TO:     HONORABLE CITY COUNCIL

ATTENTION:  FINANCE COMMITTEE

FROM:  CITY MANAGER        DEPARTMENT: UTILITIES

DATE:    AUGUST 3, 2004                CMR:335:04

SUBJECT:  GAS UTILITY LONG-TERM PLAN RECOMMENDATIONS

RECOMMENDATION

Staff requests that Council approve the six Gas Long-Term Plan (GULP) recommendations.

BACKGROUND

The City of Palo Alto meets a total annual gas demand of approximately 3,250,000 MMBtu comprised of approximately 20,000 residential customers, 2,300 commercial customers, and 10 large customers. The load has declined slightly over the past few years due to the economic downturn.

The pie chart below, Figure 1, shows the make-up of Palo Alto’s load by major customer class. Palo Alto also offers direct access to the 10 largest customers. This rate has been in effect since 1999 (CMR:148:99). However, to-date no customers have elected to receive gas commodity from any alternative supplier. Currently all 10 large customers are on either the monthly variable market rate or a 12- or 24-month fixed-term rate.
Three main factors drove the need for GULP: (1) a need to review and update the current commodity purchasing strategy with public input, (2) the possible need to commit to PG&E assets as part of a PG&E bankruptcy negotiation (not applicable at this time), and (3) the need to be prepared for possible new regulations imposing minimum asset holdings for core customers. In addition, development of a GULP addresses recommendation #20 in the Assessment of Utility Risk Management Procedures by the City Auditor, “CPAU should continue to regularly and actively (a) review the performance of the energy procurement strategy, (b) quantify the risk and cost consequences of alternatives, and (c) communicate the risks and costs of recommended revisions to the City Council.”

**DISCUSSION**

The GULP analysis evaluated potential City of Palo Alto acquisition and participation in five main areas: gas storage capacity, gas pipeline capacity, gas wellhead reserves, prepayment for gas, and gas efficiency programs. In parallel, the City gas commodity procurement strategy was revisited and revised (CMR:167:04). Currently the City holds no long-term gas-related assets.

Storage was analyzed for two potential purposes: (1) swing gas for load-supply balancing and (2) taking advantage of season price differences. The results of the analysis led to
staff’s recommendation not to purchase storage assets at this time. The current arrangement the City has with suppliers whereby gas is sold to or bought from the City at a pre-arranged daily market index in order to balance load and supplies is more cost effective than storage. Storage cost is much greater than the expected benefit of seasonal price differences.

Pipeline capacity acquisition is not recommended given the City’s current gas commodity portfolio. Staff’s analysis showed that the tariff rates are much above the expected future value of all relevant pipeline routes and that the uncertainty of pipeline capacity value is such that the necessary long-term nature of such acquisitions does not result in an expected positive value.

Staff recommends pursuing joining a consortium to investigate potential natural gas reserve acquisition and, if successful, proceeding with the next step, namely hiring an investment bank and consultants to scout for gas reserve properties. This phase will utilize the proposed FY 04/05 budget for this project of $65,000.

The City could take advantage of its low cost of capital and prepay for natural gas in exchange for a discounted price under new regulations implemented by the IRS as of October 2003. Staff investigated the activities of other municipalities and heard that it is possible to structure a prepay deal with little credit risk to the City. While this appears to be a low-risk alternative for Palo Alto, the estimated benefit of $50,000 per year is too small to justify the staff time and cost of formal, expert advice required to structure a deal and then explain it to the City’s decision makers. As a result, staff recommends not participating in prepay arrangements at this time. Staff does recommend the pursuit of low-cost, high-reward supply-related opportunities as they arise.

Staff recommends developing comprehensive demand-side management goals and an implementation plan by Fall 2004 in time for incorporation into FY 05-06 and future ratemaking and budget decisions. This will include evaluation of opportunities to increase efficiency of commercial, industrial and institutional gas customers by deploying advanced metering technologies and on-line usage analysis.

In the interim, staff recommends continued implementation of current and planned FY 04-05 demand-side management programs (DSM). This includes evaluating opportunities to leverage portions of the annual Gas DSM budget of $225,000 to reduce Utilities costs. An example would be targeting supplemental furnace rebates to Rate Assistance Program (RAP) participants having older pilot light units in order to reduce the number of Field Service seasonal pilot turn-on and turn-off workload. This could result in savings to both the participating customer (operating costs) and the Utilities Department (labor and financial subsidies).

Details of all the analyses can be found in the attachments to the June 2004 Utilities Advisory Commission (UAC) report.
COMMISSION REVIEW AND RECOMMENDATIONS
At its February 4, 2004 meeting, the UAC was given a lengthy presentation of the GULP analysis and preliminary recommendations. The UAC had no substantive comments at that time. On June 2, 2004 the UAC unanimously voted to recommend Council approval of the six GULP recommendations. There were no comments by the public.

POLICY IMPLICATIONS
The GULP recommendations support the Utilities Strategic Implementation Plan (CMR:223:01), in particular, Strategy 2 – Preserve a supply cost advantage compared to the market price and Strategy 6 – maintain stable General Fund transfers, and maintain financial strength.

In summary, the six recommendations are:
1. Do not contract for natural gas storage capacity at this time.
2. Do not acquire additional natural gas pipeline capacity at this time.
3. Approve staff undertaking initial steps related to gas reserve acquisition including:
   a) Identifying and evaluating potential consortiums including joint action opportunities;
   b) Entering into consortium agreement to scout properties;
   c) Through the consortium, employing an investment bank and consultants to scout properties and spend up to $65,000 in FY 04-05 related to this effort;
   and
   d) Through the consortium, identifying attractive, feasible opportunities.
4. Do not participate in a gas prepay deal at this time.
5. Pursue any low-cost, high-value prospects to acquire supply-related resources that may arise from time to time.
6. Develop comprehensive demand-side management goals and implementation plan by Fall 2004 in time for incorporation into FY05-06 and future ratemaking and budget decisions. In the interim, continue implementation of current and planned FY 04-05 demand-side management programs.

ATTACHMENTS
A: June 2, 2004 UAC Report
B: June 2, 2004 Presentation
B: Minutes from UAC Meeting June 2, 2004

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