

Agenda Report

To: City Council

Date: October 5, 2009

Through: Municipal Services Committee (September 22, 2009)

From: City Manager

Subject: Authorize the City Manager to amend the contract with Southern California Public Power Authority ("SCPPA") for a 30 Year Prepaid Natural Gas Supply Agreement to reduce the duration and size of the existing agreement

RECOMMENDATION:

It is recommended that the City Council:

1. Authorize the City Manager to amend the agreement with Southern California Public Power Authority (SCPPA) for the 30 Year Prepaid Natural Gas Supply Agreement ("Agreement") to reduce the duration of the Agreement by three (3) years and reduce the size of the Agreement from an average of 2,000 MMBtu (Million British Thermal Units) per day to an average of 1,340 MMBtu's per day; and
2. Adopt a Resolution authorizing amendment of the Natural Gas Supply Agreement.

EXECUTIVE SUMMARY:

On August 13, 2007, the City Council approved a staff recommendation to authorize the City Manager to enter into a 30-year agreement with SCPPA to deliver natural gas through a prepaid supply agreement.

The agreement provided a guaranteed discount for natural gas delivered from market standard pricing for natural gas delivered and utilized favorably priced fixed rate bonds to "lock in" reinvestment opportunities for the funds that would maximize savings to Pasadena for the duration of the agreement.

This transaction has recently been adversely affected by the reduced credit ratings of AIG FP Broadgate Limited ("AIG"), which is the commodity swap provider for the prepaid gas agreement. As a result, SCPPA's exposure to AIG poses a potential risk to

the savings of gas prepay project. If AIG's ratings are downgraded another level, they will be considered below investment grade. In that case, the agreement includes provisions that would result in termination of the prepayment transaction and loss of the expected discount on the gas purchases.

Goldman Sachs and Company ("Goldman") recently purchased approximately one-third of the outstanding SCPA bonds associated with the transaction at a discount. The proposed amendment to the Agreement provides an opportunity to retire those bonds and to effectively terminate that portion of the transaction. It will provide the savings of the terminated portion in the form of deeper discounts to the natural gas delivered over the next three year period. This method of conveying the savings "up front" for prepay agreements is the only method allowable under current tax law.

The proposed amendment will reduce the risk associated with exposure to AIG, thereby preserving the original savings anticipated in the prepaid supply agreement. It will also reduce the volume and duration of the agreement, ensuring that the savings are maximized "up front" and increasing the Water and Power Department's ("PWP") flexibility for securing natural gas through other agreements.

BACKGROUND:

City Council approval of the prepaid gas supply agreement with SCPA provided for a long-term, stable supply of natural gas to cover approximately 40% of the PWP's average daily requirement for the 30-year transaction term. The agreement allowed PWP to diversify its gas supply arrangements and provide some mitigation for supply and price volatility.

The Agreement provided for a 30-year supply of natural gas to be delivered to the SCPA project participants, including the City of Pasadena, by J.Aron & Company ("J.Aron"), with guarantees and protections provided by The Goldman Sachs Group, Inc. ("Goldman Sachs"). Some highlights of the transaction are:

- Provided a \$0.905 per MMBtu discount on the prepaid natural gas supply equating to savings ranging from \$16 million to \$21 million over the term of the transaction.
- Funded the transaction through issuance of a fixed rate bond structure that took advantage of low tax-exempt interest rates available at the time to fund this type of transaction.
- "Locked in" the reinvestment of funds deposited into the debt service account and working capital reserve fund at favorable rates to maximize the savings available to PWP on a monthly basis.

The unique financing structure of the transaction was specifically designed to minimize risk to Pasadena while maximizing the long-term benefit to PWP's ratepayers. Virtually all transaction risks were allocated to other parties, primarily Goldman Sachs. While certain events could cause the transaction to terminate, the costs associated such a

termination were borne by Goldman Sachs and other parties. The primary risk to the City of Pasadena was the loss of the discount savings in the event of termination of the transaction. Over the past two years, the gas prepay project has functioned as originally executed.

