ITEM 4A

DESERT COMMUNITY ENERGY

Special Board Meeting

July 25, 2018

Staff Report

Subject: Desert Community Energy Pre-Launch Review

Contact: Tom Kirk, Executive Director
Don Dame, Energy Consultant

Recommendation: Provide Direction to Staff on the options described under Recommended Action.

Background: Over the last 18 months DCE, in concert with CVAG, has taken all prudent and necessary steps to investigate and prepare for its scheduled August 1, 2018, CCA program launch. The Board and staff have become increasingly familiar with potential business/power market risks and regulatory actions which can affect business outcomes, as well as establishing beneficial goals to be attained via this new, locally controlled CCA. DCE is now in its final days before commencing formal retail business activities and it is valuable to reassess undertaking this very consequential business endeavor given recent events and possible associated future business implications.

Recent Events: New CCAs face multiple hurdles including learning power business complexities, understanding power markets, regulatory formalities and uncertainties, building financial reserves, establishing credit, and the like. Unlike the IOUs (Investor Own Utilities), CCAs do not have near boundless funding coupled with decades of regulatory experience and influence. The PCIA is one manifestation of the IOU's (and CPUC's) ability to impact CCA business viability. The DCE Board has been well informed of this mechanism which currently imposes about $15/MWh (megawatt-hour) and in aggregate, over $15 million dollars, on SCE departing CCA customers.

Moreover, SCE has recently projected close to a 6% reduction in its 2019 generation rate component in its most recent Energy Resource Recovery Account (ERRA) filing. If accurate, this translates to a decrease of about $5/MWh. Although technical skepticism suggests that a reduction of this size will fully occur, this forecast is "on the street" and IOU generation rate reductions make it yet more difficult for a CCA to be cost competitive. (please see following link for more information: 2019 SCE ERRA Workshop.pdf). Further, volatility in southern California power market has been accentuated by in-state gas supply constraints and record hot weather --- with SoCal Citygate natural gas prices spiking to near $40/MMBtu (one million BTU) on July 23, 2018, from approximately $5/MMBtu the month before, and in the $2-$3/MMBtu range at the end of 2017. The significance of the high natural gas price is that it directly correlates to higher wholesale electricity prices. And although DCE has undertaken significant hedging actions for

2018, residual supply and balancing costs for 2018, 2019 and beyond are showing upward price movement. Over the prior several days TEA has indicated that including very recent market movements in DCE's portfolio could add $2 million to 2018 supply costs and $8 million to 2019 supply costs. These current forecasts diminish the likelihood of positive margins over DCE's first several years of operation absent upward adjustment in DCE rates.

Financial Impacts: The result of these occurrences has been a steady erosion of DCE's ability to price competitively versus SCE --- a key objective of the DCE Board. During DCE's early modeling efforts, it appeared feasible to provide a 3-5% discount versus SCE generation rates and simultaneously attain a net positive margin in the range of $10-$12/MWh (or about $10-$12 million annually). Table 10 of DCE's Implementation Plan filed with the CPUC in December 2017 estimated cumulative net reserves of over $40 million by 2021. More recently, DCE's FY2018-2019 accrual-based Budget adopted by the Board in June assumes a 3% rate discount versus SCE (which consumes about $2.50/MWh of margin) and, coincidentally, an overall net residual after all expenses and rate discount also about $2.50/MWh --- a combined total net margin of only $5.00/MWh. The approved Budget shows continuance of a 3% rate discount during FYs 2020 and 2021, with overall net residuals growing slightly to a $7.00/MWh range to use for building reserves. However, including TEA's most recent 2018/2019 supply cost forecast (which was not included in the approved Budget) suggests DCE may only break even, or possibly run a deficit.

Moreover, any further upward pressure on the PCIA and or power market prices, coupled with predicted SCE rate declines could result in a situation where DCE rates need to be set higher than SCE's for some period of time. And this "margin squeeze," if it intensifies, will inevitably impact DCE's ability to build reserves, offer discounts, and attain a healthy credit rating, all of which must occur for DCE to remain a viable enterprise and negotiate long term power contracts.

DCE Launch Implications: Upon launch DCE will be fully immersed in the power business and decision makers will be compelled to take all actions necessary and proper to set rates such that total revenues meet or exceed total costs, including the establishment of a significant reserve fund and a favorable DCE credit rating. The only effective mechanism to increase revenues is to increase rates, and quite possibly at levels above SCE.

