TO: HONORABLE CITY COUNCIL

FROM: CITY MANAGER DEPARTMENT: UTILITIES

DATE: JULY 22, 2002 CMR:331:02

SUBJECT: APPROVAL OF THE NATURAL GAS SERVICES AGREEMENT WITH PACIFIC GAS AND ELECTRIC ENERGY TRADING GAS CORPORATION FOR AN AMOUNT NOT TO EXCEED $10.9 MILLION FOR NATURAL GAS OPERATIONS AND RESIDUAL GAS BALANCING SERVICES

RECOMMENDATION
Staff recommends that Council:

Authorize the City Manager or his designee to negotiate and execute the attached Natural Gas Services Agreement with Pacific Gas and Electric Energy Trading Gas Corporation in the amount not to exceed $1.6 million for natural gas operations and residual gas services to commence September 1, 2002 and end December 31, 2003.

1. Authorize the City Manager or his designee to exercise the option to renew the contract through August 31, 2005 in an amount not to exceed $6.9 million.

2. Authorize the City Manager or his designee to negotiate and execute one or more amendments to the contract with Pacific Gas and Electric Energy Trading Gas Corporation to cover additional gas commodity cost associated with an increase in wholesale natural gas prices and/or natural gas usage. The total of these change orders shall not exceed $2.4 million.

3. Adopt the attached resolution authorizing the City Manager or his designee to confirm its legal authorization to enter into a contract with Pacific Gas and Electric Energy Trading Gas Corporation.
BACKGROUND
The City of Palo Alto Utilities Department (CPAU) is obligated to provide reliable natural gas supplies to its approximately 23,000 gas customers. To do this, the CPAU procures gas from multiple gas commodity suppliers at the California-Oregon border (Malin) and at the Pacific Gas and Electric Company’s (PG&E) Citygate. The gas commodity is then transported via PG&E’s gas transportation system to the CPAU’s distribution system.

As a gas wholesale customer on PG&E’s gas transportation system, CPAU must adhere to PG&E’s rules and regulations relating to gas operations, which include daily nominating and scheduling on PG&E’s system, monitoring and responding to Emergency and Operational Flow Order (EFO/OFO) events as called by PG&E, and assuring that gas supplies are balanced with CPAU’s actual usage. In order to properly carry out these functions, coverage is needed on a 24 hours per day, seven days a week basis. Failure to meet PG&E’s operational requirements may expose CPAU to penalties in accordance with PG&E’s published tariffs.

In Spring 2001, Enron North America (Enron) was selected through a Request for Proposals (RFP) process to be CPAU’s natural gas operations services and residual gas provider. On November 30, 2001, CPAU terminated its contracts with Enron. Since termination, Enron has not provided operations or gas commodity to CPAU. An existing gas consultant to CPAU, Interstate Gas Services (IGS), has been providing daily gas operations services. Gas supplies are being purchased from British Petroleum Energy Company (BP) and Sempra Energy Trading Company (Sempra) through agreements signed by CPAU on March 1, 2001 and July 31, 2001 respectively and later ratified by Council (CMR’s 341:01 and 420:01).

DISCUSSION
Selection Process
On April 1, 2002, staff sent an RFP to 37 natural gas suppliers operating in North America and to IGS, CPAU’s interim gas operations provider. Firms were given 22 days to respond to the request. A total of eight firms submitted proposals. Two proposals were rejected for not meeting the RFP requirements and one was withdrawn. The expected cost of the proposals for operational services and premiums to the residual gas commodity index ranged from an estimated $22,000 to $613,000. This range does not include the cost of residual gas commodities since all proposals offered to provide residual supplies at prices based on the same daily index.
Those firms not responding indicated that they did not submit a proposal because the process was either too cumbersome, they were not interested in providing operations services, or they did not have markets in Northern California.

An evaluation committee consisting of staff from Administrative Services’ Treasury and Purchasing Divisions and Utilities Resource Management Division reviewed the proposals, and four firms were invited to participate in oral interviews. The committee carefully reviewed each firm's qualifications and submittal in response to the RFP relative to the following criteria:

1. Creditworthiness
   Current CPAU Energy Risk Management Guidelines for counterparty creditworthiness were applied as a screening criteria for firms providing residual gas.

