TO: HONORABLE CITY COUNCIL

ATTN: FINANCE COMMITTEE

FROM: CITY MANAGER DEPARTMENT: UTILITIES

DATE: JANUARY 17, 2007 CMR:106:07


RECOMMENDATION

Staff recommends that Council approve the following:

1. Authorize the City Manager to negotiate and sign new, amended, or restated NAESB contracts with the following suppliers:
   a. ConocoPhillips Company;
   b. Coral Energy Resources, L.P.;
   c. Sempra Energy Trading Corporation;
   d. BP Energy Company;
   e. JP Morgan Ventures Energy Corporation; and
   f. Powerex Corporation

2. Authorize the City Manager or his designee, the Director of Utilities, to execute multiple transactions under the Master Agreements with one or more of the above suppliers to procure natural gas supplies sufficient to meet the City’s forecasted natural gas load, with the date for delivery of the gas for each transaction not to exceed 36 months from the date the transaction is executed. The delivery date for any transaction will not extend beyond December 2022, and the maximum aggregate transaction limit under each Master Agreement shall be $65 million.
BACKGROUND
Prior to July 2001, the City contracted with a single supplier to supply the entire natural gas load of the City over the period of the agreement. This approach had the merits of operational ease and lower overhead for the City. However, the City had only one supplier with whom to fix the price of a portion of the gas supply. This gas purchasing approach did not provide sufficient incentive to the sole supplier, once selected, to provide the best prices for gas supplies that the City wanted to buy at a fixed price. In addition, the sole supplier approach did not provide the City any credit risk diversity.

The City’s Natural Gas Procurement Plan is designed to meet Palo Alto’s gas loads at low and stable retail rates calls for procuring gas supplies in a diversified, systematic fashion over a rolling 3-year period [CMR:196:01]. To implement the “laddering strategy” and to facilitate obtaining price quotes from each supplier each time the City decided to procure gas, the City sought to establish Master Agreements with multiple suppliers, awarding each specific transaction to the qualified supplier offering the best price. This approach was implemented to meet the City’s credit diversification and cost stabilization risk management strategies. The City currently procures natural gas supplies from four suppliers (BP Energy, Coral Energy, ConocoPhillips and Sempra) under Master Agreements that were approved by Council in 2003 [Ordinance #4810]. An additional Master Agreement with Duke Energy Marketing, LLC was approved in 2003 but that counterparty has since exited the Western energy markets and is, therefore, no longer transacting with the City.

The July 2002 Assessment of Utility Risk Management Procedures by the City Auditor made recommendations to improve the City of Palo Alto Utilities’ (CPAU) energy procurement process. The Auditor’s report recommended that Master Agreements with suppliers be approved by the Council with clearly defined dollar, volume and duration limits and with clear definition of the types of transactions staff is authorized to execute under the agreements (recommendation #4). The Auditor’s report also recommended that the process of securing Master Agreements be undertaken in an open and competitive manner (recommendation #6).

DISCUSSION
The current Master Agreements were approved by Council for transactions with delivery no later than December 31, 2009. Given the City’s 36-month laddering strategy, it is now necessary to make purchases beyond that time horizon. In addition, the exit of Duke Energy Marketing, LLC increased the need for additional counterparties to ensure competitive pricing and diversifying purchases across multiple creditworthy suppliers. To that end, an RFP was issued in June 2006 to solicit interest from suppliers to sign Master Agreements with the City to enable future procurement of natural gas supplies required to meet the City’s natural gas needs. The supplier selection process for the RFP is provided in Attachment A. The six proposed Master Agreements were negotiated
under terms and conditions acceptable to the City. The Master Agreements with Coral and Sempra approved under Ordinance 4810 remain valid and do not require re-execution at this time. Due to the size of each agreement, staff has elected not to attach copies to this CMR in an effort to save paper. However, the Master Agreements are available for review in the Office of the City Clerk.

Description of a Master Agreement
The proposed Master Agreements are based on the 2002 North American Energy Standards Board, Inc. (NAESB) Standard 6.3.1 dated April 19, 2002. A Master Agreement is similar but not identical to a blanket purchase order. A Master Agreement details all of the contractual terms that govern transactions that are completed under the Master Agreements. The Master Agreement consists of a Base Contract, Special Provisions, and a Credit Support Addendum. Executing a Master Agreement does not commit the City to any transaction. Each transaction for part of the City’s monthly, annual, or multi-year gas requirements is completed through subsequent competitive bidding, as evidenced by a completed Transaction Confirmation document. Executing a Master Agreement is not a promise of business by the City or by the supplier. It serves only to qualify suppliers to bid on individual transactions solicited by the City.

