VALLEY CLEAN ENERGY ALLIANCE

Staff Report – Item 14

To: Valley Clean Energy Alliance Board of Directors

From: Mitch Sears, Interim General Manager
Lisa Limcaco, Director of Operations
Gary Lawson, Wholesale Energy Services Manager, SMUD

Subject: PCIA Exit Fee Increase - Policy Adjustments to Counter PCIA and Other Impacts to VCE's Financial Position

Date: November 15, 2018

RECOMMENDATIONS

1. Adopt a minimum VCE net margin (after bank loan principal payments) target of 5%;
2. Postpone enrollment of Net Energy Metering customers until at least January 2020 with a reassessment of enrollment date in mid-2019;
3. For 2019, adopt electric generation rates identical to PG&E, after factoring the Power Charge Indifference Adjustment (PCIA) imposed by regulatory agencies;
4. Study adoption of a new rate structure featuring an annual dividend rebate structure to be implemented starting in July 2019;

BACKGROUND AND ANALYSIS

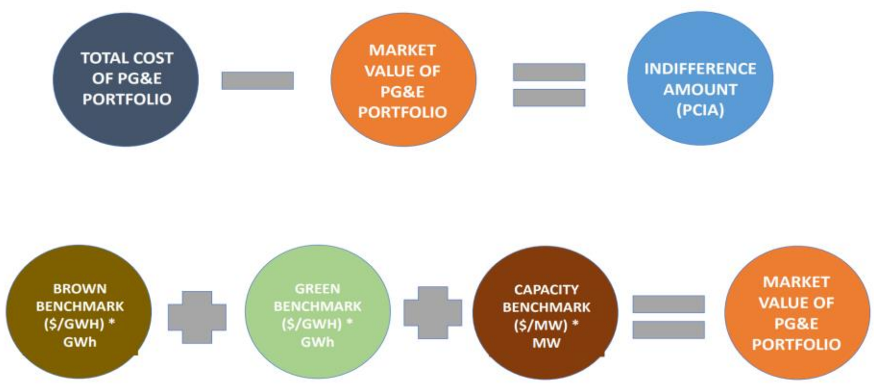
Valley Clean Energy (VCE), like other Community Choice Aggregation (CCA) programs across the state, is facing uncertainty and volatility in several arenas that significantly impact the cost of doing business. Each of the 18 CCA's operating in California is impacted differently depending on the year it began service, the electricity load shape is serves, and its ability to absorb cost volatility. The primary drivers of this volatility are State regulatory action and rising forward power market prices. In October 2018 the California Public Utilities Commission (CPUC) made a ruling which, all other factors being equal, pushed the 2019 Power Charge Indifference Adjustment Fee (PCIA) 30% higher than the 2018 value, which will result in a $5.0 Million dollar/yr increase in costs for VCE more than if the CPUC had not made the new ruling; the California Energy Commission (CEC) recently revised VCE's load forecast used for determining Resource Adequacy (RA) requirements, which had the impact of increasing VCE's RA requirement by 25% resulting in a $1.25 Million dollar/yr increase in costs for VCE; and forward market power market prices have increased such that VCE's market power costs are higher by $0.8 Million than originally forecast for 2019.

Through the Cal-CCA trade association, VCE joined the other 17 CCA programs to participate in the decision-making processes of the CPUC and CEC. These efforts did not yield results favorable to CCA's and as a result VCE must consider the cost saving measures outlined in this report. Additional background on the primary drivers creating cost volatility for VCE (and other CCA's) is provided below.

Power Charge Indifference Adjustment (PCIA)
The PCIA is an exit fee charged by the State's investor-owned utilities (IOUs) to those customers that leave PG&E as their generation provider to become Direct Access customers, or customers of Community Choice Aggregators (CCAs). The intent of the PCIA is to make remaining bundled utility customers economically "indifferent" to customers that have departed from the utility bundled service. The utilities, over time, procured or built and owned resources to serve all of their customers. The PCIA is charged so that departing customers bear their share of resources procured for them when they were bundled IOU customers.

The PCIA is the "exit fee" that is intended to ensure such indifference. The PCIA can be negative (PG&E customers paying VCE customers) or positive (VCE customers paying PG&E customers). Figure 1 below shows the fundamental PCIA formula, in addition to the Market Value component of the PCIA formula.

