

Agenda Report

May 23, 2005

To: CITY COUNCIL
THROUGH MUNICIPAL SERVICES COMMITTEE

From: CITY MANAGER

Subject: AUTHORIZATION TO ENTER INTO A CONTRACT WITH THE SOUTHERN CALIFORNIA PUBLIC POWER AUTHORITY FOR THE PURCHASE OF UP TO 1,000 MILLION BRITISH THERMAL UNITS PER DAY OF NATURAL GAS

RECOMMENDATION:

It is recommended that the City Council Authorize the City Manager to contract with the Southern California Public Power Authority ("SCPPA") for up to 1,000 Million British Thermal Units ("MMBtu") per day of natural gas derived from various natural gas reserve properties located in North America. It is also recommended that the City Manager, or her designee, be authorized to elect full participation in the SCPPA Natural Gas Development Project.

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 Municipal Services Committee and the City Council approve the staff recommendation.

BACKGROUND

Pasadena Water and Power's ("PWP") current local generators are flexible, intermediate and peak power producers and thus fuel consumption varies dramatically from zero to 35,000 MMBtu per day, averaging about 5,500 MMBtu per day 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.

PWP has a long history of operating local gas fired generation and procuring fuel for these units through a combination of long-term and short-term commodity and pipeline purchase contracts. However, PWP has not previously purchased gas through interest in producing properties. Securing up to 1,000 MMBtu per day, which represents about 13% of PWP's gas needs, through the proposed SCPPA Gas Sales Agreement ("Contract") is expected to provide PWP with a reliable fuel supply at a stable price that is not dependent upon the volatile natural gas market or contracts with private energy marketing firms and is predictable for budgeting purposes.

PWP intends to pay cash for the properties and deplete (draw down) these accounts as fuel is consumed on a level \$/MMBtu basis, providing a stable fuel cost component that will be charged to the Energy Charge Fund ("ECF"). Variable operating, maintenance, and transportation costs will be charged to the ECF as they are incurred.

SCPPA Natural Gas Development Project

On June 28, 2004, the City Council approved Pasadena's participation in the SCPPA Natural Gas Project Development Agreement ("Development Agreement"). Under the terms of the Development Agreement PWP and a consortium of eight other publicly owned electric utilities collectively developed a cost-based gas procurement program through the purchase of working interests in gas reserve properties. The initial development work completed to date, which includes confidential negotiations for the first pending acquisition, indicates the expected delivered cost of gas under the proposed Contract is substantially lower than current and forward contract prices through about 2010, and is expected to remain competitive with other alternatives throughout the contract life.

Under the terms of the Development Agreement, Pasadena's obligations are limited to its pro-rata share of initial development costs of up to \$14,750. By making the election for full participation in the Development Agreement PWP will incur additional development costs up to a maximum of \$97,560 (assuming a 2.25% share) to locate and evaluate additional properties for acquisition.

Contract and Project Structure

SCPPA will purchase working interests in up to eight gas field acquisitions until the aggregate elections of all participants are met. Each acquisition will include an undivided interest in existing oil and gas leases for proven, developed, and producing gas properties and the associated extraction facilities. SCPPA may own all, a majority, or a minority interest in each acquisition, with the gas field

operator holding any remaining interest.

SCPPA will enter into an operating agreement that will establish the relationship among the gas field owners and provide a means of extracting, processing, and delivering the gas from the property to the inlet of an interstate pipeline, where 100% of the gas produced will be sold by SCPPA to the participating members, i.e., Anaheim, Colton, Glendale, and Pasadena for the life of the Contract, which is expected to be 20-25 years. PWP will secure transportation and schedule the gas to its local generation facilities or Magnolia.

In addition to the gas purchased from SCPPA, Pasadena will hold a perpetual entitlement share of the underlying gas reserve properties, which will be transferred to Pasadena upon the expiration of the Contract.

The Los Angeles Department of Water and Power ("LADWP") and possibly other municipal utilities including the City of Redding and the Turlock Irrigation District ("TID") will also enter into separate purchase agreements with each seller and hold undivided shares of the same properties as SCPPA under identical terms and conditions. LADWP will be the overall project manager for property acquisitions and on-going operations and capital improvements for each property.

Property Selection Process

SCPPA will target primarily proven-developed-producing reserves for procurement, which have been verified by a nationally recognized independent petroleum reservoir engineer, and all gas reserve acquisitions require a super-majority vote of the Development Agreement Coordinating Committee comprised of representatives from each member utility, which is a party to the Development Agreement, including Pasadena. Furthermore, the economics of each potential acquisition will be evaluated by a risk management sub-committee comprised of gas procurement and finance experts from each party to the Development Agreement. The economic analysis will include a comparison of the expected cost of gas from the acquisition to other long-term procurement alternatives to mitigate the risk of holding above-market gas reserves.

