TO:        HONORABLE CITY COUNCIL
FROM:      CITY MANAGER          DEPARTMENT: UTILITIES
DATE:      MAY 7, 2007            CMR:224:07

SUBJECT:  ADOPTION OF ORDINANCE OF THE COUNCIL OF THE CITY OF PALO ALTO AUTHORIZING THE CITY MANAGER TO PURCHASE A PORTION OF THE CITY’S ELECTRICITY REQUIREMENTS FROM CERTAIN PREQUALIFIED ELECTRICITY SUPPLIERS UNDER SPECIFIED TERMS AND CONDITIONS DURING CALENDAR YEARS 2007 THROUGH 2022, INCLUSIVE

RECOMMENDATION
Staff recommends that Council approve the following:

1. Authorize the City Manager to negotiate and sign new, amended, or restated Master Agreements with the following electricity suppliers:
   a. ConocoPhillips Company;
   b. Coral Power, LLC;
   c. Sempra Energy Trading Corporation;
   d. BP Energy Company;
   e. JP Morgan Ventures Energy Corporation;
   f. Powerex Corporation; and
   g. Pacific Summit Energy, LLC

2. Authorize the City Manager or his designee, to execute multiple transactions under the Master Agreements with one or more of the above suppliers to procure electricity supplies and related services sufficient to meet the City’s forecasted electricity load, with the date for delivery of the electricity 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 $75 million.
BACKGROUND
The City’s 40-year contract with Western Area Power Administration (Western) expired at the end of December 2004. This contract was replaced with the new Western Base Resource contract in January 2005. The energy delivered under the new contract was approximately 40% of the energy provided under the prior contract, resulting in the need to purchase new supplies in 2005 to meet approximately 55% of the City’s electricity load during an average hydrological year. In addition, the energy provided under the new contract varies with changing hydro conditions.

A large portion of the deficit has since been met through long-term renewable contacts. The remaining energy needs are met through market purchases. This remaining energy deficit is highly variable and dependent on hydro conditions, with the deficit as high as 50% in a dry hydro year and with the potential for surpluses in a wet year.

Council has previously approved the City’s Long-term Electric Acquisition Plan (LEAP) objectives, guidelines and implementation plan (CMR:425:01, CMR398:02, and CMR:354:03). The LEAP objectives are to serve electricity loads of the City at competitive and predictable costs. The City meets these objectives by procuring electricity supplies in a diversified, systematic fashion over a rolling 36-month period. To implement the “laddered electricity purchase strategy” and to facilitate obtaining competitive price quotes from suppliers, the City established Master Agreements with a set of pre-qualified suppliers.

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 clearly defined transaction types that 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).

The City currently procures electricity supplies from three suppliers (BP Energy, Coral Power, and Sempra Energy) under Master Agreements that were approved by Council in January 2004 [Ordinance #4812]. An additional Master Agreement with Duke Energy Marketing, LLC was approved in 2004 but that counterparty has since withdrawn from the Western energy markets and is, therefore, no longer transacting with the City.

DISCUSSION
The current Master Agreements were approved by the Council for transactions with deliveries no later than December 31, 2011. By the end of December 2008, the existing Master Agreements will no longer be in accord with the City’s 36-month laddered purchase strategy. In addition, the exit of Duke Energy Marketing, LLC increased the need for additional suppliers to ensure competitive pricing and diversification of purchases across multiple creditworthy suppliers. Finally, new regulations to meet resource adequacy standards create the need to purchase capacity-related products that were not contemplated in the original Master Agreements. To that end, an RFP was issued in June 2006 to solicit interest from new and existing suppliers to sign Master Agreements with the City to enable future procurement of electricity supplies required to
meet the City’s electricity needs. The supplier selection process for the RFP is provided in Attachment A. The seven proposed Master Agreements were negotiated under terms and conditions acceptable to the City. The Master Agreements with BP, Coral and Sempra approved under Ordinance 4812 remain valid, however, a number of amendments were negotiated during the process. Due to each agreement’s multiple page count, staff has elected to not 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 2000 Edison Electric Institute (EEI) Master Power Purchase and Sale Agreement. A Master Agreement is similar to a blanket purchase order, and includes the general terms and conditions that govern transactions. The Master Agreement consists of a Base Contract and a Cover Sheet, which lists special provisions negotiated between the City and the supplier. Addendums to the Master Agreements include Schedule P, which defines energy and capacity products.

