THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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Analysis of the Proposed Gas and Electric Franchise Agreements

OVERVIEW

The Council is being asked to grant new franchises to serve electric and gas customers within the City of San Diego. The franchise agreements were advertised in an Invitation to Bid (ITB) by Mayor Gloria on March 19, 2021. On April 16, the ITB was closed and there was only one bid submitted for each franchise by San Diego Gas & Electric (SDG&E). Mayor Gloria then subsequently negotiated various aspects of the ITB with SDG&E and is now submitting the proposed franchise agreements to the City Council, which can only be granted through a two-thirds vote of approval, per Charter Section 103.

These franchise agreements will replace the current electric and gas franchise agreements, which are currently set to expire on June 1, 2021, following the completion of a 50-year term and follow-on six-month extension. For the last 100 years, these rights have been granted to SDG&E through two separate 50-year agreements.

This report will provide additional detail and clarification on the material terms of the proposed franchise agreements, with comparisons to both the current franchise agreements as well as to a previous franchise ITB released by Mayor Falconer in 2020 (hereafter referred to as the 2020 ITB). In this report, we focus on the terms that have been of the greatest interest to the Council and public, such as the length of term, financial considerations, the City's reserved rights, and accountability measures.

BACKGROUND

Per Charter Section 103, the City Council has the authority to grant franchises on recommendation by the Mayor by a two-thirds vote after the opportunity for free and open competition has been provided. In light of the initial expiration of the existing agreements in January 2021, Mayor Falconer and City staff procured consultants and worked through the process of drafting new franchise agreements, which were to be advertised through an ITB process. Prior to the advertisement of the ITB, Mayor Falconer, along with the City's Core Franchise team and consultants presented a draft ITB for information and feedback to the City Council on August 6, 2020. IBA Report 20-17 provides more detail on the history of the franchise agreements, the process leading up to the initial presentation to Council, and a more detailed discussion of the various major terms contained within the new franchise agreements as presented on August 6.

At the August 6 meeting, Council could not come to a majority consensus to provide specific direction to the Mayor on the terms of the ITB. Subsequently, Mayor Falconer issued the 2020 ITB on September 23, 2020, and included various changes to the proposed terms of the franchise. These major changes included:

- The removal of a proposed increase to the Gas Franchise Fee from 3.0% to 3.5%. This increase was recommended by the City consultant.

- An increase in the minimum bid from a total of $62 million to a total of $80 million (the gas franchise fee increased from $8 million to $10 million, while the electric franchise fee increased from $54 million to $60 million).

- A 12.5% upfront discount in the minimum bid if the winning bidder provided the entire payment upfront in one lump sum, as opposed to the over ten years option (this provision was not included in Mayor Gloria's ITB or the proposed agreements).

- Reducing the term for the regular auditing reports from once every four years to once every two years.

- The removal of the right to purchase through appraisal provision, which was originally recommended by the City's consultant.

The response window for the 2020 ITB was closed on October 23, 2020. However, the docketed opening of the bids did not come until December 17, 2020, when it was revealed that SDG&E submitted the only bids for both franchises. However, based on the terms of the 2020 ITB process, SDG&E's bids were deemed unresponsive and the bidding process was canceled.

Following the canceling of the 2020 ITB process, Mayor Gloria announced that he would reissue a new ITB, following opportunities for more extensive community feedback and reserving the right to consider other policy considerations. The current ITB was then released on March 19, 2021. However, different from the previous iteration, Mayor Gloria reserved the right to negotiate with the highest bidder and to bring back a modified agreement to the Council for approval.

FISCAL AND POLICY DISCUSSION

Length of Term

As mentioned, both of the previous franchise agreements for both gas and electric services were for 50-year terms. However, the City's consultant recommended that the City consider a 20-year term during this process, which is what was included in the 2020 ITB. In this current agreement, Mayor Gloria has proposed to have two separate 10-year terms, with an initial 10-year term being followed by an automatic 10-year extension. The extension would only be voided by an action of the Council to terminate the franchise agreements prior to the expiration of the first term.

