VALLEY CLEAN ENERGY ALLIANCE

Staff Report – Item 16

TO:	Board of Directors
FROM:	Mitch Sears, Interim General Manager Edward Burnham, Director of Finance & Internal Operations
SUBJECT:	Preliminary Draft Operating Budget Calendar Year 2022
DATE:	November 10, 2021

RECOMMENDATION
Receive informational report and provide direction on development of final budget for 2022.

OVERVIEW
This update is the first of two discussions leading to Board adoption of the calendar year 2022 budget (2022 Budget) ending December 31, 2022. The basis for the staff preparing a CY 2022 budget is a result of the companion agenda Item 13, adopting a resolution to change the current fiscal year (July 1 to June 30) to align with the calendar year (January 1 to December 31).

The purpose of this staff report is to: (1) provide an update on the FY2020-21 and 2021-22 Operating Budgets, (2) provide an overview of key factors influencing the operating budgets, (3) present an analysis of three draft budget scenarios for the Board discussion and feedback.

As detailed in the body of this report, the previous FY 2020-21 has resulted in a net loss of $3.8M for a total loss of $.3M more than budgeted. The current FY 2021-22 for the first six months is anticipated to be approximately $1.6M net more favorable than the approved Budget. The three 2022 budget scenarios outlined in the analysis section of this report range between $0.3M net income to $3.8M net loss based on net rate increases due to rising power costs and resource adequacy costs as VCE transitions to its fixed price long-term renewable power purchase agreements.

VCE's short-term outlook (2022 and 2023) indicates continued volatility in market prices and PCIA with associated financial challenges which requires corrective action on rate setting to ensure cost recovery. The longer-term outlook (2024+), indicates increased stability and cost certainty due to long-term PPA's coming on-line and cost-based rate structure allowing VCE to rebuilt reserves and achive positive margins.

BACKGROUND
As discussed in staff reports leading to the adoption of the FY 2021-22 Budget and budget monitoring process in June, the past two years have seen high volatility in the energy sector

and overall economy primarily driven by the uncertainty during the COVID-19 pandemic and possible long-term recession. In addition, the increases in 2021 Power Charge Indifference Adjustment (PCIA), resource adequacy, and power market costs have required VCE to draw against reserves to stabilize customer rates and maintain its current rate policy of matching PG&E generation rates. As part of the budget adoption and monitoring process, VCE has taken the following key actions:

- In June 2020, the Board adopted a FY 2020-21 budget that included the fiscal mitigation policy adjustments starting in fiscal year 2019-20 that reduced the net loss from over $5M to $2.8M. The policy adjustments scaled back VCE's near-term acquisition of renewable energy credits (RECs) and GHG-free power content. This policy was adopted by the Board to address: (1) the objective of aligning VCE's short and long-term power procurement efforts, (2) the increasing/unpredictable PCIA, and (3) volatility in Resource RA power pricing, which have created uncertainty for CCA programs across the State. The policy adjustments placed VCE in a better position to maintain competitive rates and clean power content for its customers while meeting its baseline compliance obligations.

- In October 2020, staff presented a mid-year budget update to monitor actual customer load demand, revenue, and expenses during the pandemic. The June 2020 forecasted net deficit for FY 2022 was approximately $6.0M; the follow-up mid-year update in October 2020 showed a net $7.1M deficit due to rising RA, power, and PCIA costs.

- In May 2021, in conjunction with SMUD, staff provided a budget update, including the annual electricity demand forecast for VCE for a projected net income loss of approximately $7.70M for FY 2022. The primary fiscal drivers included: (1) a load increase of 0.5% as the predicted dampening effects of an ongoing recession from COVID were no longer anticipated, (2) 7% increase in market power costs compared to FY 2021 due primarily to the hot 2020 summer and its impacts on forward market power prices, and (3) Time of Use (TOU) rate transitions for non-residential customers were lower than anticipated due to the methodology applied by PG&E. Based on the best information available at the time, the budget model incorporated assumptions of a 5% increase in PG&E's generation rates and a 5% decrease for the PCIA in 2022. As noted below, these assumptions are in the process of being revised to reflect updated information indicating a larger increase in PG&E's rates and a larger decrease in PCIA for 2022.