Executing a Master Agreement does not commit the City to execute any transaction nor is it a promise of business by the City or by the supplier. Each transaction for part of the City’s monthly, annual, or multi-year electricity requirements is completed through subsequent competitive bidding, as evidenced by a completed Transaction Confirmation document.

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 electricity 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 or transaction limits, a supplier credit downgrade event, supplier default or suspected default, or where inclusion in the solicitation would not comply with the law or City policies, guidelines, rules or 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 intends to conduct another RFP to solicit new suppliers within 5 years, well before the 2022 term limit on these Master Agreements. This provides the City with 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 a recommendation is made to make purchases outside of the 36 month purchase plan, 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 $75 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 to ensure that risks inherent in the energy industry are managed prudently. Staff provides Council with an update of all executed transactions under the Master Agreements in the quarterly Energy Risk Management reports.

**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 electricity 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. Regular reporting of all transactions in excess of $65,000 to Council (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 $75 million for aggregated electricity 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 beyond 3 years from the date of transaction;
- Any transaction beyond the limitations listed above; or
- Any transactions costing more than the limits specified above.

In no event shall any transaction with either BP Energy Company or Sempra Energy Trading Corporation exceed 4 years.

**Collateral**
Of the seven Master Agreements, two require that the City post collateral in the form of cash or a Letter of Credit for assurances under certain circumstances. Such a circumstance would occur in the rare event that the City purchases a high portion of its forward electricity supply with one of the counterparties after which forward prices fall to such a level that the value of the transactions versus the cost is negative. Much of the risk of this occurrence can be managed through sound counterparty diversity practices and monitoring of the value of each transaction executed per supplier. The other event in which the City may be required to post collateral would be if 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 contract requires that the City be prepared to promptly offer credit collateral assurances. A separate City Manager’s Report (CMR) detailing these
issues recommended a plan for implementing a credit facility for posting Letters of Credit (CMR:108:07). The costs associated with developing this facility will be covered by the relevant enterprise funds.

**ALTERNATIVES**

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

Council could elect to approve the contracts with different contract limits. Lower limits could reduce the ability of staff to competitively bid and diversify electricity supplies or could require staff to return to Council to increase the limits on certain Master Agreements within the terms of the Master Agreements thereby delaying transactions. Staff does not recommend higher limits at this time. 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**

The cost of the transactions executed under the Master Agreements are a function of the electric market prices and the City’s forecasted and actual volume of electricity needs.

Currently, electricity can be purchased for between $60 and $90 per megawatt-hour (MWh) for deliveries during the next several years. The City’s expected market purchases are about 300,000 MWh per year, which translates to an annual commodity cost of about $18 million to $27 million. Since electricity prices are volatile and the amount of electricity to be purchased under the Master Agreements is dependent on hydro conditions, it is conceivable that the market purchase cost could double from expected levels. The table below is an illustration of market purchase cost under various scenarios.

<table>
<thead>
<tr>
<th>Projected Electric Market Purchase Cost (SM)</th>
<th>FY 06-07 $M</th>
<th>FY 07-08 $M</th>
<th>FY 08-09 $M</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected Hydro and Market Prices</td>
<td>$23.0</td>
<td>$25.0</td>
<td>$26.0</td>
</tr>
<tr>
<td>Change in Market Purchases Cost Under High Prices and Expected Hydro</td>
<td>+ $ 0.5</td>
<td>+ $ 3.5</td>
<td>+ $ 5.0</td>
</tr>
<tr>
<td>Change in Market Purchase Cost Under Dry Hydro Conditions</td>
<td>+ $ 0.5</td>
<td>+ $ 9.5</td>
<td>+ $ 9.0</td>
</tr>
<tr>
<td>Total Purchase Cost Under Dry Hydro &amp; High Market Prices</td>
<td>$24.0</td>
<td>$38.0</td>
<td>$40.0</td>
</tr>
</tbody>
</table>

As shown in the table above, the expected electricity market purchase cost for the next several years is between $23 and $26 million/year. The cost estimates are relatively certain for the current fiscal year since a large portion of the electricity has already been purchased at fixed prices and the fiscal year is nearly over. Costs for FY 07-08 and FY 08-09 are less certain as less electricity has been purchased in advance, and future electricity prices could rise above expectations and supply from hydro could fall below expectations.
The following table summarizes the City’s historical electricity purchase costs and projected costs for the next several years. As of March 20, 2007, transactions worth $24 million have been entered in with existing suppliers for deliveries during the period April 2007 though December 2009.

