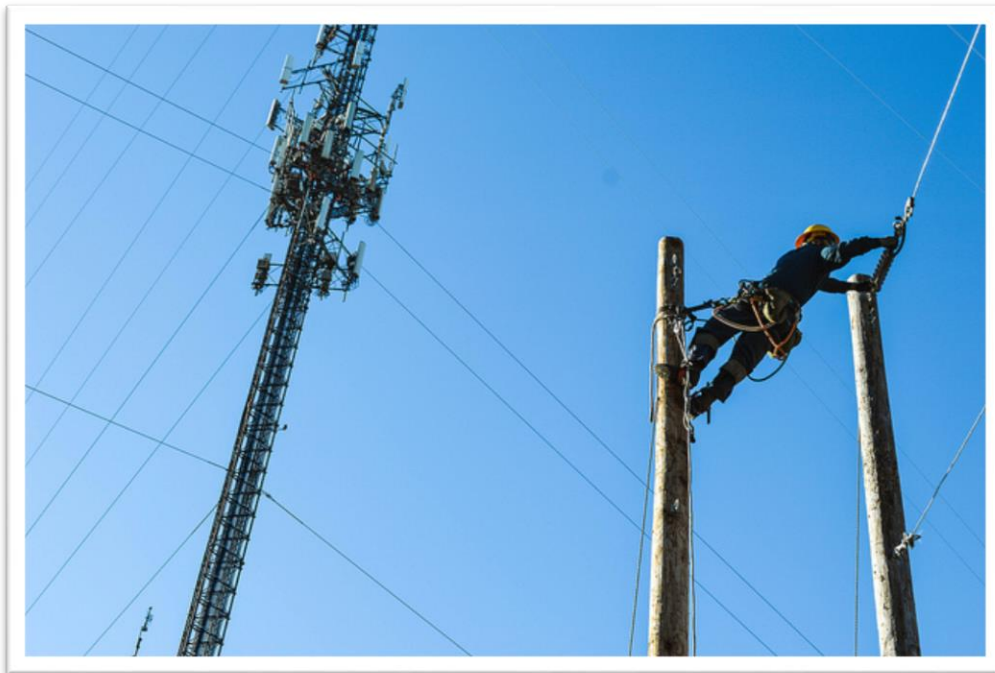




GRU at a Crossroads

How we got here and what path to take

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ABSTRACT

In anticipation of Gainesville Regional Utility's fiscal year 2020 budget-making process, GRU General Manager Ed Bielarski addresses several questions already posed by GRU's governing body, the Gainesville City Commission. On the following pages, Bielarski answers:

1. Is this really a general fund transfer (GFT) problem?
2. How did GRU get to this point?
3. Why is it so hard to find costs to reduce in a \$420 million budget?
4. What solutions are available to close the \$6- to- \$12 million future funding gap?
5. What if we don't reduce the GFT and don't increase rates?

INTRODUCTION

When I was negotiating the buyout of the power purchase agreement (PPA) with Gainesville Renewable Energy Center (GREC), I found it useful to inform the commission, publically and privately, about my progress on a variety of issues. One such public communication was an emailed paper, *Blueprint to a Buyout*, in which I walked the commission through my thought process starting with the Idea, the Understanding, the Memorandum of Understanding and the Next Steps. The feedback from the commissioners was useful, and I enjoyed challenging myself to express the process in a manner that helped people without knowledge of the inner workings to come away with a more solid comprehensive understanding. It worked then, and I think it will work as we discuss GRU's projected budget shortfalls and its various implications.

I decided to take this approach while listening intently during the commission meeting concerning the general fund transfer (GFT) in GRU's multi-purpose room this January. It struck me that most, if not all, of the commissioners were not even in office when the core of GRU's financial issues began. As I am apt to do, I heard the soft refrain of the lyrics from an old Billy Joel song in my head:

We didn't start the fire, it was always burning, since the world's been turning ...

We didn't start the fire, no we didn't light it, but we tried to fight it ...

These lyrics shed new light on the commissioners' questions and made me realize that I must connect GRU's past to the present; I must connect the current budget challenges to the past decisions and explore how we got here. Understanding how we reached this crossroad helps us find the best path forward, hopefully avoiding past mistakes.

When I say, "at the crossroads," I am not simply visualizing a path diverging in front of us. This is about recognizing how certain decisions cannot coexist, such as struggling under a biomass PPA while keeping rates low. Being at a crossroads means choosing a course of action that will change GRU's future in irrevocable ways. That image is powerful to me, and I hope to all of you.

During one of last year's Utility Advisory Board (UAB) meetings, former member David Denslow pointed out that the general manager of GRU would surely be the first to know when the utility was approaching a crossroads.

With that concept in mind, as the basis of this paper I will answer the questions presented in the abstract above.

Keep in mind that before we cross the Rubicon, let's explore the past, the present and the future of GRU. As John J. Geddes, author of *A Familiar Rain* wrote, "I see myself at a crossroads in my life, mapless, lacking bits of information – then, the moon breaks through, lights up the path before me."

BACKGROUND OF GRU AS THE CITY'S FINANCIAL ENGINE

Gainesville Regional Utilities is entering its 107th year of operation and service to the community. During this time, GRU has grown to be the fifth-largest municipal utility in the state.

GRU continues to be an essential part of the City of Gainesville. The utility is one of the primary financial engines of General Government (GG), through its monetary transfer to the city's General Fund, along with its collection of utility taxes and sharing the costs of combined departments such as human resources, fleet and legal services. All told, GRU provides over \$50 million on an annual basis to the General Fund.

