrast, when MOUs need cash, only debt and cash reserves are options. As a result, it is very common for MOUs to establish financial policies that ensure adequate cash flow and cash reserves in order to successfully manage day-to-day business risk.

Seeking an independent perspective on the adequacy and use of its cash reserves, AE retained NewGen Strategies and Solutions, LLC (“NewGen”) to perform an assessment of AE’s reserve funds, including a review of supporting financial policies. Specifically, NewGen has reviewed the purpose, use, and funding of the Working Capital Reserve, the Strategic Reserve, the Repair and Replacement Reserve, the Capital Improvement Plan Fund, and the Non-Nuclear Decommissioning Reserve.

Types of Reserves

MOUs establish different types of reserves for different purposes. Reserves are generally either “restricted” or “unrestricted.” Restricted reserves are limited in terms of what the funds may be used to pay for and are associated with a specific purpose. Restrictions are generally required and enforced by third parties or legal requirements. For example, a bond reserve is a common reserve with restricted use per the applicable bond ordinance. Cash set aside in such a reserve can only be used to retire debt. Unrestricted reserves are often more flexible and allow the utility to apply funds to a wider range of purposes within predefined limits. The use of unrestricted funds may be defined by utility policy, but the governing body can change or re-purpose its use of these funds, if necessary. Thus, although AE has reserves that it identifies as “restricted,” such as the Strategic Reserve, these reserves may only be restricted by City of Austin (“City”) designation, which could be changed by Austin City Council (“City Council”). As a result, from the perspective of rating agencies, only reserves that are restricted by external parties, such as restrictions by contract or regulation, are truly restricted. Thus, use of the terms “restricted” or “unrestricted” in this report are consistent with the rating agencies’ view of the reserves. However, it is also common for funds dedicated or earmarked for a specific purpose, such as decommissioning or specific capital projects, to be excluded from some rating agency calculations, such as Days Cash on Hand.

Description of Current Reserves

Reserve balances relevant to our analysis at the end of Fiscal Year (“FY”) 2014 are shown in Table ES-1. This excludes some restricted reserves – specifically the Bond Reserve and Debt Service Reserve as well as the externally managed Nuclear Decommissioning Trust held by an independent trustee. The Bond Reserve was funded in FY 2010 with \$44 million to comply with Financial Policy No. 4. The Debt Service Reserve accrues monthly deposits to facilitate periodic principal and interest payments on debt. The Nuclear Decommissioning Trust holds funds for the eventual decommissioning of AE’s share of the South Texas Project. Each of the excluded reserves are considered restricted by AE as well as rating agencies. Thus, they are not included in calculations of financial liquidity, such as Days Cash on Hand.

Table ES-1
Funding Levels for Evaluated Reserves

Reserves	FY 2014 Actual
Working Capital	\$ 150,799,894
Strategic Reserve	
Emergency	80,765,286
Contingency	25,811,754
Rate Stabilization	-
Repair & Replacement	64,071
Non-Nuclear Decommissioning	8,138,072
Capital Improvement Plan Fund ⁽¹⁾	78,528,932
Total	\$ 344,108,009

Notes:

1) The cash balance for the Capital Improvement Plan Fund was \$76,340,936. The remainder of the FY 2014 balance reflected receivables.

A description of each reserve listed in Table ES-1 is as follows:

- **Working Capital:** The Working Capital Reserve¹ (also sometimes referred to as the operating reserve or operating cash) is intended to meet normal day-to-day operation and maintenance (“O&M”) expenses, less pass-through costs related to net power supply (“Net Power Supply Cost”).² Per financial policy, AE must maintain 45 days of budgeted O&M expense, less Net Power Supply Cost.
- **Strategic Reserve:** The Strategic Reserve provides funds to offset revenue or expense fluctuations due to natural disasters or unplanned economic stress. The Strategic Reserve is currently comprised of the following reserve components:

¹ Although not technically a reserve, as it is simply the cash available to facilitate day-to-day operations, we have labeled this the Working Capital Reserve for consistency within the report.

² Net Power Supply, as used in this report, includes the cost of fuel, power purchase agreements, net ERCOT revenue, green choice costs not billed to customers directly, regulatory charges associated with the Fuel Adjustment Clause, and the hedging program.

