

Agenda Report

November 22, 1999

TO: City Council

FROM: City Manager

SUBJECT: Supplemental Information to Energy and Credit Risk Management Policy for Water and Power Department Wholesale Energy Transactions

RECOMMENDATION:

This is for information only.

BACKGROUND:

At its September 13, 1999 regular meeting, the City Council approved the Pasadena Water and Power (PWP) Energy and Credit Risk Management Policy (Policy) for wholesale energy trading. At that time, the City Council directed staff to respond, within sixty (60) days, to questions raised regarding Sections 2.2 and 2.3 of the Policy. Specifically, additional information was requested relating to the criteria PWP plans to use to rate counter-parties credit worthiness, and the type/quality of the credit instruments PWP will require from these counter-parties before transacting wholesale energy trading.

Currently, PWP conducts business with several types of counter-parties including utilities, municipalities, and energy service providers. PWP only conducts transactions, on an unsecured basis, with counter-parties who meets PWP's creditworthiness standard.

To meet the PWP credit worthiness standard, the potential counter party must have:

- A short term rating of "Acceptable Capacity", or better, and a long term rating of at least BBB, from at least two public rating agencies such as Standard & Poors' or Moody's

or

- A rating of BBB from the PWP Internal Credit Process.

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The current rating agencies and their current, minimum required rating level are as follows:

<u>Agency</u>	<u>Short Term Rating</u>	<u>Class</u>
Moody's	Prime 3	Acceptable Capacity
Standard & Poor's	A3	Acceptable Capacity
Fitch	F3	Acceptable Capacity
Duff & Phelps	D3	Acceptable Capacity

<u>Agency</u>	<u>Long Term Rating</u>
Moody's	Baa
Standard & Poor's	BBB
Fitch	BBB
Duff & Phelps	BBB

As the industry evolves, new potential trading partners may enter the marketplace. As this occurs, these ratings will require updates/customization to help ensure the required level of security is attained. Periodic updates are a part of this process and will occur on an as-needed basis.

PWP will not buy/sell to/from any publicly rated company below the then current level. Thus no credit facilities such as cash, securities or letters of credit are expected to be necessary from these parties.

Currently the marketplace has sufficient publicly rated participants that meet this requirement, such that it will be unlikely that the PWP Internal Credit Process will be initiated. However, if it becomes necessary, PWP Finance and Administration will utilize the PWP Internal Credit Process detailed below in evaluating the credit worthiness of prospective counter-parties.

PWP INTERNAL CREDIT PROCESS

PWP's Internal Credit Process employs a strict, financially based quantitative measurement process. These measurements are designed to identify factors that signify levels of credit worthiness. The measurements are divided into two sections: Financial Analysis (80%) and Equity Analysis (20%).

The Financial Analysis section includes the use of six financial ratios, which are applied to the balance sheet, income statement and cash flow statement. These ratios include total debt/total tangible capital, return on capital, total tangible assets, EBIT/interest expense, cash flow/total debt and current ratio. Once each ratio is calculated, the results are evaluated against a comparative scoring key and a numeric value is determined. Credit scores range from 1 to 12, with 1 being a very strong credit and 12 being a very

weak credit. In general, counter-parties with a rating equal to 7.5 or less are considered creditworthy while counter-parties who have a score above 7.5 are considered less creditworthy. A numeric score is attached to each category taking into account the specific predetermined weighting.

The Equity Analysis section incorporates the counter-party's total tangible equity. Counter-parties with tangible equity less than \$100 million are not approved for trading. Counter-parties with equity over \$100 million are evaluated against an internal scoring key and a numeric value is determined. Higher equity levels result in a more favorable score.

The Financial Analysis and Equity Analysis scores are aggregated together and an overall credit score is calculated. This total score is then used by PWP Finance and Administration Division as a guideline for deciding whether or not to extend credit. If the decision is to extend credit, a corresponding dollar credit limit is assigned.

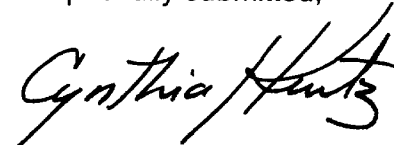
A copy of the proposed form that will be used for this process is attached.

The PWP credit scoring methodology provides a consistent way in which to evaluate the numerous components of potential counter-parties credit worthiness. This process is designed to compare the counter-parties with the industry averages currently in existence. As new components of measurement become relevant to the process, they will be incorporated.

Fiscal Impact

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

Respectfully submitted,



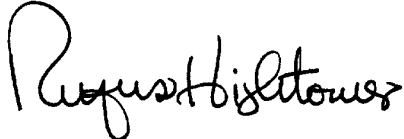
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