Pragmatically an argument can be made that even with SCE rate parity or somewhat above, local, non-profit energy decision making can be more responsive and beneficial to power customers than decisions made by a large for-profit IOU. The CCA business model, with its legislatively prescribed default service provider status will likely continue to be financially viable even if rates are somewhat higher than the IOU's. And the Board could consider some form of rate adjustment mechanism that would automatically increase or decrease rates under specified conditions. There may be a mild increase in opt-outs but many end-users will remain. Ultimately it is the customer's choice.

If decision makers believe a key and essential component of CCA success requires rates lower than the incumbent IOU, there is no realistic assurance of this outcome at this time. Staff and vendors would take known and available actions to avoid or diminish negative outcomes, but rates would need to adjust to cover all costs under all circumstances. The DCE Board needs to be fully informed of the options, including, if called for, perhaps delaying DCE implementation now. And while such a decision may be difficult to contemplate given the significant efforts and aspirations to date, it may avoid a more complicated process in the unlikely but possible scenario that DCE were to find itself having to unwind business operations in the future due to a premature start. One option before the Board is to delay CCA program implementation now. Liquidation of existing DCE forward power procurements would limit near term financial impacts to DCE.

Summary: DCE was formed to provide locally responsive power supply with added economic and environmental benefits for participating members and customers. Multiple recent happenings indicate at present it will be difficult to build reserves, establish credit and provide local environmental benefits without increasing rates. As a new organization, DCE does not have funds to draw on to alleviate these issues. If the Board has a strong commitment to adjust rates as may be warranted, adhering to the August 1 launch date is likely appropriate. If the Board does not consider upward rate adjustments to be in the best interests of DCE, its members or its retail customers, delaying the August 1 launch date is likely appropriate. Any decision to delay program launch will set in motion an array of necessary notices and actions between and among DCE, DCE members, SCE, the CPUC, vendors and other affiliated parties. Staff and consultants are currently reaching out to these parties to investigate appropriate courses of action and options. Additional updates on these investigations will be provided at the meeting.

Recommended Action:

1. If the Board deems local environmental and other benefits associated with DCE to be sufficiently significant even if rates must set at levels greater than the incumbent utility, then staff recommends continuance with DCE's scheduled August 1, 2018 service start.

Or

2. If the Board deems that the effort and possible local repercussions of higher rate levels are not manageable or acceptable, then staff recommends delay of program launch and to direct the Executive Director to undertake all necessary actions to immediately effectuate such delay, including authorization for the Executive Director, in consultation with TEA, to liquidate DCE hedge positions as appropriate.

Attachments:

1. Resolution No. 2018-04 (if Option 2 is chosen)
2. SoCal Citygate natural gas price chart for June through July 23, 2018.
3. SCE ERRA Power Cost Changes (Workshop Presentation on July 19, 2018).

RESOLUTION NO. 2018-04

A RESOLUTION OF THE BOARD OF DIRECTORS OF DESERT COMMUNITY ENERGY DIRECTING THE EXECUTIVE DIRECTOR TO TAKE ALL NECESSARY AND SUFFICIENT ACTIONS TO DELAY CCA PROGRAM LAUNCH.

WHEREAS, Desert Community Energy ("DCE") is a joint powers authority established on October 30, 2017 for the purpose of studying, promoting, developing, conducting, operating and managing energy and energy-related climate change programs including but not limited to implementing a community choice aggregation program under Public Utilities Code Section 366.2.0

WHEREAS, the members of the DCE include the Cities of Cathedral City, Palm Springs, and Palm Desert;

WHEREAS, DCE has undertaken all necessary steps in preparation for an August 1, 2018 CCA Program start date;

WHEREAS, two essential objectives of DCE's CCA Program are to provide DCE customers with lower rates than the incumbent IOU and to build financial reserves;

WHEREAS, recent power market and regulatory events indicate that establishing a DCE CCA program at this time may require DCE to set rates higher than the incumbent IOU in order to recover Program costs and build financial reserves;

WHEREAS, given CCA Program current financial uncertainties, the DCE Board deems it to be in the best interest of DCE, DCE members and prospective DCE customers to delay implementation of DCE's CCA Program.

NOW THEREFORE BE IT RESOLVED as follows:

1. The Board of Directors, after conducting a duly noticed public hearing as required by Public Utilities Code Section 366.2(c)(3), hereby: 1) directs the DCE Executive Director to take all necessary and sufficient actions to delay DCE's August 1, 2018 CCA Program launch; and 2) authorizes the Executive Director, in consultation with TEA, to liquidate unneeded power portfolio hedge positions.

