

**QUARTERLY GAS ISSUES UPDATE
December 2006**

I. Supply Issues

Wholesale Natural Gas Prices

Above normal temperatures and a lack of hurricane activity caused market prices to decrease in October. By November, some winter weather resulted in a return to prices similar to those seen in August and September. Prices are approximately 22% more than in 2004 but 7% less than in 2005. Figure 1 below provides historical monthly bid week index prices and projected future natural gas prices at PG&E Citygate.

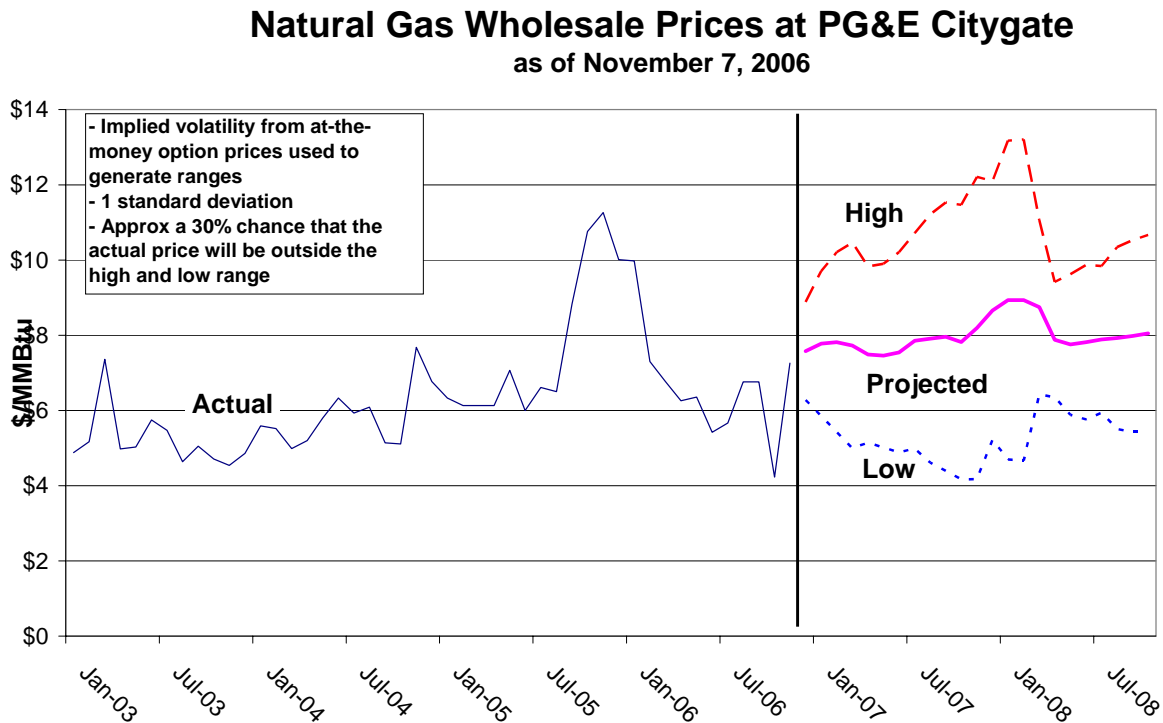


Figure 1

Supply Acquisition

In June 2000, staff began to implement the “laddered” gas procurement strategy to lock in gas costs for pool customers (customers not eligible for direct access). The laddering strategy was revised in January 2004 and presented to the City Council in March 2004 [CMR:167:04].

In October 2005, the Director of Utilities revised the hedge targets to be equal to the greater of: 1) the current hedge level and 2) the midpoint between the minimum and maximum hedge guideline. This translates to a target of 82% of expected pool load to be hedged for the near 18 months, 58% for the following 9 months, and 35% for the last 9 months in the 36-month horizon. Approximately 82% of the expected pool load is hedged for FY 06-07 with a total expected pool cost of \$17.6 million at the PG&E Citygate. The expected cost for the City’s entire portfolio (pool customers plus large customers either on the G-3 rate or a contract rate) is \$22.1 million. Approximately 72% of the

expected pool load is hedged for FY 07-08 with an expected pool cost of \$21.4 million and a cost of \$26.6 million for the entire portfolio. Figures 2 and 3 show the expected pool load for the next 36 months and the status of the laddering strategy.

