City of Palo Alto Utilities

Energy Risk Management Policies

For Consideration by City Council
October 2005
City of Palo Alto Utilities Energy Risk Management Policies

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I. INTRODUCTION

It is the policy of the City of Palo Alto, to provide reliability and affordable energy and energy services to its industrial, commercial and residential customers in an environmentally sustainable manner. Furthermore, this policy is consistent with the City’s business objectives of making financially sound and timely investments in the capital infrastructure of the Utilities to ensure the reliable delivery of energy and energy services to its customers.

The Energy Risk Management Policy details the key control structures and policies for a prudent risk management processes based on sound utility risk management principles, while ensuring adherence to financial requirements set forth by City Council and Director of Administrative Services as well as all pertinent legal requirements. The control structures and policies are focused on the following issues:

- Clearly defined segregation of duties and delegation of authority
- Organizational structure for risk management controls
- Policies related to setting acceptable risk parameters and risk limits.
- Policies for risk reporting
- Permitted transaction and product types.

II. ENERGY RISK MANAGEMENT PHILOSOPHY

The mission statement of the Utilities Department is “To build value for our citizen owners, to provide dependable returns to the City and citizens of Palo Alto, and to be the preferred full service utility provider while sustaining the environment.” The Utilities Strategic Plan, adopted by the Council on November 13, 2000\(^1\) contains four supporting objectives: 1) Enhance customer satisfaction by delivering valued products and services; 2) Invest in utility infrastructure to deliver reliable service; 3) Provide superior financial performance to the City and competitive rates to customers; and 4) To identify and maintain the unique advantages of municipal ownership.

Palo Alto recognizes that certain risks are inherent in the deregulated energy business environment. The City seeks to minimize risks in order to provide retail rate stability to its retail customers and a stable financial return to the City’s General Fund. The basic premise underlying the City’s energy risk management attitude is that no activities related to energy purchase and sales should expose the City to the possibility of large financial losses in relation to the size of the electricity and gas reserve funds.

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\(^1\) Council approved the Utilities Strategic Plan on Nov. 13, 2000 (CMR:418:00) and the Utilities Strategic Implementation Plan on May 21, 2001 (CMR:223:01).
III. ENERGY RISK MANAGEMENT OBJECTIVES

The primary objectives of energy risk management activities are to balance the business objectives of (1) providing stable gas and electric rates to end users, (2) preserving a supply cost advantage through obtaining the best available price, and (3) managing business processes to allow the City to work efficiently and cost effectively.

1. Retail Rate Stability

Stable rates are of high value to the citizens and businesses in Palo Alto. However, energy commodity market prices are extremely volatile. Therefore, a primary objective is to manage the risks inherent in the energy commodity markets in which CPAU participates. The rate stability objective will be to mitigate market risk and credit risk.

Reserve balances maintained by the gas and electric utilities provide financial liquidity and flexibility in entering into other shorter-term contracts and purchases of energy in the spot and forward market as needed to meet the projected load. Maintaining the safety of these reserve funds is a matter of high priority for CPAU and the City.

2. Preserve a Supply Cost Advantage

CPAU will endeavor to: (a) reduce exposure to potential adverse energy price movements; (b) enhance revenue by taking advantage of flexibility inherent in CPAU contracts and resources; and (c) enhance revenue by offering commodity products that address customer needs and adequately cover costs.

3. Efficient and Cost Effective Business Processes

City staff will utilize business practices and controls that are sufficient to identify, evaluate, and manage risks, and are designed to streamline and minimize recording, analysis and reporting requirements. Staff will strive to improve the risk management procedures to enhance productivity, reduce the cost of conducting risk management activities, and maintain transparency and value of the risk management process.

IV. SCOPE

These Energy Risk Management Policies shall apply to the electric and natural gas supply business units as well as telecommunications business units. The electric and natural gas units are the part of the electric and natural gas enterprise funds that deal directly with the acquisition of energy supply resources.

- These Energy Risk Management Policies prescribe the management, organization, authority, processes, tools and systems to monitor, measure, and control market risks to
which the City is exposed in its normal course of business, including wholesale and retail operations, capital projects (related to generation, transmission, transportation, or storage, not distribution projects), and participation in joint powers authorities.