- **Contingency Reserve:** The Contingency Reserve shall not exceed a maximum of 60 days of O&M expense, less Net Power Supply Cost. This reserve is used for unanticipated or unforeseen events that reduce revenue or increase obligations such as extended unplanned plant outages, insurance deductibles, and unexpected costs created by Federal or State legislation, and liquidity support for unexpected changes in fuel costs or purchased power that stabilizes fuel rates for AE customers.
- **Emergency Reserve:** The Emergency Reserve must have a minimum of 60 days of O&M expense, less Net Power Supply Cost. This reserve is only used as a last resort after the Contingency Reserve has been exhausted to provide funding in the event of an unanticipated or unforeseen extraordinary need of an emergency nature.
- **Rate Stabilization Reserve:** The Rate Stabilization Reserve was established to protect customers from higher than anticipated power costs and is intended to defer the need for future rate increases when costs exceed existing rate revenues. Per Financial Policy No. 16, the Rate Stabilization Reserve balance shall not exceed a 90 days of Net Power Supply Cost.
- **Repair and Replacement Reserve:** The Repair and Replacement Reserve has a targeted balance no greater than 50 percent of the prior year's depreciation expense. This reserve is used for extensions, additions, replacement of aging infrastructure, and improvements to the electric system.
- **Non-Nuclear Decommissioning Reserve:** The Non-Nuclear Decommissioning Reserve was established to ensure that adequate funding is available to decommission non-nuclear power plants.
- **Capital Improvement Plan Fund:** The Capital Improvement Plan Fund ("CIP Fund") accrues funds for the equity portion of planned capital projects based on monthly contributions. The CIP Fund is currently funded to pay for the equity portion of capital projects, rather than mitigate risks or offset obligations. The purpose of the CIP Fund is to pay for current capital projects and, therefore, the fund does not act as a reserve – only a funding mechanism for approved capital projects. The CIP Fund is included in this report for completeness and for its relationship to the Repair and Replacement Reserve.

Credit Rating Goal

Although not explicitly identified in financial policies, AE has had in place for many years a financial goal to achieve and maintain a 'AA' credit rating. The first reference to this goal appears in AE's 2003 Strategic Plan. In the 2015 budget, under AE's Mission and Goals for 2015, the utility states the following goal:

Maintain strong financial position in support of the Utility's Risk Management strategy and achieve improved credit ratings as measured by bond ratings agencies. Achieve the 'AA' credit rating on separate lien electric utility system revenue bonds on the Standard & Poor's rating.

However, AE is currently rated 'AA-' by Fitch, as well as Standard & Poor's, and the median Days Cash on Hand for similarly rated utilities by Fitch is 180 days, which is well in excess of

AE's current level of Days Cash on Hand.³ Ratings are the result of many factors, and simply attaining (or not attaining) 180 Days Cash on Hand is not, in of itself, cause to upgrade (or downgrade) a utility's rating. In AE's case, there are other factors, such as its relatively low leverage, that have facilitated its 'AA-' rating. However, in order to maintain its current rating, AE is expected to improve its Days Cash on Hand to be more in alignment with its similarly rated peers. In its April 2015 publication, Fitch stated, "Liquidity and cash flow metrics remain somewhat low relative to rating category medians, but additional improvement *is expected* based on AE's multiyear financial forecast." (emphasis added)⁴ Thus, it is important for AE to continue to improve its liquidity position, including its Days Cash on Hand, in order to maintain its current rating, or improve to a 'AA' rating.

Non-Nuclear Decommissioning Study

A "Non-Nuclear Decommissioning Cost Study" was performed to determine reserve amounts that should be set aside for decommissioning AE's ownership share of the Fayette Power Project, Decker Creek Units 1 and 2, and Sand Hill Energy Center. The Decker Creek decommissioning cost is based on a site-specific engineering cost estimate, while Fayette Power Project and Sand Hill Energy Center decommissioning cost estimates were developed using a benchmark approach based on scaled costs from actual decommissioning costs for similar power plants and commission approved decommissioning cost data. A more detailed description of this study can be found in Section 10 of this report and Appendix 2.