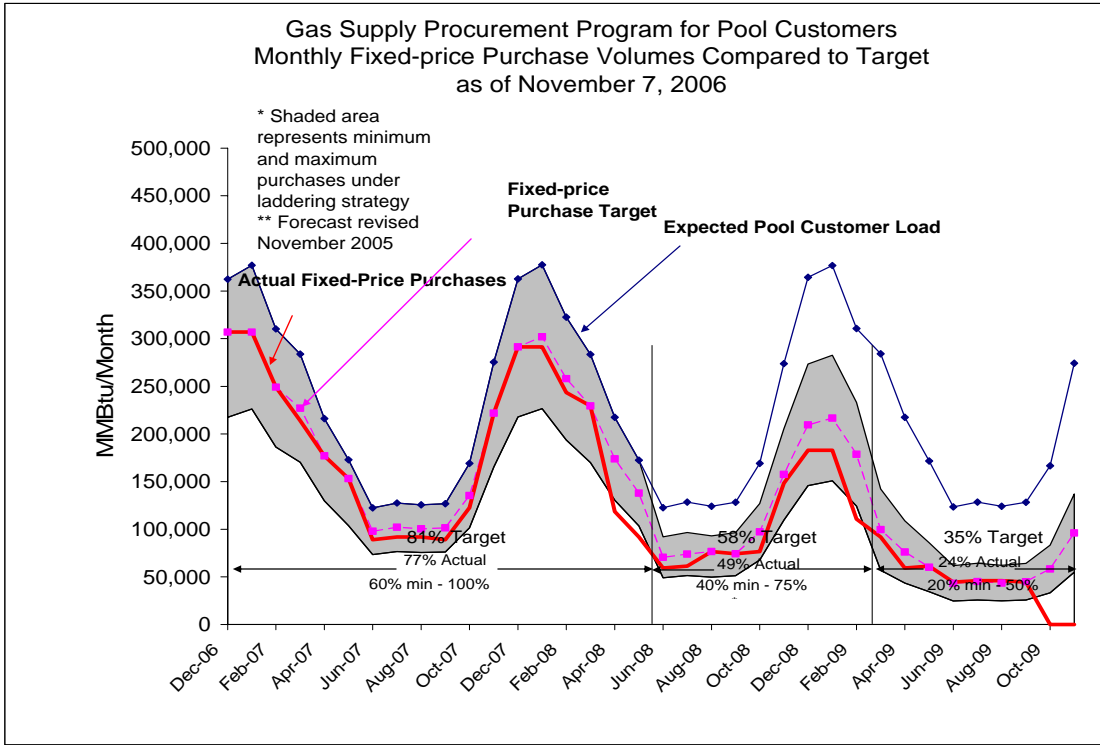


Figure 2

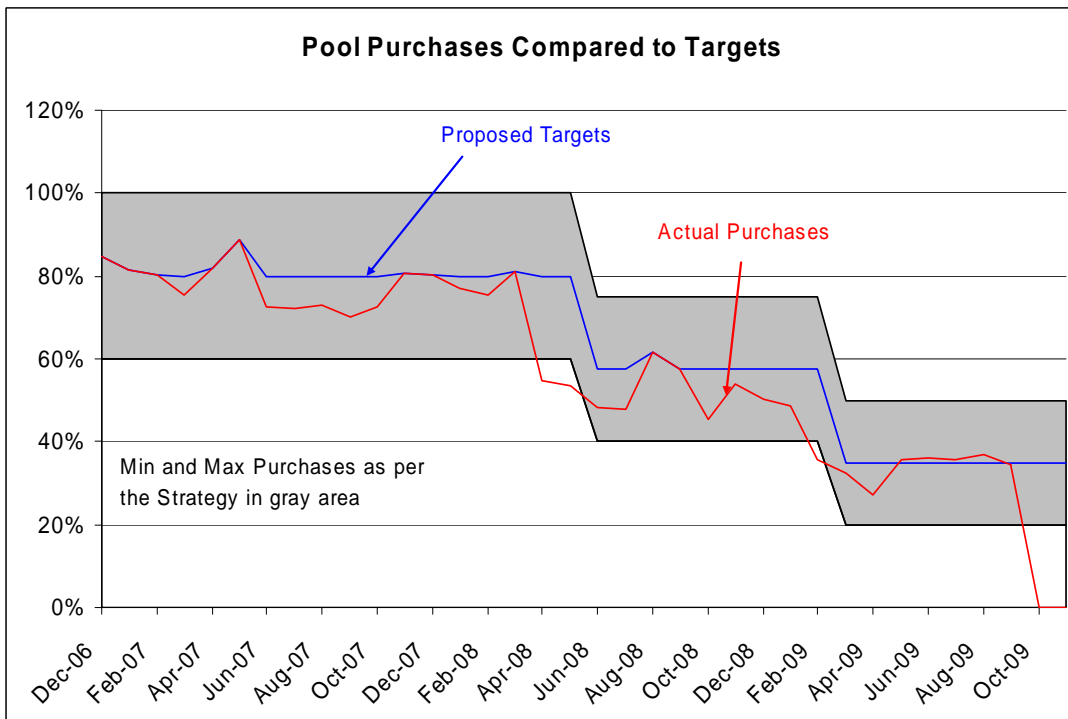


Figure 3

Because of the fixed-price purchases, the City’s weighted average cost of gas (WACOG) differs from the monthly market price. The City’s estimated WACOG for the pool is \$6.64 per MMBtu for FY 06-07, approximately 7% less than the weighted average market price for that same period of approximately \$7.15 per MMBtu. This results in a projected savings to pool customers of approximately \$1.4 million in FY 06-07. The City’s estimated WACOG for the pool is \$7.97 per MMBtu for FY 07-08, compared to the current weighted average forward market price of approximately \$8.29 per MMBtu, a savings of approximately 4%, resulting in a projected savings to pool customers of approximately \$800,000 in FY 07-08. In the months close to the end of the laddering time horizon, the City’s WACOG is closer to the forward market price since purchases were done more recently and because a smaller fraction of the total gas needs have been purchased for this period (as shown in Figure 2).

