TO: CITY COUNCIL

ATTENTION: FINANCE COMMITTEE

FROM: CITY MANAGER DEPARTMENT: UTILITIES

DATE: APRIL 20, 2004 CMR:191:04

SUBJECT: ORDINANCE OF THE COUNCIL OF THE CITY OF PALO ALTO APPROVING A CUSTOM PRODUCTS CONTRACT WITH THE WESTERN AREA POWER ADMINISTRATION FOR THE PROCUREMENT OF ELECTRICITY AND AUTHORIZING THE CITY MANAGER TO PURCHASE UP TO $10 MILLION OF CUSTOM PRODUCTS FROM THE WESTERN AREA POWER ADMINISTRATION

REPORT IN BRIEF

Council has approved a 20 year Base Resource contract with the Western Area Power Administration (Western) to replace the current contract ending on December 31, 2004. Western is offering the attached Custom Product Contract as a vehicle to subscribe to certain market-based services in conjunction with the City’s Base Resource Contract. These services include day-ahead schedule firming to assure replacement of power when plant outages or changes to operations occur. The Council has approved the Long-term Electric Acquisition Plan (LEAP), which sets out how supplies will be purchased; including the guidelines that among other things, directed staff to maintain the flexibility to adopt favorable custom products offered by Western. Additionally, the LEAP implementation plan directed staff to pursue low cost, high value prospects to acquire supply-related resources. Therefore, staff requests the authority to transact under the Western Custom Product Contract under certain limitations set forth in the attached ordinance.
RECOMMENDATION

Staff recommends the Finance Committee recommend that the Council adopt the attached ordinance authorizing the City Manager to execute a Custom Product Contract, substantially similar to the one attached, with the Western Area Power Administration for the option to purchase electric power Custom Products with a cost not to exceed $2,000,000 per year and not to exceed $10,000,000 during the term of the agreement from January 1, 2005 through September 30, 2010; and to execute electric commodity day-ahead schedule firming service transactions under the terms of the agreement and subject to proposed parameters and limitations.

BACKGROUND

City of Palo Alto Utilities’ (CPAU) existing Western Commercial Firm Power contract is an important resource providing electricity from a share of the Central Valley Project (CVP) net output and a share of Western’s integration contracts at cost-based prices through December 31, 2004. Palo Alto has executed a Base Resource Contract with Western for the years 2005-2024 to provide the City with an initial 11.62% share of CVP net output. Council approved the Western Base Resource Contract on October 16, 2000 (CMR 378:00). As a signatory of the Base Resource Contract, the City is entitled to execute the attached Custom Product Contract for additional products and services not included in the Base Resource. These additional custom products can partially replace some of the expiring features of the current contract. Western developed the attached Custom Product Contract as an enabling agreement to allow signatories the flexibility to subscribe to market purchases procured by Western at signatories’ request. Western set a June 30, 2004 deadline for customers to execute the Custom Product Contract. Signatories can later subscribe to the underlying services and products as they see fit.

DISCUSSION

Staff is requesting that Council adopt an ordinance authorizing the City Manager to execute the Custom Product Contract with the Western Area Power Administration for power purchases with a cost not to exceed $2,000,000 per year and not to exceed $10,000,000 during the term of the agreement. Western will provide a signed version of the attached Custom Product Contract for Palo Alto to execute for the January 1, 2005 - September 30, 2010 time period. Custom products will likely be available and economically attractive for part or all of that period. Western offers signed standardized
Custom Product Contracts to all customers. The customization is that different customers can subscribe to different services and purchases in Exhibit A of the Contract.

Western proposed two products for subscription under the Western Custom Product Contract. The first is a day ahead schedule firming service that would allow Western to purchase energy on the City’s behalf to replace any energy lost due to generator outages after the schedules were established. The second product available is fixed volume, fixed market priced forward energy purchase contracts for one to 60 months duration.

The day ahead schedule firming service would only be utilized when an event such as a sudden generator outage caused a shortage of deliverable energy compared to schedules already committed up to 72 hours ahead. In that event, Western would procure short term replacement energy from the market to keep schedules intact and delivered. For utilities that do not subscribe to the day ahead firming service, Western would simply inform them of the sudden change to their scheduled energy delivered and leave it to the utility to handle the shortfall (presumably by buying from the market or increasing the output of the utility’s other generation units). Using Western to make the short term purchases will free up other generation resources that otherwise may have to be held back as replacement reserves. Additionally, using this day ahead firming service is expected to reduce NCPA real-time dispatch administrative costs.

The forward market fixed price and volume purchases may be used to make purchases that are free of California Independent System Operator charges and that may enjoy lower transmission costs. They may also be able to be used to shift the timing of delivery of part of Palo Alto’s share of CVP hydro energy to higher-value daytime hours. Staff is not proposing to take advantage of the fixed forward purchase opportunities at this time. Staff may return to request Council authority for making fixed price forward purchases after various risk management issues have been resolved. On December 15, 2003 (CMR: 465:03) Council authorized the mayor to execute five Electric Master Agreements. Council also authorized the City Manager or designee to manage Electric Master Agreements (EMAs) with the five energy marketing companies. The EMAs are not intended to provide, nor would be a cost effective vehicle to provide, the day ahead firming service.