Figure 1. Fundamental PCIA Formulas



California Public Utility Commission (CPUC) Proceedings and Decisions
On August 1, 2018, the CPUC Administrative Law Judge Roscow issued the Proposed Decision (PD) modifying the PCIA methodology after studying the issue for a year and took testimony from all sides. The PD was generally acceptable to CCAs.

On August 14, 2018, Commissioner Peterman issued the Alternate Proposed Decision (APD). The major contested difference between the PD and APD dealt with whether Public Utilities Code allows legacy utility owned generation (UOG) under the PCIA and whether to continue the 10-year limit on cost recovery for post-2002 UOG and certain storage costs under the PCIA. The PD established a PCIA collar with an upper cap starting at 2.2 cents/KWh while the APD established a PCIA collar starting in 2020, with the cap limiting upward or downward changes in the PCIA to 25 percent in either direction from the prior year. The APD was generally favorable to PG&E and the other IOU's.

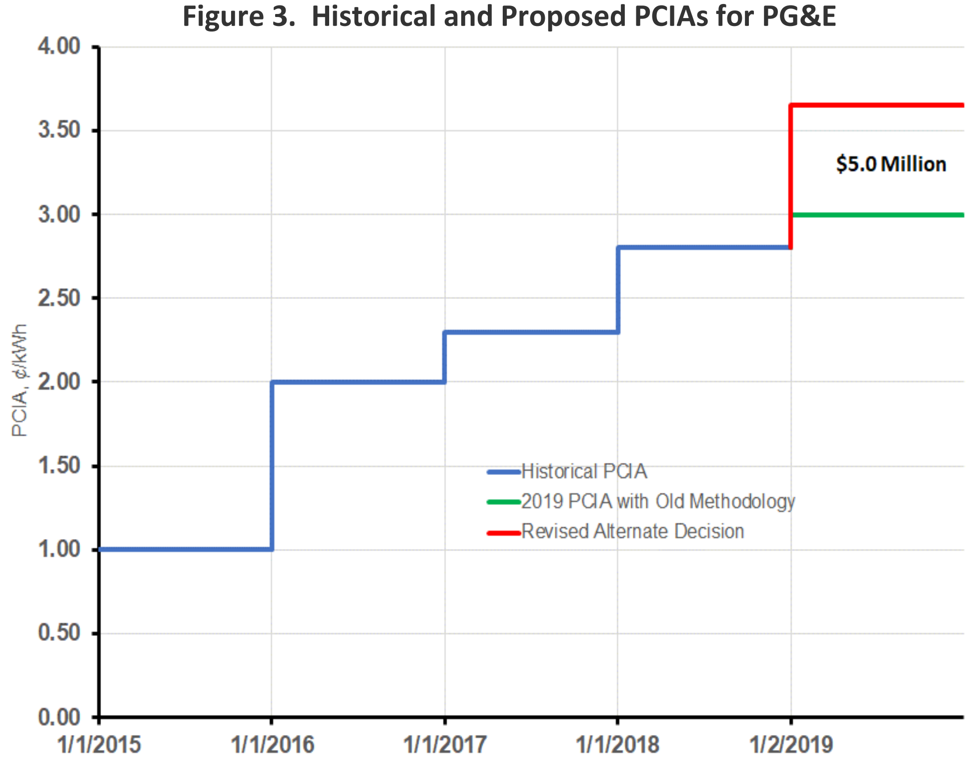
On October 5, 2018, Commissioner Peterman issued a Revised Alternate Proposed Decision which contained no substantial revisions except to set the annual PCIA cap at $0.5 cent/kW starting in 2020.

On October 11, 2018, the CPUC voted unanimously to approve the revised APD. The revised APD increases Total Portfolio Cost and reduces the Portfolio Value which, with all other PCIA components remaining constant, will result in an increase of the PCIA. Figure 2 below shows the relative impacts to the PCIA from the CPUC decision.

Figure 2. PCIA Decision Impact on PCIA

Under the old methodology of calculating PCIA, the 2019 PCIA would have increased by 9%. However, under the Revised APD, the 2019 PCIA increased over 27% for the system wide average rate but for VCE the increase is over 30% due to VCE's customer load profile. As shown in Figure 3 below, the Revised APD has a $5.0 Million per year financial impact on VCE's revenue beginning in 2019.