2. Operations Service Level
   Firms were evaluated on their willingness and ability to provide daily operations services as required by PG&E’s operational requirements.

3. Residual Gas Services
   Firms were evaluated based on their ability to provide residual gas services and whether they provided daily or monthly balancing.

4. Minimization of Risk
   Firms were assessed based on their ability to minimize commodity price and operational risks.

5. Cost
   Cost consisted of the annual fee for providing daily operations, and the premium, if any, to the index price for the residual gas commodities. The cost was adjusted to account for different levels of service proposed. Additional costs were added for proposals that provided lower levels of service.

6. Past Performance
   If applicable, past performance with CPAU was evaluated.

Pacific Gas and Electric Energy Trading Gas Corporation (PGET), a subsidiary of PG&E Corporation, was selected because it met CPAU’s creditworthiness criteria, was willing to provide adequate daily operations services and its proposal resulted in the lowest
expected annual cost to CPAU for operations and residual gas services. Further, PGET demonstrated a greater knowledge of the California’s gas markets, specifically operations on PG&E’s system. Additionally, because of PGET’s extensive pool of gas customers in Northern California, CPAU staff believes and anticipates that PGET is better able to manage and minimize operational risk, thus further reducing CPAU’s expected annual gas cost.

**RESOURCE IMPACT**
PGET’s proposal consists of a management fee of $0.005 per million British thermal units (MMBtu) on all gas used by CPAU to cover daily operations. All residual gas purchases and sales are to be provided at a daily index price. The initial term of the contract is September 1, 2002 through December 31, 2003. The contract has an option to extend through August 31, 2005, a maximum of three years. The total cost for the term of the contract is dependent on actual usage and the daily index price both of which are unknown until the end of the delivery month.

For FY 2002/03 CPAU has procured roughly 100 percent of its expected load at a fixed price through its current suppliers BP and Sempra. CPAU anticipates purchasing baseload gas for up to 75 percent of its expected load for FY 2003/04 and 2004/05 via multiple suppliers and not under this contract. Thus, the residual gas quantities are not anticipated to be more than 25 percent of expected usage. The expected usage is based on a forecast that is highly weather correlated, therefore actual usage will vary and residual quantities will likewise vary.

Staff estimates the management fee and residual gas costs to be $50,000 and $8.45 million respectively over the three-year term of the contract for a total cost of $8.5 million. A contingency of $2.4 million is requested to cover a scenario where prices and load are higher than the expected case for a six month period. Under certain circumstances of usage and market prices, the cost of residual gas under this contract may be substantially higher than $8.5 million. If this occurs, staff will return to Council for further authorization.

CPAU has budgeted for this amount within the fiscal year 2002/03 budget. The funds for subsequent years to cover the cost of residual gas and the management fee are included in the Utilities Department’s ten-year financial forecast and will be included in future year budgets.
ALTERNATIVES
The alternatives evaluated include:

1. Develop the necessary skills, systems, and gas commodity counterparties to carry out all daily operations and residual gas balancing functions in-house by existing staff.

2. Outsource the operations function to a non-commodity supplier and perform the residual gas balancing function in-house by existing staff.

3. Outsource both the operations and residual gas balancing functions to a single gas commodity supplier.

Staff’s recommendation, Alternative 3, was selected based on a lower overall cost to the City versus the other alternatives.

POLICY IMPLICATIONS
This recommendation is consistent with the Council approved Utilities Strategic Plan to:
1) Preserve a supply cost advantage compared to market price; 2) Streamline and manage business processes to allow CPAU to work efficiently and cost effectively; and 3) Provide superior financial performance to CPAU and competitive rates to customers.

This recommendation is consistent with the Council approved Utilities Risk Management Policies and Procedures specifically adhering to the Counterparty Credit Policy.

Further, this recommendation adheres to the City’s competitive selection process for services and to the Utilities Interim Risk Management Policies and Procedures, which require competitive bidding for commodity products.

ENVIRONMENTAL REVIEW
The authorization of this contract does not constitute a project under the California Environmental Quality Act; therefore, no environmental assessment is required.

ATTACHMENTS
A: Draft of the Natural Gas Services Agreement by and Between PG&E Energy Trading – Gas Corporation and City of Palo Alto
B: Resolution Authorizing the City Manager to Execute the Natural Gas Services Agreement with PGET