

November 1, 2006
GM 06-224

BOARD OF DIRECTORS

2007 BUDGET

Dear Board Members:

We are pleased to present you with the District's 2007 Budget. The Budget provides funding to meet all of the Board's strategic targets within current rates. The Budget does not include funding for Yolo annexation, should the voters approve it on November 7. A supplemental budget will be developed and submitted for your approval in that event.

The District's primary financial target, set by the Board three years ago, is to increase net assets by \$300 million to reach an equity level of 20 percent by the end of 2007. The target is tied to the strategic goal (SD-3) of maintaining access to credit markets, which is key to funding resource planning, commodity hedging and infrastructure replacement programs and strategies in the future. The 2007 Budget will increase net assets by \$46.7 million to reach a projected equity level of 20.2 percent by the end of 2007. It will also produce cash flow sufficient to achieve a 1.35 times debt service coverage level, which is within the range of 1.3 to 1.5 times established by the Board as the new SD-3 financial metric starting in 2008.

The projected financial performance for 2007 is based on minimal increases in the base Operations & Maintenance (O&M) budgets in 2007, and energy supply commodity costs that are the same as 2006 on an average cost basis. This reflects the District's gas procurement program and gas and energy hedging strategies, high availability of Cosumnes and other generating plants, and resource optimization program. If our natural gas requirements for 2007 were to be procured at today's prices, the budget for natural gas would be \$77 million higher.

The largest budget exposure for 2007 continues to be the effect of a dry water year on hydroelectric generation and Western Area Power Administration (WAPA) Central Valley Project contract energy deliveries. The District's hedging program limits financial exposure on our hydro to the first 10 inches of below average rainfall. Although we are not able to hedge our WAPA contract, staff will present strategies to partially offset this

exposure using the Rate Stabilization Fund. After the proposed transfer back to the Fund of \$12 million from the PG&E refund received in 2006, the amount available in the Fund reserved for energy supply contingencies will have increased by \$19 million in 2006.

The Business Units have continued to make process improvements and achieve operating efficiencies in operations, and this enabled them to meet preestablished targets for the O&M and Capital budgets. The 2007 Budget for base O&M costs is lower than 2006 on a cost-per-customer basis, yet provides funding to meet reliability, customer relations and other operational targets. The 2007 ongoing capital expenditure budget is also lower than 2006, yet provides increased funding for aging infrastructure replacements and upgrades.

The 2007 Budget features an increase of \$5.2 million in funding for programs and initiatives to further enhance the District's leadership position in energy efficiency, renewable generation, load management, advanced metering, zero energy homes and research and development into advanced technologies and greenhouse gas reductions. The State passed legislation covering many of these areas in 2006 and is in the process of developing implementing regulations. We do not anticipate any significant budget changes will be required in 2007 to meet the State's requirements beyond the funding included in this proposed budget. Future year budgets may be impacted, however. Staff will also be supporting the Board's strategic discussions on the "Compact with the Customer" and Integrated Resource Planning, and we have proposed reserve funds of \$6.4 million in the Budget plus \$800,000 of Public Good rollover funds to implement new energy efficiency, demand-side management and solar programs and initiatives that may emerge from these processes.

Highlights of the 2007 proposed budget include:

- Begin construction of 63 MW Solano Wind expansion
- Completion and operation of the Backup Control Center
- Construct PV-powered Hydrogen Refueling Station
- Increased funding for Zero Energy Homes, PV and energy efficiency
- Higher customer participation in low income programs and Greenergy
- Expanded Spanish language and internet service options for customers
- Construction of Douglas bulk substation and environmental work for O'Banion-Elverta transmission line
- Increase in cable replacement quantity
- Implement new 2-Way Radio System and wireless infrastructure
- Install 170,000 electronic meters
- \$17 million contribution to begin funding a trust fund to support the District's projected long-term liability for retiree health benefits

In the following sections, we provide detail on the specific initiatives and programs funded in the 2007 Budget that align with the Board's core and key values and strategic directives. We have also laid out the targets and milestones that are the desired outcomes we will strive for in implementing the 2007 Budget.

COMPETITIVE RATES (SD-2) and ACCESS TO CREDIT MARKETS (SD-3)

The District's 2007 budgeted increase in net assets, cash flow and debt service coverage have been maintained at 2006 Budget levels through cost containment in commodity costs and base O&M expenses. Customer load and revenue growth of 3 percent funded increases in commodity costs to serve new load and a \$17 million annual funding contribution to a new trust fund for the District's projected future liability for retiree health benefits.