Each Master Agreement may be terminated at any time by either party according to the terms of the agreement. Termination of the Master Agreement cancels the supplier’s ability to bid on further transactions until a new Master Agreement is executed. Any transaction executed under the Master Agreement prior to termination will remain in place until the final gas delivery date, unless an event of default has transpired. In the event of default by a supplier, the City has the option to terminate the remaining transactions that were executed under the Master Agreement.

The City may suspend the privilege of solicitation to bid on individual transactions with any supplier due to counterparty credit limits or transaction limits, a supplier credit downgrade event, supplier default or suspected default, or where inclusion in the solicitation would not comply with law or City Policies, Guidelines, Rules and Procedures. If the number of eligible suppliers dwindles to an unacceptable level, the City reserves the right to conduct an RFP for new Master Agreements.

Staff does intend to conduct another RFP within 5 years, well before the 2022 term limit on these Master Agreements. The 2022 end date provides the City the flexibility to execute one or more long-term transactions with Council approval if the laddering strategy is revised to include longer-term purchases. If such a recommendation is made, the transaction(s) will have a specific cost limit and transaction time limit to be approved by Council at that time. That cost may be in addition to the $65 million per supplier limit in the attached Ordinance.
All transactions under the Master Agreements will be executed by staff in accordance with the Energy Risk Management Policies, Guidelines, and Procedures. These procedures are monitored by the Energy Risk Manager and the Utilities Risk Oversight and Coordination Committee. They ensure that risks inherent in the energy industry are managed prudently. Staff will provide Council an update of all executed transactions under the Master Agreements as part of energy risk management reporting.

Limits of Authorization
The proposed limits and parameters for Council’s authorization to the City Manager include the following:
1. Delegation of authority, in accordance with the Palo Alto Municipal Code, to the City Manager to purchase and, incidental to purchase, sell gas to meet the City’s retail load requirements within a 3-year period from the date the transaction is executed.
2. Requirement that all transactions are consistent with Council-approved Energy Risk Management Policies (CMR:128:06) and internal energy risk management guidelines and procedures.
3. Reporting of all transactions in excess of $65,000 to Council as part of regular reporting (per the Energy Risk Management Policies and Guidelines).
4. Authorization of transactions to be executed under Council-approved Master Agreements.
5. A maximum total dollar amount of $65 million for aggregated gas transactions for any single Master Agreement.
6. Requirement that commodity products allowed for purchase or sale incidental to purchase must be “authorized transacting products” as defined in the Council-approved Energy Risk Management Policies.

All other transactions lie outside of the authority delegated to the City Manager and will require Council approval, including:

- Any transactions with a term ending beyond 3 years from the date of transaction;
- Any transaction with volumes in excess of the limitations listed above; or
- Any transactions costing more than the limits specified above.

Additional limitations on transactions with the suppliers are imposed under internal guidelines. These internal guidelines include counterparty credit limits that limit transaction term and risk exposure depending upon the creditworthiness of the supplier. For example, the guidelines provide transaction limits in terms of annual volume, annual cost, and transaction term for each supplier. Thus, staff is constrained by these guidelines regarding transacting with each approved supplier. These guidelines act as an additional level of control beyond those that staff recommends Council impose under the Master Agreements.
Collateral
Of the six Master Agreements, five require the City to post collateral in the form of cash or a Letter of Credit as a form of collateral assurance. Such a circumstance would occur in the very rare event that the City purchases a high portion of its forward gas supply with one of the counterparties after which forward prices fall by over 50% for an extended period of time. Much of the risk of this occurrence can be managed through sound counterparty diversity practices. The other event when the City could be required to post collateral would be through a downgrade event whereby the City’s credit rating is downgraded by either Standard and Poor’s or Moody’s Investor Services. While neither of these events is likely, the obligations of the contract require that the City be prepared to offer credit collateral assurances. A separate City Manager’s Report (CMR) detailing the issues recommends a plan for implementing a credit facility for posting Letters of Credit (CMR:108:07). As will be detailed in a future companion CMR, the costs associated with developing this facility will be covered by the relevant enterprise funds.

