Legislation Details (With Text)

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Title: Recommendation to adopt resolution authorizing the issuance of bonds by the Long Beach Bond Finance Authority related to the prepayment of natural gas supply for a term of 30 years in an amount not exceed $1.3 billion; authorizing and approving contracts, agreements and other documents and actions relating thereto; and delegating authority to officers in connection therewith. (Citywide)

Sponsors: Long Beach Gas and Oil, Financial Management

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Date	Ver.	Action By	Action	Result
8/21/2007	1	City Council	approve recommendation and adopt	Pass

Recommendation to adopt resolution authorizing the issuance of bonds by the Long Beach Bond Finance Authority related to the prepayment of natural gas supply for a term of 30 years in an amount not exceed $1.3 billion; authorizing and approving contracts, agreements and other documents and actions relating thereto; and delegating authority to officers in connection therewith. (Citywide)

The Long Beach Gas and Oil Department (LBGO) operates California's largest municipally-owned natural gas utility (Utility). The Utility provides gas service to the residents and businesses of the cities of Long Beach and Signal Hill, along with small portions of several surrounding cities. As a gas utility, two of LBGO's primary responsibilities include reinvesting gas revenues into maintaining a safe pipeline delivery system and purchasing competitively-priced natural gas supplies on behalf of LBGO's 145,000 customers. LBGO anticipates challenges in meeting these responsibilities in the years to come based on status quo operations. Fortunately, LBGO has a recommended solution that will address these challenges to the benefit of LBGO's customers as well as the Utility.

Natural Gas Pipeline Infrastructure

LBGO's gas infrastructure includes 1,800 miles of underground pipeline, the bulk installed during the City's geographic expansion during the 1940s, 1950s, and 1960s.
Industry pipeline standards, as well as LBGO's own experience, indicate that gas pipeline begins to experience dramatically increased leakage when the pipeline exceeds 60 years of age. Increased pipeline leakage can pose serious public safety issues, and is extremely expensive to repair or replace on an emergency basis.

As such, LBGO recently began a long-term pipeline replacement program to replace the small percentage of remaining gas pipeline installed during the 1920s and 1930s, and will soon concentrate on the replacement of the 1940s pipeline. This program is being funded through the use of ongoing gas utility revenues combined with commercial paper financing.

Expected future Utility revenues may not be sufficient to continue to fund the footage of aging pipeline that will need replacement over the next three decades when the bulk of LBGO's pipeline reaches the 60-year old threshold. Failure to obtain a substantial new funding source will require the gas utility to rely solely upon greatly reducing the Utility's annual transfer to the General Fund and/or surcharging LBGO's customers to pay for pipeline reinvestment.

Gas Commodity Price Challenge

With the natural gas industry deregulation of the mid 1980s, the natural gas commodity market was opened to competition. Since that time, LBGO has been purchasing the gas supply for its customers in this open competitive market and passing this cost directly to its customers. LBGO purchases approximately $75 million of natural gas supplies annually on behalf of its customers and the City Charter requires it to charge its customers rates comparable to those charged by surrounding gas utilities in Southern California. The two primary benchmarks that LBGO is compared with are: 1) the industry-recognized first-of-the-month market index price at the California-Arizona border where most area gas purchases are consummated (CA Border Index); and 2) the Southern California Gas Company's monthly Core Procurement Price (SoCalGas CPP) which it charges to its residential and small commercial customers and is roughly comparable to the CA Border Index. Historically, LBGO has been largely successful in meeting or beating each of these two benchmarks.

However, there is the risk in the future that LBGO will not be as successful in meeting or beating these benchmarks, as well as meeting the equally important goal of obtaining a reliable long-term gas supply. In 2006, LBGO negotiated a three-year gas supply contract with Coral Energy Resources, L.P., (Coral) after issuing a Request for Proposals (RFP) to all major gas suppliers in the Southern California Market. These negotiations resulted in a price indexed to the market, discounted by $0.04 per MMBtu with 50 percent of the gas supplied during the peak winter months at a fixed price of $8.20 per MMBtu, which brought pricing protection to LBGO's customers during peak demand. The result has been mixed with the overall price of the gas supplied under this contract being slightly higher than that of the market and SoCalGas prices, largely due to the fixed price winter component. In the foreseeable future, long-term commitments for traditional gas supplies will be available only at very slight discounts off market indices and these resulting prices will inconsistently fluctuate above and below the prices charged by SoCalGas.