The GFT is a return on the city's investment in the utility and represents GRU's projected, annualized profits. In practice, every three to five years, depending on conditions, GG and GRU representatives meet to discuss their organizational needs, expectations and limitations. The goal is to collaborate on a Memorandum of Understanding, or MOU, which lays out an annual payment structure to capture GRU's projected profits.

While the public might assume simply funding the GFT through actual profits from GRU's operations would be easier, such a practice produces unintended consequences. First, the utility is better equipped to adjust to any variation between the "levelized" GFT and actual profits due to its considerable financial strength (AA- bond ratings) and structured reserve fund balances; GG is not.

Secondly, historically GRU's business model has been based on solid and predictable revenue streams. Up to 90% of costs continue to be fixed. For many decades, GRU revenue, service levels, technology challenges and other risks have remained stable and manageable.

If one were to review the history of GRU's GFT payments, the actual variances between our actual profit and GFT payments tended to average out over time. In fact, in the 10 years before FY2018, GRU had more than the amount of funds required for the GFT five times and not

enough to fund the GFT another five times. In addition, for those who espouse the GFT as the main culprit for GRU approaching the crossroads, consider that since 1987, GFT as a percentage of GRU's operating revenues has fallen from 9.58% to 9.07%. (See addendum 1.)

Virtually all public utilities use some form of a GFT formula in order to return profits, or excess revenues to the municipal organization. In fact, one could call it a best practice among municipal utilities.

Key point - This symbiotic relationship has resulted in a healthy, thriving and progressive general government organization and a utility that is consistently ranked among the safest, most reliable and competitively priced, while still maintaining state-of-the-art environmental stewardship and strong community support.

QUESTION # 1 — IS THIS REALLY A GFT PROBLEM?

GRU and GG have been discussing the next GFT MOU since November 2018, because the current MOU expires this year. The new MOU will determine the GFT structure moving forward and will impact the FY2020 budget and beyond.

As a prelude to those discussions, GRU updated its budget presentations from last year and developed projections that it shared with GG. These projections reflected an annual shortfall of between \$6 million and \$12 million a year; in other words, GRU isn't earning enough profits to cover the GFT.

It's not surprising that GG and GRU have been unable to reach a consensus on how to approach this shortfall, given the tightness of both organizations' budgets.

The impasse in these discussions required a meeting with the City Commission, in which GRU was asked to answer a series of "what-if" scenarios and provide the commission with cost/benefit analyses.

GRU staff is developing detailed responses to the commissioners' questions and meeting with representatives of GG, as well as formulating additional suggestions. Another public meeting is scheduled for February 28.

As one commissioner suggested, I think it's unfortunate that the meeting focused on the GFT rather than discussing the overall sustainability of GRU and its profits. I would rather discuss the broader subject in terms of sustainability for GRU.

Key point – It is important that we ensure the financial health of GRU so the utility can continue to be the financial engine of the city far into the future.

QUESTION # 2 — HOW DID GRU GET TO THIS POINT?

a. GRU doesn't have the critical mass to withstand uneconomical business decisions

Although GRU has nearly 100,000 customers, it is not a large utility. Our size means that uneconomical, broad-based business decisions can substantially place GRU and its stakeholders at risk. This will be important to remember for later discussion.

b. The industry trend has not been GRU's friend

The utility business model has dramatically shifted in the last decade. Newer appliances, more efficient homes and a spirit of conservation have resulted in dramatic downward shifts in the use of the utility's services. While almost all utilities have seen reduced consumption of their products, the overall financial impact of conservation has hit GRU particularly hard.

c. Conservation programs worked but at a cost to GRU

In FY2006, the Commission directed GRU staff to include a Total Resource Cost (TRC) test and "... pursue all cost effective and feasible demand side management side measures," about which a former Interim GRU General Manager wrote, "Frankly, there is a certain element of try it and see if it works, that has not been a significant part of GRU public proposals." (See addendum 2.)

As a result, between FY2006 and FY2013, GRU actively encouraged/promoted and paid for customers to use less of its product. In all, GRU spent a combined \$32 million on conservation programs, including efficiency rebates, increased marketing, personnel and other operations and maintenance (O&M) expenses. When the programs ended in FY2013, GRU was spending \$3.7 million per year, with rebates to customers representing \$2.6 million of those expenditures.

In addition to the conservation program costs, GRU lost both peak demand load and overall energy sales. GRU estimates that from FY2006 until FY2013 the conservation program resulted in 21 megawatts (MW) of lost peak demand and approximately 108,000 megawatt hours (MWh) per year of overall energy sales. (See addendum 3.) The financial impact of the loss of 108,000 MWhs is approximately \$14 million in lost gross revenues and \$10 million in lost net operating revenues.

Between 2009 and 2013, GRU entered into European-style Solar Feed-in-Tariff (Solar FIT) contracts with up to 256 separate suppliers, culminating in 18.6 MW of installed capacity delivering an annual average of 23,000 MWs. These contracts require GRU to accept the solar

power generated from the suppliers' installations in exchange for payment from GRU at a fixed rate over 20 years. The average fixed rate was approximately \$260 per MW, which is approximately eight times the cost of GRU's power generating costs.

These costs have been absorbed by GRU's electric customers for the past 10 years. We are committed for another 14 years to the Solar FIT contracts. (See addendum 4.)

