

1. The Public Utilities Commission's Failure to Develop a Hetch Hetchy Enterprise Business Plan

- Hetch Hetchy Enterprise management has not developed effective business planning processes or performance measurement systems. As a result, the Department has been less able to effectively advise the Mayor, the Board of Supervisors, and the Public Utilities Commission on its resource needs, appropriate retail power rates, the reasonableness of General Fund departmental rate discounts, and the costs and benefits of alternative energy use strategies. In addition, without a business plan, the Hetch Hetchy Enterprise has been slow to respond to changes in the deregulated energy market since 1998 and remains unable to obtain a credit rating for borrowing related to the voter approved Energy Efficiency and Renewable Energy Revenue Bonds.
- Recognizing these concerns, the Board of Supervisors has previously requested and the Public Utilities Commission has repeatedly directed Department management to prepare a Hetch Hetchy Enterprise business plan. Despite these repeated directives, the establishment of an in-house planning group of senior managers, and the expenditure of \$57,071 on consultant contracts, the Department has not yet produced such a plan.
- The Department's inability to produce a business plan can be attributed to frequent changes in project leadership; management's inability to resolve certain conflicts between the Power Policy, Power Operations, and Water Operations Divisions; and the lack of a coherent strategic vision with defined business goals. Efforts to produce a business plan have been suspended while Department management works with stakeholders to assess the planning process and determine power policy direction.
- The General Manager should make the development of a Hetch Hetchy Enterprise business plan an early priority of her administration. To ensure timely completion, the Board of Supervisors should reserve 75 percent of FY 2005-2006 capital project appropriations for the Hetch Hetchy Enterprise until the Department transmits a business plan to the Board of Supervisors.
- By successfully completing and maintaining a business plan, the Hetch Hetchy Enterprise will have established a long-term financial strategy and statement of credit worthiness. In addition, risks associated with operating a utility that generates \$126 million in annual revenues will be minimized.

Lack of a Hetch Hetchy Enterprise Business Plan

There is no current Hetch Hetchy Enterprise business plan that sets out the Hetch Hetchy Enterprise's management, operational, marketing, and financial goals, objectives, and performance measures, and specific business initiatives. This represents a significant risk for the Hetch Hetchy Enterprise, which generates approximately \$126 million annually in revenues, because:

- The Hetch Hetchy Enterprise lacks a clearly defined operating policy, a clear business vision for the future, and a forum for deciding on major policy and planning options.
- Hetch Hetchy Enterprise staff members' roles, responsibilities, and accountabilities are unclear.
- There is no organizational performance measurement framework.
- Since the Hetch Hetchy Enterprise does not control the application of its rates and which City organizations receive subsidized power, and since it lacks a business plan, the Hetch Hetchy Enterprise cannot responsibly seek a credit rating from the credit rating agencies.
- Significant net revenues are at risk given the volatile nature of the electricity market.
- There is no business planning context for funding capital programs, funding energy efficiency and alternative energy initiatives, or determining the optimal personnel resources and organizational structure.
- There are delays in making business-critical decisions.

Previous Board of Supervisors and Public Utilities Commission Direction to Prepare a Hetch Hetchy Enterprise Business Plan

The lack of a Hetch Hetchy Enterprise business plan is despite:

- The Board of Supervisors' request, through the Generation Solar Ordinance, that a Hetch Hetchy Enterprise business plan be developed for the purpose of obtaining a credit rating so that the Department could issue Energy Efficiency and Renewable Energy Revenue Bonds for additional energy efficiency and alternative energy projects, as authorized by the voters in 2001.¹ Since the Hetch Hetchy Enterprise has

¹ In September of 2003, the Board of Supervisors enacted an ordinance regarding implementation of Proposition B, the Energy Efficiency and Renewable Energy Revenue Bonds, which empowers the City to raise \$100 million in revenue bonds to support energy efficiency and renewable energy facilities. That ordinance recognizes that the Hetch Hetchy Enterprise cannot issue revenue bonds until independent credit rating agencies have rated the Hetch Hetchy Enterprise, and that such a rating cannot be obtained until a long-range Hetch Hetchy Enterprise business plan has been developed, along with detailed plans for the use of the revenue bonds and the collection of revenues.

no borrowing history, it lacks a credit rating. Without a credit rating, it is unable to issue revenue bonds.