Average commodity costs are level with 2006 due to effectively hedging our natural gas requirements against market price fluctuations. The average portfolio cost of gas for 2007 is \$5.36/Mmbtu, 6 percent less than 2006 and \$2.40 less than current market prices. However, many of these contracts expire by the end of March 2008. Gas prices in 2008 and 2009 are approximately \$2.75 and \$2.50 higher than the budgeted 2007 average cost, well above the level supported by current District revenues. We are currently exploring prepayment and long-term contract opportunities that will add to our long-term portfolio at less than these short-term market prices. The addition of the 500 MW Cosumnes Power Plant in 2006 has allowed us to replace expiring long-term power contracts and meet our customer load obligations, but our gas purchases and commodity budget gas exposure will increase as a result.

The 2007 non-commodity O&M budget is \$35 million higher than 2006, but virtually all of the increase is for commencing annual funding for projected future retiree health care and one-time increases such as thermal plant overhauls, project-related legal costs and renewable project funding. Other than these increases, base O&M cost-per-customer in 2007 is lower than 2006. Cost increases for contractual cost-of-living increases were offset by savings in meter reading costs and the current portion of retiree health premiums, and the Business Units achieved reductions in non-labor costs without affecting work or service levels. In spite of 2 percent customer growth, staffing was reduced by 15 positions reflecting the wind-down of Cosumnes construction and phased reductions in Rancho Seco decommissioning requirements.

RELIABILITY (SD-4)

RELIABLE LONG-TERM ENERGY SUPPLY

The severe heat storm of July 2006 was a real stress test of the District's load serving capability and transmission system reliability. The commissioning of the Cosumnes project allowed the District to cover the 10 percent growth in peak load from this extreme event. After reviewing system performance, Energy Operations is stepping up its inspection and maintenance programs for 2007, accelerating its capital replacement and upgrade program, particularly in transmission substations, and undertaking a comprehensive evaluation of transmission infrastructure to update its long-term capital replacement plan.

The planning focus in 2007 will be on continuing implementation of Integrated Resource Planning, evaluating generation, transmission, energy efficiency and peak load management options for the near- and long-term. This process will evaluate integrated strategies for effectiveness in not just meeting resource adequacy and load serving capability in various scenarios, but also integrating with anticipated new State regulations governing energy efficiency, renewable generation and greenhouse gas reductions. It will also integrate with the Board's Compact with the Customer discussions to identify load management tools for customers to use in managing their energy usage and contributing to peak load and greenhouse gas reductions. We have included reserve funds in the Budget for implementation of new Compact with the Customer pilot programs, such as advanced metering options and zero energy homes.

The 2007 Budget contains full funding for the District's existing load management programs, and will fund 18.5 MW of load reduction through customer energy efficiency and PV programs. The Budget also funds environmental work on the O'Banion-Elverta transmission line in the North County, a joint project with WAPA that is required for long-term load serving capability, and \$2 million for local projects to further enhance local reliability.

DISTRIBUTION SYSTEM RELIABILITY

The 2006 heat storm also stressed components of the District's distribution system, although we are experiencing only a slight degradation in outage frequency and duration as a result. The increased emphasis on inspections, maintenance and cable and pole replacement in previous years, and the implementation of new technology systems such as GIS and outage management, contributed to these results. The 2007 Budget continues to fund all critical system reliability programs. Funds are being shifted to cable replacement to respond to an increase in cable failures, from pole replacement as the backlog has now been cleared.

In addition to cable and pole replacement and new residential and commercial hookups, construction activity in 2007 will focus on completion of the Douglas bulk substation and several unit substations. Some of these projects, totaling approximately \$10 million, are being carried over from the 2006 Budget due to land acquisition delays. Several 4kV substations in the older part of Sacramento will be upgraded or retired, as this program nears expected completion in 2008.

Distribution is also performing a comprehensive review of systems and components using data from its new GIS and Outage Management systems. This review will serve two purposes: develop a long-term infrastructure replacement plan, and fine-tune system design practices to incorporate new technologies, increase operating efficiencies and reduce losses, and reduce capital and maintenance lifecycle costs.

Distribution has made great strides in recent years addressing its ageing workforce issues. Working closely with Human Resources, it has fully staffed apprentice programs and hired new journey-level employees in critical classifications. This will insure a full complement of trained, journey-level workers to carry out the ambitious workplans.

EMERGENCY PREPAREDNESS

The District is further strengthening its emergency preparedness and response capability in 2007 with completion of the Backup Control Center and 2-Way Radio projects. We are also making good progress in implementing security upgrades at critical facilities, moving towards enterprise risk planning, and working closely with local agencies in developing and implementing coordinated disaster response plans and exercises. 2007 planning exercises will focus on flooding scenarios.