During this time, GRU also provided solar customers Net Metering opportunities, the ability to sell their solar power back into GRU's electric grid and offset it against usage. Under the Net Metering program, the utility lost 7.2 MW of installed capacity and an estimated 10,000 MWhs.

Key point – GRU estimates that the Solar FIT, Net Metering and the Conservation programs have reduced customer demand by 46 MWs of peak demand. That reduction has cost the utility gross revenues of \$18 million per year and net operating revenue of \$13 million per year, or the equivalent of removing over 13,000 homes from our community, in addition to having to pay \$5 million a year as a premium price to the Solar FIT customers.

d. The Great Recession of 2008

In the midst of an industry which was experiencing diminishing consumption of its products as well as a community that was actively engaged in having GRU pay customers to use less of its products, the overall U.S. economy had its worst economic period since the Great Depression. Economic activity necessarily reduced demand on top of the aforementioned trends.

One can see the impact in our peak demand. GRU's summer peak electric demand in FY2007 was 481 MW. Peak demand this summer was 408 MW. (See addendum 5.) With the loss of Winter Park as a wholesale electric customer, that demand will fall to under 398 MW and maybe as low as 390 MW. That's a loss of almost 90 MW of peak demand load in a decade (or the equivalent of two times the UF on-campus load, if we supplied UF's on-campus power).

GRU's water and wastewater systems have been hit hard as well. Water usage in GRU's territory has fallen from a peak of just over 9 million kgal (a kgal is 1,000 gallons) in FY2007 to under 7 million kgal in FY2015 (See addenda 6 & 7.) That's more than a 25% reduction in usage in the system. Wastewater collection has followed a similar trend. Despite these reductions in usage, GRU must continue to invest in its aging infrastructure. For example, actual water treatment has increased due to stormwater entering our wastewater system, known as inflow and infiltration, or I&I.

Key point – The Great Recession completed the reduction in GRU's electric power demand, as overall electric usage fell from a high of 1,882,767 MWh in FY2005 to 1,689,244 MWh in FY2012. (See addendum 8.) GRU ended FY2012 with almost 200,000 less MWhs being delivered to its customers, resulting in an overall reduction of \$26 million of total revenue.

e. Underlying utility costs are rising

Unfortunately, in addition to selling fewer services, GRU’s operating costs are rising due to inflation. The cost of chemicals, services, supplies and other products from third parties are beyond GRU’s control. Both GRU and city employees have lagged the market in terms of pay increases and while these lower increases in wages are helping to keep rates low, even small increases cause upward rate pressures.

Key point – Even if GRU can control its own costs, it can’t control the costs of its suppliers.

f. Debt doubled between FY2000 and FY2013

GRU had just over \$400 million in debt on its books at the end of FY2000. By FY2005, it had just over \$450 million in debt. But over the next eight years GRU debt grew to approximately \$975 million. In addition to the aforementioned conservation programs, the utility invested in multiple expansive and costly capital projects, listed below:

Cost of Large Capital Projects (FY2005 –FY2013)	
DH2 Air Quality Control System	\$150.9 million
Eastside Operations Center (EOC)	\$76.2
Shands South Energy Center	\$53.3
Software Upgrades (FMIS FY2009, CCS FY2006)	\$28.4
Manufactured Gas Plant (Depot Park)	\$21.6
Wastewater Biosolids Program	\$19.9
Sweetwater Wetlands	\$18.4
Total	\$368.7 million

Without a doubt, this GRU asset expansion plan (while not a formal program) was an admirable and legitimate response to our multiple challenges, such as confronting an aging power generation infrastructure, responding to changing environmental regulations and correcting years of deferred maintenance to modernize the organization.

For example, GRU equipped DH2 with state-of-the-art emission control technology; built a new operations center moving the trucks and staff away from downtown; negotiated a contract with UF Health to construct and operate a state-of-the-art energy facility for its UF Health Shands hospital; converted our computer software system to SAP; constructed a passive remediation site for storm water and wastewater effluent named Sweetwater Wetlands Park; upgraded the Kanapaha Wastewater Treatment Facility and remediated and “greenfielded” the old Gainesville Gas site, which has become Depot Park, Gainesville’s new Central Park. All of this has added to GRU’s debt.

Key point - GRU's investment into asset expansion, along with rebate-heavy conservation programs multiplied the millions of dollars of debt and annual expenses, respectively, on its books during a period of rapidly reduced consumption of its electric, water and wastewater utilities.

These asset expansion and conservation programs were so costly for this small municipal utility that GRU's debt doubled, resulting in considerable rate increases as well as future pressure – largely in the electric system – that exists to this day.

g. Electric rates necessarily increased

This rate pressure grew so high that by FY2008 GRU's electric rates increased to \$127 per month* as compared to \$83 per month in FY2003. That's a \$44 per month increase in five years, or 53%. (See addendum 9.)

**All monthly electric rates in this paper are based on the industry standard 1,000 kWh of usage.*

The trend reversed from FY2008 through FY2013 when overall GRU electric bills fell from \$127 per month to \$125 per month. This trend was the result of 1) re-engineering GRU's debt, which substantially reduced debt payments for nine years in exchange for increasing them for over 20 years; and 2) benefiting from lower natural gas prices.

