

Agenda Report

DATE: August 30, 1999

TO: CITY COUNCIL
Through: DEREGULATION COMMITTEE

FROM: CITY MANAGER

**SUBJECT: Energy and Credit Risk Management Policy for Water and Power
Department Wholesale Energy Transactions**

RECOMMENDATION

It is recommended that the City Council adopt the General Principles of an Energy and Credit Risk Management Policy, and direct the City Manager to implement such principles to govern wholesale energy transactions for the Water and Power Department.

BACKGROUND

A formal energy and credit risk management policy for the Pasadena Water and Power Department (Water and Power) has become a necessity for wholesale energy transactions because of the increased number, type, and financial strength of market participants and the increased volatility of energy prices.

Water and Power has participated in the wholesale energy market since the 1970s because it was often less expensive to buy electrical energy from the spot market than to generate it locally. Additionally, Water and Power routinely sells excess capacity or energy to other wholesale buyers to generate additional revenues, which offset other fixed costs. Until recently, counter-party risk had been minimal because Water and Power never engaged in speculative activity and the market entities were well-capitalized utilities with investment grade credit ratings. Deregulation has changed the market landscape. It is prudent to establish a formal risk management policy to govern participation in the wholesale markets because there are more market participants with less capitalization and lower rating than investment grade. The purpose of the policy is to establish guidelines for the Water and Power to plan, execute and control the management of a variety of risks associated with energy sales, purchases and distribution in a deregulated energy marketplace.

The major risks Water and Power will be exposed to in the new marketplace will be price, credit, organization, position, and market information. A description of these risks and the potential impact are shown in the following table:

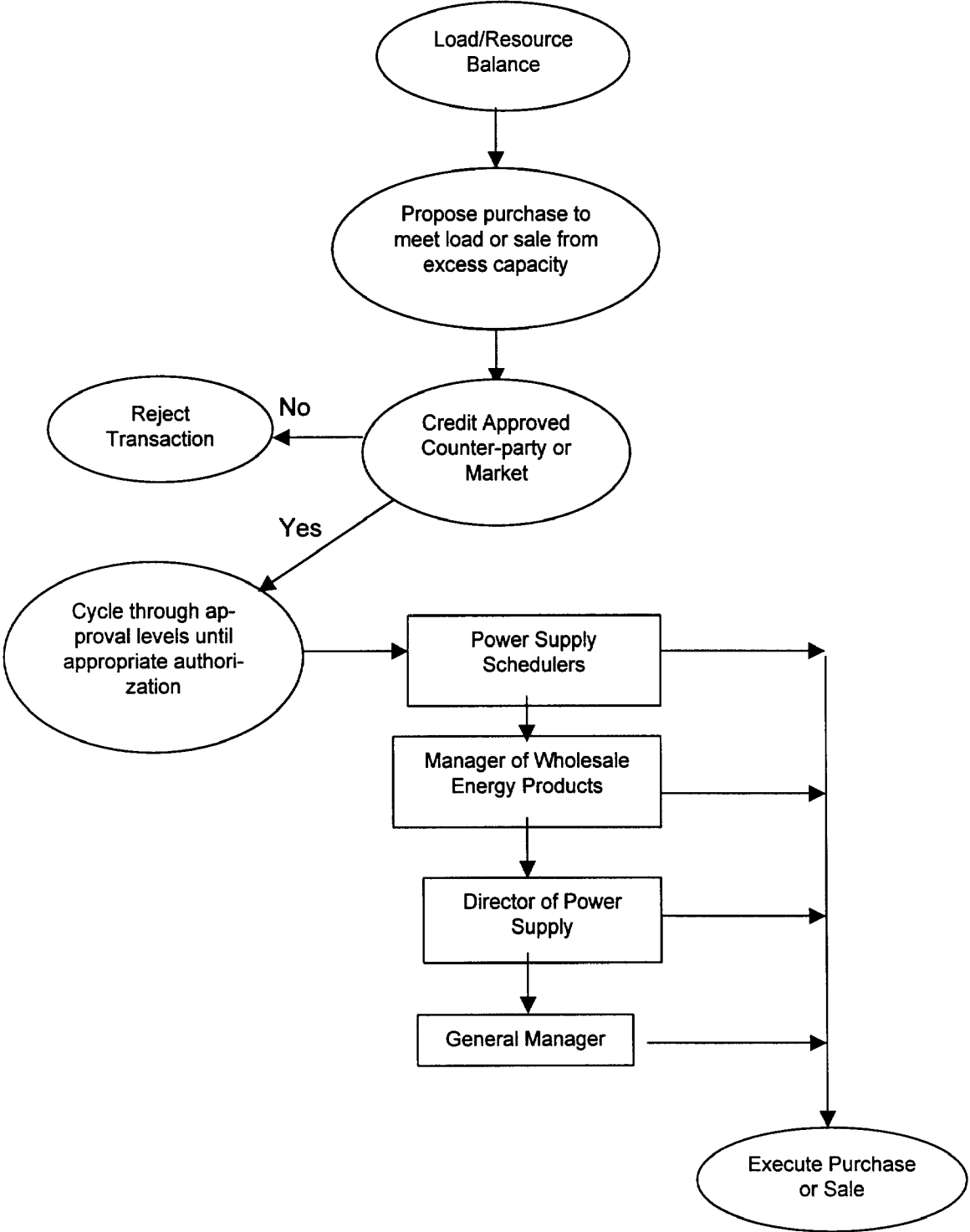
Risk	Description	Potential Impact
Price	Unbundled energy cost vs. retail price risk <i>or</i> Opportunity risk	Cash flow below budget or negative if energy cost equals or exceeds retail price
Credit	Inability or unwillingness of a counter-party to perform in a bilateral transaction	Resale of energy at a lower price resulting in reduced revenue or repurchase of energy at a higher price resulting in increased cost
Organizational	Unclear lines of authority and inadequate staffing, lack of transactions "ownership"	Sub-optimum pricing and operational decisions; confusion within and outside the organization
Position (Volume long or short)	Size of individual or total positions exceeds authorization for transaction level	Breakdown in trust in individual and/or risk management system
Market Information	Inaccurate, incomplete, or untimely information on market conditions affecting price	Sub-optimum pricing decisions on sales and purchases