CUSTOMER RELATIONS (SD-5)

The District improved on both its JD Power customer satisfaction rating and our internal customer contact survey ratings in 2006, and the 2007 Budget provides funds and resources to continue our customer service position in the industry.

Internally, we are continuing to expand the services, information and language options available to customers through the contact center, key account services, and our website, as well as the timeliness and ease-of-use of customer transaction processes. Customer visits to our website and transactions completed there are increasing rapidly. We are also expanding our customer outreach efforts utilizing a variety of media, including our own employees through the Ambassador program. These efforts will raise customer awareness and participation in programs such as low income assistance, Greenergy, Home Power and energy efficiency. We have added \$350,000 for market assessment and outreach for solar programs in connection with the California Solar Initiative.

2007 is the first year of our three-year program to install new electronic meters at all customer locations. The meters will enable automatic meter reading and save \$2.9 million in meter reading costs in 2007, through normal position attrition. Business Technology will be installing new wireless communication infrastructure in connection with the project, and this technology will enable other future handheld device applications for field services, distribution and other processes. They will also begin work on a new Meter Data Management System that will be required for future advanced metering applications. We have also included \$2.2 million in the Capital reserve for pilot programs involving other advanced metering technologies in 2007. These technologies will be an integral part of the Customer Compact strategy to give customers tools for managing energy usage and reducing peak load requirements.

2007 will be a transition year for the District's energy efficiency and solar program offerings to customers. We are funding energy efficiency at \$21.7 million, a \$1.6 million increase over 2006 to offer additional commercial lighting rebates. We are increasing low income funding from \$18.9 million in 2006 to \$20.5 million in 2007, primarily because outreach efforts are increasing the number of participating customers. For PV retrofit activities, the budget of \$2.6 million is \$900,000 higher than 2006 due to more commercial retrofit activity and subsidies to convert decommissioned PV1 installations to PV2. For both energy efficiency and solar, we will be doing market assessments of existing and new potential programs, both for the Board's Customer Compact strategy discussions and to begin to comply with new State mandates passed in 2006.

Recognizing that its employees are its greatest asset in satisfying customers, the Customer Business Unit has been aggressively implementing the diversity initiative and expanding its ability to communicate with and serve the diverse local community. Customer and Business Technology are also implementing a pilot technology-supported "work at home" program that will provide greater coverage and faster service during peak hours.

SAFETY (SD-6)

2007 is the final year of the District's effort to reduce safety incident rates by 50 percent over 5 years. Although we have not always met all of these aggressive targets, incident rates have shown steady declines over that period. The Business Units are funding a variety of District-wide or individualized safety programs focused on defensive driving, development of safe work practices, and safety observations. Staff will be presenting recommended metrics and targets for 2008 and beyond.

ENVIRONMENTAL PROTECTION (SD-7)

There are several initiatives and programs in the 2007 Budget that reflect the District's ongoing commitment to environmental stewardship and advancing environmental technologies:

- Begin construction of Solano Wind 63 MW expansion
- Residential and commercial PV retrofit programs and PV1 to PV2 conversion
- Developing Greenhouse Gas Action Plan and participate in California Climate Action Registry
- Achieve Leadership in Energy and Environmental Design (LEED) certification for Customer Service Center
- Achieve interim renewable goal of 12 percent; continuing to evaluate and negotiate renewable proposals from RPS solicitation
- 38,120 customers in Greenergy Programs
- Increased funding for energy efficiency programs and higher pollutant reduction target
- Construct PV-powered hydrogen refueling station
- Support for additional dairy biomass projects
- Increase in Zero Energy Home program funding
- RideSharing program with 30 percent employee participation
- Recycling 50 percent of non-hazardous waste
- Adding flexible fuel vehicles to District fleet
- Purchase low-emission diesel engine heavy vehicles and continue to replace all diesel vehicles in fleet
- Follow Environmental Procurement Policy and implement environmentally-friendly construction practices

We will be working closely with the State as they develop regulations for the greenhouse gas reduction and renewable standards legislation passed this year. We are also continuing to work closely with the CEC on administering ReGen projects (we are administering \$800,000 in grants in 2007), and we are investigating a number of potential biomass and wind projects for possible future development.

EMPLOYEE RELATIONS (SD-8)

One of the most important issues facing the District is managing the wave of baby-boomer retirements. The District has addressed this issue by expanding and fully staffing apprentice programs in critical skills areas, providing employee development and leadership training programs for continuity planning, and implementing a diversity program to insure that the District has the human resources to effectively serve the diverse local community. Each Business Unit has developed programs in these areas

adapted to their specific needs, and the success of the programs is evident in increases in employee satisfaction as measured in our annual surveys.