- The policy does not address general business risks such as fire, accident, casualty, worker health and safety, and general liability. Neither does the policy does not cover the water fund or the electric and natural gas distribution business units.

V. GENERAL TRANSACTING POLICY

1. Anti-speculation
Speculative buying and selling of energy products is prohibited. Speculation is defined as buying energy not needed for meeting forecasted load or selling energy that is not owned. In no event shall transactions be entered into to speculate on market conditions.

2. Maximum Transaction Term
The maximum term of any supply resource transaction (purchase or sale) should be ten years, unless specifically approved by the City Council, to meet long-term portfolio planning objectives.

3. Portfolio Performance and Value Reporting
Staff shall prepare performance reports containing an analysis of physical and financial positions of all electric and gas commodity contracts. The frequency and content of performance reports for each oversight body shall be prescribed in the Energy Risk Management Guidelines. Should the ratio of the market value of the portfolio to the cost of the portfolio fall outside of the risk limits prescribed in the Energy Risk Management Guidelines, the City Manager will report this fact to the City Council within a reasonable period and evaluate whether there is any risk of holding any of the contracts in the portfolio to delivery.

4. Competitive Process
Whenever possible, CPAU will obtain three or more quotations when making a purchase or sale transaction and select the best price from a responsible bidder.

VI. OVERSIGHT BODIES

1. City Council
The City Council is responsible for making high-level broad policy and strategy statements as contained in this Policy document. The Policy shall guide the general vision of CPAU business practices, articulating the City’s risk philosophy, and establishing risk tolerances. The City
Council adopts the Energy Risk Management Policies as developed and recommended by the Risk Oversight Committee and delegates the City Manager to execute it. The City Council will review the Policy every year. Additionally, the City Council shall receive reports quarterly from the City Manager regarding energy risk management activities. These reports will be provided to the Council as soon as possible after the end of each quarter and no later than eight weeks following the end of the quarter.

2. **Utilities Advisory Commission**

The Utilities Advisory Commission (UAC) is responsible for advising the City Council on long-range planning and policy matters relating to the electricity, gas and water utilities. While it has no formal responsibility in Risk Management, the UAC does receive and review regular management reports prepared by the Risk Manager for the City Council. In addition, the UAC can serve as an important source of advice and comment to the City Council on risk management.

3. **City Manager**

The City Manager has overall responsibility for executing and ensuring compliance with policy adopted by the City Council. The City Manager reports quarterly to the City Council regarding energy risk management activities.

4. **Risk Oversight Committee**

The Risk Oversight Committee (ROC) consists of the Director of Utilities (Chairperson), the Director of Administrative Services, and the Assistant City Manager. The Senior Assistant City Attorney assigned to Utilities and the City Auditor act as non-voting advisors to the ROC. The Energy Risk Manager serves as the Secretary to the Committee.

The ROC is the primary body responsible for creating and implementing a sound approach to managing risk consistent with the business strategy and risk tolerance of the organization as defined by the City Council. As such, the ROC is critical to overseeing and reviewing the risk management process and infrastructure and managing the Utilities’ risk exposure.

5. **Management Oversight**

Risk management oversight at an operational level is accomplished through supervisory review and approval and appropriate separation of duties. Risk management functions are separated as follows:

a. **Front Office – Planning and Procurement**

   The Front Office is primarily responsible for resource planning and procuring energy supplies and services. The Front Office oversight role is accomplished through supervisory review and approval.
b. Middle Office – Controls and Reporting

The Middle Office provides the primary independent management oversight role. The Middle Office institutes, supervises, and reviews all risk management activities including portfolio exposure, credit exposure, transaction compliance and on-going approval of counterparties and transacting precuts. The Middle Office responsibilities include monitoring CPAU’s risk exposures and ensuring compliance with policies, guidelines, and procedures. Additionally, the Middle Office is responsible for reporting to the ROC on Risk Management issues, and recommending to the ROC when changes in policy or operating procedure are required. These recommendations may relate to the temporary or permanent halting of transactions with one or more counterparties, exceptions to rules and procedures, other operational exceptions, and any other topic the Risk Manager believes represents an unacceptable risk exposure.