- In June 2021, the Board extended the policy strategy adjustments described in the bullet point above one year to reduce procurement of short-term renewable resources (RECs) to partially mitigate current financial impacts. The Board approved the FY 2021-22 Operating Budget with $51.2M of operating revenues and $58.1M of operating expenses for a net loss of $6.9M.

- In October 2021, the Board received updated power market forecasts and VCE financial model results that corrected an overestimation of the value of VCE's long-term renewable contracts of approximately $13M over the next 2 years. The Board approved an accelerated rate adjustment of approximately 2% on the average customer bill in mid-October to reduce pressure on reserves; additional information on this action is included in the companion board item 16.

<u>Long-term Fixed Price Power Purchase Agreements</u>
VCE renewable power and storage resource deliveries resulting from our contracted long-term power purchase agreements (PPAs) began in 2021 and will significantly increase over 2022 and 2023. The PPAs are fixed-price contracts and are projected to cover over 80% of VCE's annual load by 2024 to reduce VCE costs compared to current RPS and RA market costs and significantly reduce volatility as VCE moves forward. As discussed with the Board leading up to the FY 2021-22 budget adoption in June, the undesirable but necessary RPS policy adjustments and utilization of cash reserves have helped VCE stabilize customer rates and partially bridge the gap until the long-term PPAs begin full delivery in the 2021-24 timeframe.

ANALYSIS
This report updates the information provided to the Board in September 2021 and provides the basis for the presented budget scenarios. The sections below provide updates on: (1) the FY2020-21 and 2021-22 Operating Budgets, (2) provide an overview of key factors influencing the operating budgets, and (3) present an analysis of three budget scenarios for discussion and Board feedback.

1. Operating Budget Update – FY 2020-21 & FY 2021-22 (6 Month)
As presented to the Board in September, VCE has faced financial challenges associated with power market and regulatory volatility, requiring VCE to draw on reserves to stabilize customer rates and maintain its current policy of matching PG&E generation rates.

FY 2020-21 (July 2020-June 2021) – The audited financials presented in the companion Board agenda item 15 increased losses by approximately $300K.

- NEM revenues unfavorable $800K related to reporting for the annual true-up process.
- Rugged Solar PPA performance deposit of $220K was forfeited by the developer to VCE, resulting in additional other revenue
- The receivables account was reconciled for an increase of $180K
- VCE released accrued expenses of $90K as reconciled

FY 2021-22 (6 Month) – The unaudited financials for the six months of July-2021 to December-2021 are currently forecasted to be net favorable to Budget by $1.6M for a forecasted loss of $3.5M. The key factors that resulted in the $1.6M difference include:

- PCIA. A net 46% increase in the PCIA from 2020/21 continues to have significant revenue erosion for approximately $23M total paid for the 9-months of the current calendar through September.
- Power Prices. Average forward market power prices have increased 57% since May 2021.
- Customer Rate Increase of 2% - The Board approved an accelerated rate adjustment of approximately 2% on the average customer bill in mid-October for $300K.

The following table summarizes the FY 2021-22 (6 Month) actuals vs. approved Budget.

FY 2021-22	APPROVED BUDGET FY 2021 (6 MO)	Actual YTD Sept. 30 (3 MO) + Forecast (3 MO)	Variance
Revenue	$ 25,043	$ 28,606	$ 3,564
Power Cost	$ 27,592	$ 29,616	$ (2,023)
Other Expenses	$ 2,509	$ 2,469	$ 41
Net Income	$ (5,059)	$ (3,478)	$ 1,581

Staff will continue to monitor the FY 2021-22 (6 Month) Operating Budget, including October and November results in the December CY 2022 Budget adoption.

2. Key factors – Operating Budgets

The VCE financial outlook for CY 2022 and CY 2023 has changed significantly since the Board approved the current fiscal year budget in June 2021. PG&E's rates are forecast to increase in while PCIA is forecast to decrease significantly in 2022. These forecasted changes, in combination with VCE cost-based rate adjustments will off-set higher forecasted power costs as VCE transitions into its long-term fixed price renewable PPA's scheduled to come on-line in 2022 and 2023. The budget scenarios shown in Tables 2 though 4 below incorporate these factors in the short and longer-term forecasts.