Human Resources and Business Technology have partnered to develop and implement several new technology applications that have greatly helped the Business Units in managing the employee recruitment and retention processes, and Technology has also worked with Media Services to expand employee communications channels.

Employee benefits and wellness is also a key component of employee recruitment, retention and satisfaction, as well as productivity in each Business Unit. The District was able to achieve a significant reduction in retiree health care costs in 2007 through a competitive bid process, and we are beginning to contribute money to a trust fund to pay retiree health benefits as required by new governmental accounting standards. We also continue to expand our wellness program offerings and to see an increase in employee participation, which should have a positive long-term benefit in terms of health care costs and employee productivity.

RESOURCE PLANNING (SD-9)

The District will be spending funds on several components of the Integrated Resource Plan in 2007. For the third year, we will be funding energy efficiency IRP programs that are cost-competitive with conventional supply resources. Total funding is \$5.5 million, an increase of \$1.7 million for additional commercial lighting rebates. We are continuing to solicit and evaluate proposals for new renewable generation and energy, to meet long-term Renewable Portfolio Standard goals of 23 percent (including Greenergy) by 2011. Construction of the 63 MW Solano Wind expansion will begin in 2007, and we are exploring sale arrangements that will allow the District to benefit from renewable energy tax incentives. For the long-term, we are evaluating a variety of options for load serving capability and peak load reduction: generation and transmission additions or upgrades, projects to increase generation plant fuel efficiency and reduce system losses, metering options, other customer tools for demand side management and energy efficiency, and distributed generation. These options will also be evaluated for their potential contribution to greenhouse gas reductions and other State mandates.

RESEARCH & DEVELOPMENT (SD-10)

The District is budgeting \$5.3 million for R&D activities in 2007, an increase of \$800,000 over 2006. Areas with promising new technologies that we are focusing on include: energy efficiency and demand-side reduction, anaerobic and digester gas generation, photovoltaic and other distributed generation, plug-in hybrid vehicles, hydrogen vehicles and zero energy homes. Evaluating the commercial potential of these new technologies will be a central part of the Compact with the Customer discussions, and will also factor into the District's long-term greenhouse gas reduction strategy.

ECONOMIC DEVELOPMENT (SD-13)

Our economic development activities for 2007 will focus on promoting business opportunities for local companies through our SEED program to achieve the Board's 20 percent participation goal, tie-in to energy efficiency and PV programs and promoting business incubators, working with local governments to implement the Partnership for Prosperity initiative, and working directly with local developers on upcoming projects. On the commercial side, we have budgeted funds for work on the Railyards project, which we hope will serve as a model for future development. We will attempt to link business development and jobs growth to installation of renewable or distributed generation, energy efficiency and load management that will achieve environmental, peak reduction and greenhouse gas reduction goals and also make good business sense for developers. We will be working with local governments as well to incorporate these features into residential development standards.

SYSTEM ENHANCEMENT (SD-14)

We have planned one project in the 2007 Budget, the Citrus Heights/Auburn Boulevard Utility Undergrounding Project, estimated at \$1.2 million. We will be actively working with other jurisdictions that have proposed projects to help them meet established qualification criteria, and we are proposing to include \$3.8 million in the Capital reserve for additional projects that may qualify.

OUTREACH & COMMUNICATIONS (SD-15)

We will be implementing this new directive in 2007 based on the results of surveys that are currently underway, and we have added \$250,000 to the Budget for additional efforts in 2007. Our efforts will focus on raising awareness of District programs and services and providing information that is valuable to our customers in utilizing these programs. We have also added \$350,000 for outreach efforts related to existing and potential new customer solar programs under State bill SB-1.

