Late Backup

Navigant Report Summary
Austin Energy Financial Position Review
January 31, 2012

Principal Findings:

- "AE's financial performance has been strong for many years."
- "Its bond ratings of A+ to AA- from the three major rating agencies reflect sound financial practices and performance, as well as a strong management team."
- "AE's approved financial policies, which target a double-A bond rating from Standard & Poor's based on a minimum DSC (debt service coverage) ratio of 2.0x and revenue "pay as you go" funding for 35 percent to 60 percent of capital projects, provide a clear indication to the rating agencies that the system has high financial targets."
- "AE's strong bond ratings have provided low cost financing for the system. AE's practice of utilizing short-term commercial paper as part of an overall financing strategy for its capital improvement program, in conjunction with a longer term refunding revenue bond program, is an effective strategy for reducing interest costs over time."
- "Until 2009, kilowatt hour sales growth and increasing revenues for AE were more than adequate to offset rising system expenses, resulting in no customer base rate increases since 1994."
- "In 2009, the economic slowdown and lower natural gas prices resulted in a decrease in off-system sales revenue, decreased interest earnings on fund balances, and an overall reduced growth rate for electricity sales. In addition, an increase in transmission expenses related to the expansion of the transmission system in Texas and increased debt service caused operating margins and DSC to drop significantly, from 2.4x to 1.7x, and a deficiency of revenues versus expenditures occurred. This deficiency was covered by drawing down the fund balance in its operating fund."
- "In addition to a significant fund balance in its operating fund that totaled $237 million at the end of 2009, AE maintains a Strategic Reserve, which includes an Emergency Reserve, a Contingency Reserve, and a Competitive Reserve. At the end of 2009, the Strategic Reserve totaled $138 million, or 127 days of operating requirements, excluding fuel. Reserve policies vary widely across governmental entities, including enterprise operations like an electric utility. AE's current reserve policies are intended to provide a cushion to protect AE against short-term downward fluctuations in the economy or unanticipated one-time spending requirements that might arise."
    - "During 2009 and 2010, AE was able to rely on fund balances in its operating fund to make up the deficiency in revenues and did not use

the Strategic Reserve for balancing the budget. While AE's reserve levels are currently adequate to cover revenue shortfalls through 2015 and have been available to fund short-term revenue deficiencies, such an approach is not sustainable into the long-term future."

Prospective Assessment:

- Reviewed Austin Energy's 2011-2015 Financial Forecast
- "The forecast shows that without reduced expenses, reduced "pay as you go" capital funding from revenues, or increased electricity prices, AE's financial condition will deteriorate over time. Expense reductions alone will not be sufficient to balance the forecast."
- "The forecast shows that, without a rate increase but with currently projected expenses and projected revenue funding of capital projects, reserve funds will be entirely depleted by 2015."
- "The forecast also shows that during this period declining financial metrics would not likely support the system's existing bond ratings."

Rate Review:

- "AE plans to continue reviewing operating expenditure levels, working with the City's corporate financial team to assess the general fund transfer methodology and reviewing its capital program to focus on its highest funding priorities while it studies the more complex funding options, primarily a comprehensive review of rates and rate structure that is currently underway."
- "A fundamental challenge of this rate review will be balancing multiple objectives identified by the utility including:
    - Ensuring revenue sufficiency to prevent further deterioration of the utility's financial condition
    - Financing the utility's generation plan and implications of an increased energy efficiency goal
    - Balancing rates across customer classes
    - Maintaining electric rates competitive in the Texas market
    - Preparing for a new "business model" with increased reliance on distributed generation, solar and energy efficiency."
- "Balancing these objectives will likely require implementing rate changes in stages over several years – addressing some objectives initially, while deferring others. Developing a long-term strategy for adjusting electric rates will be important."
- "The rate review is important as it is the means to address the multiple objectives outlined above. The first priority needs to be revenue sufficiency."

"Conclusion: Significant action will be required to assure AE's financial health over the next several years."