Figure 4 below illustrates the difference between market prices and the City’s estimated WACOG.

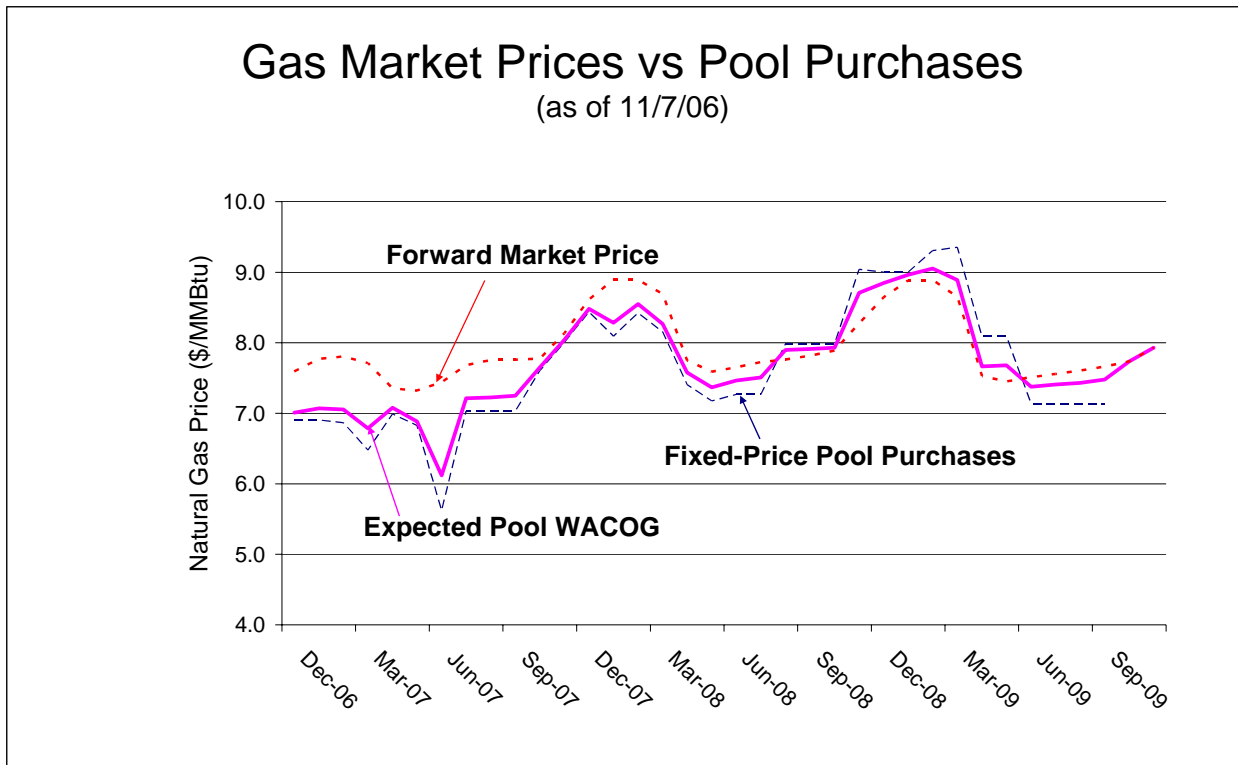


Figure 4

Table 1 below shows the City’s commodity-only costs relative to the market and approximate commodity-related savings for each customer class. Table 1 does not include distribution and other costs; it is only a broad indicator of commodity savings.

Table 1
Customer Savings Relative to Wholesale Market

(Commodity only, does not include distribution, reserve movements etc.)

	FY 02/03	FY 03/04	FY 04/05	FY 05/06	FY 06/07	FY 07/08	FY 08/09
Palo Alto's average gas cost	\$4.57	\$4.39	\$5.28	\$5.77	\$6.64	\$7.97	\$8.43
Market Cost	\$4.61	\$5.06	\$6.27	\$8.22	\$7.15	\$8.29	\$8.28
Savings for pool	\$92,811	\$1,595,565	\$2,547,941	\$6,277,261	\$1,361,219	\$843,710	-\$403,499
Savings for pool	1%	13%	16%	30%	7%	4%	-2%
Savings per resident	\$2	\$38	\$61	\$149	\$32	\$20	-\$10
Savings per commercial customer	\$17	\$295	\$472	\$1,162	\$252	\$156	-\$75

RFP for New Gas Suppliers

An RFP for new gas suppliers was issued to expand the number of available suppliers. Proposals were received in July and are being evaluated. An expanded set of master agreements with suppliers is expected to be presented to the Council for approval in early 2007.