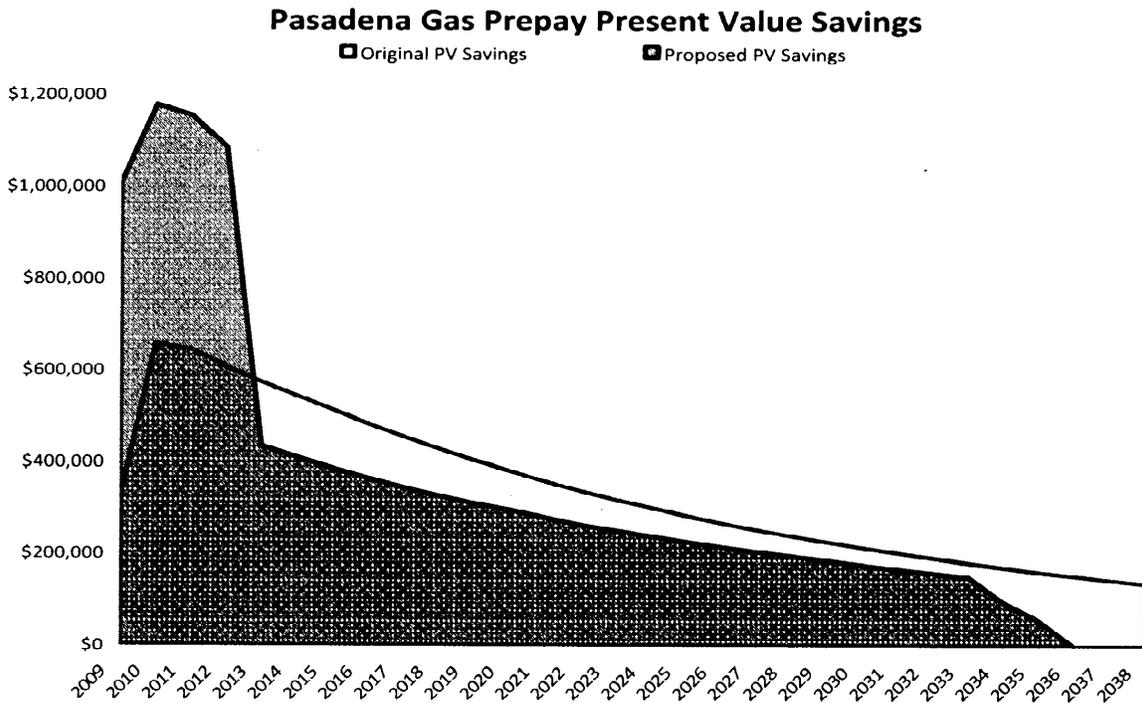
Unfortunately, this transaction has been adversely affected by the unforeseen and extreme market events of 2008 and 2009. In 2008 the commodity swap provider for the gas prepay agreement, AIG FP Broadgate Limited ("AIG"), experienced severe losses which ultimately resulted in an effective "rescue" of the company by the federal government. In late 2008, AIG's credit ratings of Aa3/AA- at the time the prepayment transaction was completed fell three levels to the current levels of A3/A-. At this time, AIG continues to pose a risk to the savings of gas prepay project. If AIG's ratings are downgraded another level, they will be considered as below investment grade. In that case, the agreement includes provisions that would result in termination of the prepayment transaction and loss of the expected discount on the gas purchases.

Over the past twelve months, SCPPA and the project participants, including Pasadena, have been exploring options to preserve as much of the expected savings of the original Agreement as possible while also minimizing the potential exposure to AIG. The proposed amendment to the Agreement reflects a negotiated option with Goldman which will effectively terminate the portion of the transaction associated with the last three years (2036-2038) of the original agreement. The savings of the terminated portion of the agreement will be preserved in the form of deeper discounts to the natural gas delivered over the next three year period.