Since Water and Power will be prohibited from engaging in speculation, speculative trading is not listed in the table as a risk relevant to Pasadena.

In general, Water and Power wholesale market activity consists of customer supply, asset optimization and related activities. Water and Power customer supply activities are transactions executed to meet obligations to its retail customers and wholesale supply to third parties.

Asset optimization activities are transactions executed to take advantage of current prices or price relationships within the market to generate revenue from excess resources and/or protect the anticipated revenue from load-serving resources. For Water and Power, the revenues are typically used to reduce power costs. Asset optimization activities involve the purchase and sale of transmission, capacity, and energy in the wholesale electricity market. A flow diagram of a typical supply and/or asset optimization transaction is as follows:

Transaction Flow Diagram



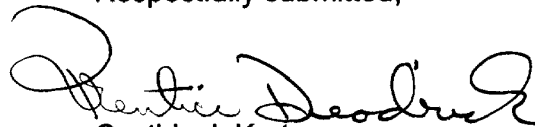
Since Water and Power marketplace activities are limited to energy purchases to meet projected load (or to replace higher cost resources) and sales of excess resources only, these activities are "covered" and speculation is not permitted. This means that any potential financial "losses" will be only opportunity losses, not outright losses.

The Energy and Credit Risk Management Principles will minimize financial and credit risk to Water and Power.

FISCAL IMPACT

The approval of the Pasadena Energy and Credit Risk Management Principles has no direct fiscal impact, but it will minimize potential financial and credit risks associated with Water and Power's participation in the deregulated wholesale energy markets.

Respectfully submitted,



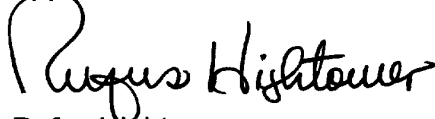
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