II. Regulatory Issues

Gas Accord III

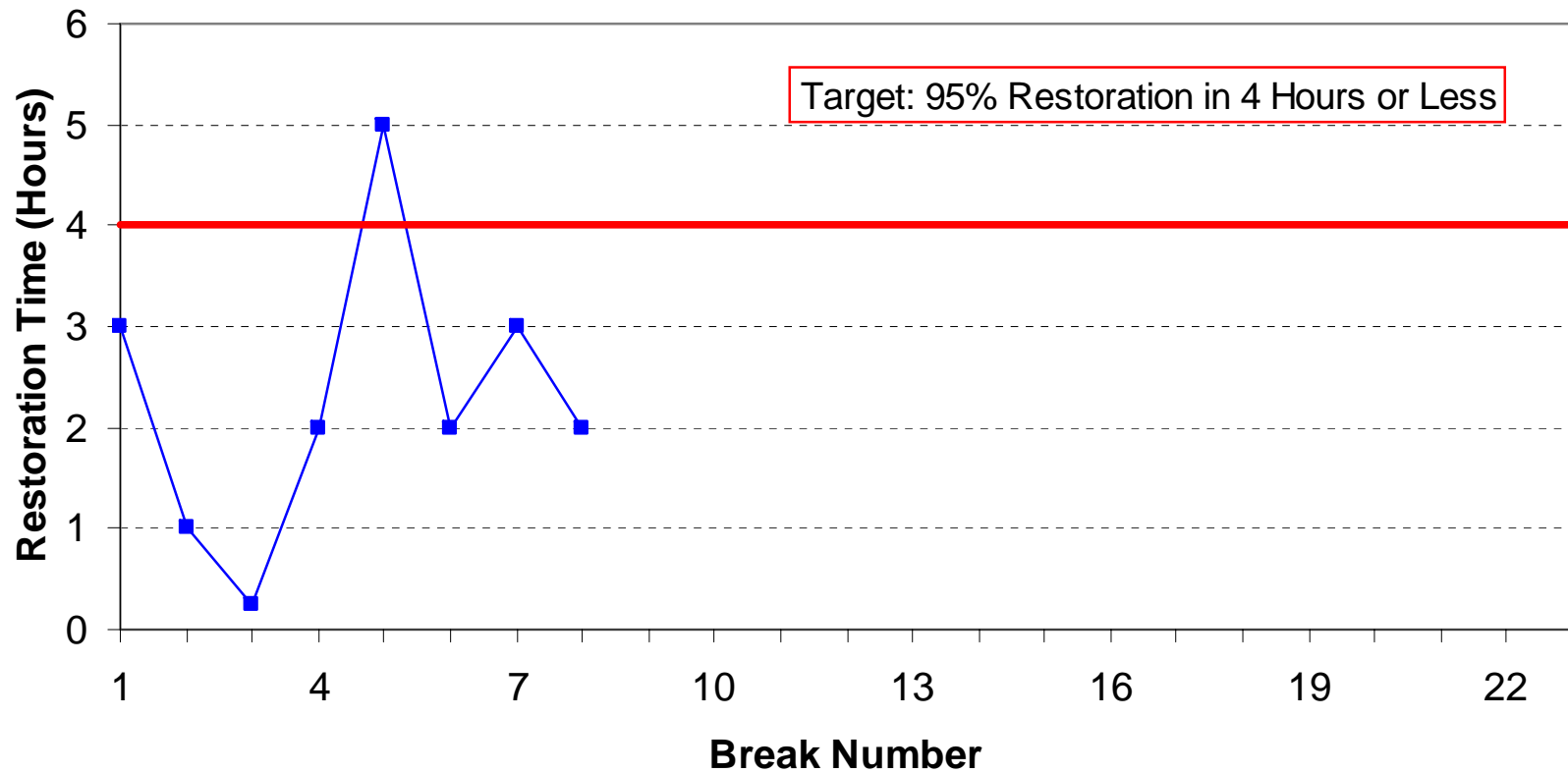
The current Gas Accord expires in 2007. PG&E called a meeting for interested parties on November 14, 2006.

