This is an information report and no action is required.

BACKGROUND

The purpose of this report is to inform the City Council of the status of the City’s energy portfolio as of the end of the first quarter of fiscal year 2003-04. The City’s risk management policies require that staff report to Council on the City’s energy portfolio composition compared to Council-adopted policy, portfolio performance, and other key market information.

DISCUSSION

Open Transactions as of September 30, 2003
Open transactions are commitments which the City has made to purchase either electricity or gas, but for which supplies have not been delivered.

Electricity: The City’s current transactions in electricity are with Western Area Power Administration, which provides 100% of current load, and Northern California Power Administration, which provides “within month” balancing. The City currently holds one long-term position in the energy market with non-governmental organizations. This is a Quarter 1 and Quarter 4 purchase for calendar years 2005 through 2009. The delivery of the commodity is 25 MW for 24 hours per day, seven days a week. The City purchased this commodity for $20.0 million. The current market value of this transaction is $26.7 million. The Mark to Market (MTM) value, the difference between the original purchase price and the current value of the contract, is $6.7 million, representing an increase of 33 percent. A positive MTM indicates that the contract (or portfolio) is currently worth more now than when it was purchased, based on the current forward price curve. It is important to note, however, that the MTM represents a snapshot only, and changes on a
daily or even hourly basis. One would expect that, given the City’s laddering purchasing strategy, the MTM value will tend to be relatively stable and closely track the market. This means that the purchases will, on average, largely mirror the marketplace. The market valuation is based on data provided by NYMEX and BP North America.

The electric portfolio is approximately 9% in surplus in the coming year, assuming average hydro conditions. Considerable deficits exist from January 2005 and beyond and staff is working to fill future requirements. Completion of the Gas and Electric Master Agreements, and their approval by Council last quarter (CMR:482:03 and CMR:510:03) will provide the authority and contract terms and conditions for staff to execute block purchases approved by Council (CMR:288:03) and bring the portfolio within appropriate bounds set by expected load. Master Agreements represent contracts that qualify suppliers to serve as eligible counter party suppliers for the City.

Electric supply portfolio net costs for FY 03-04 are presently estimated to be approximately $10 million below budgeted levels. This is a result of commodity purchase credits from the Western Area Power Administration (WAPA). The June 30, 2004 supply reserve balances are projected to be $6.3 million above the $54 million maximum reserve target. These projections do not provide for considerable regulatory/legal uncertainties.

**Gas:** The current gas portfolio consists of 44 open transactions (transactions for which gas has yet to be delivered). The contract volume of these transactions is 5,882,485 MMBtu with total commitments of $25.6 million. The current MTM value of these transactions is $557,000. The average transaction duration is approximately 3.7 months with transactions ranging in duration from 1 to 24 months. The counterparties for the open transactions include BP North America and Sempra Inc.

The figure below shows the historic MTM value for the gas portfolio since January 2002.
The laddered purchasing strategy continues to be implemented, with 89% of gas required to meet pool loads in FY 03-04 purchased already. The weighted average cost of gas for Palo Alto pool customers is currently below market prices.

Total supply portfolio costs are up by $1.5 million from budgeted numbers, though a corresponding revenue increase from G3 customers largely offsets these higher costs. The gas supply rate stabilization reserve balances are projected to be approximately $8 million at the end of June 2004. The Council approved reserve minimum maximum range is $6-12 million.

Value at Risk
The “riskiness” of an energy portfolio that changes over time can be measured in many different ways. The industry standard is to use a “value at risk” (or VaR) measure as a key indicator. The VaR measures the risk that adverse market conditions will force CPAU to use reserves to cover costs over what is charged to ratepayers on purchases not yet made to meet load. In using VaR, the focus is made solely on negative or adverse changes that could impact ratepayers. In this report, the VaR measures the amount of money required from reserves due to adverse market changes occurring within a one week period. In addition, the VaR assumes that the “worst” outcome occurs only one in 20 times (95%) over the next 12 months.
In compliance with the Risk Management Guidelines, the Utilities’ Front Office and the Energy Risk Manager monitor the VaR and ensure that its value is limited to below 10% of the existing supply reserve levels for both electricity and gas. Currently, the VaR for the electricity portfolio is 1.8% and that for the gas portfolio is 2.1%. The historic levels of both these values are presented in the following graphs, along with the values of the reserve levels.

Electricity Reserve Levels and VaR History
Credit Risk

Electricity: Currently, the City purchases electricity from the Western Area Power Administration (WAPA) for most of its load. WAPA is a Federal Agency and operates under the full faith and credit of the United States Government, minimizing the City’s credit risk. The City does have one transaction with an A- rated counterparty. The current credit exposure is $6.5 million for a contract for delivery between 2005 and 2009.

It should be noted that post 2004 credit risk is likely to increase as the City increases its transactions with non-governmental counterparties which have a lower credit rating than the Federal Government. All counterparties on the proposed supplier list are highly creditworthy and will be carefully monitored as part of risk management program.

Gas: Details on the City’s credit exposure are presented in the following table. The City has exposure to two counterparties. The first counterparty is rated AA+, and currently this party has a credit exposure to the City of approximately $543,000. The second counterparty is rated BBB+ and the City’s credit exposure is $1.1 million. Thus, the
City’s total credit exposure is $557,000. In both cases the City’s credit exposure is well within the limits established by the Risk Management Policy and Guidelines.

**ATTACHMENTS:**
Attachment A: Consolidated Mark to Market Report of All Open Gas Transactions as of September 30, 2003

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