Conclusions and Recommendations

In the conduct of our review, for each established reserve, NewGen evaluated the established intended purpose, compliance with reserve funding requirements per AE's financial policies, historical use of funds, and industry acceptance and appropriateness of reserve fund types and funding levels. Our review took into consideration the practices and policies at peer Texas public power utilities, the applicable rules and standards at the Public Utility Commission of Texas ("PUCT") and the opinions of rating agencies (e.g., Fitch and Moody's). Additionally, the target level of funding for each individual reserve was evaluated to determine if the current target is appropriate or, alternatively, too high or too low to support its intended purpose(s). The reserves were also evaluated overall to test adherence to rating agency guidance on expected reserve levels for the credit rating desired by AE.

Based on this review, we conclude the following:

- Overall, current unrestricted reserves levels do not meet minimum funding requirements as stipulated in AE's current financial policies.
- Overall, current unrestricted reserve levels are too low to meet AE's credit rating objectives. Austin Energy desires to achieve and consistently maintain a 'AA' credit rating. However, AE is currently rated 'AA-' by Fitch and AE's Days Cash on Hand is well below the median Days Cash on Hand for similarly rated utilities. In order to maintain its current rating, AE is expected to improve its Days Cash on Hand to be more in alignment with its similarly rated peers.

³ "U.S. Public Power Peer Study," Fitch Ratings, June 13, 2014.

⁴ "Fitch Affirms Austin's (TX) Electric Utility Systems Revs at 'AA-'; Outlook Stable," April 23, 2015.

- The current reserve structure is confusing with overlapping purposes associated with several reserves.
- Other Texas public power utilities do not maintain the breadth of reserves that AE employs. Further, for reserves that are similar across utilities (e.g., working capital), the peer utilities do not often calculate their compliance in the same way as AE or use the same basis for appropriate funding levels.
- In certain cases, given the prescribed use of funds, reserve funding requirements are out of balance, with some reserves with too little funds and others with too much. Reserves that are underfunded include the Rate Stabilization, Non-Nuclear Decommissioning, Repair and Replacement and Contingency reserves. The Working Capital Reserve is over funded.

Given these conclusions, we recommend the following:

- Austin Energy's total unrestricted reserves, excluding the Non-Nuclear Decommissioning Reserve and CIP Fund, should meet or exceed 150 Days Cash on Hand as measured by the rating agencies. Cash reserves at this level will help AE maintain its 'AA-' credit rating and may help AE achieve a 'AA' credit rating. This targeted level of liquidity is more consistent with, but still lower than, the reserves levels of other 'AA' rated municipal utilities.
- For the internal setting of reserves, the Non-Nuclear Decommissioning Reserve should be excluded from the rating agency calculation, as these reserves are set aside for the long-term to achieve a specific purpose. Also, the CIP Fund is earmarked for specific capital projects. Therefore, these reserves should be excluded from calculations when establishing fund balances in other reserves. This appears to be consistent with the treatment by rating agencies based on a review of their calculated Days Cash on Hand.
- Reserves should be modified and funded in the following manner:
 - Working Capital Reserve – The Working Capital Reserve should be funded consistent with PUCT guidelines, which exclude fuel and other power supply costs from the calculation. AE's internal calculation for this reserve is, thus, consistent with the PUCT guidelines. However, we recommend that reserves be greater than 45 days cash based on this formula. Days cash approaching 60 days considers firm obligations associated with City transfers, including both shared services and the General Fund Transfer. Austin Energy may reasonably target a greater number of days, but NewGen recommends that there be some maximum limit on this reserve (e.g., 90 days).
 - Strategic Reserve – NewGen recommends eliminating this overarching reserve category in lieu of specific reserves, as described below.
 - Emergency Reserve – We find the use and application of the Emergency Reserve to be duplicative with other reserve funds and, therefore, we recommend the elimination of this reserve.
 - Contingency Reserve – We recommend that the Contingency Reserve balance be maintained at a maximum of 60 days cash, per AE's current policy. Contingency Reserve funds should be used to replenish all other reserves where funds drop below minimum levels. Contingency Reserve funds should be replenished as soon as practically possible and, in the near-term, should be funded by a transfer from the eliminated Emergency Reserve.