Key point - The 2012 debt restructuring clearly masked the need to increase rates during this period and is a reminder that any debt restructuring needs to come with a plan to absorb future debt payments.

h. Change in public perception surrounding GRU

During this same period, GRU's customers increasingly began to view GRU with a less-than-favorable eye. Electric rate increases could be seen and felt in their bills. At the same time, public discussions ensued about renewable power – biomass versus gas or coal plants.

Key point – GRU had been a low-cost provider of utility services and within a decade had become a high-cost provider.

i. Two ill-fated electric business decisions

As previously mentioned, the first ill-fated business decision was the European-style Solar FIT contracts. At average rates of \$250 a megawatt, these created up to a \$6 million per year, 20-year deficit in GRU's electric budget.

Additionally, on April 29, 2009, GRU executed a power purchase agreement (PPA) for the off-take of biomass power from GREC and capacity up to 102 MW (enough to power 80,000 homes), whether the energy was delivered or not, which ended up costing customers another \$75 million per year when the plant went online in late 2013.

The biomass plant has been one of the most discussed topics in Gainesville history. For the subject of this paper, I will avoid all issues associated with the choice of a biomass plant vs. gas or coal and other controversial elements of the PPA, other than the choice to enter into a PPA. The degree to how unwise the PPA choice has been was ultimately monetized in GRU’s buyout of the PPA for \$250 million more than what it cost to build, after spending another \$200 million while operating under the PPA for almost three years.

Key point – The reason GRU entered into a PPA as compared to building the plant was due to the debt it had already encumbered through its asset expansion and spending on conservation programs, which shrunk revenue and narrowed its financial metrics. Solar FIT and the PPA burdened GRU with approximately \$81 million of added annual costs necessary to recoup through its electric customers.

To consider the full impact of the Solar FIT, the PPA and the aforementioned asset expansion program on GRU’s overall financial position, one need look no further than a comparison between FY2004 and FY2016 expenditures (see chart that follows).

- Labor rose an average of less than 3% per year
- Non-labor O&M grew by just over 5% per year
- UPIF (the cash GRU uses to fund capital projects) grew by just over 3% per year in accordance with the debt covenants
- GFT grew by less than 2.5% per year

Key point – While the additional costs from the Solar FIT, Biomass PPA and increased debt service payments on the asset expansion added \$112 million to an overall \$245 million budget, labor, non-labor O&M and the GFT simply grew at the rate of inflation.

Put another way, debt payments grew by 124% and the cost of fuel grew by 84%, while the *sum* of labor, non-labor O&M, UPIF and the GFT grew by 43%.

To offer some perspective, if all of GRU’s expenses had grown at the same level as the average of its labor, non-labor O&M, UPIF and GFT, total expenditures in FY2016 would have been \$352 million, not \$407 million, resulting in GRU spending \$55 million per year less.

Cost Categories	FY2004	FY2016	Variance
Fuels	\$91 million	\$167 million	\$76 million
Labor	\$40	\$54	\$14
Non-Labor O&M	\$31	\$51	\$20
Debt Service	\$25	\$56	\$31
UPIF	\$31	\$44	\$13
GFT	\$27	\$35	\$8
Total	\$245 million	\$407 million	\$162 million

In the face of a daunting financial future, management at the time applied the following mitigation strategies:

Mitigation Strategy No. 1:

Aware of the impending debt payment crunch, GRU restructured its debt in 2012 to shape the debt payment curve to projected cash flows. This reduced GRU's near-term debt payments by \$83 million in exchange for placing another \$151 million of debt payments into later periods. *That later period is now.*

As a result, GRU's debt payments will increase between FY2021 and FY2026 by an additional \$3 to \$4 million; between FY2027 through FY2032 by an additional \$5 to \$6 million; between FY2032 to FY2040 by an additional \$8 million per year and in FY2041 and FY2042 by an additional \$17 million more per year. (See addendum 10.)

While debt restructuring is an often-used financing strategy, a successful conclusion needs to be guaranteed with an *overall* strategy to cover those higher debt payments in the "out years." In GRU's case, there was really no effective plan to do so.

Mitigation Strategy No. 2:

Faced with already high electric rates, GRU didn't ask for or receive any base rate increases from FY2012 through FY2015. With no electric base rate increases, GRU might have experienced a shrinking profit margin. Instead, wage increases were foregone in some years, positions left unfilled and some maintenance, such as tree trimming, cut. Both safety and reliability suffered, resulting in higher systems costs in future years (e.g. deferred maintenance issues). Effectively, GRU tried to "cost-cut" its way to sustainability.

Mitigation Strategy No. 3:

By FY2015, GRU's electric rates had grown to \$140 a month, largely due to the PPA being accounted for under the fuel adjustment (up 69% since FY2003). The GFT was \$37.3 million. In recognition of GRU's continuing rate dilemma, GG and GRU negotiated a \$3 million downward bump in the GFT, with a 1.5% projected increase over the next five years, ending in FY2019. (See addendum 11.)

Mitigation Strategy No. 4:

In FY2014, GRU management offered UF an opportunity to purchase blocks of power at a cheaper rate than what they could buy from Duke. Although well thought out and less costly to UF, the offer was never accepted. In FY2016, my team and I entertained UF with a similar offer and it, too, was rejected.

Mitigation Strategy No. 5:

The 2017 successful buyout of the PPA was not GRU's first attempt to do so. Previous management worked with its financial advisor PFM and the City Commission to develop an offer to deliver to GREC owners. That offer (approximately \$425 million) was substantially less than the value GREC owners had negotiated into the PPA. As a result, and as mentioned earlier, GRU operated another three years under that PPA, paying an additional \$200 million to the organization to which it had been unwilling to pay a higher buyout price.