- Repeated requests from the Public Utilities Commission. According to the official minutes of the February 5, 2004 Public Utilities Commission meeting, Commissioner Ann Moller Caen “asked why there was not a business plan, noting the Finance Office asked for one 1.5 years ago,” and then “stated she had sat on the Commission for seven years and remembered asking for a [Hetch Hetchy Enterprise] business plan for at least five of those years.” According to the official minutes of the February 10, 2004 Public Utilities Commission meeting, in response to Commissioner Adam Werbach’s comment that a business plan was needed for the entire Hetch Hetchy Enterprise, “President [E. Dennis] Normandy commented this was why the Commission had been pushing for the last couple of years for a reorganization of the SFPUC that would allow for business plans for the entire organization and individual entities. ... [Further, he emphasized] the priority of doing the business plan.” According to the official minutes of the February 12, 2004 Public Utilities Commission meeting, in response to the former General Manager’s argument that a Hetch Hetchy business plan could only be considered within the context of strategic business planning for the Department as a whole, and that a Request for Proposals for a strategic planning process was being developed, President Normandy “interjected and stated the Commission, on several occasions over the past few years, had defined where the agency was to go and how it was to go.”
- Recommendations made on May 17, 2001 by Mr. D. Randall Abe, a risk management consultant hired by the Department to prepare an initial Hetch Hetchy Enterprise risk assessment. Mr. Abe, who drew upon earlier concerns raised by KPMG in its FY 1999-2000 audit of the Hetch Hetchy Enterprise, advised that clarification of the Hetch Hetchy Enterprise’s business strategy by the Board of Supervisors and the Public Utilities Commission “will help define departmental interdependencies and improve coordination between water operations, maintenance and repair, finance and the City Attorney’s office.” Mr. Abe further advised that, due to competing goals and priorities within the Hetch Hetchy Enterprise, “it is essential that the Board and the Commission articulate [their] operating policies and give clear direction as to operational priorities and long-term business strategy, vision and objectives.”
- The primacy given to water supply over power supply in (a) the Department’s filings on the Modesto and Turlock Irrigation District contract disputes, (b) the Department’s filings to the Federal Energy Regulatory Commission on the Don Pedro Dam, (c) the “water first” policy statement in State legislation Assembly Bill 1823, and (d) the Proposition E language approved by the voters in 2002.

Reasons for the Lack of a Hetch Hetchy Enterprise Business Plan

There are a number of reasons why there is no Hetch Hetchy Enterprise business plan:

- The Department lacks an overarching strategic plan, with clear financial, infrastructural, social, and environmental objectives and performance measures set by the Public Utilities Commission. As a result, the Department lacks a strategic framework for the organization as a whole within which the Hetch Hetchy Enterprise can develop a more detailed and integrated regional water and power business plan that acknowledges the restrictions imposed by the Raker Act² and the 1987 Pacific Gas and Electric Company Interconnection Agreement.³ For example, the Department has not articulated, in clear operational terms, its water first policy. Consequently, the Hetch Hetchy Enterprise operates within a context of unresolved issues related to water resource management, coordination between water resource management and power generation, and the scope and nature of new power initiatives. This suggests that executive management has not been proactive in bringing overarching policy questions before the Public Utilities Commission with recommendations.
- There has been no business plan developed for the Hetch Hetchy Enterprise Department since the FY 1998-99 *Hetch Hetchy Power Operations Strategic Business Plan*. Further, whereas the Department is conducting a Clean Water Master Planning process to ensure a comprehensive analysis of its entire clean water system so that the Department, utilizing extensive public consultation, can definitively determine what is and what is not possible, the Hetch Hetchy Enterprise is not holding itself to a similar master planning standard for either its water services or its power services.
- The dearth of executive management guidance is exacerbated by the fact that the Department's Risk Management Committee and Risk Oversight Committee are non-functional. These committees should be providing guidance to executive management on clear decision-making parameters for the Hetch Hetchy Enterprise.
- No one manager under the Assistant General Manager, Operations position is responsible for managing the Hetch Hetchy Enterprise or its budget. Organizational conflict between water goals and power goals is inherent in the current management structure, given the bifurcation of water and power responsibilities between the

² The Raker Act of 1913 specifies how and to whom the Public Utilities Commission must distribute Hetch Hetchy water and the power generated from the Hetch Hetchy system.