Figure 3. Historical and Proposed PCIAs for PG&E



These changes to the PCIA by the CPUC have created volatility and uncertainty for CCA programs across the State. Allowing for such large and unforecastable swings in the PCIA means that CCA's must be more defensive in their financial posture going forward and is the driver for the policy recommendations contained in this report. These policy modifications will partially counter the negative impacts that an increasing and volatile PCIA has on VCE's finances so that VCE is in a better position to maintain competitive rates for its customers while meeting its baseline financial obligations. VCE's financial obligations are outlined later in this report.

Resource Adequacy (RA) and Forward Power Markets Cost Increases

Resource Adequacy (RA) is the generating capacity all electricity providers like VCE are required to have available to the grid for reliability purposes. Entities can either own generating resources that provide RA or can purchase the RA from generator owners. When VCE was provided its "Final RA Determination" for 2019 on September 27, 2018, the CEC had adjusted VCE's load forecast resulting in VCE's RA procurement requirement being 25% higher than forecast. The CEC indicated this adjustment was due to a "load forecast" error of all load serving entities (including VCE), as compared with the CEC's own system load forecast.

This late notice of such a large adjustment left VCE with 1 month to procure the additional RA in order to show compliance on October 31, 2018 as required by the CPUC. This additional RA requirement resulted in an increase in power procurement costs of $1.25 Million dollars and left many load serving entities in the same situation, scrambling for what appears to be a limited supply in the RA market. Compounding this is that some RA sellers appear to be holding back some supply from the market causing prices to rise and preventing many CCA's (and Direct Access electricity providers) from meeting their RA procuring requirements. Not meeting compliance exposes VCE (and others) to penalties potentially being assessed by the CPUC.

Additional cost pressure has come from increasing forward market power prices. VCE is exposed to market power prices because it purchases the power supply for its load out of the CAISO market on a daily basis. Forward markets power prices have increased from the start of the year such that VCE's 2019 market power costs are forecast to be $0.8 Million higher than initially forecast. While this type of price volatility is not uncommon and was incorporated into VCE's financial modeling, when combined with the increases in the PCIA and RA costs it places additional financial strain on VCE. This combination of factors has made it necessary for VCE to consider policy modifications to solidify its financial standing to maintain competitive rates for its customers while meeting its baseline financial obligations and to help insulate it from additional volatility. The policy modifications are described in greater detail later in this report.

Operating Costs Savings

With the issuance of the APD in August 2018, staff reviewed the operating budget and reduced several expenses including, 1) Salaries & Wages, 2) Legislative & Regulatory expenses, 3) Audit fees, 4) Accounting fees and 5) the contingency expense line item to 5% (previously 10%) of operating expenses (excluding power costs). These actions resulted in an approximately 20% reduction of operating costs, totaling approximately $0.8 million for FY 2019.

Financial Obligations

VCE has several financial obligations with SMUD and River City Bank. In reviewing the financial proforma for the changes in PCIA, RA costs, and policy modifications, VCE will need to meet these baseline financial obligations:

1. Under the Wholesale Energy Services contract with SMUD - Task Order 3, VCE is required to fund a Reserve Account in the amount of $1 for each MWh of wholesale energy procured in SMUD's name and delivered to VCE. This required reserve amount is approximately $750,000 in 2019.
2. Under the River City Bank Credit Agreement, VCE must maintain minimum profitability requirements during the period the Revolving Line of Credit is outstanding (July 2018 through September 2019. The minimum profitability requirement for the period July 1, 2018 – June 30, 2019 (fiscal year) is $6.1 M.
3. Under the River City Bank Credit Agreement, if the Revolving Line of Credit is converted to the Term Loan, VCE shall maintain a minimum Debt Service Coverage Ratio (DSCR) not less than 1.25 measured annually as of VCE's fiscal year end beginning with June 30, 2020.

RECOMMENDED POLICY MODIFICATIONS

To remain cost competitive in 2019 while strengthening VCE's financial position to help address its baseline financial obligations, staff is recommending the following package of policy modifications. As discussed in the October 18th and November 1st Board presentations, the recommendations are discrete but work together to address PCIA volatility and resulting budget shortfalls anticipated for 2019 and 2020.