BUDGET SUMMARY

The 2007 Budget totals \$1.36 billion, an increase of \$90.0 million or 7.1 percent over the 2006 Budget. The O&M Budget for 2007 totals \$911.1 million, which is \$62.5 million or 7.4 percent higher than the 2006 Budget. The Commodity budget for 2007 of \$510.6 million is \$21.2 million or 4.3 percent higher than 2006, due to a 4 percent increase in total energy requirements to serve customer load. The Public Good Budget is increasing \$6.7 million or 14.6 percent due to funding for the PV-powered Hydrogen Refueling Station, higher funding for commercial lighting rebates, higher customer participation in the low-income assistance program, and funds for PV1 to PV2 conversions. The Other O&M Budget, excluding reserves, is increasing \$29.8 million due to \$17.0 million for funding of the District's retiree health care obligation, a \$6 million increase in thermal plant overhaul costs, and a \$5.9 million increase in project-related legal costs. The O&M Budget also includes a reserve of \$6.4 million for implementation of new energy efficiency/load management (LEEDERS) and solar (SB-1) programs in 2007. The Debt Service component of the 2007 Budget totals \$176.8 million, an increase of \$6.7 million or 3.9 percent over 2006. This increase is due to higher scheduled bond principal repayments in 2007. The Capital and Net Loan Budget for 2007 is \$272.3 million, an increase of \$20.8 million or 8.3 percent over 2006. \$11.0 million of this increase is to fund a reserve for distribution system undergrounding, advanced metering pilot, and 2006 carryover. The remaining increase is attributable to the electronic meter installation project and an increase in the nuclear dismantling budget. Detail of changes in each of the Budget components is provided in the attachment to this letter.

FINANCIAL ASSUMPTIONS AND TARGETS

The 2007 budgeted increase in net assets (net income) target, based on current retail rates, is \$47.6 million, which is slightly less than the 2006 target. Customer revenues projected for 2007 are approximately \$32.1 million higher than 2006. The increase is due to customer growth and higher average usage per customer. We are also assuming a transfer of \$6.7 million from surplus 2006 revenues set aside in the Rate Stabilization Fund, to cover costs added to the 2007 Budget for new IRP, LEEDERS and SB-1 solar programs. Interest income is increasing \$7 million from higher interest rates, and depreciation is going down \$4 million as technology assets have been fully depreciated. Budgeted commodity costs for 2007 are \$20.0 million higher than the 2006 Budget for purchases to serve the increased load. O&M costs in 2007 are also increasing by \$29.8 million due to retiree health care funding and one-time increase in overhaul and litigation costs. The District's Public Good funding is increasing \$6.7 million in 2007 due to higher low income and medical discounts, construction of the PV-powered hydrogen refueling station, additional energy efficiency funding for lighting rebates, and funding for decommissioned PV1 systems to PV2.

The fixed charge coverage ratio measures the extent to which budgeted operating cash flow exceeds budgeted debt service, including interest expense and principal repayments on the District's outstanding debt, the JPA debt and SMUD's share of TANC/COTP debt. The fixed charge coverage ratio target for 2007 is 1.35 times, which is slightly lower than the 1.45 in the 2006 budget. The decrease is due to higher scheduled debt principal repayments in 2007. The budget assumes a median rainfall year for both District hydroelectric generation and WAPA contract energy deliveries, and average temperatures for customer sales. In the event of a dry year either for the District, WAPA or in the Northwest, or other contingencies that could affect commodity costs or customer revenues, our risk management strategy is to insure with 95 percent certainty that parity bond coverage will remain above 1.5 times. The budgeted parity bond coverage for 2007 is 2.10 times, and the estimated contingency from a dry year and higher natural gas prices is \$40 million. If cash available for debt service were reduced \$40 million in 2007, the parity bond coverage would be 1.80 times.

Projected financial results for 2006 are for net income of approximately \$140 million, versus the budget target of \$49.1 million. The projection includes the transfer of \$7 million to the Rate Stabilization Fund for a wet year per the Budget Resolution, and the proposed transfers to the Fund of \$12 million for the PG&E refund, \$6.7 million to cover new IRP, LEEDERS and Solar (SB-1) costs in the 2007 Budget, and \$6.4 million as a reserve for implementation of additional new energy efficiency (LEEDERS) and solar (SB-1) programs in 2007. Customer revenues are expected to be \$40-45 million over budget in 2006 due to hotter summer temperatures, and commodity costs are projected to be approximately \$58.0 million under budget from the wet hydro year. O&M and depreciation costs will be under budget, and interest and other income will be significantly higher than budget due to higher rates and cash balances.

LONG-RANGE BUSINESS FORECAST

Having reached our primary strategic financial target of 20 percent equity by the end of 2007, our target for 2008 and beyond is to maintain debt service coverage for SMUD, the JPAs and TANC/COTP within a range of 1.3 to 1.5 times. With our current cost structure, this debt service target will provide adequate cash flow to fund anticipated capital expenditures and resource additions, maintain an equity structure in line with other “A” rated municipal utilities, and help insure continued access to capital and credit markets as needed in the strategic plan.

