



THE CITY OF SAN DIEGO

---

## OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

---

**Date Issued:** August 4, 2020

**IBA Report Number:** 20-17

**Docket Date:** August 6, 2020

**Item Number:** 601

---

# Analysis of the Initial Recommendations Concerning the Electric and Gas Franchise Agreements

## OVERVIEW

The Council is currently being asked to consider and provide feedback on the proposed terms for both the electric and gas franchises within City limits. The franchise agreements grant the right for an investor owned utility to operate within the right-of-way owned by the City. For the last 100 years, these rights have been granted to San Diego Gas & Electric (SDG&E) through two separate 50 year agreements. The latest agreements expire in January 2021.

The Council is being asked at this point to provide feedback on the overall terms that the Mayor's consultant has proposed. As explained further, this is not a final action on either franchise agreement, but rather an opportunity for the Council to provide the Mayor with direction on the proposed terms through a Resolution of Intention, which is the item before the Council during the meeting of August 6, 2020. It will ultimately be up to the Mayor to issue the invitation to bid (ITB). Bids will then be brought to Council, opened and considered for responsiveness, and Council will award the franchise to the highest responsive bid.

This report will provide additional background on the franchise agreement, what work has been completed to date, how the rest of the process will play out, provide some clarity on the recommended terms, and raise questions that the Council may wish to consider as it hears the terms and provides direction to the Mayor. Our Office would also like to thank the City's Core Franchise Team, as well as the City Attorney's Office and the consultants for meeting with us on numerous occasions and for providing information to our Office during this entire process.

## 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 an opportunity for free and open competition has been provided. As mentioned, the last franchise agreements for these services were auctioned in 1970. At that time, SDG&E was the only bidder in the process, and submitted numerous unresponsive proposals to the City Council. SDG&E submitted a letter of exception to the initial proposal that, among other provisions, took exception to the original term length (10 years), the franchise fee amount (3% for each franchise), and the duty to relocate its facilities at its own expense when the conflict with City uses of the streets. Eventually, the City agreed to a 50 year term, and SDG&E agreed to the 3%, subject to approval from the California Public Utilities Commission (CPUC) of its proposal to impose a 1.9% electric and 1.0% gas franchise fee differential surcharge on customers within City geographical limits.

At the CPUC, SDG&E successfully convinced the Commission to allow the utility to charge a surcharge to City of San Diego customers that was equal to the differential between the City franchise fee (3%) and the average franchise fees of other jurisdictions (at that time, 1.1% for electricity and 2.0% for gas). This created differential surcharges for City customers of 1.9% and 1.0% for the electric and gas franchise, respectively. It is worth noting that, although City of San Diego customers, not SDG&E, pay for franchise fees through this differential, the base franchise fees of 1.1% for electric service and 2.0% for gas are also paid by ratepayers, but are incorporated into the base rates for electricity and gas for all customers in SDG&E's service area.

Utility undergrounding was also approved as part of this 1970 franchise, and SDG&E was to ramp its undergrounding expenditures in the City to 4.5% of its gross receipts by the end of the 1970s. The 1970 franchise also provided that the parties would renegotiate the consideration for the franchises after the thirtieth year (i.e. in 2000). In 2002, after two extensions both parties agreed to keep the franchise fees at 3% and to keep the electric franchise undergrounding requirement at 4.5% provided that the CPUC would approve a 3.53% surcharge for the undergrounding component in addition to the 1.9% general differential surcharge approved in 1972. The CPUC did approve the Utility Underground Surcharge of 3.53% in 2002, which the City supported. This 3.53% was added to the existing 1.9% differential for electricity. Also, prior to the renegotiation in 2000-2002, starting around 1990, there was a dispute over whether the definition of "gross receipts" included surcharge revenues, which had never been contested by SDG&E before 1990. The 2002 franchise amendment effectively settled this dispute by specifically including surcharge revenue within the definition of "gross receipts." This "redefinition" resulted in yet another additional electric surcharge of 0.35%. This raised the overall electric surcharge for City ratepayers to 5.78%.<sup>1</sup>

Given that the existing franchise agreements are both set to expire in January 2021, City staff procured two different consultants to begin to analyze the best path forward for the City. In the fall of 2019, the first consultant, NewGen Strategies, began work by conducting a survey and benchmarking of other municipal franchise agreements, as well as a valuation study of the existing electric and gas infrastructure owned by SDG&E within the City right-of-way and a preliminary

---

<sup>1</sup> For the sake of clarity, the total electric surcharge includes the 1.9% differential granted in 1972, plus the 3.53% and 0.35% differentials approved in 2002.

analysis of severance costs. These studies were done to inform the City and the second consultant, JVJ Pacific Consulting, on the potential value of the franchise agreements, as well as the initial financial feasibility of pursuing the municipalization of electric and gas services. JVJ Pacific Consulting was specifically retained by City staff to provide guidance and formulate recommendations for the franchise agreements.

