TO: HONORABLE CITY COUNCIL

FROM: CITY MANAGER       DEPARTMENT: UTILITIES

DATE: JUNE 24, 2002       CMR:285:02

SUBJECT: APPROVAL OF AMENDMENT NUMBER TWO TO THE
DELOITTE AND TOUCHE CONTRACT C9115650 FOR RISK
MANAGEMENT SERVICES TO INCREASE THE FUNDING IN
THE AMOUNT OF $300,000 FOR A TOTAL MAXIMUM
COMPENSATION OF $740,000 TO CONTINUE ASSISTANCE IN
IMPLEMENTING AN ENERGY RISK MANAGEMENT PROGRAM

RECOMMENDATION
Staff recommends that Council approve the Amendment No. 2 (Attachment A) to the
Deloitte and Touche Contract C9115650 for risk management services to increase the
funding in the amount of $300,000 for a total not-to-exceed amount of $740,000.

BACKGROUND

On April 5, 1999, Council authorized the City Manager to enter into an agreement with
Deloitte and Touche for risk management services (CMR:186:99). Funds for services
were budgeted during FY 1998-99 and FY 1999-00 for a total not to exceed $225,000.
Council further delegated the City Manager the authority to extend the contract term as
needed. Funds for the contract were carried over through FY 2000-01.

Deloitte and Touche was selected through the City’s Request for Proposal process to
assist the Utilities Department (CPAU) in the development and implementation of a
comprehensive energy risk management program. Deloitte and Touche was selected
from eight other firms because of its professional approach, talent pool and in-depth
knowledge of the relationship between CPAU and the Northern California Power Agency
(NCPA). The scope of services under the Deloitte and Touche agreement were to be
carried out in three phases, as follows:
Phase 1: Review of existing risk management materials and program.

Phase 2: Develop suggested risk management plan and senior management training.

Phase 3: Assistance with risk management implementation.

Deloitte and Touche completed Phase 1 and Phase 2 in the fall of 1999. In Spring 2000, D&T began assisting CPAU under Phase 3 of the contract. Tasks under Phase 3 were broadly defined in the original contract, and included review of risk management controls and infrastructure and assistance with development of risk management policies and procedures. In calendar year 2001, Deloitte and Touche provided the following Phase 3 services:

- Review of NCPA’s risk management systems;
- Review of CPAU’s commodity pricing policy;
- Review of CPAU’s interim risk management policies and procedures;
- Development of draft credit risk management guidelines and procedures;
- High level assessment of CPAU’s risk management control infrastructure;
- Review and feedback on various gas and electric supplier contracts; and
- Staff training for Financial Accounting Standard Board Statement 133 applicability.

In August 2001, Deloitte and Touche completed the Risk Management Control Infrastructure Assessment, in which it made several recommendations to improve and formalize CPAU’s risk management program. The recommendations from that report included:

- Reorganize and update the control documents (policies, guidelines, and procedures) including the establishment of formal policies and procedures for credit approval and credit risk management;
- Establish validation and risk measurement methodology and procedures for all transactions;
- Define the roles and responsibilities of all parties responsible for risk management and develop and train staff as appropriate for those roles;
- Ensure that systems support CPAU activities;
- Perform annual audits of the policies and procedures to ensure alignment with objectives; and
- Create senior management reports for improved oversight.
On November 19, 2001 (CMR:409:01), Council approved Amendment #1 to the contract and increased the contract funding by $215,000 ($105,000 for FY 2001-2002 and $110,000 for FY 2002-03) for a total maximum not to exceed amount of $440,000 for the amended contract. Amendment #1 to the contract provided additional funds for completing additional Phase 3 tasks. Those tasks included performing annual and mid-year review of energy risk management controls, processes, and performance, and other general risk management tasks. Some of this work has been completed and the funds budgeted for FY 02-03 ($110,000) are expected to be utilized to complete the annual review and mid-year review of the risk management program.