³ The 1987 Pacific Gas and Electric Company Interconnection Agreement between that company and the Department complies with the Raker Act. This agreement expires in 2015 and it requires the Pacific Gas and Electric Company to provide electrical transmission, distribution, and scheduling coordination services to the Department. There are currently a number of disputes between the Pacific Gas and Electric Company and the Department over various provisions in this interconnection agreement.

Acting Director of Water Operations and the Acting Director of Power Operations positions.

- There are unresolved conflicts between the Power Policy Division and the Water Operations and Power Operations Divisions within the Hetch Hetchy Enterprise which means that there is no collective prioritization of business goals. As noted by Red Oak Consulting's *Revised Draft Interim Performance Assessment Phase I: Hetch Hetchy Water and Power* (June 11, 2004), "It is not clear when Power Policy should coordinate activities, or obtain consent or approval from other parts of the [Hetch Hetchy Enterprise] when decisions are made that impact the enterprise. This lack of clarity can also negatively impact the organization's support of Power Policy as it endeavors to implement its mission. ... In some instances, Power Policy project implement is viewed as at cross-purposes with other [Hetch Hetchy Enterprise] functions."

Ramifications of the Lack of a Hetch Hetchy Enterprise Business Plan

Business plans are a fundamental management tool for enterprises and are a utility industry best practice. There are a number of serious negative ramifications arising from the lack of a Hetch Hetchy Enterprise business plan:

- The Department does not have a clearly defined operating policy because its water first policy is interpreted in a variety of ways by different staff. This has resulted in unresolved tensions between often competing priorities such as (a) water storage, supply, conservation, and contractual obligations under the Raker Act versus power production and contractual obligations under the long-term power supply agreements with the Modesto and Turlock Irrigation Districts, (b) short-term revenue benefits versus long-term asset management, (c) ongoing water supply and power generation needs versus the timely scheduling of maintenance, repair, replacement, and upgrade work, and (d) investments in hydroelectric power infrastructure repair, replacement, and enhancements versus investments in energy efficiency and alternative energy initiatives. By working through a business planning process, the Hetch Hetchy Enterprise would be able to establish priorities if potential activities are in conflict or would exceed the available resources.
- The Department does not have a clear business vision for the future of the Hetch Hetchy Enterprise. A business plan would clarify the Hetch Hetchy Enterprise's role in the California power market, given Raker Act constraints, and the management and organizational structure necessary to support that role.
- There has not been a forum in which to make informed decisions about the merits of major policy and planning options. For example, should the Department develop alternative sources of water to permit greater generation of hydroelectric power from the Hetch Hetchy system? Should the Department partner with the Modesto and Turlock Irrigation Districts by investing in the construction of new power plants those districts are currently considering? Should the Department develop more

transmission lines? How should the organization be structured if it becomes a community choice aggregator and assumes a greater power retail role? How should the 1987 Pacific Gas and Electric Company Interconnection Agreement be renegotiated within a deregulated power market, particularly if the Department becomes a community choice aggregator?

- There are unclear roles, responsibilities, and accountabilities for the Public Utilities Commission, Department managers, and Department staff. For example, strategic and operational policy-making is delegated to staff level personnel without the benefit of a decision-making framework approved by executive management. The current Assistant General Manager, Operations position, which has been filled on an acting basis for some years, has an overly broad responsibility for all of the Department's business lines (water, clean water, and power) and, therefore, has had insufficient capacity to focus on major Hetch Hetchy Enterprise policy matters. The cumulative risk of these factors is that business planning and risk management decisions are made by middle level staff on an ad hoc, reactive basis, rather than by executive management staff from a strategic perspective.
- There is no organizational performance measurement framework for the Hetch Hetchy Enterprise to measure its performance in terms of financial, infrastructural, social, and environmental goals. The Hetch Hetchy Enterprise's current objectives and performance standards, as outlined in the FY 2004-2005 budget, are general, non-measurable, and statements of intent. They need to be stated in terms of accomplishment of business plan goals. Similarly, individual staff performance is not measured in the context of a business plan's goals, objectives, and performance measures.
- Without a long-term business plan, the Hetch Hetchy Enterprise is difficult to present to the credit rating agencies as a credit worthy enterprise. Without a business plan, there is a risk that the Hetch Hetchy Enterprise Fund could be over-subscribed given the volatility of the power market, fluctuations in the economy, deferred capital improvements, and the growing number of energy efficiency and alternative energy projects. The Department does not conduct periodic cost of service studies to establish a cost-of-service rate structure, which covers all of the Hetch Hetchy Enterprise's expenses. Since the Hetch Hetchy Enterprise does not control the application of its rates and which City organizations receive subsidized power, and since it lacks a business plan, the Hetch Hetchy Enterprise cannot responsibly seek a credit rating from the credit rating agencies. A business planning process would (a) determine the water and power rates necessary to support the Hetch Hetchy Enterprise's operations and capital program, and (b) provide a framework for determining how certain customers, such as General Fund departments, should be subsidized.
- Significant revenues are at risk given the volatile nature of the electricity market. For example, as discussed in the Introduction, the Hetchy Hetchy Enterprise estimates that total losses under the Department's long-term power purchase agreement with