There are multiple ways in which the franchise agreements can be terminated by the Council per the terms of the agreement. The one method that has the most discretion for the Council is Section 15(d), which would allow the Council, through a two-thirds vote, to void the automatic 10-year extension for any reason. Unlike the advertised ITB, which would have required the Mayor to recommend such an action to the Council, the currently proposed provisions do not require the Mayor to initiate the action. One important caveat to this provision, however, is that it can only be invoked within a very specific time frame. Per the terms in the franchise agreement, this action may only be invoked no earlier than the ninth anniversary of the Effective Date, and no later than thirty days prior to the tenth anniversary date. As such, there is only one 11-month period where the Council may void the automatic extension for any reason.

In addition to the ability to void the second 10-year term during the tenth year of the agreements, the Council, or electors of the City, maintain the right to terminate the agreements at any time if the Council or electors decide to pursue municipalization per Charter Section 104. While the City has always maintained this right in previous iterations of the franchise agreements, it is just more explicitly stated in this agreement within its own provision.

Finally, if the Mayor determines that a breach of the agreements has occurred, and the new dispute resolution process is unable to absolve the issue, the Mayor, in consultation with the City Attorney, can recommend to the Council that the agreements be terminated, which would also require a two-thirds vote of the City Council. This action may only be taken if the Mayor decides against seeking liquidated damages for violations of the franchise. The City, per the terms of the proposed agreement, is not permitted to seek both liquidated damages and a termination.

One important caveat to the potential termination of these agreements, as will be explained in greater detail below, is that if the agreements do not last for the full 20 year potential, including due to a termination by the Council or electors of the City under any of the previously discussed provisions, the City would have to return to SDG&E a portion of the electric minimum bid proceeds based on how much time was left on the franchise agreements. This is different from the current agreements, as well as the advertised ITB, in that those agreements would have required SDG&E or another grantee to provide all of the bid proceeds up front in the event of a forfeiture due to a breach in the agreements. In the proposed agreements, even in the event of a termination due to a breach of the agreements by SDG&E, the City would instead have to refund a portion of the bid proceeds.

Minimum Bid and other Financial Considerations

Minimum Bid

Both franchise agreements contain the same minimum bid amounts as previously proposed in the 2020 ITB. In total, SDG&E would pay to the City a total of $80 million for both agreements, with $10 million for the gas franchise and $70 million for the electric franchise. In both instances, SDG&E would take the option to pay the agreements in installments. However, each franchise agreement contains a separate payment plan.

The gas franchise minimum bid would be paid in equal annual installments of $500,000 over the entire 20-years covered by the agreement. These payments would be subject to an annual interest rate of 3.38%. Further, if the agreements are terminated at any time, any payments not already made would be voided.

For the electric franchise minimum bid, SDG&E would pay $10 million annually for the first five years (2021 through 2025). The final two $10 million payments would be delayed until years 10 and 11 of the agreement (2030 and 2031). After the initial $10 million payment in August 2021, the remaining payments will earn interest at an annual interest rate of 3.38%. It is worth noting that the 2031 payment would only occur if the automatic 10-year renewal comes into effect, as the payment date for this payment would be beyond the initial 10-year term.

There are also provisions that would require the City to return minimum bid proceeds if the electric franchise agreement is terminated for any reason. The amount required to be returned would be determined by a formula contained within the agreement and is based on how many months the agreement has been in force from the enactment date. However, for illustrative purposes, we will only discuss the return payment required if the City Council decides to void the 10-year renewal under Section 15(d). In this instance, the City would have only received $60 million of the minimum bid proceeds, and per the agreement, would be required to return $18.75 million.

As has been included in both previous ITBs, minimum bid proceeds would come from SDG&E shareholder funds and would not be taken from ratepayers. The agreements prohibit SDG&E from seeking reimbursement for these funds from the California Public Utilities Commission (CPUC).

Franchise Fees

The proposed franchise fees in the agreements are kept at 3.0% for each agreement, which is the amount that is contained in the current agreements. As mentioned, there was a recommendation by the City's consultant to increase the gas franchise fee to 3.5%, but this recommendation has not been included in any City issued ITB.

However, another recommendation that was included in previous agreements, but is not included in the proposed agreements, is the removal of the 0.35% electric surcharge. This provision was previously recommended as a way to provide rate relief to City ratepayers. However, SDG&E in their response to the 2020 ITB took exception to the inclusion of this provision. More information on the surcharges and their history can be found in IBA Report 20-17.