City staff also distributed a Request for Expression of Interest (RFEI) to potential bidders and the public seeking answers to the following questions: 1) what terms and policies would you like to see in the next franchise for gas and electric services?; and 2) are you interested in bidding on this franchise? City staff also conducted numerous informational public outreach sessions. These sessions and the RFEI resulted in a tremendous amount of public feedback, as well as responses from three potential bidders: SDG&E, Indian Energy LLC, and Berkshire Hathaway Energy.

Following receipt of this feedback and considering the first set of consultant reports, the second consultant (JVJ) then developed a report outlining their recommended terms and approach for securing new franchise agreements. The consultant recommends that the City once again pursue the bidding on both franchises, with various terms that will be discussed below. However, this time the consultant also recommended that, if the City could not get a bidder to agree to these terms, that it begin the process of municipalization. This is the report that came to the Environment Committee on July 16, 2020, and which is front of the City Council now.

Following the City Council meeting on August 6th, the Mayor and his staff will consider the feedback received from Council, and then draft and release the ITB. After receiving the responses to the ITB, it is our understanding that the bids will be brought to the City Council to be opened for the first time in the meeting. At that point, the bids will be unsealed and a determination of responsiveness will be undertaken. The bidders will then have the opportunity to increase their bids to the Council in an open bidding process to satisfy the charter requirements for a free and open competition. During the bidding process, the only thing respondents will be allowed to change is the cash offer of their bid.

As of the writing of this report, City staff anticipate that they will have the ITB out shortly after the Council approves of the resolution of intention, and that the responses to the ITB will be back with the City after the August recess. The bid open bidding at City Council could take place at some point in September. The Council may wish to seek additional clarity on this process.

When the bids are in front of the City Council, the Council must either select the highest responsive bidder, or if there is no responsive and responsible bidder then cancel the bidding and provide further direction to City staff. It is important to note that certain terms in the franchise agreements relating to surcharges will also require the approval of the CPUC following Council approval, which could potentially take several months, or even longer depending on the CPUC schedule. Moreover, if a non-incumbent utility is the high bidder, an even longer approval process would be required to obtain the license and other approvals necessary from the CPUC to exercise the franchise rights.

## FISCAL AND POLICY DISCUSSION

As presented to the Environment Committee on July 16, 2020, City staff, along with a consultant, recommended a series of terms they believe should be the basis of the City's ITB. While there are many terms to be considered, there are some that have become more controversial than others. This report provides more detail on these terms, and provides some guidance on issues that the Council may wish to consider.

### **Minimum Bid**

One of the main terms that the consultant has proposed is an increased minimum bid. While the 1970 franchise agreements also included a minimum bid for each franchise (\$50,000 each), the consultant is now recommending that the bid be based in part on the value of the franchise to the franchise holder. As such, it has recommended that the minimum bid be roughly equivalent to one year's worth of franchise revenue to the City, which is \$54 million for the electric franchise and \$8 million for the gas franchise (\$62 million in total). This is also roughly equivalent to 1% of the estimated value of a 20 year franchise agreement with the City, which the consultant estimates at roughly \$6.4 billion.<sup>2</sup>

The consultant also recommends that the winning bidder be offered the opportunity to pay this money either up front or in installments not longer than ten years with inflation, and that this money come from corporate assets and not from utility ratepayers. It is important to note that this recommendation is just for a minimum bid. The overall franchise parameters are designed to be enticing to multiple bidders. If the City receives multiple responsive bids, it is expected that bidders may increase the bid amount in order to win the franchise.

During Committee, there was discussion of allowing for the minimum bid to be in either cash or projects and services that would be provided by the utility. As determined in City Attorney memo RC-2020-5, the City Attorney believes that in order to maintain a fair and open competition the equivalent of cash (which could include secured notes) must be delivered with the bid. Further, a cash offer would provide the City, and the Council, with more control over what services are provided with this funding. The Council at this point may wish to consider, however, providing the Mayor with further direction as to what the bid proceeds should be spent on.