the Calpine Corporation, which represents the difference between the cost of power purchases under the long-term power purchase agreement and the market price for electricity, will be approximately \$64.5 million.

- There is no business planning context for the Hetch Hetchy Enterprise's capital repair, replacement, and upgrade programs so that individual projects can be prioritized in terms of both (a) the long-term sustainability needs of the entire system's physical infrastructure, and (b) the business justification for each project. Since FY 2000-2001, the Hetch Hetchy Enterprise has operated a ten-year repair and replacement program, which prioritizes capital projects. However, capital projects previously approved on the basis of forecast revenues have to be defunded in the event of emergencies, new priorities, and/or shortfalls in actual revenues.
- There is no business planning context for the Hetch Hetchy Enterprise's funding of (a) energy efficiency and alternative energy initiatives, particularly in terms of how such initiatives will impact the Hetch Hetchy Enterprise's revenues, and (b) subsidized power for certain public sector agencies. Further, if the City chooses to become a community choice aggregator,⁴ it will be entering into a new business activity, which might involve Hetch Hetchy Enterprise-generated hydroelectric power.
- There is no business planning context for determining the optimal personnel resources and organizational structure of the Hetch Hetchy Enterprise.
- There are delays in making business-critical decisions. A significant example of this is described in detail below in terms of the Department's inadequate response to changes in the deregulated electricity market.
- The Hetch Hetchy Enterprise does not incorporate formal business planning, including cost-of-service rate review and performance measurement processes, into its ongoing business processes.

The Department's Inadequate Response to Changes in the Deregulated Electricity Market

The Public Utilities Commission's response to the changing electricity market resulting from the 1998 deregulation has been slow. The Hetch Hetchy Enterprise has not adequately planned for changes to the 1987 Pacific Gas and Electric Company Interconnection Agreement.

The Hetch Hetchy Enterprise schedules electricity on the State electricity grid, managed by the California Independent System Operator. Electricity schedules are balanced to match the amount of electricity provided with the amount of electricity that is required.

⁴ Community choice aggregation would allow the City to procure electricity from a portfolio of power providers on behalf of citizens currently served by the Pacific Gas and Electric Company.

Therefore, when electricity is scheduled, all electricity resources, whether Hetch Hetchy Enterprise hydroelectric power or power purchased through either the long-term power purchase agreement with Calpine or the spot market, must equal the minimum electricity demand (or load) from municipal customers and the Modesto and Turlock Irrigation Districts.

Under the 1987 Pacific Gas and Electric Company Interconnection Agreement, which extends until 2015, the Pacific Gas and Electric Company provides electricity transmission, distribution, and scheduling coordinator services. Therefore, the Pacific Gas and Electric Company serves as the scheduling coordinator for the Hetch Hetchy Enterprise. The Hetch Hetchy Enterprise submits balanced electricity schedules to the Pacific Gas and Electric Company, and the Pacific Gas and Electric Company submits the schedule to the Independent System Operator.

After the 1998 deregulation of the California electricity market and the establishment of the California Independent System Operator, the regulatory environment, rules and protocols began to change, and the Pacific Gas and Electric Company turned over control of its transmission facilities to the California Independent System Operator. The Federal Energy Regulatory Commission has regulatory oversight over electricity transmission. Using a consultant hired by the City Attorney's Office, the Public Utilities Commission participated in Federal Energy Regulatory Commission hearings pertaining to issues that would affect the Public Utilities Commission.