The Middle Office adopts and updates as necessary the Energy Risk Management Policies, Guidelines and Procedures so that portfolio management functions occur in compliance with the Council-adopted Energy Risk Management Policies and ROC-adopted Energy Risk Management Guidelines. The functions of the Middle Office can be broadly defined as Quantitative Analysis, Compliance Review, Credit Administration, and Management Reporting.

Quantitative Analysis
The Middle Office performs rigorous risk analysis to evaluate the risk exposure on both a transaction and portfolio basis.

Compliance Review
The Middle Office monitors all transactions to ensure compliance of transactions with the Risk Management Policies, Guidelines and Procedures.

Credit Administration
The Middle Office monitors counterparty creditworthiness. The Middle Office objectively measures and monitors credit limits and credit histories, and may temporarily or permanently halt trading, upon recommendation of the ROC, with an approved counterparty because of credit exposure or credit condition.

Management Reporting
The Middle Office administers reports to the ROC related to risk management, and performance in alignment with the Energy Risk Management Policies and Guidelines and the requests of the ROC.
c. **Back Office – Settlement and Recording**

The Back Office is primarily responsible for settlement of bills, recording transactions, bookkeeping and accounting, and contract administration. The Back Office roles in oversight are ensuring that bills reflect orders, independently monitoring and recording transactions into a tracking database, and verifying and reporting on compliance with procedures as reflected in the deal tracking documentation. Functions within the Back Office are performed by both ASD and CPAU personnel and are detailed in the Risk Management Procedures.

**VII. CUSTOMER CONTRACT POLICY**

Guidelines for oversight, review, approval, pricing, and reporting of customer contracts and fixed-term commodity rates are necessary to ensure staff is implementing contracts as directed by Council and contained within the CPAU Rules and Regulations of the City of Palo Alto Utilities #5, Section D.

**VIII. COMMODITY PRICING POLICY**

1. **Policy Statement**

Retail prices for energy supplies will be fair and equitable to all customers and will recover all incurred costs. The commodity pricing policy will be used both for the development of standardized commodity tariffs and for long-term, or customized, customer contract rates. The City Manager is responsible for implementing this policy by overseeing the process of all commodity rate development and ensuring that all procedures are followed consistently and that all calculations are appropriately documented.

The commodity pricing policy is composed of the following five principles with the first principle having priority over the remaining four:

- **a. Direct Cost Recovery**
  All direct costs of providing commodity service will be recovered in commodity rates.

- **b. Risk Management**
  To the extent practicable, all risks must be insured, and contract terms must protect CPAU from major contingencies. To the extent that CPAU assumes risk to provide commodity products to customers, the customer shall pay reasonable compensation for bearing that risk.

- **c. Indirect Cost Recovery**
  To the extent practicable, it is an objective to recover all indirect costs of commodity service from commodity customers.
d. **Nondiscrimination**
   All customers within a customer class shall be treated in a fair and impartial manner and be entitled to acquire commodities at the same or substantially similar terms and conditions.

e. **Nonsubsidization**
   To the extent practicable, costs will be allocated to customers and customer classes according to how those costs are incurred. Thus, commodity rates will not be established in a manner that permits one class of customers to be subsidized by another.

**IX. COUNTERPARTY CREDIT POLICY**

1. **Objectives**
   The objective of the Counterparty Credit Policy is to minimize the potential adverse financial impacts on the City in the event of a defaulting counterparty. The policy is to minimize the City’s credit exposure and potential adverse financial impacts by:

   - Establishing a credit risk management governance and oversight structure within the existing energy risk management program;
   - Providing a framework to enable the City to qualify energy suppliers and transact with approved counterparties;
   - Providing counterparty transacting parameters (limits) to control and measure the City’s exposure to any one supplier; and
   - Implementing a mechanism to monitor and report on supply portfolio related counterparty credit exposures.

   This policy applies to market-based commodity transactions as well as to physical asset-based transactions related to generation, transmission, gas wells, pipeline capacity, natural gas storage, etc.

2. **Organizational Roles and Responsibilities**
   The Middle Office has the responsibility to ensure that energy procurement transacting activities and supply portfolio management conform to the Counterparty Credit Policy.