### **Length of Term**

Another major recommendation from the consultant is that the franchise be granted for a term of 20 years. This is much shorter than the previous 50 year agreements (which were controversial even in 1970), and it is important to note that the term length relates to the value of the franchise itself. As estimated by the consultant, a 20 year agreement is estimated to be worth \$6.4 billion in net operating income. A longer agreement might be considered more valuable, while a shorter agreement might be considered less valuable.

---

<sup>2</sup> As noted in the JVJ Report, SDG&E's most recent estimated net operating income from the City was \$322 million in 2019. This value, times the 20 years of the agreement, equals the \$6.4 billion valuation.

In regards to both the minimum bid and the length of term, there have been many questions raised by the public on any precedents utilized to determine these recommendations. When it comes to precedents with franchise agreements, most agreements within the State are perpetual, including SDG&E's agreements with many other municipalities in the region. However, as the consultant notes in his report, the length of those agreements that have been renegotiated has been shrinking. The length of 20 years is designed to be long enough to entice multiple bidders, while also short enough to maintain considerable flexibility on behalf of the City. If the Council wishes to change the term of the agreement that will be put out to bid, the Council may also wish to consider changing the minimum bid valuation in the agreement.

## **Franchise Fees**

As previously mentioned, the City currently has a 3% franchise fee for each of the electric and gas franchise agreements. Since this is higher than all jurisdictions in the SDG&E service area, City residents see most of this charge on their bill in the form of a differential surcharge. However, in all jurisdictions, the system average franchise fees are charged to ratepayers within the base rates. It should also be noted that, per State law, most municipalities within the State are restricted to a 1% fee.

As part of the recommendations from the consultant, City staff are proposing to increase the gas franchise fee by 0.5%, to a total of 3.5%. As part of this recommendation, City staff mention the possibility of utilizing the additional revenue to advance the Climate Action Plan, but for now the staff report provided at committee indicated that this additional revenue would be distributed similarly as other franchise fee revenue. It is worth noting that, per Charter Section 103.1a, 25% of all franchise fee revenue has to go to the Environmental Growth Fund. The remaining 75% goes to the General Fund. This would apply to any increase in franchise fees as part of this agreement.

City staff, while recommending an increased gas franchise fee, are also proposing to remove the 0.35% electric surcharge differential from City of San Diego ratepayers. Even with the 0.5% gas franchise fee increase, this proposed drop in the electric differential surcharge would potentially save money for City residents since the dollar value of the electric surcharge is much higher than the dollar value of the gas surcharge. However, this change could also result in lost revenue for the City, which is estimated to be approximately \$165,000 per year. For reference, the current SDG&E franchise fees totaled \$47.8 million in General Fund revenue in FY 2020.<sup>3</sup> Council should consider whether they desire to increase any of the franchise fees, and for what purposes they wish to utilize any potential increase in revenue.

## **Other Financial Considerations**

There are other provisions within the consultant's recommendations that would also have a financial benefit to the City beyond cash payments in the form of a franchise fee or initial bid. These include provisions that give the City the right to use unused space on utility infrastructure as well as the right to utilize unused utility real property within the City at no cost. This would also include a provision that the City have first right of refusal to purchase real property from the utility within the City. This potentially opens up possibilities for the City to explore unique opportunities,

---

<sup>3</sup> Total revenue associated with SDG&E franchise fees included \$47.8 million for the General Fund, \$15.9 million for the Environmental Growth Fund, and \$63.6 million for the Utility Undergrounding Surcharge Fund.

such as installing pocket parks or crating other public amenities on utility property. However, it is unclear to what extent this would have a dramatic financial benefit to the City. It should also be noted that all of these provisions would be subject to CPUC approval. Council may wish to inquire about the CPUC approval process for these items, as well as seek more information about the potential benefits.

Also, the consultant recommends that the winning utility place their sales office within City limits in order to capture enhanced sales tax revenue. Given that SDG&E already maintains their headquarters within City limits, this provision would not have a large financial impact for the City if SDG&E were to retain their franchises for services. However, if a new potential bidder wins in this process, this could be an important provision in order to maintain the sales tax base of the City.

### **Administrative Manuals and Other Policy Issues**

Beyond financial arrangements, a franchise agreement can also stipulate additional terms that control responsibility for costs that arise from use of the City right-of-way, as well as further the policy goals of the City. As the Council is aware, in recent years there have been numerous disputes with SDG&E over relocation costs occasioned by its interferences with City reserved uses of the streets, as well as timeliness and accountability for expenditure of municipal undergrounding surcharge money and other service work. With these in mind, the consultant recommended new polices be included within the franchise agreements to help address and alleviate these issues.