Looking ahead to 2008, we have increased exposure to market prices of natural gas and there are several areas where other costs may also increase in the future. These include: tightening Western power markets and increasing market prices for capacity, energy and renewable resources, expiring long-term energy contracts, the effect of potential hydro relicensing operating constraints and costs, increasing regional transmission fees from the California ISO, State mandates relating to energy efficiency investment and incentives, renewable energy, solar, GHG emission requirements for new long-term power contracts and greenhouse gas reductions, other legislative or regulatory actions, and capital requirements for aging infrastructure. We will analyze the impact of these variables on 2008 and beyond and report to you early next year the likely impacts on the District’s finances and future budgets. Staff is making every effort to mitigate cost increases in controllable costs wherever possible. We continue to set three-year O&M and ongoing Capital targets that limit non-commodity, non-regulatory O&M increases to the rate of customer growth, and we prioritize capital projects through a formal process in terms of their strategic value to the District and its customers.

Respectfully submitted,

JAN SCHORI
GENERAL MANAGER

2007 OPERATIONS & MAINTENANCE BUDGET

	\$ Millions		
	<u>2006 Budget</u>	<u>2006 Forecast</u>	<u>2007 Budget</u>
Commodity Expenses (1)	\$489.4	\$431.7	\$510.6
Other Operating Expenses	258.1	270.6	277.3
Decommissioning Funding	27.0	27.0	27.0
Retiree Health Funding	0.0	0.0	17.0
JPA Interest Expense	27.9	24.4	26.2
Public Good Expenses	<u>46.2</u>	<u>45.4</u>	<u>53.0</u>
TOTAL	<u>\$848.6</u>	<u>\$799.1</u>	<u>\$911.1</u>

The 2007 Budget for Operations & Maintenance (O&M) expense totals \$909.8 million - \$509.4 million for energy supply commodity costs, \$53.0 million for public good programs, \$277.3 million for O&M activities, \$27.0 million for decommissioning funding, \$17.0 million for the trust fund for retiree health premium funding (new in 2007), and \$26.2 million for JPA interest expense. The 2007 O&M Budget is \$61.2 million or 7.2 percent higher than the 2006 Budget.

The 2007 Commodity Budget of \$510.6 million is \$21.2 million or 4.3 percent higher than the 2006 Budget due to additional purchases or generation to supply higher customer load. Purchased power costs in the 2007 Commodity budget total \$182.1 million, which is \$1.1 million or .6 percent lower than 2006. We are buying less long-term contract energy in 2007 due to expiration of contracts, but we also have significantly less surplus sales. Natural gas commodity costs, including depletion and interest on Rosa reserves, are \$311.9 million, an increase of \$22.5 million over 2006. Generation at our thermal plants is 12 percent higher in 2007 because of higher customer load and less long-term contract energy.

The 2007 Budget for other operations and maintenance (O&M) expenses totals \$277.3 million, which is \$19.2 million or 7.4 percent higher than the 2006 Budget. This line item covers core business operations of the Distribution, Customer, and Energy Supply

Business Units, including O&M for the three cogeneration plants and Cosumnes, supporting costs of Technology and Internal Services, Corporate Services and Insurance. Energy Supply O&M costs in 2007 total \$97.4 million, which is \$12.1 million or 14.2 percent higher than 2006. This increase is due to higher costs of \$5.0 million for thermal plant overhauls, \$6.4 million in legal expenses, \$.5 million for higher O&M costs at Solano Wind from the 24 MW expansion, and \$1.5 million for increased water rights cost and regulatory fees. The budget for Distribution O&M increases \$1.4 million or 2.3 percent over 2006. Labor costs increased due to contractual cost-of-living increases and increases negotiated in the new IBEW contract, but Distribution was able to reduce non-labor costs due to efficiencies in maintenance work. Customer Business Unit O&M, net of revenues, is \$1.5million or 2.3 percent lower in the 2007 Budget. Meter reading costs are decreasing \$2.9 million as new electronic meters are installed, and labor costs are up 3 percent from contractual cost-of-living increases. The 2007 O&M Budgets for Corporate Services, Technology and Internal Services are in total approximately \$.4 million or 2.7 percent lower than 2006, due to lower technology –related costs associated with Human Resources systems. The budgets for Internal Services and Technology are allocated to the core business units based on their usage of the services provided, so this increase is a part of the overall variance in the core business unit budgets. These budgets increased 2-3 percent in 2007 over 2006 from labor cost increases.

The 2007 Budget commitment for Public Good programs is \$53.0 million, which is an increase of \$6.7 million or 14.5 percent over the 2006 Budget. \$1.5 million of the increase is in low income and medical rate assistance and administration, as a result of a projected 10 percent increase in the number of participating customers. Energy efficiency spending is up \$1.6 million or 7.9 percent, due to a \$1 million increase in commercial lighting rebates, \$.5 million for Savings by Design, and funds for the Railyard project. Research and development and renewable generation programs are increasing approximately \$3.5 million, with additional funding for the PV-powered Hydrogen Refueling Station, PV1 to PV2 conversions, Zero Energy Homes, LEEDERS–related costs and new renewable initiatives in 2007.

