

Agenda Report

June 28, 2004

To: City Council
Through Municipal Services Committee

From: City Manager

Subject: Authorization To Enter Into Contracts With The Southern California Public Power Authority For A Maximum 2.25% Share Of The Natural Gas Project Development Agreement

RECOMMENDATION:

It is recommended that the City Council Authorize the City Manager to contract with the Southern California Public Power Authority ("SCPPA") for a 1,000 million British Thermal Units ("MMBtu") per day (maximum 2.25%) share of the SCPPA Natural Gas Project Development Agreement ("Contract") in an amount not to exceed \$97,560.

The Contract is exempt from competitive bidding pursuant to City Charter Section 1002(h) contracts with other governmental agencies or their contractors.

UAC RECOMMENDATION:

The Utility Advisory Commission (UAC) recommends that the City Council approve the staff recommendation.

BACKGROUND

Pasadena Water and Power ("PWP") has a long history of operating local gas fired generation and securing fuel for these units through a combination of long-term and short-term commodity and pipeline purchase contracts. PWP's current local generators are flexible, intermediate and peak power producers and thus fuel consumption varies dramatically from zero to 35,000 million British Thermal Units ("MMBtu") per day, averaging about 5,500 MMBtu over the course of the year. The addition of Magnolia in June 2005 will add a fairly stable demand for gas averaging 2,000-2,220 MMBtu per day.

In preparation for deregulation, fuel commodity contracts were not renewed as they expired due to uncertainty with respect to continued operation of local generation. Since then PWP, has followed a strategy of procuring all fuel commodity under short-term and index prices to avoid the potential for stranded fuel costs. The downside of this strategy, as experienced during the California energy crisis of 2000-2001, is that procurement costs can increase dramatically when market prices surge.

In the last few years, it has become apparent that the price for natural gas can be very volatile and subject to a number of factors. For instance, during the California Energy Crisis natural gas prices ranged from \$3/MMBtu to as high as \$58/MMBtu. Excluding industry upheavals, natural gas price volatility will continue due to winter conditions in the mid-West and East Coast, hurricane conditions along the Gulf of Mexico where a large amount of off-shore drilling is located, the decline in productivity of existing wells, and particularly the price of oil. Currently, the price for natural gas at the California Border, including transportation is in the range of \$5.50-\$6.50/MMBtu.

Although forward purchase contracts for fuel and pipeline limited PWP's exposure during the crisis, purchase contracts do not serve their intended purpose when market swings are so dramatic that suppliers are forced into bankruptcy. For example, prior to December 2001, PWP secured all of its gas from Enron. Even if PWP had multi-year forward contracts for low-priced fuel, these would have been terminated upon their bankruptcy and been of no value.

To reduce the impact of market volatility on fuel costs, PWP believes that it would be prudent to acquire approximately one-third of its overall gas requirements through long-term contracts. By contracting with SCPPA for some of this long-term supply, credit risk is substantially mitigated as well. At the recommended level of 1,000 MMBtu per day, this would represent about 13% of PWP's projected 7,500 MMBtu/day annual average fuel use. The remaining fuel portfolio will be a mix of other long-term, mid-term, and spot market gas supply contracts in accordance with strategies and risk policies in place at the time.

Project Summary

With the amount of volatility of prices in the short-term gas market, credit risks associated with producers and energy marketers, and the added base-load demand for gas required for Magnolia, PWP, along with several members within SCPPA believe that securing long-term gas supplies would be part of a prudent strategy to lock in the certainty of gas availability as well as provide stable pricing for budgeting for fuel cost for the next 20-25 years of operation. One manner to

achieve this would be to acquire existing natural gas reserves in the Western Region. This is an approach Sacramento Metropolitan Utility District (SMUD) successfully utilized in acquiring over \$135 million in gas reserves in the last several months and is conceptually similar to coal reserves Pasadena owns (through Intermountain Power Agency) for its entitlement in the Intermountain Power Project.