One recommendation is the development of a Biennial Permit to replace the current Manual of Administrative Practice which was infrequently updated. This would allow for the proactive review of operational details between City staff and the utility as they work together within the City streets and right-of-way. Along with these permits, the recommendations also include that the utility be required to provide the City with as-built diagrams to the extent permissible by law. These recommendations would improve coordination between City staff and utility staff during times of potential conflict.

The consultant also made recommendations at address what has become a significant issues within the franchise agreements. While the current agreement requires the utility to pay for the relocation of any utility assets which conflict with City uses of streets, in some significant circumstances SDG&E has refused unless the City pays it for the costs to perform the work. The City has been forced to pay the utility up front to keep projects on time while the City pursues litigation over this term. The consultant recommends that the new franchise agreements stipulate that, if the utility wishes to dispute such a charge, that they pay for the charges up front as opposed to the City.

Finally, the consultant also recommends that the utility and City develop a Joint Policies Guide that stipulates ways for the utility and the City to effectuate the greenhouse gas reductions required in the Climate Action Plan. As part of this recommendation, the agreements would also include good faith consideration by the utility to petition CPUC to permit the City to manage certain public purpose charges already paid by ratepayers within City limits.

## **Audits and Enforcement Features**

With the various policy recommendations, the consultant also added some audit and enforcement measures as well to make sure that the future utility will adhere to the terms of the franchise agreements. One important recommendation is for a performance audit of the utility once every four years, which will be made public. These audits would provide public accountability and also inform the City Council on if they need to take further action against the utility. Potential actions will also be included in the new agreement, including a new dispute resolution procedure as well as provisions for liquidated damages and attorneys' fees should litigation be necessary. These actions should enable to the City to more efficiently and effectively identify and resolve issues that will arise in the future.

## **Municipalization**

One of the main issues raised by the public during the outreach process has been the prospect of the City assuming responsibility for all municipal electric and gas utilities, similar to the City's operation of the water and sewer utilities. As a Charter City under the California constitution, the City has always retained the right to municipalize these utility functions and form such entities. This was considered by the consultant, and recommended as a course of action only if the City does not receive any bids favorable to the other terms provided. As noted in the consultant's report, the consultant during the 1970 process indicated they would have recommended municipalization had interest rates been lower at the time. Given that interest rates are lower right now, the NewGen report did do a preliminary analysis of the potential cost differential for ratepayers under the current utility framework and under a municipal gas and electric utility. In most cases, City ratepayers were estimated to pay less under a municipal structure than under the private utility. However, it should be noted that this analysis was necessarily preliminary, it contained a lot of variance in its estimates, and is not an actual appraisal of the utility assets, nor a comprehensive plan for the work that would need to be completed prior to forming a municipal entity. Municipalization would require condemnation by City, and the outcome of a court case on valuation is uncertain in terms of cost, time, and result. This does not include the assumption by City of the costs and risks of gas and electric utility operations and ownership.

Further, the Council may wish to consider the impact of municipalization on the recently formed Community Choice Aggregator, San Diego Community Power (SDCP). If the City were to form a municipal electric utility, it could no longer participate in SDCP since the State law that created Community Choice Aggregation does not apply to a municipal utility, which would potentially have a terminal effect on the City's participation in SDCP.

## **CONCLUSION**

At this time, the Council has several issues to consider as it hears from the City's consultant on the recommended process for negotiating new gas and electric franchises, which is a rare occurrence in the City's history. While this is not the end of the process, if the Council would like to see changes in any of the major terms such as length, policy considerations, or other financial conditions, this is the time to provide that feedback to the Mayor. The Council may also wish to consider the amount of the proposed minimum bid, with the understanding that this is just where the pricing starts. Further the Council should also remember that any stipulations or provisions


contained within the franchise agreement that go beyond just strictly the length of term or bid price will be subject to CPUC approval, which is a process that could require months to complete.

Once again, we would like to thank City staff, including Mayoral staff and the City Attorney's Office, as well as JVJ Pacific Consulting for meeting with us numerous times throughout the entire process and providing our Office with any information and materials that we felt were necessary.




---

Jordan More  
Fiscal & Policy Analyst



---

Jeff Kavar  
Deputy Director



---

APPROVED: Andrea Tevlin  
Independent Budget Analyst