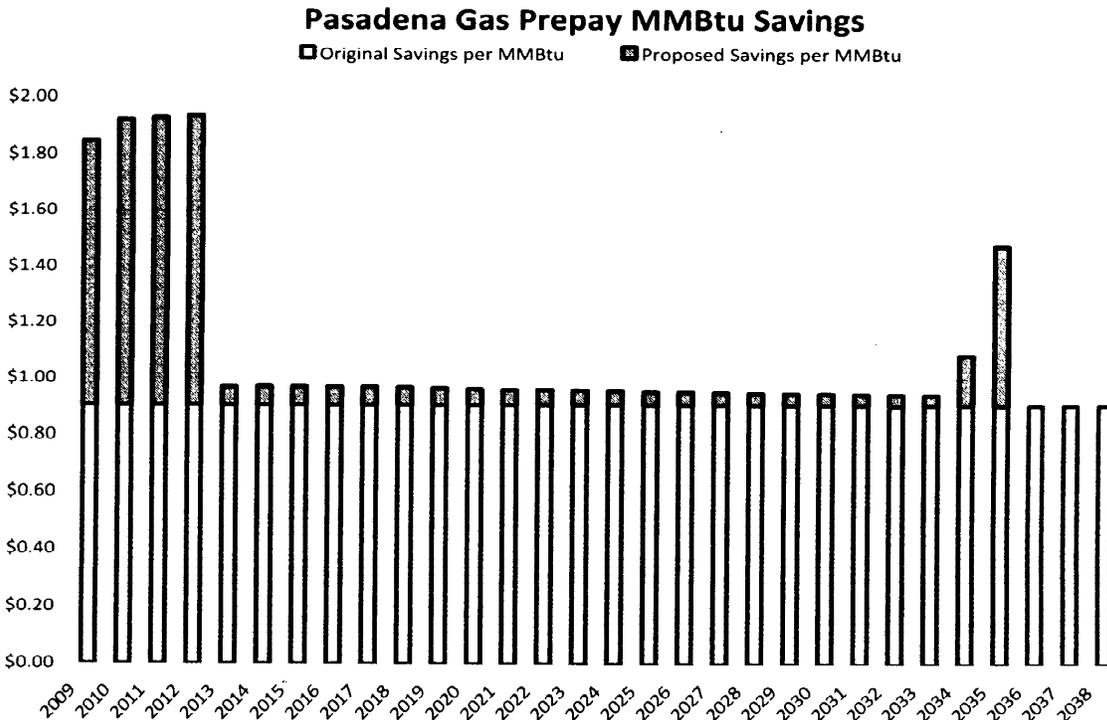
This will be achieved by reducing the volume of natural gas delivered from an average of 2,000 MMBtu's per day to an average of 1,340 MMBtu's per day for the duration of the project. The daily reduction reflects the volumes that would have been delivered during the last three years of the Agreement. To provide the savings, the discount applied to each MMBtu will increase from \$0.905 per MMBtu to \$1.927 per MMBtu for the next three years. The increased discount will result in an accelerated receipt of the savings associated with the total volumes that would have been delivered under the original Agreement.

At the end of three years, the discount will be reduced from \$1.927 to approximately \$0.984 per MMBtu to ensure continued savings commensurate with the shortened term of the Agreement, which will now end in 2035.

The chart below shows the impact of the amended Agreement on the expected annual savings from the project and the reduced volumes of natural gas to be delivered:



The following chart shows the impact on savings **per MMBtu** under the original agreement and the revised agreement:



FISCAL IMPACT:

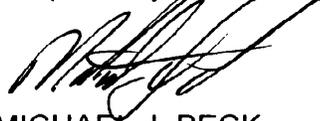
The original transaction provided delivery of natural gas at index prices less a fixed discount. The restructured agreement will provide reduced volumes of natural gas at index prices with varying discount levels over a shortened duration. The restructured agreement will also accelerate the savings that would have been realized over the 30-year term by providing an increased discount over the next three years of the project while preserving the total savings of the original transaction.

For the next three years, the discount will increase from an average of \$0.905 per MMBtu to \$1.907 per MMBtu. The volume of gas to be delivered will decrease from an average of 2,000 MMBtu per day to 1,340 MMBtu per day for the duration of the project. The overall duration of the project will be shortened by three years and will terminate in 2035 instead of 2038.

The restructured agreement will produce \$688,000 of savings immediately at the close of the transaction and \$1.5M of additional savings over the next three years. This accumulated savings plus interest earnings will offset lower annual savings of \$85,000 from the fourth year to the end of the agreement due to reduced volumes of natural gas delivered. The accelerated savings will be used to offset the impact of purchasing replacement gas at index rates without the discount. The average daily volumes to be replaced are approximately 660 MMBtu per day from 2,000 MMBtu per day in the original agreement to 1,340 MMBtu per day in the restructured agreement.

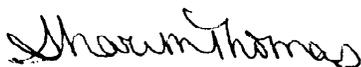
SCPPA will continue to bill Pasadena for actual quantities of natural gas delivered each month. This cost is recovered from customers through the energy charge component of the electric rates as they are incurred. Estimated costs for natural gas purchases are included in the budget of the Power Supply division account 8229-401-841910-0501. Actual costs associated with the purchase of natural gas delivered through the Agreement will be based on index prices at the Citygate delivery hub (less the discount).

