TO:     HONORABLE CITY COUNCIL  

ATTENTION:  FINANCE COMMITTEE  

FROM:   CITY MANAGER  DEPARTMENT: ADMINISTRATIVE SERVICES  

DATE:  JANUARY 17, 2007  CMR:108:07  

SUBJECT:  REQUEST TO ESTABLISH LETTER OF CREDIT FACILITIES TO PROVIDE COLLATERAL ASSURANCE UNDER NEW ELECTRIC AND GAS MASTER AGREEMENTS  

RECOMMENDATION  

Staff recommends that Council direct staff to establish a credit facility with Wells Fargo Bank, the City’s current banking services provider, for the sole purpose of providing credit assurance instruments for the natural gas and electricity commodity supplies. The amount of the facility recommended is $1.0 million for gas and $2.0 million for electricity. Costs associated with the establishment of the facility will be covered by the respective utility funds. 

BACKGROUND  

The new master agreements for natural gas purchases are being presented to Council under CMR:106:07. The CMR for electric purchases will be prepared shortly. These contracts differ from the existing contracts in the manner to which collateral assurance terms are applied. In previous agreements, the City was not required by the counterparties to post collateral assurance if the City maintained a superior credit rating (BBB- or better) and if the Council maintained the ability to set rates. 

In the new contracts with five of the counterparties (BP, Coral, JPMorgan, Powerex, Conoco Phillips), collateral assurance is a requirement of the City’s energy and gas contracts and applies to both the City and the energy providing counterparties. Collateral assurance provides additional forms of assurance to one party when the outstanding contracts constitute a large credit risk for that party. The level of risk is based on the market value of the contracts and the credit condition of the counterparty.
DISCUSSION

Collateral assurance is a key term in energy purchase agreements. The assurance reduces the risk to one party when its exposure to the counterparty is high, the counterparty’s credit rating declines, or both conditions emerge. Collateral assurances can be issued either in the form of cash or a Letter of Credit (issued via an independent third party financial institution), or some other form of security.

Collateral assurance is provided when the risk exposure of a party exceeds the credit threshold specified in the contract. The threshold is determined by the counterparty’s credit rating with the threshold rising in $2.5 or $5 million increments for each “notch” increase in the credit rating (Table 1). Once the exposure exceeds the credit threshold, the counterparty can request collateral assurance in $250,000 increments.

<table>
<thead>
<tr>
<th>Credit Rating of City or Counterparty</th>
<th>Threshold (Millions)</th>
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</thead>
<tbody>
<tr>
<td>AA- or Above</td>
<td>$20.0</td>
</tr>
<tr>
<td>A- to A+</td>
<td>$15.0</td>
</tr>
<tr>
<td>BBB+</td>
<td>$10.0</td>
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<tr>
<td>BBB</td>
<td>$5.0</td>
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<tr>
<td>BBB- or below</td>
<td>$0</td>
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</tbody>
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For example, if the City has a contract with a counterparty rated at BBB, and the value of those contracts initially increases above the $5 million level, the City is able to request collateral assurance of $250,000 from the counterparty. If the value of the contract (the “mark to market” value) increases above $5.25 million, the City can request additional payments of credit assurance of $250,000 with each $250,000 increase in the mark to market value. If the value of the contracts declines, the City is obligated to return the collateral assurance within 5 days of the reduced valuation.

In each agreement, the amount of collateral the City is required to post is symmetrical to the City’s rights to request collateral from the counterparties at a given credit rating. That is, for each credit rating, the City’s ability to request credit is equal to the counterparty’s ability to request credit in the reverse situation.

The probability of the City requesting collateral is significantly higher than the probability of the City having to post collateral. This asymmetry in likelihood of outcome is the result of energy market behavior and the City’s purchasing strategy.

a) Market behavior. Energy prices can show greater upswings in price than downswings. Prices for electricity, for example, currently at approximately $65 per MWh can quickly spike to $200 per MWh (as observed last summer) but can never drop below $0. The City’s right to request collateral will be based on a high positive mark to market value of the outstanding contracts. The counterparty’s right to request
collateral from the City requires a high negative MTM, a situation that can only occur when prices drop.

b) Purchasing Strategy. While the City purchases energy commodities from counterparties who offer the lowest price, a key component of its risk management strategy is diversification of suppliers. Therefore, the City actively manages its risk of possible credit exposure resulting from a large position with one counterparty.

Under the City’s laddering program, the City has committed to approximately $35 million in forward purchases for gas and $25 million for electricity. Exposures to any one company for gas and electric purchases are not combined. To trigger a collateral call, the City would have to purchase essentially all forward gas or electricity positions from one counterparty (a violation of risk management protocol), experience an unprecedented drop in prices of 75%, and suffer a four-notch rating decline. While such a succession of events is possible, it would require market dislocations as broad and deep as those occurring during the energy crisis in 2001. In such a turbulent environment, the LOC facility would provide assurance to the counterparty without the City issuing cash.

Conversely, the City can request collateral assurance when prices increase. Historically, the City has been in the position on at least one occasion when it was prepared to request collateral assurance from a counterparty. In October and November of 2005, shortly after Hurricane Katrina, escalating energy prices exposed the City to a credit risk of $29.5 million with one counterparty, Coral Energy. Had the mark to market value of the contracts risen to $30.0 million, the City would have requested collateral assurance from Coral.

The use of an LOC is recommended over the use of cash for several reasons.

1. Issuing cash exposes the City to additional financial risk. A steep decline in prices is required for a collateral request to the City and would likely impact negatively the credit ratings of energy counterparties. Such a loss in credit quality of a counterparty at the time that the City was being requested to post collateral would expose the City to risks of not being able to readily retrieve the collateral in the event that the counterparty defaults or enters bankruptcy proceedings.

2. The issuing of collateral assurance must occur within 5 business days of a request. Transferring cash in such a short period of time could be problematic.

3. Under the terms of the contract, a posted LOC assurance cannot be “called” (i.e., cashed) unless the other party defaults in receiving or supplying the energy purchased. Thus, the City would not be required to actually transfer funds when collateral is requested unless it defaults on the contract.

However, that if an LOC is called and the bank of record transfers the funds to the counterparty, the City will be required to repay the bank “immediately.”
RESOURCES IMPACT

The costs associated with opening a Letter of Credit Facility are in the order of 50 basis points (one half of one percent) per year for the maximum dollar value of the facility plus initial legal fees. With the recommended initial $3 million facility, the total costs would be approximately $17,500 for the first year and $15,000 for each subsequent year.

If the facility is used, an additional cost of approximately 50 basis points is also levied against the City. These costs will be paid by the gas and electricity enterprise funds on an annual basis.

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