3. **Guidelines to Qualify Suppliers**
   Counterparty credit risk management involves selecting reputable companies to supply the City and allocating purchases amongst multiple suppliers. The guidelines set out qualification
criteria for potential counterparties of the City. The ROC maintains a list of approved counterparties.

4. **Assignment of Transaction Limits and Credit Exposure Limits to Counterparties**

The ROC approves the Counterparty Credit Limits proposed by the Risk Manager and ensures that such limits diversify the credit exposure of the City as it relates to energy supply procurement activities. Transaction and Credit Exposure Limits are established by evaluating a counterparty’s credit worthiness, net worth of assets held by the counterparty, quality of guarantees, market intelligence, and credit enhancement tools provided by counterparty, as set forth in the Energy Risk Management Guidelines.

5. **Monitoring and Reporting on the Counterparty Credit Exposures**

Counterparty credit exposures and transactions volumes relative to the established limits are to be monitored on an ongoing basis and reported to the ROC on a monthly basis by the Risk Manager.

X. **POLICY REVIEW AND REPORTING ON TRANSACTING**

Key to energy risk management is the monitoring of risks. Accurate and timely information must be provided to all parties involved in any aspects of energy risk management to allow them to perform their functions appropriately. Quarterly reports will be provided for distribution to the ROC, the UAC, and the City Council which provide details on the City’s forward purchases, market exposure, credit exposure, transaction compliance and other relevant data.

XI. **AUTHORIZED TRANSACTING PRODUCTS**

Products allowed for electric transactions include energy, capacity, transmission, and ancillary services. Products allowed for natural gas transactions include energy, transportation, and storage. The Risk Oversight Committee is responsible for authorizing all products and commodity types as further detailed in the Energy Risk Management Guidelines. At this time, only physical transacting products are approved. Financial products are explicitly prohibited. Transactions of products not approved by the Risk Oversight Committee are strictly prohibited. All transactions must follow certain requirements as described throughout this Policy. Key elements of CPAU’s transaction policy are as follows:

- All transactions must be committed to by authorized transacting personnel.
- All transactions must be with approved counterparties with executed and Council approved contracts.
- All transactions must be with counterparties with adequate available credit.
- All transactions must be committed over recorded phone lines or via electronic mail.
• All transactions must be Approved Transaction Types.
• All transactions must be consistent with Risk Management Policy as described in this document, as well as Risk Management Guidelines and Procedures.

Failure to observe the above minimum requirements when executing energy transaction is a violation of Policy and is subject to disciplinary action.

XII. TRANSACTING AUTHORITY

The City Manager has the authority to purchase and sell wholesale energy commodities for terms of up to three years under open purchase contracts. The Director of Utilities is granted the authority to negotiate for the purchase and sale energy commodities. Purchases and sales are subject to signature authority limits as defined in the Municipal Code. Currently, energy purchases exceeding $250,000 per year and exceeding a three-year term require City Council approval (Municipal Code Sec 2.30.210 (l)). Authority to enter into transactions must be based on City Council approved contracts such as master agreements, purchase agreements, or other contractual forms. In all cases the Municipal Code provides the final authorization rules and regulations for energy purchases.

City Manager authorities may be delegated by the City Manager. Authorization levels for City staff as delegated are maintained in the Risk Management Procedures manual by the Middle Office. The City Clerk maintains the list of individuals authorized to make wholesale transactions.

XIII. CONFLICT OF INTEREST

In accordance with the Municipal Code and California law, personnel involved in transacting and oversight of the Utilities supply resource acquisition programs may not engage in financial conflicts of interest, unless the City is duly informed and it elects to waive such conflicts. The Energy Risk Management Guidelines contain detailed requirements for staff conflict of interest disclosure and prohibitions as to acquiring or maintaining financial interest in energy trading counterparties. All personnel in procuring or selecting counterparties for contracting or transacting are required to complete, on an annual basis, the Form 700 Disclosure forms and submit these forms to the City Clerk. Utilities Department senior management are responsible for routinely reviewing the Form 700 of each staff member engaged in the supply resource decision-making process for the purpose of identifying potential financial conflicts of interest. The City Attorney's Office will assist Utilities Department senior management in reviewing these forms and providing legal advice in connection with such reviews.