Key baseline factors that influenced the development of the budget options presented in Section 3 below include:

- Power Prices. Average forward market power prices have increased by approximately 57% since the April-2021 preliminary draft budget. This impacts the Budget directly since VCE buys forward energy price hedges to manage energy price risk. Based on the Board approved procurement policy, SMUD is in the process of completing hedge purchases for 2022. Speculation in the energy markets on the potential for a repeat of the heat storm event of last summer 2020 pushed forward market power prices significantly higher in 2021. Beyond 2022, a significant portion of these short-term energy costs and the associated price volatility will be mitigated by the commencement of VCE's long-term PPA agreements.
- Financial Power Cost Model - Total difference between adopted and corrected forecasts is approximately $13M over the three FYs 2022 to 2024, resulting from a modeling error that overestimated the financial benefits of VCE's long-term renewable power purchase contracts.
- PCIA. A net 39% increase in the PCIA from 2020/21 continues to have significant revenue erosion for approximately $21M for the 6-months of the current calendar through July.
- Fiscal Year and Budget adoption timing. As described in October and in the proposed adoption of companion agenda item 13 (revised fiscal year), the budget adoption

process occurs during the load forecast updates and the beginning of the hedging process for the following calendar year.

Based on information provided by CalCCA forecast analysts, the results of various regulatory, legislative and market factors are expected to lead to a more significant normalization of PCIA and RA power costs in 2023 and beyond and are factored into VCE's long-term outlooks. These factors, in combination with VCE's fixed-rate longer term PPA's, indicate some moderation in financial volatility for VCE going forward. Staff will continue to monitor and update the Board should conditions change. The CY 2022 Draft Budget options shown below are inclusive of the above factors.

3. FY 2022 Draft Budget Scenarios

Staff developed three budget scenarios to test the sensitivity of two key variables that drive financial outcomes for VCE: PCIA and PG&E generation rates – all scenarios incorporate the same power cost assumptions based on the best available market information from SMUD and so are consistent in each scenario. The scenarios represent a best, worst, and most likely scenario that serve to bookend the analysis while offering a third "most likely" scenario that incorporates the best available information and forecasts for the PCIA and PG&E generation rates. In addition to consistent power cost assumptions, each budget option includes the same PCIA scenario based on the October 2021 CPUC filings, as shown in Table 1 below.

Rate Forecasts and Revenue

VCE, along with all other California CCAs, receives PG&E PCIA and generation rate forecasts modeling information produced by financial analysts under contract with CalCCA. The latest forecast from the consultant (Oct 2021) predicts significant increases in PG&E's generation rates and decreases in PCIA over the CY 2022 time period. These changes are based on information from separate filings to the CPUC and are scheduled to be finalized in November 2021.

Table 1 – Rates Scenarios

		RATES		
	PCIA	Scenario 1	Scenario 2	Scenario 3
CY2022	-30%	12%	10%	15%
CY2023	5%	-7%	-7%	-7%
CY2024	-2%	2%	2%	2%
CY2025	2%	1%	1%	1%

- **Generation rate changes (1% change approximately $650K Net Annual Impact to VCE) -** Generation rate changes are related to PG&E's 2022 Annual Consolidated Rate Change and request to recover costs recorded in its Catastrophic Event Memorandum Account (CEMA). PG&E implements several rate changes at the start of each year to reflect the consolidation of authorized and pending revenue changes and recovery of balances in various balancing accounts.

- **PCIA (1% change approximately $300K net annual impact to VCE) -** The PCIA is calculated from the utility's Indifference Amount, updated annually in each IOU's rate setting proceeding. The Indifference Amount is the difference in the target year between the cost of the IOU's supply portfolio and the market value of the IOU's supply portfolio. Since the PCIA is a backwards look, higher market power prices in 2021 would result in a lower 2022 PCIA.

As with the volatility in costs, forecasted PCIA and Generation rate changes impacting CY 2022 are included in the budget options ranging from 10% to 15% net increase that includes PG&E's rate increase for 2022 plus any rate adjustment by VCE (not in addition to the rate increase adopted in October 2021).

The budget options detailed below incorporate these rate forecasts as follows:

- Scenario 1: Moderately discounted forecast of PG&E generation rate increases.
- Scenario 2: Highly discounted forecast of PG&E generation rate increases.
- Scenario 3: Low discounted forecast of PG&E generation rate increases.