Consequently, several members of SCPPA and other municipal utilities will pursue acquiring gas reserves and have hired Petrie Parkman consulting group (the same firm that assisted SMUD) to identify potential sellers and assist in the evaluation of those fields. Petrie Parkman has recommended that as many as 8 separate gas reserve sites should be identified and procured in the next 18 months to develop a diversified portfolio that will meet participant needs. The cost of actually acquiring each reserve would be determined in separate purchase agreement between the owner of the reserves and SCPPA. In addition to the property acquisition costs for "gas in the ground", other costs would include operational expenses to retrieve the gas and transportation costs to get the gas to Pasadena. All of these costs will be arranged through SCPPA, and paid by Pasadena pursuant to separate gas purchase agreement(s). It is estimated that PWP's effective cost of gas from these reserves should be in a range of \$4.75 - \$5.25/MMBtu over the life of the reserves, which is higher than historical norms but below current market rates for long-term gas.

Development Contract Summary

The Natural Gas Project Development Agreement with SCPPA provides a vehicle to fund expenses for engineering firms to evaluate appropriate reserves, hire petroleum engineering consultants to determine remaining available reserves at a well site, hire environmental, and title/land consultants and legal expertise prior to actual acquisition, and related due diligence efforts. SCPPA members that intend to participate in the Project include Los Angeles Department of Water and Power and the Cities of Anaheim, Burbank, Colton, and Glendale. The non-SCPPA entities that are interested include the Cities of Redding and Santa Clara, Turlock Irrigation District and Southern Nevada Water Authority. The combined interest in gas reserves totals 59,000 MMBtu/day, of which PWP's 1,000 MMBtu/day share would be 1.7%. However, because other parties may reduce participation levels prior to contract execution, PWP is requesting authority for up to a 2.25% share of the Contract expenses.

Execution of the Contract will Preserve Pasadena's option to participate in the gas purchase acquisition phase Project, but does not obligate PWP beyond the initial development phase until PWP notifies SCPPA of its election to participate in the gas purchases. Prior to making this election, PWP is only obligated pay its

\$14,750 share (assuming 2.25%) of the initial Project development budget this Contract.

Upon making the election to proceed with the gas procurement and purchase agreement, PWP will incur additional development costs under this Contract up to a maximum of \$97,560 (assuming a 2.25% share).

Additional Actions and Authority

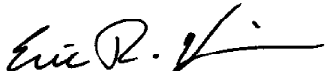
PWP has until September 2004 to commit to the amount of gas reserves procured through the Project. Prior to making this election, PWP will continue to evaluate market conditions and results of initial development work. Provided that the results demonstrate that Project continues to be a desirable component of PWP's gas portfolio, PWP will seek authorization to enter into the Gas Purchase agreement(s) with SCPPA necessary to secure and operate the gas properties, and authorizing associated capital funding, and financing, if needed.

Once PWP has notified SCPPA of its amount of participation (from 0 to 1,000 MMBtu/day), PWP will be committed to participate in each natural gas property acquisition that the majority of Project participants agree to purchase until the specified allotment has been fulfilled pursuant to the gas purchase agreement(s) with SCPPA. PWP's share of the total cost to acquire such properties is estimated at \$7-13 million, depending upon many factors such as purchase price of properties, expected life of facility, etc. PWP intends to fund the acquisition of these properties as they are acquired through its capital budget. These issues will be fully addressed when PWP seeks authorization from Council for participation in the gas purchase agreement(s) prior to September 2004.


FISCAL IMPACT:

The initial development work will be charged to 8115-401-841500-0557. Beyond the initial costs under the Contract, all additional costs associated with the Gas Reserves Project will be capitalized and recovered in the Energy Charge component of Pasadena's electric energy rates as the fuel is consumed. To the extent the cost of fuel procured under the Contract is below market rates, the Energy Charge will be lowered to reflect the savings.

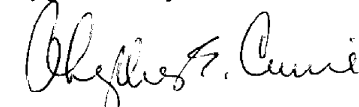
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Respectfully submitted,


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