Energy efficiency funding for 2007 is \$21.7 million, an increase of \$1.6 million over the 2006 Budget. The budget for rebates and incentives for installing energy efficiency measures is increasing \$1.4 million to meet higher customer demand for popular cost-effective programs such as commercial lighting. This will result in higher levels of peak and energy savings from Public Good spending next year. There is also \$5.9 million included in the O&M Reserve for implementation of new energy efficiency programs in connection with LEEDERS and the Customer Compact. With this additional money, energy efficiency spending would increase \$7.5 million or 37 percent. Energy efficiency programs are aided by the District’s energy efficiency loan program, which is funded for \$31.6 million in new loans in 2007. Funding for renewable generation, electric transportation, customer advanced technology, and renewable generation R&D is 47.8 percent higher at \$10.7 million in the 2007 Budget. The District has been at the forefront of renewable energy development and technology advancement for the last decade, and

the 2007 Budget funding will enable us to continue this leadership role. Besides the District funding for technology R&D, the District is managing \$850,000 million in California Energy Commission grants in 2007.

2007 DEBT SERVICE BUDGET

	<u>\$ Millions</u>		
	<u>2006 Budget</u>	<u>2006 Forecast</u>	<u>2007 Budget</u>
Interest Expense	\$106.2	\$107.4	\$102.4
Charged to JPAs	(11.1)	(11.1)	(11.1)
Principal Repayments	74.7	74.7	85.2
Trustee Fees & Issuance Costs	<u>0.3</u>	<u>0.3</u>	<u>0.3</u>
TOTAL	<u>\$170.1</u>	<u>\$171.3</u>	<u>\$176.8</u>

The 2007 Budget for debt service totals \$176.8 million, an increase of \$6.7 million over the 2006 Budget. This increase is primarily due to a higher level of scheduled revenue bond principal repayments in 2007.

Interest expense represents accrued interest on revenue bonds and commercial paper, net of any related swap revenue, and amortization of deferred debt issuance costs and refunding gains and losses. The credit for interest costs charged to the JPAs represents the portion of the interest expense on the District's investments in the PG&E Line 301/400 pipeline, the local gas pipeline (including Cosumnes extension) and the Rosa natural gas reserves which is allocated to the cogeneration plants for fuel delivery and included in the JPA budgets under fuel commodity. Principal repayments represent scheduled repayment of revenue bonds and commercial paper notes.

The 2007 Budget does not include any early debt retirement or issuance of commercial paper notes or revenue bonds. The unrestricted cash balance at the end of 2006 is sufficient to carry us through 2007 and remain well above the \$75 million minimum balance.

Interest expense is decreasing from the 2006 to 2007 Budget due to no new debt issued in 2007.

2007 CAPITAL INVESTMENT BUDGET

	\$ Millions		
	<u>2006 Budget</u>	<u>2006 Forecast</u>	<u>2007 Budget</u>
<u>ONGOING CAPITAL</u>			
Energy Supply	\$ 29.0	\$ 35.0	\$30.9
Distribution	78.8	66.3	80.0
Customer	10.0	10.4	4.8
Technology	21.2	15.7	22.7
Internal Services	19.9	18.1	18.5
Corporate Services	<u>0</u>	<u>0</u>	<u>0</u>
TOTAL ONGOING	<u>\$158.9</u>	<u>\$145.5</u>	<u>\$156.9</u>
DECOMMISSIONING	<u>29.9</u>	<u>24.9</u>	<u>43.9</u>
AUTOMATIC METERING	<u>0.0</u>	<u>0.0</u>	<u>14.0</u>
<u>RESOURCE CAPITAL</u>			
Cosumnes Power Plant	16.3	16.3	0.0
Solano Wind Project	23.3	33.9	29.1
O'Banion-Elverta Transmission	5.2	1.0	3.0
Rosa Gas Reserves	<u>14.1</u>	<u>12.1</u>	<u>6.9</u>
SUBTOTAL	<u>\$247.7</u>	<u>\$233.7</u>	<u>\$253.7</u>
CAPITAL RESERVE	<u>0.0</u>	<u>0.0</u>	<u>11.0</u>
TOTAL CAPITAL	<u>\$247.7</u>	<u>\$233.7</u>	<u>\$264.7</u>
Net Loans	<u>\$3.8</u>	<u>\$5.3</u>	<u>\$ 7.6</u>
TOTAL CAPITAL AND LOANS	<u>\$251.5</u>	<u>\$239.0</u>	<u>\$272.3</u>

The 2007 capital investment and loan budget of \$272.3 million provides the funds to continue investing in electric system improvements necessary to serve a rapidly increasing customer base, to continue replacing and upgrading aging infrastructure, to increase the amount and efficiency of local generation capability, and to implement technology improvements recommended by reengineering projects.