Climate Equity Fund

There are numerous commitments in the franchise agreements for SDG&E to support the City's Climate Action and Climate Equity goals. The most explicit commitment is for a total of $20 million in addition to and separate from the minimum bid. However, the agreement does not require SDG&E to make these payments until the period 2037-2040, which would be in $5 million installments. Further, SDG&E would only be required to make these payments in these years if the electric franchise is still in effect. We would note that the present value of these future payments would be significantly less that the face value of the $20 million.

A future consideration for the Council is that, while these contributions are slated for the purposes of Climate Action and Climate Equity in the terms, the distributions are proposed to be made to the City General Fund for these purposes. In order for these proceeds to be sent to the City's Climate Equity Fund, the City Council would need to take the appropriate budgetary action at that time to effectuate the transfer.

The franchise agreements also stipulate that any shareholder payments proposed within the Energy Cooperation Agreement with SDG&E above the franchise fees and the bid proceeds must be paid to the Climate Equity Fund.

City's Reserved Rights

The current franchise agreements require SDG&E to relocate their assets within the City right-of-way at their expense if they come into conflict with a City project or priority. These rights have been maintained in the current proposal, but many of the enhancements to these rights that have been sought in prior proposals have been removed. These enhancements were sought due to a recent history of litigation with SDG&E over the extent of these rights, which most recently required the City to pay $35 million, under protest, to relocate SDG&E assets in order to facilitate the Pure Water Project. The responsibility for these costs is still subject to ongoing litigation.

Most notably, previous ITBs, including the ITB issued by Mayor Gloria, would have required SDG&E to bear the costs for the relocation of their equipment in the event of a dispute. This provision would have prevented the City from being in its current situation where City funds have been provided under protest as opposed to SDG&E funds. The current proposal eliminated this provision entirely. There is, however, a specified liquidated damages provision related to this section of the franchise, which states that failure to timely coordinate, bear costs, and physically relocate facilities as required in Section 8 would result in a fine of $1,500 per day. More detail on the liquated damages provision is provided below.

Further, the proposed agreements also recognize the fact that SDG&E and the City are in litigation over whether this provision applies to City water projects, and the proposed agreement would require either party to adhere to the final court decision not just for the disputed projects, but for all future City water projects as well.

Accountability Measures

The proposed agreements also contained numerous provisions to provide the City with accountability measures to ensure that the franchise agreements are adhered to. The following descriptions highlight some of the main measures, including new provisions first contained in these agreements.

Biennial Audits and the Compliance Review Committee

The proposed agreements maintain the requirement for biennial audits of SDG&E for compliance with the terms of the franchise. These audits would be conducted by an outside, independent auditor chosen through a competitive process overseen by the City. Further, a new provision in these proposed agreements is the inclusion of a Compliance Review Committee. This committee would be made up of five appointed members, with three appointments made by the Council and two by the Mayor. This committee would be created by the Council every two years for the express purpose of retaining an independent auditor and overseeing the implementation of the audit. This committee would then also review the completed audit, and provide the auditor's report, as well as its own written report and recommendations to the City Council at the end of each two-year audit period.

Administrative MOU

The proposed agreements contain a provision that requires SDG&E to obtain and maintain an Administrative Memorandum of Understanding (MOU) at all times in order to exercise the rights of the franchise. While the previous franchise agreements also required an Administrative MOU, the provisions contained in the proposed agreement are much more robust than the current franchise agreements. This document is designed to resolve differences between the City and SDG&E for work in the right-of-way proactively, by requiring each party to prepare enough information for the parties to work cooperatively with each other.

Coordinating work between City projects and SDG&E has been an issue in the past, as the previous Administrative MOU was not regularly updated. In order to rectify this situation, the consultant recommended that the franchise contain a provision for SDG&E to acquire a Master Administrative Permit every two years. While the proposed agreements do not require the Master Administrative Permit, the new Administrative MOU does contain many similar provisions to what would have been required in previous ITBs.

Dispute Resolution and Liquidated Damages

The proposed agreements contain a new dispute resolution process that provides the City and SDG&E with an avenue to resolve disagreements within the franchise potentially without litigation. This process, which was contained in both of the previous ITBs, would require the Mayor and an SDG&E executive to seek resolution first for 15 days before turning to a mutually selected mediator who would then conduct a non-binding mediation process, which would conclude in 45 days. If the parties do not agree on the solution through the non-binding mediation process, then either party can pursue litigation.