III. Operational Measures

The attached graphs provide information on operational measures for the first quarter of FY 06-07 (July – September 2006):

- Gas System O&M – Mainline Leak Repairs
- Gas System O&M – Service Installations
- Gas Main Leaks By Type of Pipe
- Gas Meter Exchange Productivity Measurement
- Gas Main Shutdowns & Customers Affected
- Unplanned Gas Service Disruptions

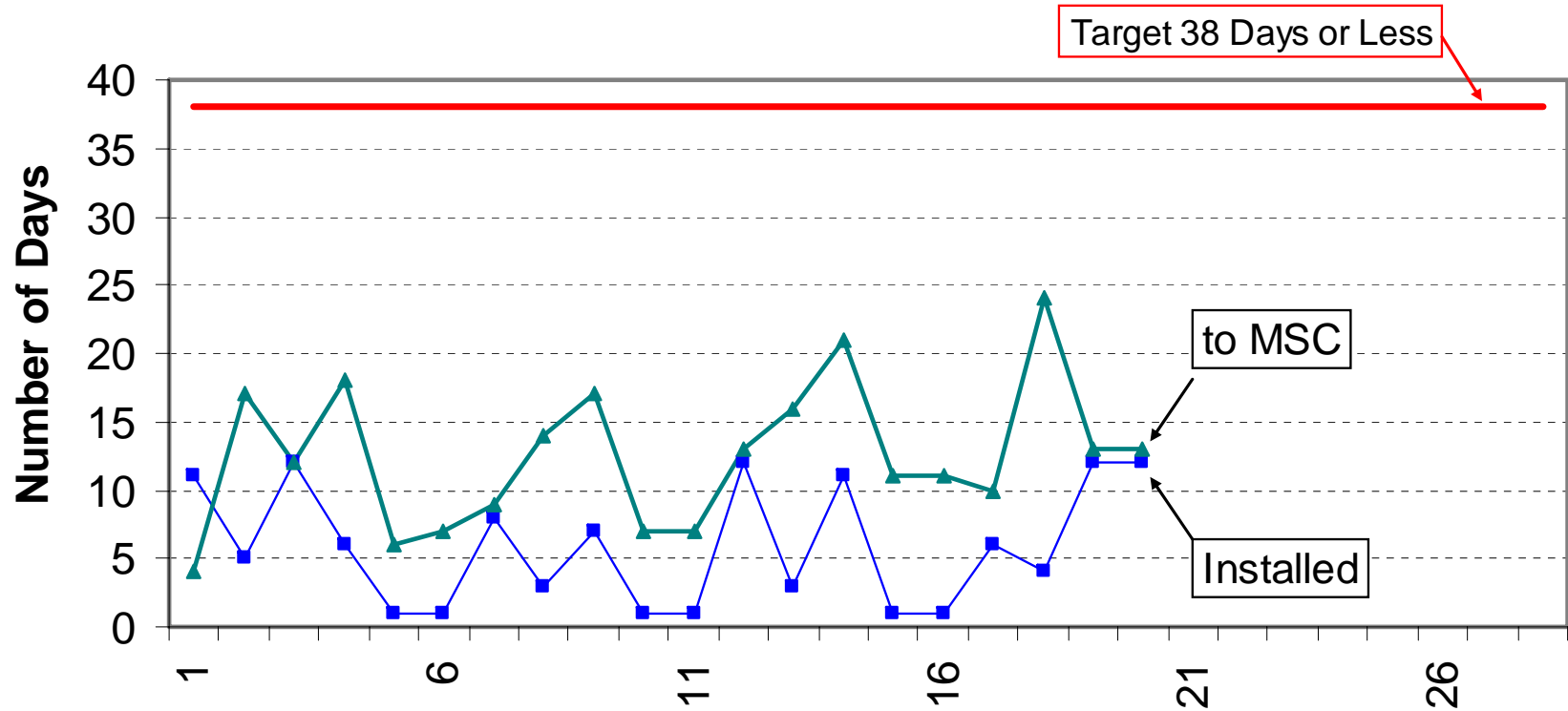
Gas System O&M Mainline Leak Repairs FY 06-07 (through September 2006)



**87% of repairs completed
within 4 hours**

**Total Number of Leaks = 8
Avg. hours to repair = 2.28**

Gas System O&M Service Installations Number of Days From Payment to Installation FY 06-07



