

- **Board of Directors**  
**Budget, Finance and Investment Committee**  
**Engineering and Operations Committee**

October 8, 2002 Board Meeting

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**8-1**

## **Subject**

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Approve risk management policy for purchase of Colorado River Aqueduct supplemental energy requirements, and amend Administrative Code

## **Description**

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This letter recommends that the Board approve a policy designed to mitigate market and credit risks that Metropolitan faces in procuring supplemental energy. Just as Metropolitan has an investment policy that guides staff's actions with respect to the management of Metropolitan's investment portfolio, Metropolitan needs a more comprehensive policy to guide staff procurement of supplemental energy for the Colorado River Aqueduct (CRA).

Metropolitan typically uses over 2,400 gigawatt-hours (GWh) of electricity per year to pump 1.25 million acre-feet on the CRA. The sources of this energy are federal power contracts for generation at Hoover Power Plant and Parker Power Plant, a contract with Southern California Edison (SCE) for benefit and exchange energy, and supplemental energy purchases. Metropolitan's federal power contracts are cost-based and, together with benefit and exchange energy from SCE, provide about 70 percent of the total annual CRA energy requirement. The remaining 30 percent is purchased in the wholesale power market to serve mainly off-peak loads and is commonly referred to as supplemental energy.

Metropolitan typically relies on both forward purchase contracts of not more than one year in duration and day-ahead purchases to secure the supplemental energy. Until 2001, the historic average cost of supplemental energy was about \$11 million per year. However, in fiscal year 2000/01, these costs were on the order of \$75 million because of the turmoil and dysfunction in the wholesale power market. Supplemental costs for fiscal year 2001/02 were \$79 million. The fiscal year 2002/03 budget anticipates supplemental energy costs of \$33 million.

Prior to the restructuring of California's electricity sector, regulated vertically integrated utilities (i.e., utilities that provide generation, transmission and distribution service) were required to provide enough generation to meet peak loads plus a reserve margin to maintain electric system reliability. As a purchaser of off-peak energy, Metropolitan was virtually assured of stable and predictable prices for ample amounts of supplemental energy. In the absence of this regulated structure, energy prices and availability are less certain. Metropolitan now needs to be prepared for substantial volatility in the cost for supplemental energy. This cost volatility can have a significant impact on Metropolitan's financial condition in any single year, and if left unmitigated may cause unanticipated water rate increases.

Specifically, the recommended policy:

- Establishes a power resource portfolio strategic management objective to maintain operational flexibility and achieve stable and predictable supplemental energy pricing at the lowest reasonable cost.
- Establishes counter-party credit guidelines for procurement of supplemental energy including: (1) limiting the amount of energy that can be provided by any one marketer to no more than 30 percent of the total annual supplemental energy requirement, (2) requiring that all counterparties with which Metropolitan has a purchase contract for energy to be provided beyond the next 90 days have a credit rating for their long-term debt of investment grade or better, or provide a letter of credit or financial guarantee.

- Delegates sufficient purchasing authority to the CEO to secure supplemental energy through purchase contracts with terms of not more than 24 months in duration and at a total payment obligation not to exceed \$35 million.

This letter further directs the CEO to:

- Establish a risk oversight committee (ROC) made up of the Chief Operating Officer, Chief Financial Officer and Water System Operations Group Manager to regularly provide oversight and guidance for the development and implementation of supplemental energy purchasing strategies and approve supplemental power purchases within the CEO's delegated authority.
- Establish purchasing guidelines including dollar amount and contract term limits for the Operations Planning Unit manager and ROC.
- Develop appropriate risk management reports and tools.
- Establish the regular review of transaction settlements by the Office of the Chief Financial Officer.

Amendments to Metropolitan's Administrative Code necessary to implement this policy are shown in [Attachment 1](#).

### **Financial Impact**

There are several financial impacts: the risk associated with long-term contracts, the cost for mitigating market price risk through financial hedges and additional operating costs associated with the development of reporting systems and the regular preparation and review of risk management reports and transaction settlements.

Purchase contract premiums vary substantially with power market conditions and the specifics of each transaction (e.g. the lower the cap placed on market prices per the agreement, the higher the premium). It is estimated that the development of risk management reporting tools will cost about \$75,000 and that additional annual labor costs of between \$35,000 to \$70,000 will be incurred to maintain these tools while providing regular financial analyses of transactions and regularly reviewing transaction settlements within the Office of the Chief Financial Officer.

### **Policy**

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Metropolitan Water District Administrative Code § 8118: Contracts in Excess of \$250,000 Not Requiring Prior Board Approval

### **California Environmental Quality Act (CEQA)**

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CEQA determination for Option #1:

The proposed action is not defined as a project under CEQA, because it involves continuing administrative activities such as general policy and procedure making (Section 15378(b)(2) of the State CEQA Guidelines). In addition, the proposed action is not subject to CEQA because it involves other government fiscal activities, which do not involve any commitment to any specific project that may result in a potentially significant physical impact on the environment (Section 15378(b)(4) of the State CEQA Guidelines).

The CEQA determination is: Determine that the proposed action is not subject to CEQA pursuant to Sections 15378(b)(2) and 15378(b)(4) of the State CEQA Guidelines.

CEQA determination for Option #2:

None required

**Board Options/Fiscal Impacts**

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**Option #1**

Adopt the CEQA determination and

- a. Approve the Colorado River Aqueduct Supplemental Energy Risk Management Policy, and
- b. Approve the changes to Metropolitan’s Administrative Code.

**Fiscal Impact:** Costs for purchase contract premiums, operational costs for up to one full time equivalent (FTE) per year, and one-time reporting tool development costs of up to \$75,000. Premiums paid for purchase contracts vary substantially with market conditions.

**Option #2**

Defer consideration of the Policy until further discussion by the Board.

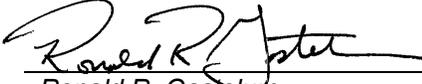
**Fiscal Impact:** None

**Staff Recommendation**

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Option #1

  
 Brian G. Thomas 9/13/2002  
 Chief Financial Officer Date

  
 Ronald R. Gastelum 9/20/2002  
 Chief Executive Officer Date

**Attachment 1 – Administrative Code changes**

BLA #1863

## Attachment 1

### § 8118. Contracts in Excess of \$250,000 Not Requiring Prior Board Approval.

#### (c) Power and Transmission Contracts.

(1) General Authorization. - The Chief Executive Officer is authorized to negotiate and execute contracts of ~~duration~~ up to ~~one year~~ 24 months duration from the end of the current month to furnish power or transmission capability to the District or dispose of power or transmission capability available to the District. Such contracts for power or transmission capability may not exceed a total payment obligation of \$35 million within any 24-month period.

~~(2) Hourly Non Firm Power Contracts.—Notwithstanding the provisions of Section 8118(c)(1), the Chief Executive Officer is authorized to negotiate and execute contracts to buy or sell non firm power on an hour to hour basis, provided that any such contract shall be terminable by the District on not more than thirty days' notice to the other party.~~

~~(3) Reporting. - The Chief Executive Officer shall report~~ quarterly to at the next regular meeting of the Board the execution of ~~any~~ contracts authorized by this Section 8118(c). ~~and any transaction made under such contract.~~

(3) Risk management. - The Chief Executive Officer shall maintain a risk management policy to provide guidance and management oversight for the purchase of supplemental energy for the Colorado River Aqueduct operations. The risk management policy shall address market and credit risks associated with the purchase of supplemental energy.