In April of 1998, the California Independent System Operator established its tariff, which was approved by the Federal Energy Regulatory Commission and provides the terms and conditions, including charges, of scheduling electricity on the State's electricity grid. The Federal Energy Regulatory Commission grandparented existing contracts, such as the 1987 Pacific Gas and Electric Company Interconnection Agreement, with the assumption that these contracts would be revised under the deregulated market. The Public Utilities Commission has not proactively initiated such revisions. While some current provisions benefit the City, and therefore could arguably be in the City's interests to maintain for as long as possible, the consequence of not looking ahead to potential contract changes is having such changes forced upon the City. In such cases, the Public Utilities Commission runs the risk of having to make decisions without adequate planning.

The Independent System Operator's tariff represented new costs to the Pacific Gas and Electric Company, which the Pacific Gas and Electric Company is attempting to pass through to the Public Utilities Commission. The Pacific Gas and Electric Company filed a "cost of service" application with the Federal Energy Regulatory Commission in 1999, claiming that the Pacific Gas and Electric Company had incurred California Independent System Operator scheduling coordinator charges on behalf of the Public Utilities Commission that were not part of the 1987 Pacific Gas and Electric Company Interconnection Agreement. The Pacific Gas and Electric Company is claiming that the Public Utilities Commission owes \$16 million for past California Independent System Operator scheduling coordinator charges from April of 1998 through December of 2003.

The Public Utilities Commission has responded to the cost of service filing and is currently litigating this matter at the Federal Energy Regulatory Commission.

During the past year, the Pacific Gas and Electric Company has indicated its interest in terminating its role as scheduling coordinator for the City. The Hetch Hetchy Enterprise has only recently begun planning for alternative scheduling coordinator services. The Hetch Hetchy Enterprise requested the City Attorney to engage two consultants, one in January of 2004 and the other in June of 2004, to evaluate the Public Utilities Commission's alternatives for scheduling coordinator services, as well as for other services under the 1987 Pacific Gas and Electric Company Interconnection Agreement. The evaluation is expected to take approximately six months, with a final report expected by April of 2005.

The Hetch Hetchy Enterprise has been slow in responding to the changes in the electricity market resulting from the 1998 deregulation. The 1987 Pacific Gas and Electric Company Interconnection Agreement was negotiated in a very different regulatory and market environment from the post-1998 deregulated energy market. According to Hetch Hetchy Enterprise staff, since the 1998 deregulation, the Federal Energy Regulatory Commission's decisions have suggested that changes would be needed to the 1987 Pacific Gas and Electric Company Interconnection Agreement. In 2002, the Hetch Hetchy Enterprise engaged two consultants:

- ICF Resources Inc., which was, contracted to evaluate options for providing scheduling coordinator services and to cost those options. According to Hetch Hetchy Enterprise staff, the options evaluation was inadequate and the costing analysis was not useful, with the result that the ICF Resources Inc. report was not used by the Department, despite that contract's \$90,000 cost.
- ECCO Consulting which was contracted to (a) validate and reconcile the California Independent System Operator's scheduling coordinator charges that the Pacific Gas and Electric Company sought to allocate to the Department, (b) develop a tool for the Department to minimize its cost exposure resulting from scheduling changes in the hour-ahead and day-ahead markets, and (c) determine the steps required for the City to become a certified schedule coordinator. ECCO Consulting issued its preliminary report in August of 2002 but was unable to complete the data validation and reconciliation and tool development because the Pacific Gas and Electric Company never provided all the required data. Subsequently, the Pacific Gas and Electric Company changed its schedule coordinator model and the California Independent System Operator changed certain charges.

The Department did not enter into any further consultancy projects to plan for its future schedule coordinator services between 2002 and the January of 2004 consultant engaged by the City Attorney. During that period, while Hetch Hetchy Enterprise staff concentrated on responding to various Federal Energy Regulatory Commission proceedings, Public Utilities Commission executive managers assigned few resources for proactive planning for changes in the electricity market and regulatory environment.