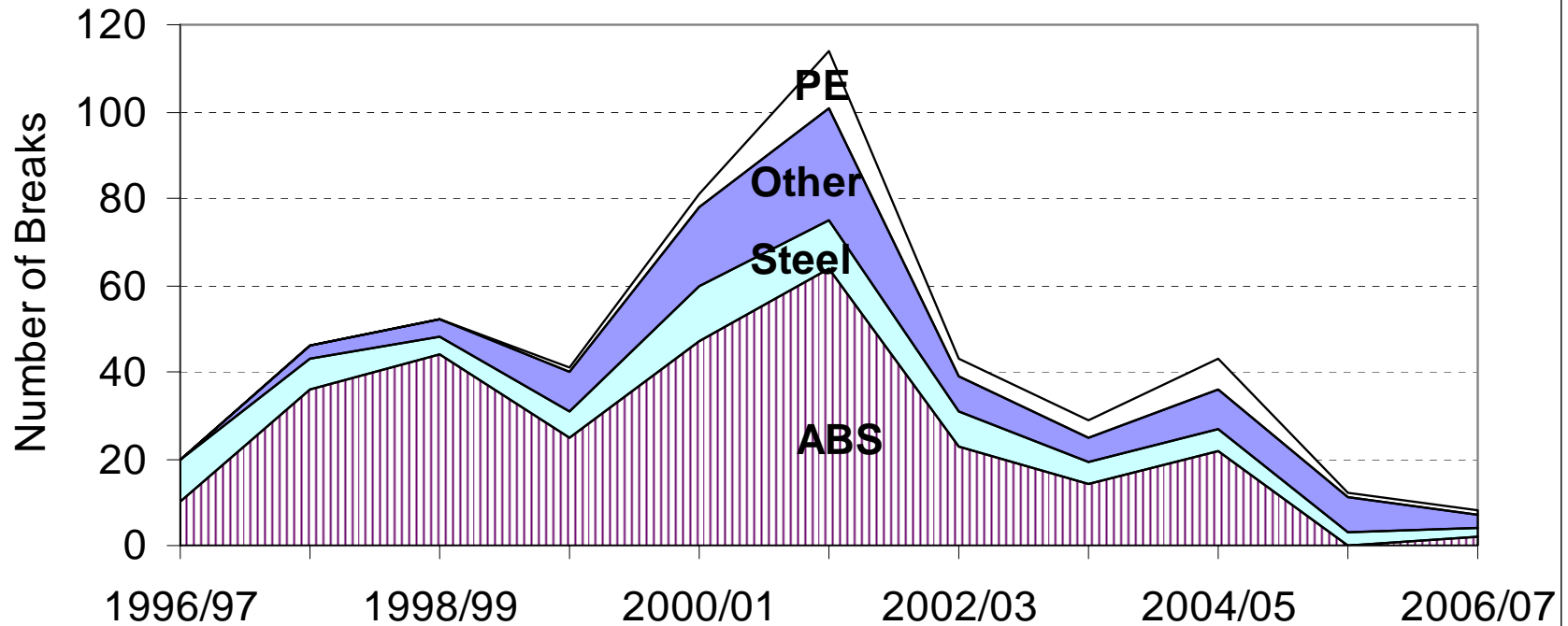
Number of Service Installations through September 2006

Total No. of Installations = 20

Avg. Days to Complete = 13.6

100% of services installed within 38 days

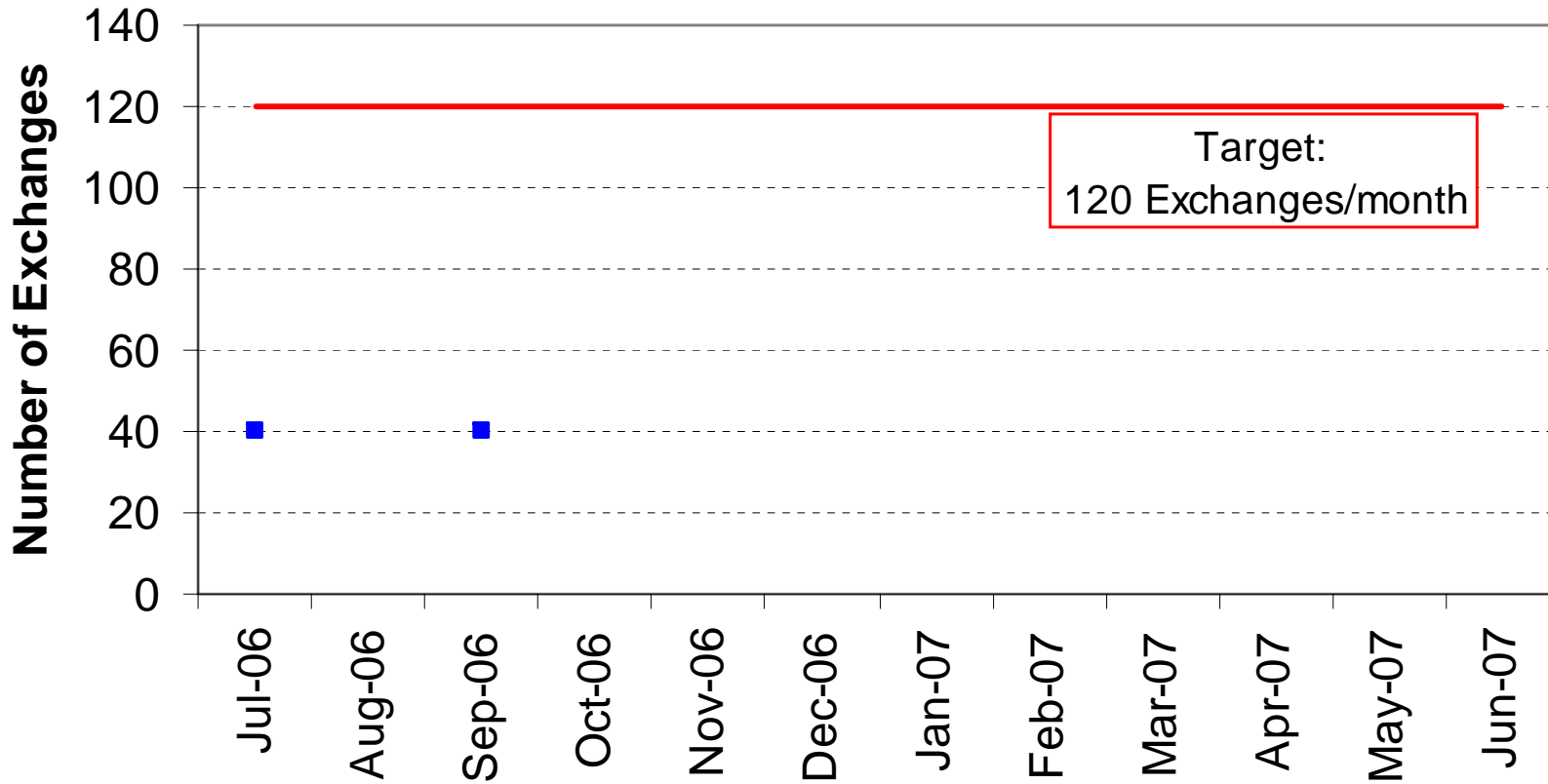
Gas Main Leaks by Type of Pipe Material Failure Only (FY 06-07 as of September 2006)