The evaluation and procurement process for each acquisition is summarized as follows:

1. **Identify Potential Acquisitions:** Petrie Parkman and Company is an expert in gas reserve property mergers and acquisitions, and they have been retained by SCPPA to assist the Coordinating Committee in identifying potential properties that meet the low-risk criteria described above. This

- step includes preliminary discussions with potential sellers to solicit interest in divestiture;
2. **Data Review:** Once a property is determined to meet SCPPA's low-risk profile, and the seller expresses interest in divestiture at a preliminary range of value, a nationally recognized independent petroleum reservoir engineer will be used to review production and cost data to produce an estimate of future gas yields and owner costs. Land-title and environmental consultants will also be employed during the due diligence process to ensure clear title and limit environmental liability associated with the reserves. SCPPA issued an RFP for independent reservoir engineering services on September 3, 2004, and will be retaining several firms with expertise in the desired gas basins;
 3. **Risk Committee Evaluation:** a risk management sub-committee comprised of gas procurement and finance experts from each party to the Development Agreement, including Pasadena. The economic analysis will include a comparison of the expected cost of gas from the acquisition to other long-term procurement alternatives; and,
 4. **Offer Development:** Based on input from Petrie Parkman, the independent engineer report, and the risk committee recommendations, a super-majority of the Coordinating Committee, including Pasadena, will determine if an offer should be made on the proposed acquisition.

Funding Acquisition Costs

PWP (and Glendale) will provide contributed capital (pay cash) for their share of the Project, which will be known as "Project B." Anaheim and Colton are requesting SCPPA to provide financing for their part of the Project, which will be known as "Project A." The Gas Sales Agreement will serve as the security for the bonds, including rate covenants and step-ups as required by the bond indentures. The Gas Sales Agreements for Projects A and B will only differ with regard to the Project indebtedness.

PWP will book the acquisition costs of the properties as a capital asset, and deplete (draw down) these accounts as fuel is consumed on level \$/mmbtu basis, providing a stable fuel cost component that will be charged to the Energy Charge Fund.

Schedule

Each of the SCPPA participants, LADWP, and other municipal utilities are expected to obtain authorization from their respective governing boards in May or June 2005. The first property acquisition, which will meet approximately one-half of the combined participant's elections, is expected to close July 1, 2005. Additional acquisitions will be pursued over the next year until all of the participant's elections are met.

Pasadena will not sign the Contract or make a final participation election until the LADWP has secured authorizations to procure properties and act as project manager.

Risks

As with any long-term procurement commitment, there is a risk that the future market price of gas will fall below the delivered cost of gas from the reserve properties, which would affect the competitiveness of the electricity produced from this fuel source as compared to other power generators using fuel purchased at the then current market price. Conversely, if market prices retain their current levels or continue to rise, this Contract will provide substantial savings. This price risk is mitigated four ways:

1. The Contract will only provide about 13% of PWP's total fuel needs, while 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;
2. SCPPA will seek to acquire properties only when they are forecast to provide gas at a discount to other long-term gas resources, contracts, or forward market prices;
3. Any upside in production associated with currently unproven reserves or resulting from future gas extraction technologies that could reduce PWP's fuel cost under the Contract will not be included in the economic evaluations of each property; and,
4. The participants will have control or influence over on-going operations and capital improvements that can increase or decrease the extraction rate as market conditions warrant.

The proposed contract has less credit and counterparty risk than a long-term contract with a private counterparty. Pasadena will hold an interest in the real property held by SCPPA that is more secure than a long-term contract with a


private counterparty that may be discharged through a bankruptcy proceeding. Also, long-term gas supply contracts do not have the mitigating upside production potential previously discussed.

The primary risk of the proposed Contract is that the properties may not perform as expected, which could increase operating costs or reduce the value of PWP's investment in the properties. To mitigate the production risk, SCPPA will pursue a diversified portfolio of gas property acquisitions in different locations and purchased at different times and perform extensive due diligence in assessing each property as described above. The economies of scale provided by the consortium under the Natural Gas Project Development Agreement ("Development Agreement") makes this diversification possible.

FISCAL IMPACT:

All costs associated with this contract will be recovered in the Energy Charge component of Pasadena's electric energy rates. 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.

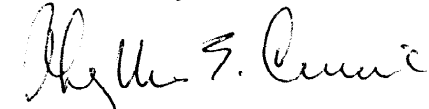
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