Current Status

In January of 2004, in response to the Public Utilities Commission's concern about the Department's lack of progress in preparing a Hetch Hetchy Enterprise business plan, the Policy Planning Division contracted with ICF Consulting, which is part of ICF Resources Inc., the consultant which prepared the inadequate scheduling coordinator report,⁵ at a not-to-exceed cost of \$55,336⁶ to:

- Review the criteria used by bond rating agencies to determine whether an organization can be given a credit rating. ICF Consulting submitted an eight page preliminary draft on March 22, 2004.
- Prepare case studies of other municipal and not-for-profit organizations involved in similar enterprises, which could provide insights into how Hetch Hetchy Power Operations could be structured. ICF Consulting submitted a five page initial review of municipal energy service organizations on April 16, 2004.
- Develop the outline of a business plan, which would configure the Hetch Hetchy Power Operations as a credit rated organization. ICF Consulting did not prepare such an outline.

Then on March 31, 2004 the Assistant General Manager, Power Policy contracted with Ms. Jeanne Clinton, a seconded subcontractor to ICF Consulting, at a not-to-exceed cost of \$63,245⁷ to:

⁵ The Department has a three-year, as-needed contract with ICF Consulting (CS 692-D). ICF Consulting is one of the five as-needed consultants for the Hetch Hetchy Enterprise selected in 2002 through a competitive process. The total projected budget for these as-needed contracts is \$6 million, with actual budget funding determined on a task by task basis. The four other selected contractors were Navigant (which subsequently withdrew following unresolved negotiations over charge rates), Brown Vince Associates, Newcombe Anderson Associates (now known as MCorp), and AEPC. The funding which would have gone to Navigant, and Navigant's subcontractors, were reassigned to ICF Consulting. During FY 2003-2004 and FY 2004-2005, ICF Consulting has received 25 task orders for a total of \$1,422,772, of which \$481,284 has been expended to date. These 25 task orders cover a range of consulting projects, including projects for unrelated firms selected by Department staff and contracted through ICF Consulting as seconded subcontractors. For example, the City has contracted with ICF Consulting under Contract CS 692-D for a subcontractor, the Mountford Group, Inc., to work on the Hetch Hetchy data mart software project. This ongoing project has yet to result in a useable product. To date, the Mountford Group, Inc. has received \$128,247 for its work on the data mart software project.

⁶ To date, under Contract CS 692-D, the Department has paid ICF Consulting \$29,000 of the not-to-exceed cost of \$55,336 despite non-delivery of any final product required by the contract. This task order is currently suspended.

⁷ To date, under Contract CS 692-D, the Department has paid Ms. Clinton, a seconded subcontractor under the ICF Consulting contract, \$28,071 of the not-to-exceed cost of \$63,245 despite non-delivery of any final product required by the contract. Given the delays in the Hetch Hetchy Enterprise business planning process, Ms. Clinton is no longer available to complete the project.

- Manage Public Utilities Commission staff's writing of a Hetch Hetchy Enterprise business plan so that such a plan is ready for the Department's FY 2005-2006 budget requests.
- Facilitate resolution of outstanding business issues, which must be addressed in the plan.
- Identify and evaluate the funding and financing options on public buildings, and recommend an approach for the Department.
- Assist Operations staff to develop a five-year capital improvement plan for the Hetch Hetchy system, to be included in the Hetch Hetchy Enterprise business plan.

Shortly afterwards, the former General Manager transferred responsibility for the Hetch Hetchy Enterprise business plan from the Assistant General Manager, Power Policy to the Director of Financial Services. The Director of Financial Services established a project group comprising the Assistant General Manager, Power Policy, the Acting Director of Power Operations, the Acting Director of Water Operations, the Manager of the Planning Bureau, and the Director of Financial Planning, with support from Ms. Clinton. Work was begun on analyzing six business cases, based on (a) how green the Hetch Hetchy Enterprise's power resources should be, and (b) how broad a customer base the Hetch Hetchy Enterprise could have.

The Hetch Hetchy Enterprise business planning process is currently on hold while the new General Manager, the new Assistant General Manager, Business Services, and the new Director of Power Policy work with key stakeholders to assess the process' current status and to determine policy direction on key power policy issues.

Conclusions

By not developing a Hetch Hetchy Enterprise business plan, the Department has failed to meet requests from the Board of Supervisors and directives from the Public Utilities Commission, and to implement recommendations from its own consultants.