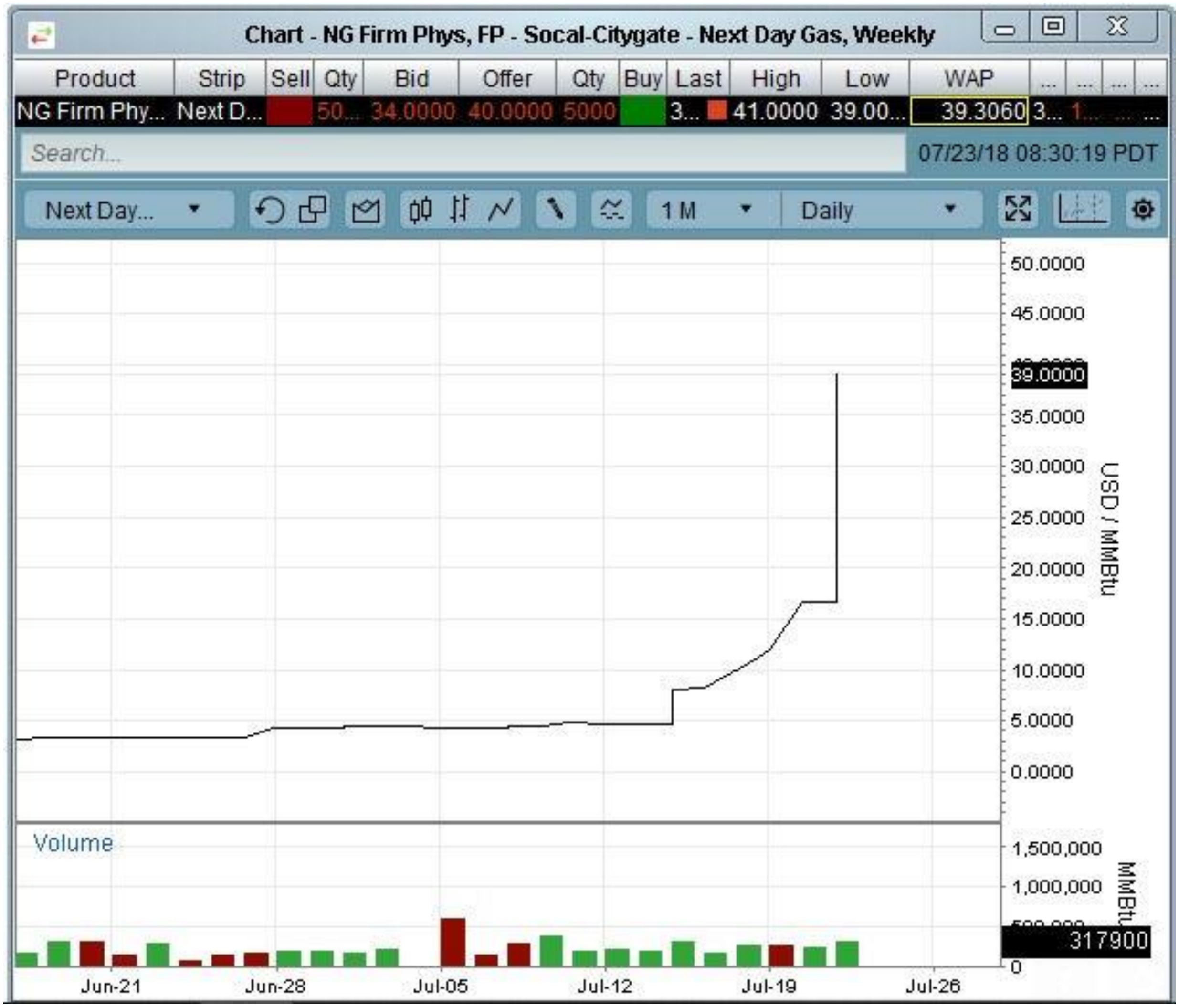
ADOPTED AND APPROVED by the Board of Directors of Desert Community Energy on this 25th day of July 2018.

____
Shelley Kaplan
Chair, Desert Community Energy

Attest:

____
Tom Kirk
Secretary, Desert Community Energy

Attachment 2
Natural Gas Price
30 days leading to July 23, 2018



Attachment 3
Southern California Edison Cost Changes
(Slide 10 from July 19, 2018 ERRA Workshop)