- Rate Stabilization Reserve – Use and funding of the Rate Stabilization Reserve should be dedicated to the Net Power Supply Cost component of the rate structure. This treatment makes the reserve’s funding criteria consistent with its calculation, which currently stipulates that the reserve level be funded at 90 days of Net Power Supply Cost. We recommend that any funds remaining from the Emergency Reserve, after fully funding the Contingency Reserve, should be deposited into the Rate Stabilization Reserve. Further, we recommend that the Rate Stabilization Reserve be funded going forward from net credit balances remaining in the Power Supply Adjustment (“PSA”) over/under account balance upon periodic reevaluation of the PSA (typically annually), rather than included as a credit in the calculation of the subsequent PSA. This recommended funding process ties the funding source to the use of funds (i.e., Net Power Supply Cost under-recoveries are funded from prior Net Power Supply Cost over-recoveries).

AE could also consider funding the Rate Stabilization Reserve, when necessary, from an automatic surcharge attached to the PSA. Under this approach, meaningful deficiencies in the Rate Stabilization Reserve could be cured by an additional component within the PSA. However, this approach should be evaluated carefully before implementation to ensure it would endure a regulatory review, if initiated.

Finally, we recommend that the Rate Stabilization Reserve maintain a cash balance between 90 and 120 days.

- Repair and Replacement Reserve – The Repair and Replacement Reserve is a critical reserve that insures AE has sufficient liquid resources to fund capital projects with equity. This reserve gives AE an important tool in managing the utility’s equity contribution to capital projects, per existing financial policies. Therefore, we recommend that this reserve be renamed the Capital Reserve in recognition of its use to fund all capital projects. Further, we recommend that the Capital Reserve be funded at a minimum of 50 percent of the prior year’s depreciation with no maximum amount identified. Without a maximum funding limit, NewGen recommends that additional cash reserves required to meet a 150 Days Cash on Hand goal be accrued in this reserve. Capital Reserve funds are available to be used on all AE approved capital projects and can be used to manage the debt to equity ratio of the utility over the long-run.
- Non-Nuclear Decommissioning Reserve – Austin Energy’s financial policy requires that funds be set aside over a minimum of four years prior to closure to fund costs associated with expected plant closures. NewGen recommends that AE begin funding this reserve for the near-term need of retiring Decker Creek Units 1 and 2 promptly and to the fullest extent possible. NewGen recommends targeting the high end of the estimated range of costs for Decker decommissioning. As mentioned in the separate “Non-Nuclear Decommissioning Cost Study” report, there is good reason to believe the costs for AE will be at the higher, rather than lower, end of the range identified. Further, any funding beyond the needs of decommissioning the Decker Creek units can be applied to the next facility to be decommissioned.
- CIP Fund – No changes to the CIP Fund are recommended.

The recommended reserve funding criteria is summarized in Table ES-2.

Table ES-2
Recommended Reserve Funding Criteria

Name	Description	Minimum Funding Requirement	Maximum Funding Requirement
Working Capital	Reserve to meet the day-to-day normal expense obligations associated with O&M expense, less Net Power Supply Cost	45 Days of O&M expense, less Net Power Supply Cost	60 Days of O&M expense, less Net Power Supply Cost (or other reasonable level as identified by AE)
Contingency	Reserve to meet emergencies or to replenish other reserves	60 Days of O&M expense, less Net Power Supply Cost	60 Days of O&M expense, less Net Power Supply Cost
Rate Stabilization	Reserve to mitigate unpredictable fluctuations in Net Power Supply Cost in order to stabilize rates and meet affordability goals	90 Days of Net Power Supply Cost	120 Days of Net Power Supply Cost
Capital (formerly Repair and Replacement)	Reserve to meet the equity funding requirements for all capital projects	½ of prior year's annual depreciation	None ⁽¹⁾
Non-Nuclear Decommissioning	Reserve to provide sufficient resources to decommission non-nuclear generation plants	Initial funding at Decker decommissioning cost estimate	Initial funding at Decker decommissioning cost estimate

Notes:

- 1) The expectation is that total unrestricted reserves, excluding the Non-Nuclear Decommissioning Reserve and the CIP Fund, would be greater than or equal to 150 Days Cash on Hand, per rating agency measurement.