Failure to develop a Hetch Hetchy Enterprise business plan is a result of (a) the Department's lack of an overarching strategic plan, (b) the dearth of executive management guidance, (c) the non-functioning of the Department's Risk Management Committee and the Risk Oversight Committee, (d) no one manager below the over-extended Assistant General Manager, Operations position being responsible for managing the Hetch Hetchy Enterprise or its budget, and (e) the unresolved conflicts between the Water Operations, Power Operations, and Power Policy Divisions.

Business plans are a fundamental management tool for enterprises and are a utility industry best practice. There are serious negative ramifications arising from the lack of a Hetch Hetchy Enterprise business plan. The Hetch Hetchy Enterprise, which generates approximately \$126 million annually in revenues, lacks a clearly defined operating

policy, a clear business vision for the future, and a forum for deciding on major policy and planning options. Roles, responsibilities, and accountabilities are unclear. There is no organizational performance measurement framework. There is no business planning context for funding capital programs, funding energy efficiency and alternative energy initiatives, or determining the optimal personnel resources and organizational structure. There are delays in making business-critical decisions.

Without a long-term business plan, the Hetch Hetchy Enterprise is difficult to present to the credit rating agencies as a credit worthy enterprise. Without a business plan, there is a risk that the Hetch Hetchy Enterprise Fund could be over-subscribed given the volatility of the power market, fluctuations in the economy, deferred capital improvements, and the growing number of energy efficiency and alternative energy projects. The Department does not conduct periodic cost of service studies to establish a cost-of-service rate structure, which covers all of the Hetch Hetchy Enterprise's expenses. Since the Hetch Hetchy Enterprise does not control the application of its rates and which City organizations receive subsidized power, and since it lacks a business plan, the Hetch Hetchy Enterprise cannot responsibly seek a credit rating from the credit agencies. A business planning process would (a) determine the water and power rates necessary to support the Hetch Hetchy Enterprise's operations and capital program, and (b) provide a framework for determining how certain customers, such as General Fund departments, should be subsidized.

Significant net revenues are at risk given the volatile nature of the electricity market. For example, the Hetch Hetchy Enterprise estimates that total losses under the Department's long-term power purchase agreement with the Calpine Corporation, which represents the difference between the cost of power purchases under the long-term power purchase agreement and the market price for electricity, will be approximately \$64.5 million.

Recommendations

The Public Utilities Commission General Manager should:

- 1.1 Make the finalization of a Hetch Hetchy Enterprise business plan an early priority of her administration.
- 1.2 Develop an ongoing Hetch Hetchy Enterprise business planning process which incorporates cost-of-service rate review and performance measurement processes.

The Board of Supervisors should:

- 1.3 Reserve 75 percent of FY 2005-2006 capital project appropriations for the Hetch Hetchy Enterprise until the Department transmits a Hetch Hetchy Enterprise business plan to the Board of Supervisors.

Costs and Benefits

While the Department may need consultant assistance to finalize its Hetch Hetchy Enterprise business plan, the primary input should be from Department staff expert in water and power operations. Despite the Department's pervasive reliance on consultants, it is time for the Department to own its own strategic planning processes and results.

A Hetch Hetchy Enterprise business plan would allow the Department to address all of the deficiencies listed in the report above in the section "Ramification of the Lack of a Hetch Hetchy Enterprise Business Plan." In particular, undertaking a business planning process, and developing an ongoing Hetch Hetchy Enterprise business planning process, would allow the Department to work out how to:

- Develop an integrated, long-term financing strategy which avoids over-subscribing the Hetch Hetchy Enterprise Fund and which establishes a cost-of-service rate structure sufficient to support the Hetch Hetchy Enterprise's operations and capital program.
- Obtain the credit rating for the Hetch Hetchy Enterprise necessary to issue Energy Efficiency and Renewable Energy Revenue Bonds, as authorized by voters in 2001.
- Minimize revenue risks for the Hetch Hetchy Enterprise, which generates approximately \$126 million annually in revenues.
- Incorporate formal business planning, including cost-of-service rate review and performance measurement processes, into the Hetch Hetchy Enterprise's ongoing business processes.

Reserving all FY 2005-2006 capital project appropriations for the Hetch Hetchy Enterprise until the Department transmits a business plan to the Board of Supervisors would ensure completion of the Hetch Hetchy Enterprise business plan before July 1, 2005.