### Electricity Procurement Summary as of 3/20/07 – Cost ($M) and Volumes (MWh)

<table>
<thead>
<tr>
<th></th>
<th>FY 04-05 $M</th>
<th>FY 05-06 $M</th>
<th>FY 06-07 $M</th>
<th>FY 07-08 $M</th>
<th>FY 08-09 $M</th>
<th>FY 09-10 $M</th>
</tr>
</thead>
<tbody>
<tr>
<td>BP Energy Company</td>
<td>$ -</td>
<td>$ 3.5</td>
<td>$ 2.7</td>
<td>$ 0.9</td>
<td>$ -</td>
<td>$ -</td>
</tr>
<tr>
<td>Coral Power LLC</td>
<td>$ 3.6</td>
<td>$ 13.9</td>
<td>$ 6.7</td>
<td>$ 5.8</td>
<td>$ 6.1</td>
<td>$ 2.0</td>
</tr>
<tr>
<td>Sempra</td>
<td>$ 2.5</td>
<td>$ 3.4</td>
<td>$ 10.0</td>
<td>$ 6.3</td>
<td>$ -</td>
<td>$ -</td>
</tr>
<tr>
<td>Duke</td>
<td>$ 4.4</td>
<td>$ 2.7</td>
<td>$ -</td>
<td>$ -</td>
<td>$ -</td>
<td>$ -</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>$ 10.5</strong></td>
<td><strong>$ 23.5</strong></td>
<td><strong>$ 19.3</strong></td>
<td><strong>$ 13.0</strong></td>
<td><strong>$ 6.1</strong></td>
<td><strong>$ 2.0</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>MWh</th>
<th>MWh</th>
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<th>MWh</th>
</tr>
</thead>
<tbody>
<tr>
<td>BP Energy Company</td>
<td>-</td>
<td>54,160</td>
<td>46,080</td>
<td>14,655</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Coral Power LLC</td>
<td>91,100</td>
<td>307,425</td>
<td>162,145</td>
<td>134,425</td>
<td>138,515</td>
<td>55,225</td>
</tr>
<tr>
<td>Sempra</td>
<td>47,560</td>
<td>86,660</td>
<td>157,855</td>
<td>93,300</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Duke</td>
<td>86,400</td>
<td>38,840</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>225,060</strong></td>
<td><strong>487,085</strong></td>
<td><strong>366,080</strong></td>
<td><strong>242,380</strong></td>
<td><strong>138,515</strong></td>
<td><strong>55,225</strong></td>
</tr>
</tbody>
</table>

While the City has selected seven suppliers with whom 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 transactions being concentrated among fewer qualified suppliers. Staff recommends a maximum transaction limit of $75 million for the term of each Master Agreement. This limit gives staff the flexibility it needs in case electricity 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 Electricity Fund retail revenues with retail rates determined by Council.

**POLICY IMPLICATIONS**

Authorizing the City Manager to buy and sell electricity to meet City load under these Master Agreements conforms to existing Council-approved Energy Risk Management Policies [CMR:128:06]. 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 the business process to allow the City of Palo Alto Utilities to work efficiently and cost-effectively.

Further, the recommendation supports the Council-approved Utilities’ Electricity Supply Portfolio Planning and Management Objectives and Guidelines for Long-term Electric Acquisition Plan (LEAP) [March 2007 CMR:158:07].
ENVIRONMENTAL REVIEW
Adoption of the ordinance approving Master Agreements and delegating electricity procurement responsibilities 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 Electricity Requirements from Certain Prequalified Electricity Suppliers Under Specified Terms and Conditions During Calendar Years 2007 through 2022, Inclusive

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