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Budget Scenario 1: CY 2022

Budget Scenario 1 incorporates net rate changes of 12%; the net impact for CY 2022 is a loss of $2.2M. This option includes a moderately reduced rate increase from the CalCCA consultant, which is considered by staff as a solid possible outcome based on additional customer cost burdens during the assumed period of recovery from the pandemic.

Table 2 – Budget Scenario 1 (12% net rate increase - moderately discounted from forecast)

VALLEY CLEAN ENERGY DRAFT BUDGET SUMMARY 2022 - BUDGET SCENARIO 1	APPROVED BUDGET FY 2021 (6 MO)	ACTUAL YTD SEP (3 MO) + FORECAST (3 MO) FY 2021 (6 MO)	DRAFT BUDGET CY 2022
Energy - Megawatt Hours			
OPERATING REVENUE	**$ 25,043**	**$ 28,606**	**$ 69,700**
OPERATING EXPENSES:			
Cost of Electricity	27,592	29,616	66,990
Contract Services	1,369	1,413	2,640
Outreach & Marketing	117	90	247
Programs	68	34	138
Staffing	580	554	1,175
General, Administration and other	382	374	754
TOTAL OPERATING EXPENSES	**30,107**	**32,080**	**71,945**
TOTAL OPERATING INCOME	**(5,064)**	**(3,474)**	**(2,245)**
NONOPERATING REVENUES (EXPENSES)			
Interest income	28	19	56
Interest expense	(23)	(23)	(42)
TOTAL NONOPERATING REV/(EXPENSES)	**5**	**(4)**	**15**
NET MARGIN	**$ (5,059)**	**$ (3,478)**	**$ (2,230)**
NET MARGIN %	**-20.2%**	**-12.2%**	**-3.2%**

As shown in Table 5 below – Budget Scenario Comparison, this scenario forecasts stabilization of VCE's financials and a return to positive net margins in 2023. Scenario 1 is a relatively cautious scenario that demonstrates the short and long-term impacts of PG&E rate changes.

Budget Scenario 2: CY 2022

Budget Scenario 2 incorporates net rate changes of 10%; the net impact for CY 2022 is a loss of $3.8M. Given the rate increases experienced in actual and forward power costs and the best available forecasting information from the CalCCA consultant, staff believes this increase would be understated and represents an unlikely outcome for this budget cycle.

Table 3 – Budget Scenario 2 (10% net rate increase - highly discounted from forecast)

VALLEY CLEAN ENERGY DRAFT BUDGET SUMMARY 2022 - BUDGET SCENARIO 2	APPROVED BUDGET FY 2021 (6 MO)	ACTUAL YTD SEP (3 MO) + FORECAST (3 MO) FY 2021 (6 MO)	DRAFT BUDGET CY 2022
Energy - Megawatt Hours			
OPERATING REVENUE	**$ 25,043**	**$ 28,606**	**$ 68,100**
OPERATING EXPENSES:			
Cost of Electricity	27,592	29,616	66,990
Contract Services	1,369	1,413	2,640
Outreach & Marketing	117	90	247
Programs	68	34	138
Staffing	580	554	1,175
General, Administration and other	382	374	754
TOTAL OPERATING EXPENSES	**30,107**	**32,080**	**71,945**
TOTAL OPERATING INCOME	**(5,064)**	**(3,474)**	**(3,845)**
NONOPERATING REVENUES (EXPENSES)			
Interest income	28	19	56
Interest expense	(23)	(23)	(42)
TOTAL NONOPERATING REV/(EXPENSES)	**5**	**(4)**	**15**
NET MARGIN	**$ (5,059)**	**$ (3,478)**	**$ (3,830)**
NET MARGIN %	**-20.2%**	**-12.2%**	**-5.6%**

As shown in Table 5 below – Budget Option Comparison, this option forecasts a more significant net loss for VCE in FY 2022 but is a less likely outcome. In this unlikely scenario, VCE would be required to take a more aggressive rate setting posture for 2022 to stabilize its finances before returning to positive net margins in 2023 and beyond.

Budget Scenario 3: CY 2022

Budget Scenario 3 incorporates net rate changes of ~15%; the impact for CY 2022 is a minor net gain. This option includes a slightly reduced rate increase from the CalCCA consultant, which is considered by staff as a possible outcome based on additional customer cost burdens during the assumed period of recovery from the pandemic.

