TO: HONORABLE CITY COUNCIL

FROM: CITY MANAGER DEPARTMENT: UTILITIES

DATE: MARCH 25, 2002 CMR:170:02

SUBJECT: EXTENSION OF EXISTING NATURAL GAS MASTER PURCHASE AGREEMENTS FOR A FIVE YEAR TERM

RECOMMENDATION

Staff recommends the City Council approve the extension of the term of two existing natural gas master purchase agreements from three to five years. Five year terms for the master purchase agreements will enable staff to implement the City of Palo Alto’s natural gas commodity procurement strategy. Staff recommends both agreements terminate March 17, 2007.

BACKGROUND

The City Manager has the general authority to enter into and execute contracts under Article IV of the Charter and Section 2.08.140 of the Palo Alto Municipal Code (PAMC). Under PAMC Section 2.30.120, the City Manager has the authority to negotiate and execute open purchase contracts for goods and services for terms of up to three years. Palo Alto is currently a party to two natural gas master purchase agreements, one with British Petroleum Energy Company (BP) and the other with Sempra Energy Trading Corp (Sempra). BP and Sempra are approved suppliers for the City based on a set of criteria approved by the Risk Oversight Committee (ROC). The ROC includes the Director of Utilities, the Assistant City Manager, the Director of Administrative Services and the Senior Assistant City Attorney. The agreements were ratified by Council last year (CMR:420:01 and 341:01). These agreements enable, but do not obligate, Palo Alto to purchase natural gas commodity.

Last winter’s unprecedented high gas prices and gas market volatility caused staff to develop a natural gas commodity purchasing plan. On November 6, 2000, staff presented to the ROC a gas procurement plan whereby defined fractions of each month’s gas requirement are purchased at a fixed price over a three year time horizon. This “laddering” approach was implemented shortly thereafter. The plan was presented to the Finance Committee as an informational report in CMR:196:01 on April 17, 2001.
Staff utilizes the agreements with BP and Sempra to purchase competitively priced gas for the City’s natural gas customers under this strategy.

**DISCUSSION**
Under the “laddering” approach, the three year horizon is constantly changing and moving forward. Because these contracts were executed by the City Manager, the termination date is three years after the initial execution date. Hence, staff may not purchase any gas for delivery beyond three years from the date of execution. By extending the two existing agreements, staff will be able to implement the City’s natural gas commodity purchasing strategy in a streamlined manner.

In addition to the transactions entered into thus far with these suppliers, staff expects to utilize these master agreements to competitively procure gas supplies to meet City loads which average approximately 10,000 MMBtu/day or 3.5 million MMBtu/annum. The commodity cost of meeting the City load is expected to be $15-$20 million per annum. Staff is working on several additional master purchase agreements and will be bringing each to City Council for five-year term approval.

**ALTERNATIVE**
One alternative is to continue without the extension. This would result in the City having to sign several new agreements every month to keep up with the rolling three-year time horizon for gas procurement. However, utilizing staff and legal resources to work on several new agreements each month would result in less time being available to the actual value-added work of purchasing commodity. That is, the costs of such an approach outweigh the benefits of a streamlined contracting procedure.

Another alternative is to abandon the laddering approach altogether and purchase gas supply on a monthly basis in the volatile wholesale market. This approach would be similar to that taken by Pacific Gas and Electric Company, wherein customers are exposed to wholesale market price volatility on a monthly basis. However, this approach would not meet the objective of providing stable prices. It would also reverse the direction of the last several years of having a transparent commodity purchasing strategy that satisfies risk management objectives.

**RESOURCE IMPACT**
Transactions for approximately $28 million have been entered into with these two suppliers already, of which approximately $7 million is for gas already delivered and paid for. The remaining $20 million in purchases were made towards meeting future loads up to June 2004 as part of the laddering procurement strategy. These
purchase costs have been incorporated in the City budget, customer rates, and the 10-year utility financial forecast. Upon approval of this recommendation, staff expects the City Manager to continue to purchase gas under these master agreements. Transaction volume may vary depending on month and commitments already made but could range from zero to $3 million dollars/month.

POLICY IMPLICATIONS

These recommendations are consistent with current City policy. Each transaction under these master agreements is executed in accordance with City’s risk management policies (CMR:103:01) and risk management procedures approved by the ROC. These recommendations meet the objectives outlined in the Utilities Strategic Plan Strategy No. 3, “Streamline and manage business processes to allow CPAU to work efficiently and cost-effectively.”

ATTACHMENTS

A: Base Contract for Short-Term Sale and Purchase of Natural Gas with BP Energy Company
B: Base Contract for Short-Term Sale and Purchase of Natural Gas with Sempra energy Trading Corp.

PREPARED BY: KARLA DAILEY, Resource Planner

DEPARTMENT HEAD: JOHN ULRICH
Director of Utilities

CITY MANAGER APPROVAL: EMILY HARRISON
Assistant City Manager