Day ahead firming purchases produces very little risk exposure because the volumes are small, the durations are short and there is minimal uncertainty in credit quality for counter parties in the front 3 days. Additionally, the City may terminate this agreement on 60 days notice.
Limits of Authorization
Staff is proposing limits and parameters for Council’s authorization to the City Manager:

1. Authority to be delegated to the City Manager to subscribe to Western’s Day ahead firming service where Western would buy electricity to meet day ahead firming requirements as needed.

2. All transactions must be consistent with Council-approved Energy Risk Management Policies [CMR:400:02].

3. All transactions in excess of $65,000 to be reported on a quarterly basis to Council as part of regular reporting (per the Energy Risk Management Policies and Guidelines).

4. The maximum annual dollar limit on Western custom Product purchases is $2 million per year.

5. The maximum total dollar amount of aggregated electricity transactions for the Western custom products is $10 million for the entire 5.75 year period. This limit gives staff needed flexibility in case electricity costs increase above expectations or there are variations in hydrologic conditions.

All transactions that lie outside the authority delegated to the City Manager require Council approval.

Staff would recommend subscription to custom products and services when cost saving opportunities would benefit utilities rate payers. Purchases made through the Custom Product Contract would be paid for 90 days ahead of the start of delivery. Palo Alto can terminate arrangements under the contract with 60 days notice.

ALTERNATIVES

The aggregate cost of all transactions to be executed under the Western Custom Products over the term of the agreement is expected to be between $1 million and $10 million. Therefore, the request for City Manager authority of a maximum of $10 million may appear much larger than necessary. Unfortunately, the actual quantities and costs for the electricity required to meet load are not known at this time. If electricity costs do not deviate greatly from expectations, and the hydrologic years over the term of the
agreements are neither dry nor wet, and generator reliability is normal, the City could transact for less than $10 million of Western custom products.

However, the total volume and cost of transactions in a wet year or a dry year can be higher than in a normal hydrologic year. Market costs for electricity could also increase significantly. Finally, generator reliability could be different from its long-term average.

As an alternative to approving an ordinance allowing purchase of up to $10 million of custom products from Western, Council could further limit the dollar amount, volume amount or the type of purchases that can be entered into, with the likely effect of decreasing the efficiencies and savings that can be achieved by using Western Custom product to fill a niche in the Palo Alto electric portfolio.

**RESOURCE IMPACT**
Net savings to CPAU from its participation in the Custom Product Contract are estimated at about $500,000 per year for the term of the agreement and could range between $0 and $1 million per year. As discussed, net savings depend on many variables including Federal CVP hydrology, generator outages and CVP pumping load variations.

Entering into the agreement has no fixed cost. Subscription to services and products under the contract will have market-based costs passed on to the City.

**POLICY IMPLICATIONS**
The proposed agreement complies with CPAU’s Portfolio Planning Objectives 1 and 2 approved by Council on November 13, 2001 [CMR: 425:01] 1: Ensure low and stable supply rates for customers; and 2: Provide superior financial performance to customers and the City by maintaining a supply cost advantage compared to the market cost and the retail supply rate advantage compared to PG&E.

The proposed agreement complies with the Council approved Long-term Electric Acquisition Plan (LEAP) Guideline 1: Electric Portfolio Dependence on Western: While maintaining the flexibility to adopt favorable ‘custom products’ offered by Western, manage a supply portfolio independent of Western beyond the Base Resource Contract.”

The proposed agreement complies with, and is subject to, continuing adherence to the CPAU’s Energy Risk Management Policies, Guidelines, and Procedures. Furthermore, all transactions undertaken by the City to manage this agreement are subject to review and approval in conformance with internal risk management policies and procedures.
This recommendation is also consistent with the Council-approved Utilities Strategic Plan [CMR 418:00 and 432:02] Strategy 2: Preserve a supply cost advantage compared to the market price; and Strategy 3: Streamline and manage business process to allow the City of Palo Alto Utilities to work efficiently and cost-effectively.

In terms of the City’s Sustainability Policy, neither CPAU’s participation in, nor the existence of the Custom Product Contracts affect the physical operation of the Central Valley Project with respect to river releases. CVP reservoir management and river releases are made for the five higher purposes of flood control, navigation, water delivery, recreation, and fish and wildlife restoration and enhancement. Power generation is only a byproduct of reservoir and river operation for the five higher purposes. Power generation is not a driver of reservoir and river operation.

ENVIRONMENTAL REVIEW

Execution of the Custom Product Contract purchase agreement does not constitute a project for the purposes of the California Environmental Quality act.

ATTACHMENTS

A: Ordinance authorizing the City Manager to execute the attached Custom Product Contract
C: Form 410: Certification of Nondiscrimination

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