The \$20.8 million increase in the capital and loan budget over 2006 is due to higher expenditures on decommissioning and Solano Wind and the first year of the Automatic Metering project.

Energy Supply Capital Investment programs focus on capital improvements and additions to the District's generation, transmission, fuel supply and bulk power system control assets, which are the responsibility of the Energy Supply business unit. Also under this category are costs related to the Rancho Seco dismantlement projects, which are reimbursable from the decommissioning trust fund. Total energy supply capital expenditures in the 2007 Budget are \$113.8 million; of this total, \$30.9 million is for ongoing capital projects, which is an increase of \$1.9 million over 2006. \$39.0 million of the 2007 Budget relates to the 63 MW expansion at Solano Wind, additional drilling costs at Rosa reserves and the O'Banion-Elverta-Natomas Transmission Line. Solano milestones include substantial completion of construction of the 61 MW expansion leading to an on-line date of May 1, 2008. The O'Banion project is a joint project with WAPA and 2007 activities will focus on environmental work. The Rosa capital expenditures will expand the capacity of available reserves. \$43.9 million of the Energy Supply capital budget is for Rancho Seco nuclear dismantling activities, which will be complete by the end of 2008.

Planned capital additions and improvements to existing SMUD generation assets in 2007 total \$11.0 million, which is a \$.2 million increase over 2006. The level of expenditures on UARP upgrade and capacity expansion projects - \$5.6 million - is \$.6 million higher than 2006. The UARP Relicensing Project budget is increasing to \$3.4 million. Transmission and energy management systems reliability projects total \$14.3 million in the 2007 Budget, a \$1.7 million increase over 2006. The increase is due to additional transmission substation capital work. Decommissioning capital is increasing from \$29.9 million in 2006 to \$43.9 million in the 2007 Budget because of more expensive work in the 2007 plan.

Distribution represents capital improvements and investment in the energy delivery infrastructure, such as overhead and underground lines and substations, that delivers electricity to our customers. Proposed capital investment for 2007 is \$79.9 million, an increase of \$1.1 million over 2006. These projects fall into two categories: new service connections, and asset management or reliability-related improvements. The new service segment decreases from \$31.6 million to \$30.4 million in 2007. New customer hookups

is projected to decline slightly in 2007, as are special facilities and local agency work. The asset management or reliability segment budget for 2007 is \$49.0 million, which is \$2.2 million higher than 2006. The increase is due to the carryover of several substation projects from 2006. The cable replacement target for 2007 is higher than 2006 at 250,000 feet, and pole replacement is declining because the backlog has been cleared.

Customer business unit capital expenditures are for improvements to equipment and systems that are used to provide service to customers, such as the Contact Center telephone system and the SAP Customer Care System, and for metering equipment for new customers and programs. The budget for 2007 is increasing from \$10.0 million to \$18.8 million due to higher meter acquisition costs for new ERT meters.

Technology business unit capital projects are for additions or improvements to the District's computer network, including hardware and operating software, SAP/SDIT enterprise software system, desktop and laptop PCs, and telecommunications and telephone system infrastructure. The Technology capital budget for 2007 totals \$22.7 million, an increase of \$1.5 million from 2006. The Two-Way Radio System replacement project totaling \$5.0 million is being carried over from 2006 to 2007.

Internal Service business unit capital investments in the 2007 Budget total \$18.5 million, a decrease of \$1.5 million from 2006. This category includes vehicles, facilities and office and general equipment. Vehicle purchases are increasing \$3.1 million due to purchasing additional new diesel trucks to meet clean air goals. Facilities capital is decreasing because the tool building project was completed in 2006.

Net Loans are budgeted for a net increase in outstanding loans of \$7.6 million in the 2007 Budget, slightly higher than the 2006 Budget of \$3.8 million. This budget segment covers loans to customers for energy efficiency improvements, economic development, and PV Pioneer participants. New loan funding is \$31.6 million, which is the same level as 2006. Repayment of existing loans is budgeted at \$24.0 million, a decrease of \$3.8 million to reflect less refinancing activity in 2006 and 2007.