Navigant Report Summary
Austin Energy Benchmarking and Program Review
January 31, 2012

Overall Findings:

- "AE is facing a series of challenges driven by a number of converging factors:
    - Financial constraints resulting from the recent economic downturn and reduced demand for electricity
    - Meeting aggressive strategic goals established by City policy makers
    - Higher costs driven by:
        - Increased [cost of] transmission infrastructure throughout the Electric Reliability Council of Texas (ERCOT)
        - Increased complexity in managing the utility due to ERCOT implementation of a Nodal market, Smart Grid initiatives, potential legislative mandates on power plant emissions, and more stringent North American Electric Reliability Corporation (NERC) compliance requirements
        - Implementation of new technologies that will enhance service and reliability
    - Need to increase electric rates and its impact on ratepayers."
- "AE's aggressive goals, along with:
    - Current expected annual cash flow deficit of $46 million,
    - Major systems implementations for customer care and electric delivery services, as well as integrating smart meter technology into the operations and services to customers,
    - Implementation of ERCOT Nodal market...new rules and protocols for the wholesale power market, increasing competition among power suppliers,
    - New NERC regulations with higher risks of non-compliance,
    - Potential Federal Regulations [to] limit emissions from power plants, impacting the cost of power from AE's coal plant,

  ...pose significant challenges for management."
- "As AE weighs the need for a rate increase while meeting the directives of City Council, regulators and its ratepayers, it must evaluate each opportunity to cut costs or gain efficiencies."
- "AE has historically taken a strategic leadership role in energy efficiency, demand side management, renewable resources, advanced metering infrastructure, technology tools and project management to support customer care and electric services delivery, reliability design for its

transmission and distribution system, and various innovative practices in support of operations."

- "AE [should] take a serious look at its initiatives and perhaps focus on one or two items that are most important to the success of AE, paring down the number of initiatives to manage risk and cost. There needs to be a balance between AE's leadership and its mission of affordability."
- "AE [should] consider establishing a discipline that evaluates the value proposition of new initiatives, capital projects, and processes."
- "There needs to be a formal system of prioritizing capital expenditures across AE based on common criteria or formulas that calculate the value proposition of the investment and its projected lifecycle cost."

Principal Findings:
Electric Service Delivery:

- "Reliability and ESD system performance exceeds industry averages, and should continue via the implementation of new technologies and automation; and targeted spending."
- "O&M spending is within industry benchmarks."

Distributed Energy Services:

- "Energy Efficiency and Green Building are very strong performers - among best in class utilities in both efficiency and effectiveness - relative to peers based on AE-provided (unverified) FY2008 savings and costs. These savings have not been evaluated by a third party as has become the industry standard for [Investor Owned Utilities] IOUs and is required of California municipals."

Customer Care:

- "AE is highly rated with business and residential customers in recent J.D. Power customer satisfaction studies, and benchmarks show high levels of customer service."
- "Customer Service cost per customer is lower than most industry segments and is average for its cost per bill, with a better than average rebill rate."
- "Contact Center benchmarking comparisons revealed lower than average cost per call and a lower number of abandoned calls; however, it also shows a slower speed to answer calls with higher than average staffing levels."
- "AE benchmarks show costs per meter read is low, with field services showing a high productivity and service level with average cost."

A&G Support Services – Information Technology [ITT]:

- "Significant increases in budget for some areas since 2007 due to a number of utility transformational and other projects [including]
    - Establishment of new architecture and PMO capabilities
    - New Customer Billing System
    - New Energy Control Center infrastructure
    - ERCOT transition to a Nodal Market

- Implementation of NERC reliability standards for critical cyber assets
  - Support of Smart Grid initiatives (Pecan Street Project)."
- "Information Technology (IT) budget...within range of Gartner and Forrester metrics, but staffing appears to be above Gartner and Forrester averages."

A&G Support Services – Financial Support Services [FSS] and Workforce development and Risk Management [WDRM]:

- "[AE Financial Support Services] current structure works well to support the activities that AE is involved in."
- "Staffing levels would appear to be within range considering responsibilities."
- "Indicated overhead rates for warehousing are reasonable."
- "Workforce Development and Risk Management (WDRM) activities are specific to Austin Energy and not duplicative of City functions."
- "Facilities and Security management are unique to electric utilities due to increased NERC and other requirements for electric utilities."