New Management & New Strategies

Faced with an embedded \$81 million of costs in its fuel adjustment for the next 14 to 27 years, along with a heavy debt load, my team and I understood that the PPA offered GREC huge financial advantages with very few risks and that if there was any chance to negotiate a buyout of the high-value PPA, GRU had to enforce it to the exact letter of the deal. That's exactly what we did, and it provided savings while GRU and GREC proceeded with arbitration on issues surrounding how the PPA should be interpreted.

This aggressive, although fair interpretation of the PPA, demonstrated to GREC owners how the plant would be better off in the hands of GRU, who could manage it and operate it in ways GREC could not.

Ultimately, my team and I were able to negotiate a buyout of the PPA in 2017 at the price of \$750 million. With the savings, GRU reduced residential and commercial rates 8% and 10% respectively in February 2018, bringing an average residential bill down to \$121, levels not seen since 2008. (See addendum 9.)

While we were able to save upwards of \$800 million in future PPA costs, GRU is still obligated to pay \$1.2 billion over the life of the debt, which would not have been the case had we built the plant ourselves or waited until 2023, when the requirement for power was originally projected (25 megawatts at that, not the 102 megawatts we built).

Weren't we led to believe that the buyout solved the sustainability problem?

Virtually all of the \$800 million savings resulting from the buyout of the PPA was returned to electric customers in rate reductions (~ \$26 million in the first year). The reserves GRU held for working capital, contingencies and in accordance with debt covenants, were not supplemented in any way. In fact, GRU reduced its reserve levels to return monies to customers from 2015 until now.

If not for the buyout of the PPA, GRU customers would likely be paying in the \$150 a month range for electric. As S&P analyst Jeffrey Panger, wrote: "It was a bitter pill to swallow, but it was the right thing to do."

The buyout of the PPA was not the proverbial "silver bullet" in addressing GRU's financial sustainability because the two ill-fated business decisions are still on GRU's books. Let's look at how heavily they continue to effect electric rates.

The Solar FIT continues to cost GRU approximately \$5.5 million more a year than it would cost to buy the power off the grid, produce the power through its generating units or purchase it at today's solar prices. Of course, the Solar FIT, Net Metering programs along with all other conservation programs by GRU customers, has resulted in almost \$18 million a year of lost revenue, I am only using the annual costs of the Solar FIT.

The cost that GRU paid to buy out the PPA was \$250 million more than it would have cost to build the biomass plant. That \$250 million costs GRU approximately \$13 million in additional debt payments annually (see the chart below):

Costs	
Solar FIT costs	\$5.5 million
PPA buyout costs	\$13 million
Total	\$18.5 million
Expense required to create 1% of rate impact	\$1.5 million
Rate impact	12.3%
Impact on residential bill	\$15
Residential bill (without Solar FIT & PPA Premium)	\$108
FMEA Average Residential bill	\$112

Key point - The bottom line is that without the Solar FIT and the impact of the PPA (PPA premium), GRU’s residential bills would be below the average for the state, even with the asset expansion and the conservation programs starting in FY2006.

QUESTION NO. 3 — WHY IS IT SO HARD TO FIND COSTS TO REDUCE IN A \$420 MILLION BUDGET?

Certainly a large part of the answer to this question lies in GRU substantially increasing its debt service payments from \$25 million to \$98 million a year, making those costs almost 25% of GRU’s budget, compared to its previous level of 10%.

But let’s dig deeper and walk through GRU’s expenditures by category between FY2004, FY2016 and FY2019 in order to place relevance and significance to how we operate.

When the FY2019 budget amounts are added to the previous chart showing FY2004 and FY2016, we have a clearer picture of the GRU operating profile:

Cost Category	FY2004	FY2016	FY2019
Fuels	\$91 million	\$167 million	\$92 million
Labor	\$40	\$54	\$59
Non-labor O&M	\$31	\$51	\$90
Debt Service	\$25	\$56	\$98
UPIF	\$31	\$44	\$41
GFT	\$27	\$35	\$39
Total	\$245 million	\$407 million	\$419 million

To further illustrate: Between FY2016 and FY2019:

- Buying out the PPA has returned fuel costs to \$92 million and in line with even FY2004 amounts. Note that \$92 million includes \$6 million of Solar FIT
- Labor costs have risen over the past three years at less than 2.4% a year
- UPIF actually went down by \$3 million
- GFT has increased just over 2.8% a year
- Debt service is modestly higher when you consider the almost \$40 million of PPA buyout debt payments

Non-labor O&M of \$90 million in FY2019 is substantially higher than the amount of \$51 million in FY2016, which requires further explanation:

Non-labor O&M Categories	FY2016	FY2019	Difference	Note
Energy Supply	\$10.3 million	\$20.4 million	\$10.1 million	1
District Energy	\$2.5	\$5.2	\$2.7	2
Energy Delivery	\$6.1	\$7.6	\$1.5	3
Water	\$6	\$6.2	\$.2	-
Wastewater	\$7.2	\$7.7	\$.5	-
GRUCom	\$2.8	\$2.9	\$.1	-
Administration	\$5.5	\$1.8	\$1.3	4
Customer Support	\$5.3	\$6	\$.7	5
IT	\$4	\$4.7	\$.7	6
Finance	\$.1	\$.5	\$.4	-
OneERP	-	\$8.9	\$8.9	7
COO Office	-	\$.5	\$.5	-
General Services	\$6.2	\$17.4	\$11.2	8
Total	\$51 million	\$89.6 million	\$38.6 million	-