Respectfully Submitted:



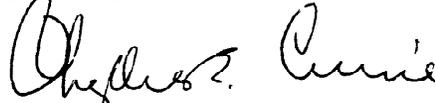
MICHAEL J. BECK
City Manager

Prepared by:



SHARI M. THOMAS
Assistant General Manager
Water and Power Department

Concurred:



PHYLLIS E. CURRIE
General Manager
Water and Power Department

RESOLUTION NO. _____

A RESOLUTION AUTHORIZING THE CITY MANAGER TO ENTER INTO AN AMENDMENT OF THE GAS SUPPLY CONTRACT DATED OCTOBER 3, 2007 BETWEEN THE SOUTHERN CALIFORNIA PUBLIC POWER AUTHORITY AND THE CITY OF PASADENA

WHEREAS, Southern California Public Power Authority ("SCPPA"), is a joint powers authority and public entity of the State of California duly organized and existing under and by virtue of the provisions of Article 4, Chapter 5, Division 7, Title 1 of the California Government Code (the "Act"), for the purpose, among others, of acquiring natural gas for the benefit of the City of Pasadena (the "City");

WHEREAS, SCPPA has previously issued its Gas Project Revenue Bonds (Project No. 1), Series 2007A and Series 2007B (together, the "Bonds"), pursuant to the Trust Indenture, dated as of October 1, 2007 (the "Indenture"), between SCPPA and U.S. Bank National Association, as trustee (the "Trustee"), for the purpose of paying the costs of acquisition of natural gas to supply the City pursuant to a Prepaid Natural Gas Sales Agreement, dated October 3, 2007 (the "Gas Purchase Agreement"), between SCPPA and J. Aron & Company (the "Gas Supplier");

WHEREAS, the City has previously entered into a Prepaid Natural Gas Program Gas Supply Agreement (Project 1), dated as of October 3, 2007 (the "Gas Supply Contract"), with SCPPA for the purpose of purchasing the natural gas acquired under the Gas Purchase Agreement from SCPPA;

WHEREAS, Goldman Sachs & Co. owns, and proposes to transfer to or for the account of SCPA for surrender and cancellation, a portion of the Bonds designated Series 2007B in exchange for SCPA's agreement with the Gas Supplier to reduce required gas deliveries under the Gas Purchase Agreement on terms that will preserve and accelerate the City's anticipated savings attributable to the reduced deliveries;

WHEREAS, the Gas Supplier and SCPA are willing to change the delivery point for gas purchased under the Gas Purchase Agreement and the Gas Supply Contract to the citygate delivery point on the SoCal System, at the request of the City, for a substantial term of years;

WHEREAS, corresponding reductions in required gas deliveries to the City and the delivery point under the Gas Supply Contract would be effected by the execution and delivery of the Amendment to the Prepaid Natural Gas Program, Project 1, Gas Supply Agreement (City of Pasadena), a form of which has been provided to the Council of the City (the "Amendment to the Gas Supply Contract"); and

WHEREAS, the City Council has determined that the transaction described above is in the best interest of the City;

NOW, THEREFORE, BE IT RESOLVED BY THE CITY COUNCIL OF THE CITY OF PASADENA AS FOLLOWS:

1. The recitals set forth above are true and correct and are incorporated herein by reference.

2. The City Manager is hereby authorized to execute and deliver the Amendment to the Gas Supply Contract, with such changes, insertions, and deletions as he shall approve, including changes to the quantities of gas to be delivered in the next few years to preserve the present value of anticipated savings despite changes in prevailing interest rates prior to execution and delivery of the same (such approval to be conclusively evidenced by such execution), subject to approval as to form of the amendment by the City Attorney, and the City Clerk is hereby authorized to attest to such execution.

3. The City Manager is hereby authorized to take such further actions as are necessary and appropriate to effectuate and carry out the intent and terms of this Resolution, including, without limitation, execution and delivery of any other contracts, agreements, notices, acknowledgements and other related documents as may be deemed appropriate to effectuate the transaction described herein.

4. This resolution shall become effective immediately.

Adopted at the regular meeting of the City Council of the City of Pasadena on

the _____ day of _____, 2009, by the following vote:

AYES:

NOES:

ABSENT:

ASBTAIN:

Mark Jomsky, CMC
City Clerk

APPROVED AS TO FORM:



Scott D. Rasmussen
Senior Assistant City Attorney