The proposed agreements also contain a process by which the City can pursue liquidated damages against SDG&E for violations of the franchise agreement. These damages would be subject to the dispute resolution process described above, or any other litigation that may result concerning the judgement. Of note, the City is only allowed to seek the liquidated damages as long as it does not also seek to terminate the franchise agreements due to the same breach that resulted in the liquidated damages.

In particular, there are three instances outlined in the agreements that would result in the accrual of liquidated damages. These are: 1) failure to deliver facility location records and other information in accordance with the Administrative MOU; 2) failure to relocate and bear the cost of relocation under the City's Reserved Powers; or 3) failure to provide and pay for standby safety engineers as required in the Administrative MOU. Each violation would incur a penalty of $1,500 per day, with a cap on days assessed not to exceed 180 days.

We would note that, in City Attorney Report RC-2021-2, the City Attorney highlights that the original liquated damages provisions in Mayor Gloria's ITB were much higher ($6,000 per day for the first provision, and $15,000 per day for the other two provisions) and that there was no cap on the days assessed. As such, the report notes that the changes to lower the penalties and cap them "would not incentivize [SDG&E's] performance and are unlikely to be used".

The Energy Cooperation Agreement

In addition to the franchise agreements, the parties are also seeking approval of an Energy Cooperation Agreement (ECA). This agreement, which is based on similar agreements that have been approved by other cities and utilities, outlines other areas of cooperation between the City and SDG&E that are more flexible and would not be appropriate to include within the ordinance authorizing the franchise agreements.

The ECA is subject to amendment as needs and priorities change, and it is within the ECA that many programmatic provisions of the overall deal between the City and SDG&E are contained. This includes the provision that SDG&E will provide up to $1 million per year for the first ten years for solar installations for low-income customers. Further, within the ECA, SDG&E has agreed to appear before the appropriate Council Committee on a varying basis to provide transparency briefings on a number of topics, including rate transparency, major projects and undergrounding, supporting customer equity, supporting climate equity, supporting municipal staff and operations, and an update to the Compliance Review Committee.

Community Choice Aggregation

Within the proposed franchise agreements, SDG&E will also agree to cooperate with the City's Community Choice Aggregation (CCA) entity, San Diego Community Power (SDCP). This includes an agreement to abide by the CCA Code of Conduct established by the CPUC, as well as including provisions within the ECA regarding cooperation with SDCP to facilitate microgrid developments for City water, wastewater, and sewer projects as well as to improve the customer experience as they transition from SDG&E to SDCP.

Potential Financial Impact

Our Office has previously been asked to quantify the potential impact to City finances should the current franchise agreements expire. Without another extension of the current agreement, it is not entirely clear what would happen to the franchise fee revenue should the current agreement lapse. Based on legal analysis from the City Attorney's Office in ML-2020-2, as well as statements made by SDG&E in a letter to the Environment Committee on July 15, 2020, there is the potential that

SDG&E would cease to pay all or a substantial part of the current franchise fees without a valid franchise agreement.

In particular, we would note that SDG&E has sent an Advice Letter to the CPUC on May 4, 2021, requesting the removal of the franchise fee surcharges in the event that the agreements expire on June 1, 2021. We understand that the City would attempt to protest this removal, and that it could take a significant amount of time for a final CPUC decision to take place. Based on the timing of a decision, estimates could vary significantly.

However, we can quantify the full year impact of the surcharges upon the FY 2022 Proposed Budget, just for illustrative purposes. We estimate that the surcharge revenue equals approximately 59.7% of the franchise fee revenue that is currently remitted to the General Fund and the Environmental Growth Funds (EGF), as well as 100% of the funding for the Underground Surcharge Fund (USF). The loss of the surcharge revenue for the entirety of FY 2022 would be a decrease of $29.6 million in the General Fund, $9.9 million in the EGF, and $65.8 million for the USF. We would also note that the FY 2022 Proposed Budget includes $8.8 million in minimum bid revenue resulting from approval of the proposed franchise agreement. This revenue would not be realized without a new agreement.

CONCLUSION

In this report, our Office has provided further details on the material terms and conditions of the proposed franchise agreements for gas and electric services. This includes an overview of the length of term and provisions surrounding the automatic renewal or termination of the agreement, any financial considerations contained within the agreement, the City reserved rights within the right-of-way, and the various accountability measures contained within the agreement. Further, where possible, we have tried to provide additional history and detail on the various terms and how they may or may not have evolved over time, from the current franchise agreement, through the two ITB processes, and up to the current proposed agreement.

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