ALTERNATIVES
Council could elect not to approve one or more of the proposed contracts. However, doing so would limit the ability of staff to competitively bid and diversify gas supplies.

Council could elect to approve the contracts with different contract limits. Lower limits would reduce the ability of staff to competitively bid and diversify gas supplies or would require staff to return to Council to increase the limits on certain Master Agreements within the terms of the Master Agreements. Staff does not recommend higher limits. Should higher limits be necessary due to unforeseen circumstances, staff believes that there would be adequate time to request a change in contract limits from Council.

RESOURCE IMPACT
Currently, natural gas can be purchased for between $7 and $9 per million British thermal units (MMBtu) for deliveries during the next several years. Since the City’s load is about 3.3 million MMBtu per year, this translates to an annual commodity cost of about $26 million. However, prices could increase dramatically as during the 2001 energy crisis. Since natural gas prices can be volatile, it is conceivable that the prices could double from current levels over the term of the Master Agreements.

The following table summarizes CPAU’s historical gas purchase costs and projected costs for the next several years as well as commitments as of November 3, 2006 with each of the four existing suppliers.

Gas Procurement Summary – Cost ($) and Volumes (MMBtus)
As shown in the chart, the expected gas commodity cost for the next several years is between $26 and $28 million/year. The cost estimates are relatively certain for the current fiscal year since a large portion of the gas has already been purchased at fixed prices. Costs for FY 07-08 and FY 08-09 are less certain than for FY 06-07 as less gas has been purchased in advance, and future gas prices could rise above expectations.

While the City has selected six suppliers to sign Master Agreements, it is conceivable that only a few suppliers may ultimately provide the most competitive prices, and some may merge or leave the industry, resulting in most transactions being concentrated among fewer qualified suppliers. Staff recommends a maximum transaction limit of $65 million for the term of each Master Agreement. This limit gives staff the flexibility it needs in case gas costs increase above expectations or if some of the suppliers are unable to continue to do business with the City or do not offer the best prices. It also sets a monetary limit on the transactions that is less than the total anticipated three-year purchase cost.

Approval of the recommendation will not impact the FY 06-07 budget. Transactions with deliveries extending beyond the approved budget horizon are contractual commitments, supported by natural gas retail revenues with retail rates determined by Council.

**POLICY IMPLICATIONS**
Authorizing the City Manager to buy and sell natural gas to meet City load under these Master Agreements conforms to existing Council-approved Energy Risk Management Policies [CMR:128:06], and are required for staff to conform to these policies.

This recommendation is consistent with the Council-approved Utilities Strategic Plan to 1) preserve a supply cost advantage compared to the market price; and 2) streamline and manage business process to allow the City of Palo Alto Utilities to work efficiently and cost-effectively.

Further, the recommendation supports the Council-approved Utilities’ Natural Gas Supply Portfolio Planning and Management Objectives and Guidelines for the Gas Utility Long-term Plan (GULP) [August 2003 CMR:355:03]. These include the following Objectives and Guidelines relevant to Master Agreements:

Objective 1: Ensure low and stable gas supply rates for pool customers
Objective 2: Provide superior financial performance to customers and to the City by managing the supply portfolio cost in a competitive manner compared to market cost and a retail supply rate advantage compared to PG&E.
Guideline 1: Market Risk Management – Manage market risk by adopting a portfolio strategy for gas supply procurement by:
   A. Diversifying energy purchases for the pool across commitment date, delivery date, duration, suppliers, pricing terms and delivery points;
   B. Maintaining a prudent exposure to changing market prices by leaving some fraction of the forecasted gas pool needs exposed to near-term market prices; and
   C. Avoiding long-term (>10 years) fixed-price commodity contracts.

ENVIRONMENTAL REVIEW

Adoption of the ordinances approving Master Agreements and delegating gas procurement to the City Manager under certain limitations does not constitute a project for the purposes of the California Environmental Quality Act.

ATTACHMENTS
A: RFP Evaluation Process
B: Ordinance of the Council of the City of Palo Alto Authorizing the City Manager to Purchase a Portion of the City’s Natural Gas Requirements from Certain Prequalified Natural Gas Suppliers Under Specified Terms and Conditions During Calendar Years 2007 through 2022, Inclusive