Miles of PE: 35.6 (17.7%)
Miles of ABS: 43.5 (21.8%)
Miles of PVC: 45.5 (24.2%)

Miles of BWP: 73.1 (36.4%)
Total miles of Main: 207

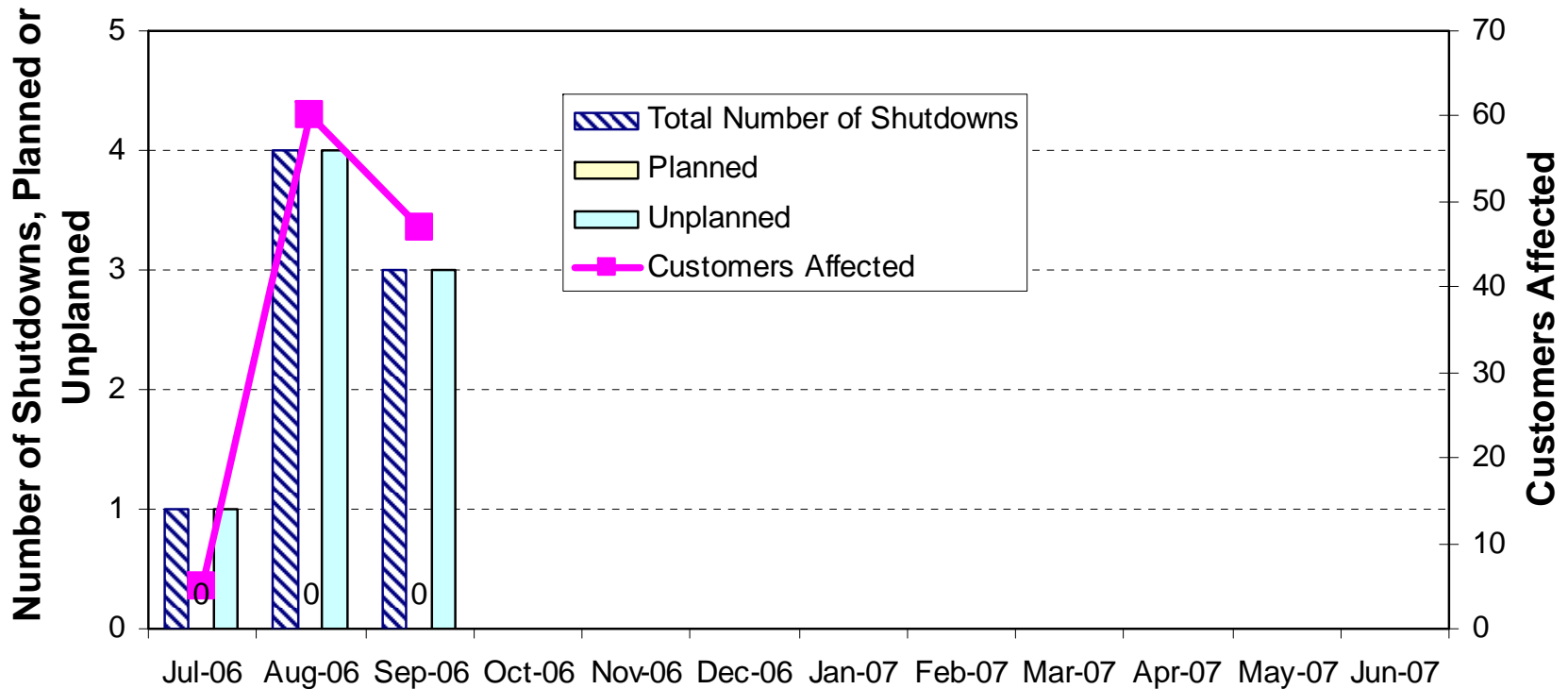
Gas Meter Exchange Productivity Measurement Target vs. Actual Exchange