**DISCUSSION**

In early 2002, Deloitte and Touche provided assistance in implementing its recommendations to improve the energy risk management program. Work has focused on establishing proper roles and responsibilities of the Council and staff, including the staff Risk Oversight Committee (ROC). Deloitte and Touche assisted in a ROC retreat in May 2002 and in redrafting the risk management policies and guidelines. Additional Phase 3 tasks have been identified resulting from improvements suggested by the ROC, Utilities and ASD staff, and the City Auditor's office to continue implementation of the risk management recommendations and additional funds are needed to perform these tasks. These tasks include, but are not limited, to the following:

- Continued support of ROC activities (finalizing the policy and guidelines, developing an organizational structure and functional review to align with roles and responsibilities of designated staff);
- Education (training and/or tutorials for City Council, City Manager, and City Auditor and operational training for ROC and other City staff);
- Response to audit report (analysis and context for the materiality and consistency with industry practices of the City Auditor’s recommendations);
- Control documentation (development of detailed risk management and transacting procedures); and
- Middle Office implementation (assist in the development of the middle office – risk management – function as this function is recommended to be under the supervision of the Director of ASD).

As a result of working with the City for over three years, Deloitte and Touche has gained a thorough understanding of CPAU’s gas and electric procurement and hedging operations and the relationship and dynamics between Utilities and other City departments. This makes Deloitte and Touche uniquely qualified in assisting the City in
carrying out its risk management objectives. Deloitte and Touche has demonstrated its ability to provide valuable and objective advice and services and to work cooperatively and productively with many departments and divisions within the City.

**RESOURCE IMPACT**

As of June 10, approximately $18,000 remains in budgeted FY 01-02 funds for this contract. The estimated cost to complete the additional identified Phase 3 tasks is shown in the table below.

<table>
<thead>
<tr>
<th>Activity</th>
<th>Estimated Professional Costs</th>
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<tbody>
<tr>
<td>ROC support</td>
<td>$56,000</td>
</tr>
<tr>
<td>Education</td>
<td>$42,000</td>
</tr>
<tr>
<td>Audit Response</td>
<td>$14,000</td>
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<tr>
<td>Control Documentation</td>
<td>$33,600</td>
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<tr>
<td>Middle Office Implementation</td>
<td>$175,600</td>
</tr>
<tr>
<td>TOTAL (not including expenses)</td>
<td>$321,200</td>
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</tbody>
</table>

An additional $300,000 is requested for these additional activities from the FY 01-02 budget. There are sufficient funds in the gas and electric fund budgets for FY 01-02 and no budget increase is required.

City staff is currently developing a formal "middle office" function (risk oversight and control) as per consultant and City Auditor's recommendations. A comprehensive proposal is being developed to address all those recommendations. Preliminarily, the proposal will include a recommendation to create a newly defined “Risk Manager” position. The estimated additional costs above might be substantially reduced (by as much as 50%) depending on the speed with which the City can establish and fill this position. The envisioned Risk Manager would assume many of the interim functions which City staff has requested assistance from Deloitte and Touche. Staff’s comprehensive proposal will address any decreased funding for Deloitte and Touche that can be accommodated.
POLICY IMPLICATIONS

This recommendation is consistent with the Council approved Utilities Strategic Plan Strategy 2: preserve a supply cost advantage compared to the market price.

ENVIRONMENTAL REVIEW

These services do not constitute a project for the purposes of the California Environmental Quality Act

ATTACHMENT

A. Amendment No. 2 To Agreement No. C9115650 Between the City of Palo Alto and Deloitte & Touche LLP
B. Fee Schedule for Phase 3 Extension (Amendment 2 to Agreement No. C9115650 between City of Palo Alto and Deloitte and Touche LLP)

PREPARED BY: _________________________________
JANE RATCHYE
Senior Resource Planner

DEPARTMENT HEAD: _________________________________
JOHN ULRICH
Director of Utilities

CITY MANAGER APPROVAL: _________________________________
EMILY HARRISON
Assistant City Manager