1. <u>Adopt a minimum VCE net margin (after bank loan principal payments) target of 5%</u>
   The VCE Board adopted a general financial reserve policy in late 2017 to establish a minimum 30-day operating expenses reserve. This reserve policy was designed based on historical PCIA, PG&E rates, and power market projections that showed VCE maintaining a 30-day operating expense reserve consistently.

   Net Margins above the industry average or the overall market indicate financial efficiency and stability. However, margins below the industry average might indicate financial exposure to an economic downturn or financial distress if a trend develops. Net margins vary greatly across different industries and sectors. For example, average net margins in the retail clothing industry run lower than the average net margins in the telecommunications sector. Large, national-chain retailers can function with lower margins due to the massive volume of their sales. Conversely, small, independent businesses need higher margins to cover costs and still make a profit. Based on Staff research, the Electric Utility industry average net margin for 2017 ranged from 8%-10%. Similarly, VCE is one of the smaller CCAs with a smaller customer base than other CCAs. Thus, VCE will require higher margins to cover its costs and still build reserves to offer local programs and customer incentives.

With the current uncertainty in future PCIA and PG&E rates, it is prudent business practice to build up additional reserves that target a level of 90 days cash and maintain a minimum net margin (after any bank debt principal payments). Therefore, staff is recommending building our reserves to a 90-day cash level within the next 4 years and maintaining a minimum net margin (after any bank debt principal payments) of 5% before funding local program funds or offering rate discounts/dividends to our customers.

2. <u>Postpone Net Energy Metering (NEM) Customer Enrollment</u>
   In September 2018, the VCE Board adopted a revised NEM policy that deferred the NEM customer enrollment to January 2019. However, in the first year they are rolled in, NEM customers do not generate as much revenue as the power costs they add. This is due to the effect of annual true-up for NEM customers. As they become new VCE customers, revenue from generation sales to them is not recognized until their annual true-up, which will begin in fiscal year-end (FYE) June 2020. Additionally, NEM customers in aggregate, cost more to serve than the revenues they bring in. This is in part due to the fact that NEM customers place nearly the same capacity load on the system as customers in similar rate classes, but have far lower energy sales, due to their self-generation. The financial impact to the FYE 2019 and 2020 financials of deferring NEM enrollment out to 2021 is an increase in net income of $0.8 million and $1.8 million, respectively.

   Prior to the projected PCIA rate increase, increased Resource Adequacy (RA) procurement costs, and increasing short term power market prices, VCE had the ability to absorb the financial impact of the NEM customers rolling in 2019.

   With the current NEM roll-in planned for January 1, 2019, VCE has opportunity to further delay that roll-in. VCE would continue its outreach and communication to NEM customers to keep them informed while emphasizing that they are still benefitting from their solar systems and are still contributing to grid de-carbonization.

   NEM customers represent a large and important segment of VCE's customer base that brings to ground VCE's goals to provide clean energy that focuses on local sources. Despite that, based on the current need to consider the positive financial impact of deferring the NEM customer enrollment on VCE's financial position in 2019 and 2020, staff is recommending that VCE postpone NEM customer enrollment at least until January 2020 with a reassessment of the future enrollment date in mid-2019.

3. <u>2019 Electric Generation Rates</u>
   To remain cost competitive and assist with meeting its baseline financial obligations in 2019, staff is recommending that VCE match PG&E's electric generation rates, less the PCIA fee. This would modify the 2018 VCE rate discount of 2.5% that was set in 2017 before the recent action by the CPUC to raise the PCIA fee, the 25% increase in Resource Adequacy procurement imposed on VCE by the State, and rising power market prices.

The advantages of setting identical rates to that of PG&E are as follows:

- The projected PCIA calculated by PG&E for FYE 2019 will reduce VCE's annual revenue by approximately $5.0 million. By matching PG&E's electric generation rates, it will provide a net savings to VCE of approximately $0.8 million in FYE 2019.
- Eliminating the rate discount is one of only two policy levers the Board has to make a significant improvement to VCE financials necessary to insure VCE can weather additional negative impacts from future movement in power market prices.

