TO: HONORABLE CITY COUNCIL

ATTN: FINANCE COMMITTEE

FROM: CITY MANAGER

DEPARTMENT: UTILITIES

DATE: OCTOBER 21, 2008

CMR: 393:08

SUBJECT: Consideration of a Recommendation to City Council to Adopt a Resolution Approving the Execution of the Agreement for a Long-Term Assignment of the City’s Share of Transfer Capability on the California-Oregon Transmission Project to Other Members of the Transmission Agency of Northern California

RECOMMENDATION

Staff recommends that the Finance Committee recommend that Council adopt the attached resolution approving the execution of an agreement for a fifteen (15) year assignment of the City’s share of the electric high voltage California-Oregon Transmission Project (COTP) to the Modesto Irrigation District (MID), the Turlock Irrigation District (TID) and the Sacramento Municipal Utility District (SMUD), thereby lowering the cost to serve the electric utility customers of the City.

BACKGROUND

The Transmission Agency of Northern California (TANC) is a California Joint Powers Agency, whose membership comprises SMUD, MID, TID, and the California cities of Alameda, Biggs, Gridley, Healdsburg, Lodi, Lompoc, Palo Alto, Redding, Roseville, Santa Clara, and Ukiah. TANC currently owns approximately 87 percent of the COTP, a 1600 MW, 340 mile long electric transmission line from the California-Oregon Border (COB) to the 500 kilovolt Tracy substation in Northern California. The City is a signatory to TANC’s 1990 Project Agreement No. 3 (PA3) (Resolution No. 6877, adopted March 26, 1990). PA3 provides the City a share of approximately 50 MW of TANC’s entitlement on the COTP.

Since the COTP became operational in March 1993, the City has utilized this asset to access low-cost electricity resources from the Pacific Northwest to serve the electricity needs of the City. While the City and the Northern California Power Agency (NCPA), as the City’s electricity scheduling agent, have continued to utilize the COTP to meet the electrical loads of the City at the lowest cost, the value of this transmission right in recent years has been lower.
than the cost of ownership. This is particularly pronounced for Palo Alto; the City is located within the control area operated by the California Independent System Operator (CAISO), while the COTP line is in a separate control area jointly operated by the SMUD and the Western Area Power Administration (Western). While the City continues to consider the COTP a strategic asset for future years when the cost of ownership can be offset by its market value, the projected short-term value of the asset prompted staff to explore temporary assignment options to members of TANC located within the SMUD-Western transmission control area. These entities have the potential to garner greater value from the transmission asset.

The Utilities Advisory Commission (UAC) in April 2008 conceptually approved staff’s recommendation to assign the City’s share of the COTP to interested parties. In July 2008, staff presented the justification for the long-term assignment of the City’s COTP entitlements to the Finance Committee and sought approval of a short-term assignment as a bridging agreement while negotiations for the 15-year assignment continued. Following the Finance Committee’s recommendation, the Council approved the short-term assignment of the City’s rights in the COTP to SMUD and TID for the months of August 2008 through January 2009, or until the 15-year agreement becomes effective, whichever is earlier (Resolution No. 8850, adopted July 28, 2008).

**DISCUSSION**

**COTP Cost**

The City’s electricity supply-related budget for FY 2008-09 (FY ’09) is approximately $78 million, of which approximately $2 million is related to the COTP transmission asset ownership cost. The debt service costs are expected to remain flat at $1.284 million/year until 2024 when the debt is fully paid-off. The other costs of $550,000 per year are expected to increase by 3% per year. In addition to these costs of ownership, COTP owners incur a number of usage-based charges such as SMUD transaction fees, transmission line losses from the COB, and other CAISO charges. These additional costs, which are highly variable and depend on utilization of the line, are estimated at between $100,000 and $400,000 per year. These costs could also change due to regulatory changes.

**Value Drivers**

The value of the COTP is derived in multiple ways, but falls into three major categories:

1. **Basis Value**: Basis is the difference between the market prices for electricity delivered to COB versus delivered into Northern California. Based on forward prices, the basis value of the COTP for the next 12 months is estimated at 40% to 70% of cost and declines even further in the outer years.

2. **Capacity Value**: Supplies imported from the Northwest have capacity and ancillary services (electricity products sold in the market) value. Imports of firm energy delivered at COB and scheduled over the COTP for the City’s load currently count towards meeting the City’s reliability requirements. Staff estimates that the potential capacity and ancillary services value associated with COTP could be $350,000 to $600,000 per year, or 15% to 30% of the cost starting in 2010.
3. **Operation Value**: The COTP has value associated with access to resources and markets in the Pacific Northwest for non-economic reasons. Staff’s assessment of operational value of the asset is $50,000 to a $100,000 per year, or less than 5% of the ownership cost.

In total, the value of COTP to the City is estimated to be about 60% to 75% of the annual cost of owning and operating the asset based on the factors identified above. A summary of these costs and values is in the Resource Impact section below.

**Risk Assessment**

The City faces low overall risk from the proposed agreement, both in the short-term, from defaults by the assignees, and in the long-term from the impacts of potential regulatory and industry changes in the future.

**Short Term Assessment**: Under the terms and conditions of the contract, Palo Alto will not be billed for any COTP associated costs during the term of the assignment; these costs will be billed directly to the assignees/counterparties. Any default by a counterparty will be remedied prior to the start of the month’s delivery. In the absence of such remedy, the assignment of the layoff will revert back to Palo Alto, limiting the cost to the lost opportunity of COTP use for one month. In the event of a default by counterparty, the City’s COTP entitlement reverts back to the City and the City will revert to its current ownership position.