As of September 2006
20,708 Residential Gas meters in system

Total Exchanges: 80
Avg. per month: 40

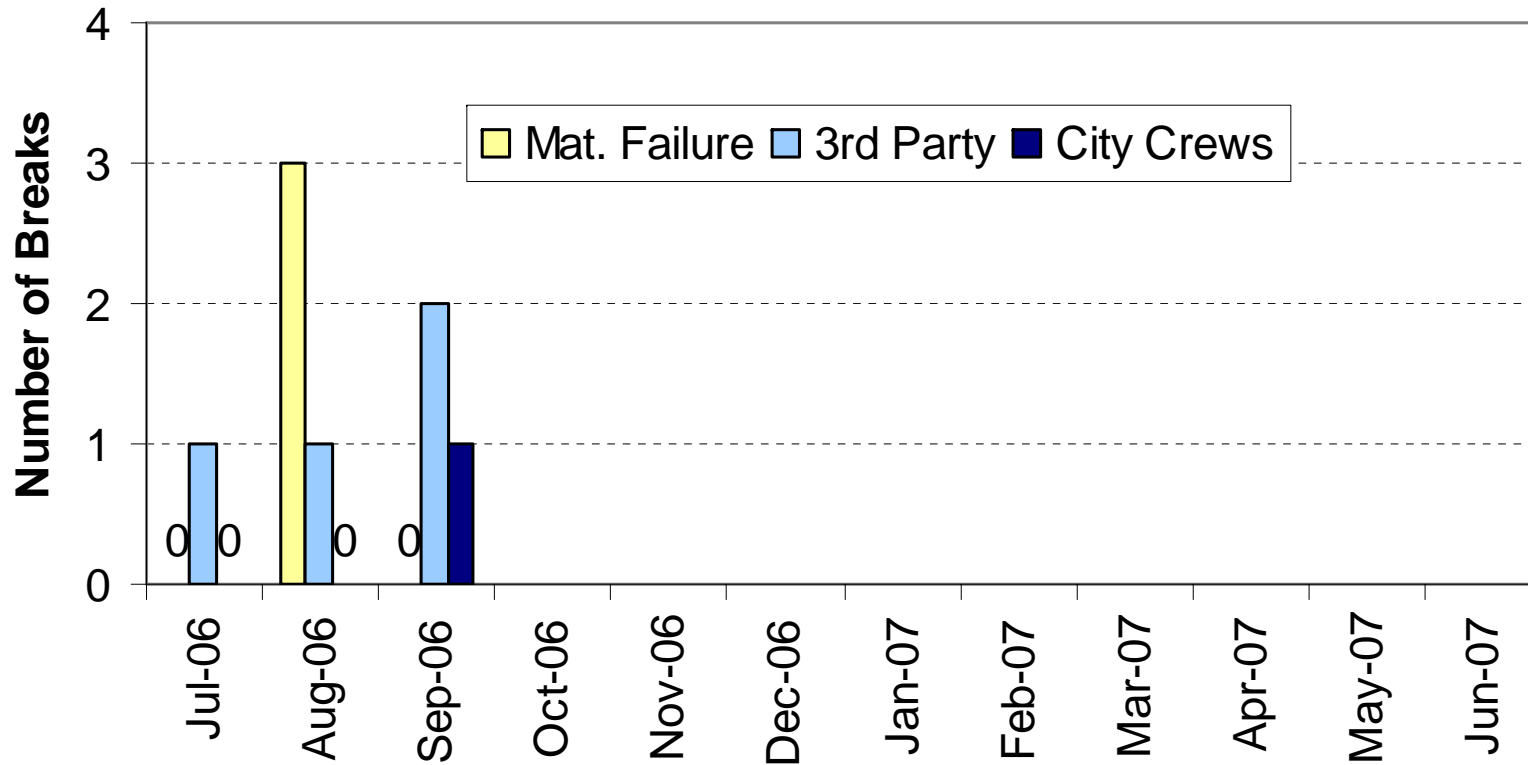
Gas Main Shutdowns and Customers Affected - FY 06-07



Total Customers Affected: 112

Total Shutdowns: (Planned - 0 , Unplanned - 8)

Unplanned Gas Service Disruptions by Cause Main Lines Only



Total Material Defect: 3
Total City Crews: 1

Total 3rd Party: 4
Total Disruptions: 8