

QUARTERLY GAS ISSUES UPDATE
June 2007

I. Supply Issues

Wholesale Natural Gas Prices

After a dip in October, prices have remained strong due to relatively high crude oil prices. Fear of a hotter than normal summer and an active hurricane season are keeping forward prices high. Prices are approximately 5% higher than in 2006 and 2% lower than in 2005. Figure 1 below provides historical monthly bid week index prices and projected future natural gas prices at PG&E Citygate.

Natural Gas Wholesale Prices at PG&E Citygate
as of May 8, 2007

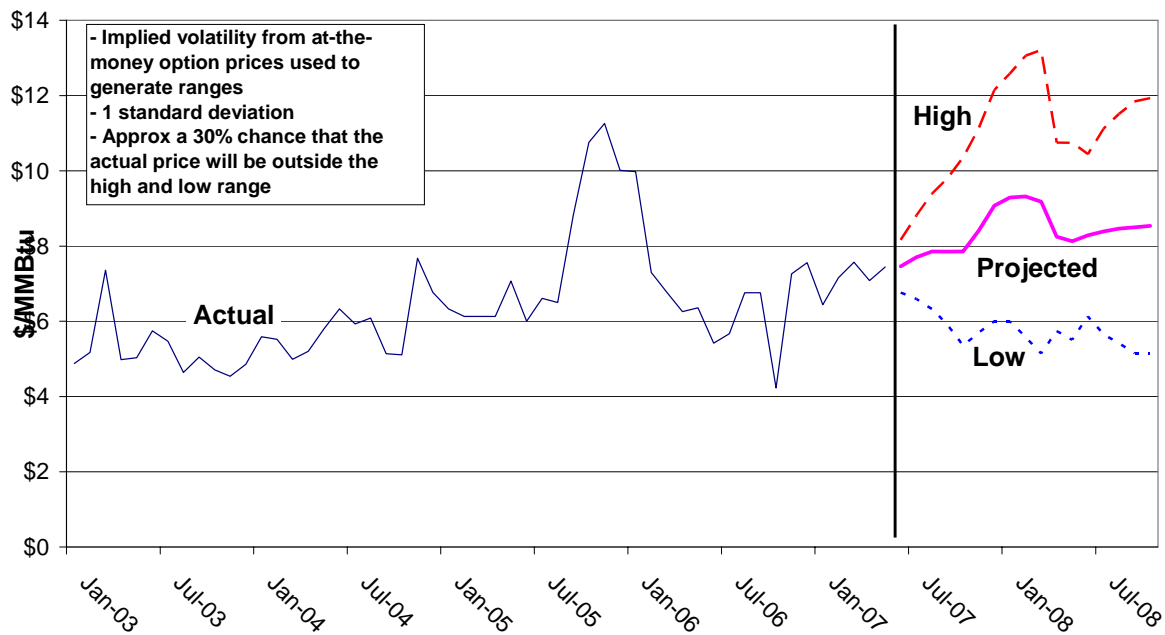


Figure 1

Supply Acquisition

Current laddering strategy targets are shown in Figure 2 below. The targets are set midway between the minimum and maximum values with the exception of November 2007 through March 2008 when a 100% hedge is planned. A total pool cost of \$17.4 million is expected for FY 06-07. 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 \$21.6 million. Approximately 79% of the expected pool load is hedged for FY 07-08 with an expected pool cost of \$22.1 million and a cost of \$25.7 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.