Natural Gas Prepay Program Solution

Fortunately, there is a long-term opportunity with mitigated risk that will allow LBGO to significantly reduce its gas purchase costs, provide significant funding for pipeline reinvestments and greatly decrease the current risk-exposure to open-market gas purchases. This opportunity is a natural gas prepay transaction whereby a municipal utility, using its ability to issue tax-exempt debt, enters into a firm, long-term gas supply contract far below the cost that is otherwise obtainable. Debt proceeds are paid upfront to the gas supplier in exchange for future gas deliveries at market prices minus a fixed discount. The discounted price is possible because the tax-exempt borrowing rate of the municipal utility is lower than the gas supplier's taxable cost of obtaining capital.

Municipal utility prepaid natural gas transactions financed with tax-exempt debt are not new and have been around since the 1990s. However, only a few transactions of relatively small size occurred before the transactions halted in 1999 when the Internal Revenue Service (IRS) began reviewing the transactions for appropriateness. In October 2003, the IRS issued new regulations that provided greater clarity on acceptable structures. Additional statutory support was provided by provisions of the Federal Energy Policy Act of 2005.

Increasing natural gas costs and price volatility caused municipal utilities to look into the need for enhanced risk management, firm long-term supply commitments, and opportunities to lower commodity costs. The regulatory and statutory safe harbors, combined with the improved economics created by the increased spread between taxable and tax-exempt interest rates, allowed municipal gas purchasers to again consider the benefits offered by natural gas prepay programs. In 2006, 11 natural gas prepay transactions were completed, involving nearly $10 billion of tax-exempt bonds. In 2007, 16 gas prepay transactions have been, or are in the process of being completed, exceeding $12 billion in total. In California, the cities of Roseville, Vernon, and the Sacramento Municipal Utilities District completed gas prepay transactions in 2007. Several other cities including Los Angeles, Pasadena, Burbank, Glendale, Anaheim, and Colton are currently in the process of jointly entering into a gas prepay transaction to provide natural gas to fuel the electric utility power plants.

To assist the City in looking further into potential risks and opportunities afforded by gas prepay transactions, the City interviewed and hired the best financial advisors, tax counsel, and bond counsel involved with these types of transactions in the nation. In February 2007, with this team in place, the City issued an RFP for a City natural gas prepay. Nine major financial institutions responded of which the City interviewed five finalists: Citigroup, Goldman Sachs, JP Morgan, Merrill Lynch, and UBS. It was determined that the proposal package offered by Merrill Lynch provided the City with the greatest overall value combined with the best risk mitigation terms.

In the ensuing months, the City had negotiated with Merrill Lynch the details of the proposed gas prepay transaction as described below:

Gas Supply Volume - LBGO would purchase approximately eight billion cubic feet annually of prepaid natural gas supply from Merrill Lynch. This volume represents the gas utility's baseload supply that will be augmented first with local gas supplies, and any further volume demand met by incremental gas purchases from Coral.

Bond Issuance - Depending upon the financial market's forward curve of natural gas prices at the time of closure, the dollar amount of bonds issued will be up to $1.3 billion, though the expected issuance is closer to $1.2 billion.

Term - The negotiated term is for 30 years, commencing October 1, 2007. While a shorter term is available, savings are significantly enhanced as the term of the transaction is lengthened. Rating agencies do not see any meaningful credit concern associated with longer terms provided the utility is paying index-based prices rather than fixed prices. The transaction with Merrill Lynch will utilize an index-based price.

Price Discount - As mentioned previously, LBGO has two primary monthly pricing benchmarks: the CA Border Index and the SoCalGas CPP. The proposed prepay natural gas will be priced 50 percent against the CA Border Index and 50 percent against the SoCalGas CPP. Each of these will be discounted by a fixed amount, estimated to be $0.70 and $1.00 per MMBtu depending upon market conditions at the time the prepay transaction is consummated. To put this amount into perspective, LBGO's most recent competitive process for a long-term gas supply resulted in a discount of $0.04 per MMBtu.