On-site Energy Resources (OSER):

- "OSER has had a history of relatively weak profitability that the current director is working to address."
- "While the operation provides benefits - not currently reflected in the organization's earnings - to the utility by shifting load off-peak, the return on net plant valued at $120 million remains low."

Power Supply: - Redacted – COMPETITIVE MATTERS

Navigant Report Summary
Analysis of Transfers from Municipal Utilities to General Government
January 31, 2012

Principal Findings:

- Moody's Investors Service "U.S. median of the General Fund Transfer is 7%."
    - o "While it is reasonable that some form of financial return be provided by the utility enterprise to the general government, [General Fund Transfer] GFT transfers that are set politically on an annual basis are less predictable and more challenging for the utility to budget for and can be a negative credit factor. Furthermore, GFT levels that lead to high or uncompetitive electric retail rates or that drain internal funds from the utility needed for maintenance and repair can also weaken the credit rating."
- Utilities surveyed:
    - o **Texas** - Austin Energy, Georgetown Utility Services, Denton Municipal Electric, College Station Utilities, CPS Energy, Lubbock Power and Light
    - o **Outside Texas** - Orlando Utility Commission, City Utilities of Springfield, Gainesville Regional Utilities, Seattle City Light, Los Angeles Department of Water and Power, Memphis Light, Gas and Water Division, and Nashville Electric
- "AE's *General Fund transfer methodology is much like that of the majority of* the utilities surveyed. Funding the transfer from its net margin is also consistent with about a third of the sample. Like Austin, all have policies or ordinances that govern the transfer calculation and the amounts are determined during the budget process. Austin, like the majority of the municipalities with utilities, has not changed the methodology or rate applied to gross revenues in several years. This is surprising given the economic strain of the last few years. However, the AE General Fund transfer *rate applied to gross revenue, although above the sample average, is within* a reasonable range when considering the comparable utilities included in the survey."
- "City of Austin has maintained its transfer policy, both in methodology and percentage, and has consistently budgeted the transfer below the maximum stated in the Financial Policy (12%)."
    - o Maintained at 9.1% since 1999, except 2002
- "It is important to determine the goals of the City and utility when *determining which method is best. There are no best practices as each City* and utility may have unique needs which drive the method in which transfers are calculated and how often they change."

Economic Development Transfer:

- "All six of the Texas municipal utilities surveyed fund Economic Development activities, but only one of the utilities outside Texas does."
- "AE's funding for Economic Development in 2009 was 0.67% of gross electric revenue compared to CPS Energy at 0.70% of gross electric revenue in 2010. Lubbock estimated that 3.00% of its electric revenue would be used for specific projects to attract development."

Conclusions:

- "The method, level, and consistent adherence to policy of the transfer between the utility and the City's General Fund affect bond ratings. The bond rating agencies consider how the transfer is established, whether both entities interests are considered, and how much is transferred each year."
- "Ten municipally owned utilities were surveyed to determine the basis of the calculation for the transfer from the utility to the City General Fund. Of the ten, seven use a similar method as AE based on percent of gross revenues."
- "The weighted average General Fund only transfer rate was 9% of gross revenue, whereas AE is slightly lower at 8.2% based on actual FY 2009 revenue. Taking into consideration all transfers and payments to the cities, AE is below the average of 10%, with 4 utilities higher than AE and 5 utilityes lower."
- "For all surveyed, the transfer authority was established by a governing body policy or ordinance and the amount is reviewed annually during the budget process."
- "Six of the ten utilities recover the cost of the transfers in base rates."
- "Four of the ten utilities survey increased their base rate in 2010 and are considering another increase in either 2011 or 2012."
- "Most utilities include fuel revenue in the gross revenue subject to the transfer percentage."
- "It is not uncommon for utilities to include a portion of fuel costs in base rates as is done by CPS Energy."
- "Texas utilities were the only utilities in the sample to fund economic development in some manner, of which all of them provided some type of funding either through paying directly for projects or other funding."