Table 4 – Budget Scenario 3 (15% net rate increase - low discount from forecast)

VALLEY CLEAN ENERGY DRAFT BUDGET SUMMARY 2022 - BUDGET SCENARIO 3	APPROVED BUDGET FY 2021 (6 MO)	ACTUAL YTD SEP (3 MO) + FORECAST (3 MO) FY 2021 (6 MO)	DRAFT BUDGET CY 2022
Energy - Megawatt Hours			
OPERATING REVENUE	**$ 25,043**	**$ 28,301**	**$ 72,200**
OPERATING EXPENSES:			
Cost of Electricity	27,592	29,467	66,990
Contract Services	1,369	1,413	2,640
Outreach & Marketing	117	90	247
Programs	68	34	138
Staffing	580	554	1,175
General, Administration and other	382	374	754
TOTAL OPERATING EXPENSES	**30,107**	**31,931**	**71,945**
TOTAL OPERATING INCOME	**(5,064)**	**(3,631)**	**255**
NONOPERATING REVENUES (EXPENSES)			
Interest income	28	19	56
Interest expense	(23)	(23)	(42)
TOTAL NONOPERATING REV/(EXPENSES)	**5**	**(4)**	**15**
NET MARGIN	**$ (5,059)**	**$ (3,634)**	**$ 270**
NET MARGIN %	**-20.2%**	**-12.8%**	**0.4%**

As shown in Table 5 below – Budget Option Comparison, this option forecasts a net income for VCE in FY 2022 of approxiemently $300K. In this scenario, VCE shows robust net margins beginning in 2023 as long-term renewable PPA’s begin full delivery.

Table 5 – Budget Scenario Comparison

	Actuals			Actual YTD Sept. 30 (3 MO) + Forecast (3 MO)	Budget Scenarios	Forecasted		
Scenario 1	FY2019	FY2020	FY2021*	FY2022	CY2022	CY2023	CY2024	CY2025
Revenue	51,035	55,249	54,657	28,606	69,700	62,600	65,500	66,600
Power Cost	38,540	41,538	54,234	29,616	66,990	52,400	47,100	48,400
Other Expenses	3,850	4,346	4,267	2,469	4,940	5,140	5,269	5,400
Net Income	8,646	9,365	(3,844)	(3,478)	(2,230)	5,060	13,132	12,800
Scenario 2	FY2019	FY2020	FY2021*	FY2022	CY2022	CY2023	CY2024	CY2025
Revenue	51,035	55,249	54,657	28,606	68,100	61,100	63,900	64,900
Power Cost	38,540	41,538	54,234	29,616	66,990	52,400	47,100	48,400
Other Expenses	3,850	4,346	4,267	2,469	4,940	5,140	5,269	5,400
Net Income	8,646	9,365	(3,844)	(3,478)	(3,830)	3,560	11,532	11,100
Scenario 3	FY2019	FY2020	FY2021*	FY2022	CY2022	CY2023	CY2024	CY2025
Revenue	51,035	55,249	54,657	28,606	72,200	65,000	67,900	69,000
Power Cost	38,540	41,538	54,234	29,616	66,990	52,400	47,100	48,400
Other Expenses	3,850	4,346	4,267	2,469	4,940	5,140	5,269	5,400
Net Income	8,646	9,365	(3,844)	(3,478)	270	7,460	15,532	15,200

* Based on preliminary audit results presented in companion item 15.

Note: 2023, 2024, and 2025 forecasted financials are based on the most current available data and assumptions, as displayed in Table 1 - Rates Scenarios. These scenarios rely the on the use of future rate adjustments, reserves, or both to mitigate future power cost volitility.

CONCLUSION

The draft FY 2022 operating budget scenarios do not meet VCE's 5% minimum annual net margin goal. Staff has prepared the draft FY 2022 operating budget scenarios based on the best available information on PG&E generation rates and PCIA as of October 2021 CPUC filings. PG&E's 2022 PCIA and rates are scheduled to be released the 2nd week of November, allowing VCE to set 2022 rates at the December Board meeting. The continued use of existing reserves for customer rate stabilization allows VCE to maintain rate competitiveness with PG&E and bridge the gap until long-term renewable contracts come on-line in 2023 and beyond as indicated in Table 5.

Based on the Board's feedback and direction, staff will return with an updated Operating Budget recommendation for CY 2022 in December.