The following explains why current non-labor O&M appears high:

1. \$8.7 million of the difference is the cost of NAES running DHR. Without that cost the increase is just above 4% per year.
2. \$2.7 million of the difference is the necessary cost of Phase 2 of the South Energy Center (SEC).
3. \$.7 million of the difference is aggressive vegetation management and T&D construction. Without that cost the increase is less than 3.5% per year.
4. \$.9 million of the difference is increased community relations spending and having communications report to the GM.
5. \$.4 mm of the difference is related to work on our Customer Information System (CIS). Without that and adding back the cost of communications (\$.5 mm), the increase is just over 3.5% per year.
6. Overall IT increase is just over 4% per year, largely due to additional licensing costs.
7. O&M expenses of OneERP implementation.
8. \$4.7 million in discontinued practice of budgeting capitalization; \$2.7 million of system recoveries of revenues reclassified to revenue, not expense reductions; \$1.8 million of bad debts now reclassified as expenses not netting revenue; \$1.1 million is increase in

joint services from GG; \$.9 million increase in risk management, pension bonds and workers comp. These account for the entire difference.

I have presented an “accounting” analysis of the numbers and used the terms “reclassification” and “system recoveries” and such. These terms have meaning to me because of my background as a CFO, so I will proceed to describe the variance in a slightly different style.

I have started with the variance and shown the amounts that are 1) associated with an operational need (running DHR, running SEC, etc.) and are not available for reduction; 2) accepted by the commission as a budget item (increased cost of internal services from GG, OneERP O&M expenses, etc.); and 3) simply an accounting nuance such as a reclassification between accounts but still not part of an amount which can be reduced; and finally, 4) a previously unacceptable accounting practice such as previous management’s capitalization policy.

Difference between FY2016 and FY2019	\$38.6 million
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Operational Needs	
Cost of running DHR	(\$8.7 million)
Cost of SEC Phase 2 Revenue	(\$2.7 million)
Total Operational Needs	(\$11.4 million)

Approved in annual budget	
One ERP O&M Expenses	(\$8.9 million)
Cost of increased reliability and T&D revenue	(\$.7)
Increased community relations spending	(\$.4)
CIS cost in customer service	(\$.4)
Increased cost from GG	(\$2)
Total Accepted by Commission	(\$12.4 million)
Accounting reclassifications	(\$4.5 million)
Discontinued capitalization practice	(\$4.7 million)
Total adjustments	(\$33 million)
Adjusted “real” difference between FY2016 and FY2019	(\$5.6 million)

As you can see, base increase in non-labor O&M expenses between FY2016 and FY2019 was \$5.6 million, or a 2.8% increase per year (reasonable expense growth under the economic conditions).

In addition – and as discussed in the past two budget presentations – GRU formerly capitalized a portion of its non-labor O&M expenses based on a pre-planned budgetary process. This practice was discontinued after FY2016 as it is not a good practice for a utility, and in GRU’s

case it understated expenses and overstated capital, which had the impact of reducing rate pressure. Let me be clear, this is not a good practice and has been discontinued; however, it has the effect of including close to \$5 million in future expenses into the rate-making process that GRU never had before.

To return to the question, “Why is it so hard to find money in a \$420 million budget?”

- \$92 million of fuel is purchased to run the plants and provide natural gas to customers
- \$98 million is paid to our bondholders and banks to fund our debt
- \$59 million is paid to our employees, an amount that has grown at less than 2.4% for the past four years
- \$41 million is paid as required by banks to fund our capital expenditures
- \$39 million is transferred to GG as profits
- Of the \$90 million left, the real increase over FY2016 expenditures is 2.8% (when you consider the additional \$11.4 million of costs of running DHR and the next phase of SEC; the additional \$12.4 million of the OneERP project, reliability work and increased costs from shared services with GG; \$4.5 million in accounting reclassifications; and \$4.7 million in discontinued capitalization practices).

Key point - In summary, within a \$420 million GRU budget, few costs are left to cut because GRU has already reduced costs through the 12 years of operating under the pressures of rates, asset expansion and conservation initiatives.

We already understand that major suppliers of products and services are looking to increase costs that flow into our non-labor O&M expenses by much more than the 2.8% average increases we have seen in the previous four years. Our internal payroll numbers have risen by 2.4%, which doesn’t allow the utility to resolve pay inequities and makes hiring outside talent for the employees we lose through normal attrition or retirement difficult.

QUESTION NO. 4 — WHAT SOLUTIONS ARE AVAILABLE TO CLOSE THE \$6-\$12 MILLION GAP?

GRU’s executive and leadership teams are working on responses to the questions and comments from the commissioners asked at the GFT public meeting in GRU’s MPR. I have built a worksheet reflecting our initial thoughts, subject to the final delivery of white papers for each item. (See addendum 12.)

GRU and GG have also continued their discussions concerning the ways in which the GFT could be modified/reduced to bridge some part of the \$6 to \$12 million gap.

GRU’s executive team delivered presentations to all three rating agencies at the end of January as an annual update and to consider the credit worthiness of the proposed 2019 bond offering (Series’ A, B and C). Series’ A & B had already been planned as part of a previous program to refinance the drawdowns on GRU’s commercial paper facility and replenish its UPIF funding.