**Long Term Assessment**: Although the COTP assignment is expected to create value for the City, the outcome could prove to be unfavorable or more favorable than expected. Listed below are the value-related uncertainties that staff considered in evaluating a long-term assignment:

1. The building of new transmission lines to the Northwest markets and British Columbia, could shrink the COB/Northern California basis values. This factor favors the proposed assignment.

2. The impact of the CAISO’s new market design could reduce the value of COTP imports compared to resources from Northern California. These combined factors favor the proposed COTP assignment.

3. An unexpected and large increase in Palo Alto’s electric demand or a move to increase Palo Alto’s renewable portfolio goal to 50% may increase the City’s interest in accessing Northwest resources. This uncertainty favors a medium-term assignment of 5-10 years.

Assessment of these risks led staff to recommend a 15-year assignment, coincident with the extinguishing of the debt service for the COTP, and ending by 2023.

**Summary**

Based on staff’s cost-benefit analysis, the COTP will continue to have a net cost to the Electric Fund until 2024. Since COTP is considered a strategic asset that provides flexibility to the electric portfolio in meeting City’s long-term loads, staff does not recommend an outright sale or permanent assignment of its rights to the project. But, a medium-to-long-term assignment of the asset at full cost is likely to prove valuable to the electric portfolio.
Should the Council approve execution of the 15-year assignment of the City’s interest in the COTP transmission line, the City will no longer have long-term access to the Pacific Northwest markets. However, there are alternative ways to access these markets on an as-needed basis, and staff is exploring a number of other contractual mechanisms to achieve the objective of accessing other regional markets when it is economically beneficial to do so. One such mechanism is to enter into enabling agreements with members of TANC that will provide the option to the City and interested TANC members to execute short-term bilateral transmission transactions for the use of COTP during periods of value. Such access to COTP transmission in certain periods might be obtained at a discount to full costs. When staff finalizes an evaluation of such opportunities, staff will return to Council to seek additional approvals.

**BOARD/COMMISSION REVIEW AND RECOMMENDATIONS**

The UAC reviewed the concept of an assignment of the COTP at its April 2, 2008 meeting. At the time of the UAC meeting, a contract was unavailable for review. The UAC voted unanimously to recommend conceptual approval of a temporary (15-20 years) assignment of the COTP.

**RESOURCE IMPACT**

The impact on the Electric Fund from the 15-year assignment of the COTP is reduced expenses, including a reduction of debt service payments of approximately $1.3 million per year and a reduction of the operation and maintenance costs of about $550,000 per year in 2008, which would escalate each year. At the same time, the values derived from use of the COTP will disappear when the asset is assigned. Staff estimates that the value of COTP is only 60% to 75% of the cost of ownership; thus, a long-term assignment at full cost will save $400,000 to $800,000 per year, which is equivalent to a favorable retail rate impact of approximately 0.5%.

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<thead>
<tr>
<th>Annual Cost</th>
<th>Cost/Value ($/year) over the 20-year assignment period</th>
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<tbody>
<tr>
<td>1. Debt Service Payments</td>
<td>$1,300,000</td>
</tr>
<tr>
<td>2. Operations and Maintenance</td>
<td>700,000</td>
</tr>
<tr>
<td>3. Usage-Based Charges</td>
<td>250,000</td>
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<tr>
<td>Total Annual Cost</td>
<td>$2,250,000</td>
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<table>
<thead>
<tr>
<th>Annual Value</th>
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<tbody>
<tr>
<td>1. Basis Value</td>
<td>$750,000 to $1,300,000</td>
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<tr>
<td>2. Capacity Value</td>
<td>$350,000 to $600,000</td>
</tr>
<tr>
<td>3. Operational Value</td>
<td>$50,000 to $100,000</td>
</tr>
<tr>
<td>Range of Monthly Value</td>
<td>$1,150,000 to $2,000,000</td>
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<tr>
<td>Annual Value as a fraction of cost</td>
<td>51% to 89%</td>
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<tr>
<td>Net Savings</td>
<td>$250,000 to $1,100,000 per year</td>
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**POLICY IMPLICATIONS**

This recommendation is consistent with the Council-approved Utilities Strategic Plan with regard to managing supply portfolio risk to preserve a supply cost advantage.
ENVIRONMENTAL REVIEW
Approval of this agreement does not require review under the California Environmental Quality Act (CEQA) because it does not meet the definition of a “project” pursuant to California Public Resources Code Section 21065.

ATTACHMENTS
A: Resolution of the Council of the City of Palo Alto Approving the Execution of the Agreement for a Long-Term Assignment of Palo Alto’s Share of Transfer Capability on the California-Oregon Transmission Project to Other TANC Members
B: Resolution 2008-xx, Resolution of the Transmission Agency of Northern California Authorizing the Execution of the Long-Term Layoff Agreement Between TANC and Certain of its Members
C: Agreement for Long-Term Layoff By and Among the Transmission Agency of Northern California and certain of its Members namely The City of Palo Alto, The City of Roseville, The Modesto Irrigation District, The Turlock Irrigation District, and The Sacramento Municipal Utility District
D: Minutes from the April 2, 2008 UAC meeting

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