The drawbacks of modifying the VCE rate for 2019 to match PG&E's electric generation rates include:

- Eliminating any rate discount so soon after launch could cause customer confusion about the status of VCE.
- The lack of a discount rate could lead to increase opt-outs for certain customer classes.

4. <u>Study adoption of a new rate structure starting in July 2019 (VCE's 2020 Fiscal Year)</u>
As an alternative to providing customers with a pre-determined, up front rate discount relative to PG&E service, but to still provide the opportunity for customers to obtain generation rate savings and to allow VCE to meet its financial obligations, staff recommends studying a move from a monthly fixed rate discount structure to a yearly "dividend" rate structure where bill credits are awarded annually if VCE meets certain financial thresholds. In essence, if VCE does well its customers will benefit by receiving bill credits. This is a rate structure currently employed by Monterey Bay Community Power (MBCP). While VCE customers would no longer receive a fixed monthly discount, they would receive an annual bill credit if VCE meets certain financial thresholds. The primary advantages for VCE include:

- Financial stabilization. Allows more precise management of financial standing based on financial thresholds defined by VCE by rewarding customers with bill credits on the basis of VCE financial performance.
- Communication with customers. Financial thresholds that trigger annual divided bill credits are transparent and can be easily communicated to VCE customers. In addition, monthly customer bill questions are likely to decrease since there will not be a monthly percentage discount to calculate.
- Simplified rate administration. As noted in the previous section on electric generation rates, setting identical rates to that of PG&E can save VCE time and money otherwise required to develop rate schedules.
- Mission driven. The "dividend" approach allows VCE to shift the focus from rate comparisons and rate design to the range of goals that define the reasons VCE was established in the first place. Namely, cost competitive cleaner resources,

local control, custom tailored programs responsive to community needs, and improving the local economy by investing in clean power resources and returning some of the annual savings back to the customers.

- Build customer satisfaction and loyalty. CCA programs are community owned, managed and directed by a local Board representing its customers. It is therefore reasonable to provide a return/dividend to VCE customers at the end of each year as a bill credit. This dividend could be announced annually at the beginning of the operating year, once staff has established a budget that will consider operational and program expenditures and reserve requirements. By allocating the dividend or credit at the end of the fiscal year, VCE would be able to pay out on a "performance basis," and build customer satisfaction and loyalty as well.

The primary drawbacks of this rate structure for VCE include:

- Changing rate design one year after launch could cause customer confusion that will need to be addressed in VCE outreach.
- Some customer classes may prefer monthly discounts. However, MBCP has observed that this type of rate design has not been a significant driver for opt-outs.
- Based on the projected PCIA rate for 2019, VCE will not have the ability to provide a dividend to its customers in the immediate future which could lead to increased opt-outs in certain customer classes.

SUMMARY

Based on the increased PCIA rate, increased RA procurement costs, short-term power market prices, operating cost savings, and recommended policy modifications, VCE net income projected for FYE 2019 and 2020 are $3.8 million and $2.6 million, respectively. Table 1 below summarizes the financial impacts of PCIA and the policy modifications to the original budget approved by the VCE Board in March 2018.

Table 1. Financial Impacts of PCIA and Policy Modifications

	Fiscal Impact ($1,000's)	
Policy Modification Action	**FY 2018/19**	**FY 2019/20**
Net income before policy modifications	**$2,259**	**$(911)**
Postpone NEM enrollment	$779	$1,767
Match PG&E generation rate	$783	$1,744
Net income after policy modifications	**$3,821**	**$2,600**

CONCLUSION

The recent PCIA proceedings and resulting trend of an increased PCIA have placed a spotlight and highlighted that CCA's are facing significant volatility and uncertainty in the regulatory and power market arenas. For VCE, based on the best available information, Staff believes this requires the policy shifts recommended in this report to address these financial uncertainties.

The policy modification recommendations are not made lightly. Staff recognizes that they are less than ideal as VCE establishes itself in the communities it serves. However, the structural changes to the rate design and the simplicity of matching the PG&E rates do offer advantages to VCE and its customers that will continue beyond the current financial challenges, and the positive impact to VCE's finances are necessary for VCE to withstand the tremendous uncertainty around PCIA variability and recent RA procurement increases.