We incorporated 2019 Series C in the already-planned financing plan to satisfy the commissioners' request to find savings to mitigate the \$6 to \$12 million annual shortfall.

Key point – We anticipate the Series C restructuring would have the potential of reducing debt payments by a cumulative \$65 million from FY2019 until FY2025, in exchange for increasing debt payments \$109 million beyond FY2025. (See addendum 13.) Obviously, this is subject to change based on a variety of market conditions.

Although the Series C offering will result in a positive net present value cash flow (due to the value of money today being higher than the value of money 20 years from now), I must make it clear that this offering comes with the following risks and caveats:

- The rating agencies are clearly concerned with GRU's leverage. In fact, based on several of the agencies' new valuation criterion, high leverage may place GRU in jeopardy of having its bond ratings reduced to single A. The consequence of a one-notch rating fall is added borrowing costs to GRU, which places additional rate pressure on GRU customers. During last year's budget meetings, Chris Lover, our financial advisor from PFM, used a figure of an initial \$1.3 million in additional annual costs as a result of a one-notch downgrade.
- The rating agencies are also concerned whenever a borrower utilizes this type of restructuring more than once within a short period of time. In GRU's case, we restructured debt in FY2012 with substantial reductions in debt payments from FY2012 through FY2020. When the increased debt payment load is being layered on, GRU is looking at a second bite at the apple. From the rating agency's perspective, GRU should have developed a plan concurrent with the original restructure, which should have made the debt restructuring through the 2019 Series C transaction unnecessary.

Key point - I would not recommend using the 2019 Series C bond offering as the only solution to GRU's sustainability. I believe a more robust solution must come with other cost reductions or revenue enhancements, which I will summarize under the last section and fully vet at our February 28 meeting.

The SAP Decision

GRU embarked on upgrading its Financial Management Information Systems (FMIS) and Customer Information Systems (CIS) under an Enterprise Resource Planning System (ERP) in FY2015. In July 2015 (a month after I arrived), GRU executed a contract with SAP for these upgrades. GRU had concluded over the previous 18 months that the current system was unsupported by the vendors, no longer able to be upgraded and didn't communicate effectively, requiring additional manpower to reconcile and maintain. SAP was chosen.

It wasn't until April 2017 that GRU went live with its FMIS implementation, but there were lessons learned in the implementation, which the City Auditor, Carlos Holt, has reviewed. Armed with that information, GRU staff met with the experts and revised a placeholder in the budget for the CIS implementation, as well as Enterprise Asset Management (EAM), from \$20 million to \$35 million.

The City Commission voted to keep the \$20 million of capital costs in the FY2019 budget, pending the results of the RFP for the CIS system and further analysis.

Given the magnitude of GRU's burden created over the past 12 years, I am considering whether to suspend any further work on CIS and EAM implementation, deferring the \$20 to \$35 million in capital and also up to \$5 million of the annual \$8 million of OneERP O&M costs.

QUESTION # 5 — WHAT IF WE DONT REDUCE THE GFT OR INCREASE RATES?

At the time this question was asked, I believe I called it the "nuclear option" because it would simply leave the utility running out of cash (see addendum 14), reducing services, running equipment to failure and trying to keep five of our generating units, all over 38 years of age, running. It is not sustainable. This is exactly why we are at a crossroads.

MY PERSPECTIVE

In hindsight, the first indication of GRU's financial red flags started to appear in the FY2006 to FY2007 timeframe. Residential electric bills moved from \$89 to \$104 a month. In FY2008, bills ballooned to \$127, and in FY2009 they reached \$133 a month.

On the expense side, GRU invested heavily into conservation programs, \$32 million from FY2006 until FY2013, in which it paid customers to use less of its services. In order to be on the cutting edge of demand-side management, GRU invested in the Solar FIT, which obligated the utility to pay close to \$300 a megawatt for select customers who fed their power into our system (overall cost of approximately \$260 per MW for 20 years). Combined with industry-wide conservation trends and after being hit with the Great Recession, GRU lost almost 90 MW of peak demand, or almost 200,000 MWh of energy, enough to power 19,000 homes. At \$130 a MW, the effect of the overall reduction in electric demand reduced profits by \$20 million a year, just on GRU's electric system.

During that timeframe, GRU shifted from being a small, cost-conscious municipal utility to a more aggressive, aspirational organization. All of this occurred before the PPA was implemented and the biomass plant went online.

Management felt the weight of these additional programs, policies and decisions to the point that in June 2012, GRU decided it needed to restructure its debt to allow for lower payments in the short term. The 2012 debt restructuring (2012 Series A & B debt) resulted in deferring \$83 million in debt payments during the FY2012 through FY2020 period into \$151 million in FY2021 through FY2042.

The first year of increased debt service payments will begin in FY2021, contributing to GRU reaching this crossroads.

In FY2013, the impact of the PPA was beginning to be felt (\$75 million in additional fuel costs passed through to GRU customers). Residential electric bills rose to \$137 in FY2014 and \$140 in FY2015 in response. Those numbers would have been higher if not for the benefit of the aforementioned debt restructuring, which lowered debt payments by almost \$14 million a year. Without that refunding, these rates would have skyrocketed to between \$150 and \$160 a month. But again, while useful at the time, that refunding is creating higher debt payments now.

Although GRU has bought out the PPA and reduced annual payments for the biomass plant from \$75 million to approximately \$48 million (\$39 million in debt and almost \$9 million to operate it), that's approximately \$48 million in payments it didn't have a decade ago. GRU also has \$681 million in debt it didn't have a decade ago.

