TO: HONORABLE CITY COUNCIL

FROM: CITY MANAGER DEPARTMENT: ADMINISTRATIVE SERVICES

DATE: FEBRUARY 6, 2006 CMR: 128:06

SUBJECT: ENERGY RISK MANAGEMENT POLICY AND ADOPTION OF A RESOLUTION APPROVING THE REVISED ENERGY RISK MANAGEMENT POLICY

RECOMMENDATION
Staff recommends that the City Council approve the revised City of Palo Alto Energy Risk Management Policy.

BACKGROUND
The City Council has previously adopted (CMR:148:05) a policy of providing valued utility services to customers and dependable returns to the City in an environmentally sustainable manner. A key element of providing dependable financial returns is the management of risk. Council approved the first Energy Risk Management Policy on March 19, 2001 (CMR:103:01) and a revised policy on October 1, 2002 (CMR:400:02). The Energy Risk Management Policy details the key control structures and policies for a prudent risk management program. It is based on sound utility risk management principles, while adhering to financial requirements set forth by City Council and Director of Administrative Services as well as all pertinent legal requirements.

The Energy Risk Management Policy (Attachment A) describes the City of Palo Alto’s overall perspective and tolerance for electric and gas commodity risk; its risk management line structure, including the roles and responsibilities of the Front Office (energy transaction), Middle Office (risk management), and Back Office (settlement); and the roles and responsibilities of risk oversight bodies, including the Risk Oversight Committee (ROC), the Utilities Advisory Commission (UAC) and the City Council.

DISCUSSION
Since Council’s last approval of the Risk Management Policy in 2002, significant changes have been implemented to enhance risk management practices. These include the hiring of a full-time Energy Risk Manager and the quarterly reporting of electricity and gas risks to the Council and the Utilities Advisory Commission. Staff has jointly implemented 24 process and procedural changes to satisfy all but two recommendations of the City Auditor’s report on Risk Management Practices. The process and procedural changes include: full implementation of
recorded phone lines for all transactions; development of a secured transaction database to manage transactions and risk exposure; and refined analytical methodologies for determining credit exposure and the financial health of counterparties. Finally, staff has implemented new energy risk management guidelines and procedures that provide greater detail and stronger controls on commodity purchases, organizational risk, counterparty risk, volume and market risk, and credit risk. The implementation of the guidelines and procedures, combined with actions to increase separation of the Front and Back Office responsibilities, are aimed at fully complying with the final two auditor recommendations.

The proposed policy was reviewed by the Risk Oversight Committee and the Attorney’s Office. In addition, the policy was presented to the Utilities Advisory Commission (which approved the policy and recommended forwarding to the Council). The policy represents leading practices in the utility industry and is applied in a manner appropriate to the risk profile of the City.

The key changes in the new version of the policy are:

- **Conflict of Interest Provision.** Provides that all staff involved in evaluating contract proposals as well as entering into transactions report financial holdings on the Form 700.
- **Responsibilities in Middle Office to halt or limit transactions.** The new policy provides for the Middle Office Risk Manager, with approval of the Director of ASD, to halt transactions with any counterparty or modify transaction limits in an expedited manner. This allows the City to manage its exposure to any counterparty in what has become a complex and volatile energy market.
- **Separation of duties between Front and Back Offices.** Provides for a clearer separation of responsibilities between the Front and Back Offices and their reporting structure. This ensures that, in accordance with industry leading practices, staff entering into transactions are not involved in billing and settlement and that the reporting structures are also separated.
- **Roles of Oversight Bodies.** The key roles of oversight bodies such as the UAC and Risk Oversight Committee have been focused on the key areas of risk.
- **Role of Risk Oversight Committee.** The role of the Risk Oversight Committee is extended to the City’s telecommunications program.
- **Technical Language.** Staff has simplified the document and removed much of the previous technical language. The revision should be more readable and provide useful information for the public.

**BOARD/COMMISSION REVIEW AND RECOMMENDATIONS**
The UAC discussed the proposed Energy Risk Management Policy at its September 7, 2005 meeting and the Commission unanimously recommended adoption of the proposed Energy Risk Management Policies.
**POLICY IMPLICATIONS**
The revised Energy Risk Management Policies are consistent with the Deloitte & Touche risk management report, the overall recommendations of the City Auditor, the Utilities Strategic Plan, and prior Council input and direction. The policy is consistent with best risk management practices through separation of duties, enhanced process controls, improved risk management techniques, enhanced training of staff, and increased data security. The policies support the Utilities Strategic Plan:

- Strategy 2: Preserve a supply cost advantage (through the proper management of energy commodity price risk).
- Strategy 3: Streamline business processes (through enhanced trade capture processes and improved risk management techniques).
- Strategy 6: Maximize the General Fund transfers and maintain financial strength (through improved risk management, credit management of counterparties, and reporting of financial risks to oversight bodies).

**RESOURCE IMPACT**
The financial resources required to implement the policies are contained within the current budget.

**ENVIRONMENTAL REVIEW**
There are no direct environmental impacts of this policy.

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**ATTACHMENTS**
A) City of Palo Alto Energy Risk Management Policy
B) Resolution