For FY 2014, the application of NewGen's reserve recommendations compared to actual cash reserves and AE current financial policies is summarized in Table ES-3.

EXECUTIVE SUMMARY

Table ES-3
Reserve Summary

	FY 2014 Actual	FY 2014 Per Financial Policies ⁽¹⁾	NewGen Recommendation ⁽²⁾		
			Basis	Low	High
Unrestricted Reserves ⁽³⁾					
Working Capital	\$ 150,799,894	\$ 62,865,158	45 to 60 days ^{(5), (6)}	\$ 62,865,158	\$ 83,820,211
Emergency	80,765,286	83,820,211	Eliminated	0	0
Contingency	25,811,754	83,820,211	60 days ⁽⁵⁾	83,820,211	83,820,211
Capital ⁽⁴⁾	64,071	75,015,500	150 day goal ⁽⁷⁾	145,318,827	83,136,939
Rate Stabilization	0	123,680,504	90 to 120 days ⁽⁸⁾	123,680,504	164,907,339
Subtotal Unrestricted Reserves	\$ 257,441,005	\$ 429,201,583		\$ 415,684,700	\$ 415,684,700
Additional Reserves to Meet Credit Rating Goal of 150 Days Cash on Hand	\$ 158,243,695	(\$ 13,516,883)		\$ 0	\$ 0
Subtotal Unrestricted Reserves with Credit Rating Goal	\$ 415,684,700	\$ 415,684,700		\$ 415,684,700	\$ 415,684,700
Non-Nuclear Decommissioning	8,138,072	8,138,072	Decker ⁽⁹⁾	27,721,374	27,721,374
Total Reserves ⁽¹⁰⁾	\$ 423,822,772	\$ 423,822,772		\$ 443,406,074	\$ 443,406,074

Notes:

- 1) Based on FY 2014 Actual, rather than Budget.
- 2) The Low and High listed do not refer to a low and high amount in reserve, as both columns reflect the same overall total reserves. Instead, this refers to using the low or the high basis for determining each reserve target.
- 3) Although AE considers some of the reserves listed to be restricted, the designation here signifies the rating agency treatment of these reserves.
- 4) Formerly the Repair and Replacement Reserve, per NewGen recommendations.
- 5) Based on days O&M, less Net Power Supply Cost.
- 6) AE may opt for a maximum greater than 60 days, but this would not change the overall total reserves (it would simply reduce the funding in the Capital Reserve) and, regardless, there should be some maximum associated with the Working Capital Reserve.
- 7) Based on a *minimum* of 50% of prior year's depreciation expense, but under NewGen's recommendations the cap on this reserve would be removed and any funding necessary for AE to attain 150 Days Cash on Hand would be deposited into this reserve, which is the basis for the amount shown.
- 8) Based on Net Power Supply Cost.
- 9) The high end estimate for decommissioning Decker Creek Units 1 and 2.
- 10) Excludes the CIP Fund, Bond Reserve, Debt Service Reserve and the externally managed Nuclear Decommissioning Trust, none of which are included in the Days Cash on Hand calculation.

As indicated in the table above, NewGen recommends that AE build reserves over time to achieve at least 150 Days Cash on Hand. For FY 2014, AE was short approximately \$158 million in reserves in order to achieve this goal. If, however, each reserve had been funded at its target under the existing reserve fund policies, AE would have had in excess of 150 Days Cash on Hand (as indicated by the negative amount needed to achieve 150 Days Cash on Hand in the table).

Applying NewGen's reserve recommendations and funding criteria, additional reserves required to meet 150 Days Cash on Hand would be deposited into the Capital Reserve (previously the Repair and Replacement Reserve), which would have no maximum balance. Note that AE may opt for a maximum in the Working Capital Reserve greater than 60 days, but this would not change the overall total reserves (it would simply reduce the funding in the Capital Reserve). Further, whether it be 60 days or some other number, there should be some maximum associated with the Working Capital Reserve.

A more in-depth description of our analyses and additional recommendations can be found in Sections 6 through 11 of this report.