Key Point – Because of GRU’s decade-long expansion into early-stage, cutting-edge, costly programs, the utility was unable to advance into smart meters, behind-the-meter services or enterprise resource planning (ERP) systems to apply the use of Big Data. The cost of being an early adopter on the cutting edge is that cutting edge can lead to the bleeding edge.

Again, it is ironic that that the absorption of GRU’s resources into these programs have crowded out our ability to keep pace with the data management side of the utility industry.

The Bottom Line

GRU is a well-run utility, as evidenced by an underlying cost structure that allows for the safe, reliable and competitively priced utility services the community experiences. The financial encumbrances from a host of embedded costs and fundamentally flawed decisions on specific, identifiable initiatives have adversely impacted GRU rates.

This paper is a vehicle to thoughtfully engage in understanding the consequences of policy decisions, understanding the overall impact of when we enter new technologies and ultimately to own those decisions. No single policy decision or action brought GRU to this crossroads, but rather the sum of individual decisions that we now have to own.

GRU’s decade-long expansion in its fixed-cost initiatives dovetailed with an intensive enlargement of its conservation programs, contributing to little or no growth in sales volume over that same decade. This means these greatly increased fixed costs (mostly debt and Solar FIT) have been spread over basically the same sales volume. This pace and pattern cannot be sustained without future price changes or aggressive cost reduction.

Solutions

In keeping with the theme of the paper, GRU at a Crossroads, I am working with my staff as well as the folks at GG on the following solutions to the \$6- to- \$12 million budget shortfalls, because as you have seen, decisions have far-reaching consequences. This will not be a one-year course correction; rather, it needs to be a long-term plan with a focus on balancing the interests of all GRU stakeholders.

- With trepidation, I recommend restructuring approximately 5% of GRU’s debt as part of the 2019 refinancing. The restructuring will shift the debt payments in a way that creates \$65 million in savings over the next six years, in exchange for higher debt service payments of \$109 million over the next 25 years. It will create annual savings that will almost fully mitigate the projected annual shortfalls. However, we must plan for years FY2025 through FY2050, with the following steps, so that the need to restructure again in this manner is not necessary.
- With a great deal of reluctance, I recommend suspending the One ERP implementation, which we believe can defer \$5 million a year in O&M costs and defer the \$20 to \$35

million of capital expenditures. During this suspension, staff will continue work on re-envisioning the CIS, EAM and smart metering projects.

- As I illustrated earlier, the GFT did not cause the current shortfall in GRU's budget projection. However, it should prove to be an avenue to mitigate those shortfalls. Therefore, I recommend that GG and GRU continue working to develop a new GFT MOU. Some concepts that GRU and GG have already discussed include, but are not limited to:
 - Freezing the GFT for a period of at least three years, depending on further GG analysis.
 - Reducing the base level by an amount up to \$6 million, depending on further GG analysis.
 - As an incentive, including a yearly true-up of the payment based on whether GRU exceeded its profit goals for the year, effectively establishing a floor with upside for GG.
- Again, reluctantly, I propose suspending GRU's participation in additional conservation programs until the utility's reserves can be projected to be sustainable over the near-term horizon. As hard as that is for me to say, it is necessary because GRU can only absorb so many reductions in its service levels before the rate pressures become politically unsustainable.
- I recommend that any expenditure imposed by the Commission on GRU that is not already in the approved GRU budget be funded as a reduction in the GFT, a supplemental rate increase or a specific cost reduction.
- GRU will work on a budget that considers the list of options in Addendum 10, which we hope will reduce expenses by a minimum of \$2 million a year (as a start, I am not filling GRU's Chief Change Officer, nor the Advisor to the GM vacancies, and I believe that a combination of limited out-of-state travel and removing several yet-unfilled positions from across each department will help us reach that total).
- GRU will work diligently to facilitate the transition of as many NAES employees to city employment as soon as possible, with the possibility of saving \$500,000 a year.
- GRU will continue to seek selective (certain areas), strategic (clever investment), cost beneficial (identifiable payback) deployment of AMI.
- GRU will work to renew the City of Alachua wholesale energy supply agreement when it expires in several years, as well as other wholesale power takers, most importantly UF on-campus.
- GRU believes it can add some level of green photovoltaic power to its grid in a cost-efficient manner.
- GRU will pursue the expansion of gas service to the town of Newberry.

Finally, let's not forget that GRU will still need to navigate the financial headwinds, such as:

- Negative bond ratings based on GRU's financial leverage
- Overall increasing rate of inflation
- Additional costs of Total Rewards implementation
- GRUCOM's financial position and its potential lead role in broadband expansion
- High commercial electric rates which are not assisting with economic development
- Political pressure to approve lower rates than what GRU recommended

CONCLUSION

Virtually all the information I have shared in this paper has seen the sunshine in previous city commission meetings, been shared with previous commissions and/or been accessed by the public at meetings or through public records requests. Quite frankly, most of my recommendations were discussed in various commission meetings. What is new here is the assembly of information formatted to answer commissioners' questions prior to the start of GRU's budget season.

Let us remember John Geddes writing about seeing the moon breaking through, lighting up the path before us and not Yogi Berra, who infamously said, "When you come to a fork in the road, take it."

I hope this paper is helpful as each one of you prepares for our next meeting on February 28, in which we discuss GRU's sustainability issues at a special commission meeting.