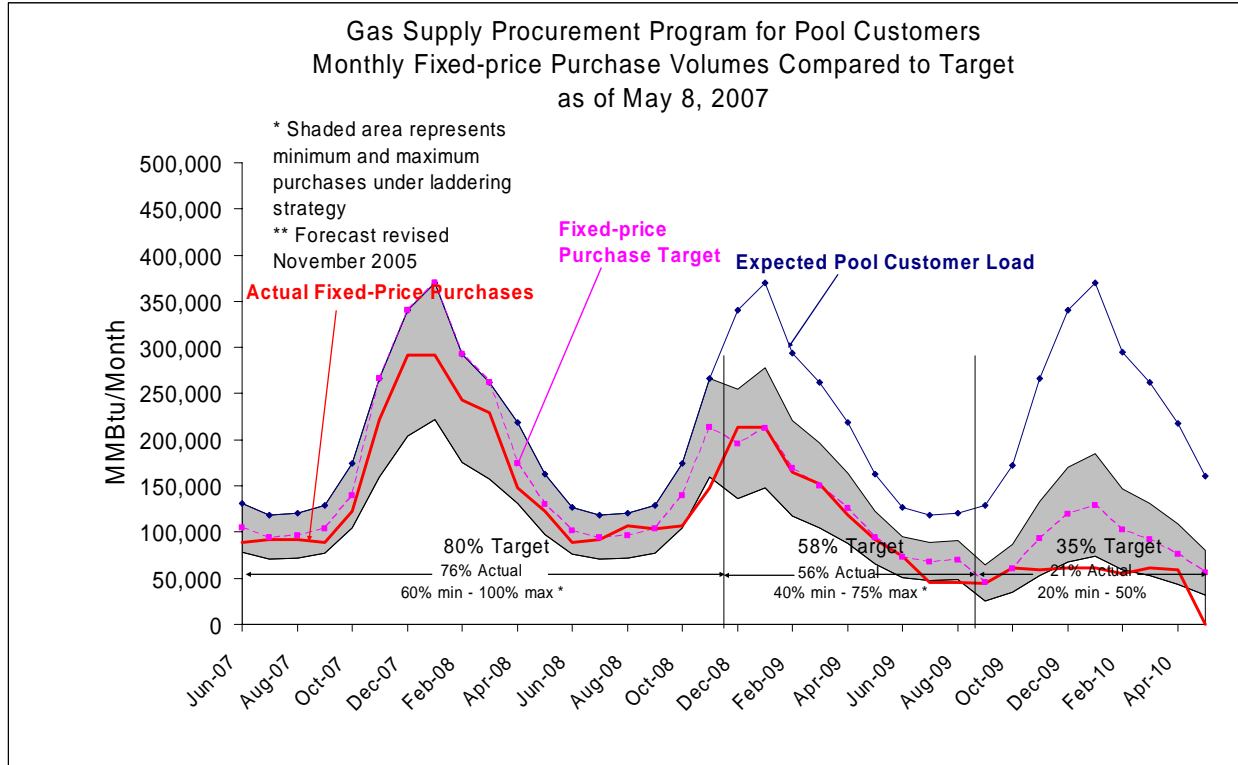


Figure 2

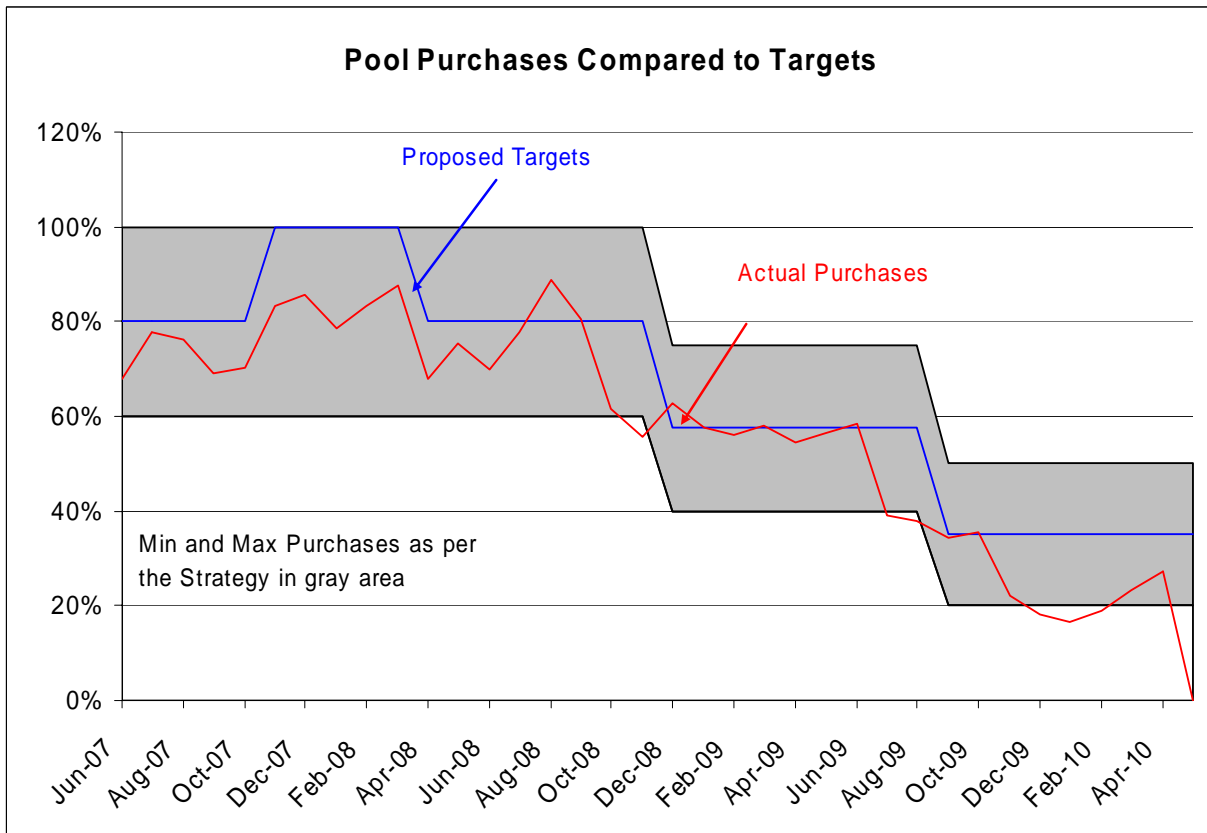


Figure 3

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 \$6.56 per MMBtu for FY 06-07, approximately 3% less than the weighted average market price of approximately \$6.77 per MMBtu. The City’s estimated WACOG for the pool is \$7.99 per MMBtu for FY 07-08, compared to the current weighted average forward market price of approximately \$8.57 per MMBtu, a savings of approximately 7%. 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 3). Figure 4 below illustrates the difference between market prices and the City’s estimated WACOG.

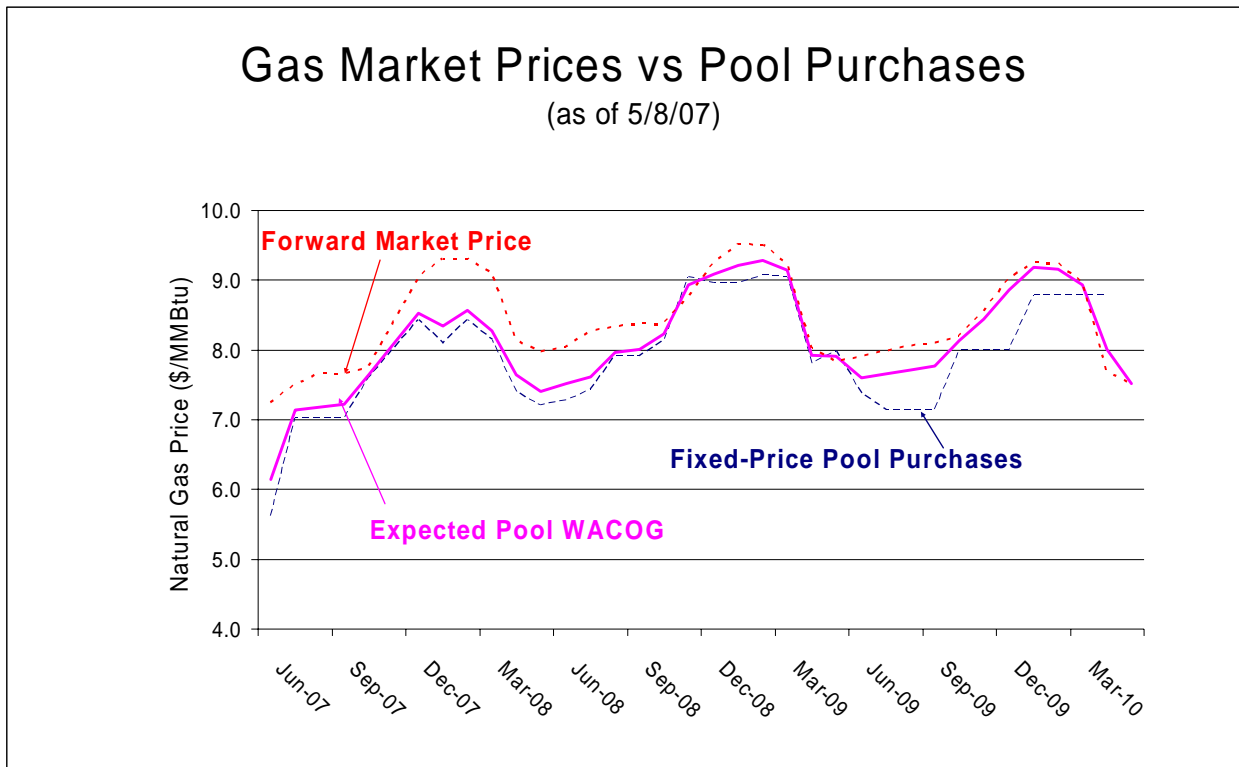


Figure 4

RFP for New Gas Suppliers

An RFP issued in 2006 resulted in master agreements with an expanded set of gas suppliers. Council approved the new agreements in March 2007.

II. Regulatory Issues

Gas Accord IV

Palo Alto participated in an all-party settlement with PG&E known as the Gas Accord IV. The Gas Accord established rates for the backbone transmission lines and customer access charges and resolved a number of outstanding regulatory issues. Palo Alto’s cost related to these PG&E services will be slightly lower over the three-year term which begins January 1, 2008. More importantly, Palo Alto successfully protected existing rights such as the ability to contract for vintage Redwood

pipeline capacity.