Cost Savings - The fixed price discount is expected to result in an estimated gas purchase cost savings of $150 - $200 million over the term of the transaction, or about $5 - $7 million annually.

Conduit Issuer - The conduit issuer will be the existing Long Beach Bond Finance Authority (LBBFA), a Joint Power Authority between the City of Long Beach and the Long Beach Redevelopment Agency. The LBBFA is the legal entity that has issued bonds for other City projects in the past. The LBBFA will also be used to contract with the gas commodity provider, Merrill Lynch Commodities, Inc. (MLCI).

It is important to note that if MLCI defaults under this transaction, the payment obligation to the bondholders is borne by Merrill Lynch as the bonds are non-recourse to the City and LBGO. However, the City's name would be associated with the bonds.

Risk Mitigation - With the release of the IRS' regulations in late 2003, combined with the recent upsurge in such transactions, prepay structures have evolved to minimize risk. These risk mitigation measures include:

Risk Scenario: MLCI defaults on gas delivery.
Mitigation: LBGO is only required to pay for actual gas delivered. In the case of a default by MLCI, the bondholders would have recourse solely against Merrill Lynch, not the City or LBGO. LBGO would then need to replace the void caused by the MLCI supply delivery failure by purchasing gas on the open market, such as is currently done by LBGO.

Risk Scenario: An MLCI gas delivery default causes LBGO to purchase replacement volumes.
Mitigation: Merrill Lynch makes LBGO financially whole for unrealized savings for the remainder of the transaction term, putting LBGO in a better position financially to purchase replacement volumes.

Risk Scenario: LBGO is unable to fully accept the agreed upon gas volumes.
Mitigation: MLCI will remarket the gas to qualified buyers (Le., municipal customers) to ensure tax and regulatory compliance.

Risk Scenario: City's debt increased through the prepay transaction, negatively impacting the City's credit capacity.
Mitigation: The conduit issuer insulates the City's credit as the prepay bonds are not considered City debt by the rating agencies.

Risk Scenario: Long-term fixed pricing may consistently exceed market prices.
Mitigation: A gas commodity swap incorporated in this proposal exchanges the fixed price gas for market priced gas for the duration of the transaction.

Risk Scenario:	The gas swap counterparty, BNP Paribas, fails to perform.
Mitigation:	While the Guarantor, Merrill Lynch, bears the risk, the transaction may terminate as a result of BNP Paribas' failure; therefore, the savings guaranty is not applicable under this scenario. Should BNP Paribas' credit ratings fall, alternative replacement options under the documents are available.

Existing Gas Supply Agreements - LBGO currently purchases its gas supply from various small local gas producers and the bulk of its gas supply from Coral. To maximize cost savings and minimize risks, it is imperative that LBGO position the prepay gas as LBGO's base load purchases. To accomplish this, it is necessary to amend or terminate the existing purchase contracts to recognize the baseload status of the prepay volumes.

LBGO notified its local producers that it intends to purchase the prepay volumes effective October 1, 2007, and that LBGO will continue to purchase the local supplier gas volumes if the local suppliers accept new terms that include a price equal to LBGO's lowest cost of gas purchased during the month of delivery; also, that LBGO's purchase of their volumes will be supplemental to the prepay volume purchased. LBGO will return to City Council in the near future with new contracts or amendments with these local suppliers.

LBGO's long-time supplier, Coral, has worked well with LBGO and Merrill Lynch to craft a solution for how to initiate the prepay volumes on October 1, 2007, despite the fact that the Coral supply contract still has approximately one and a half years remaining in its term. Under the existing contract, Coral supplies LBGO with the majority of its gas supply as well as various financial and operational services, including storage management, scheduling deliveries, load forecasting, and volume balancing. In a separate action, LBGO will seek City Council approval of several contracts with Coral that will allow Coral to continue to provide the various services and also allow LBGO to purchase at market prices any volumes needed, if any, above those supplied through the prepay transaction and the local gas suppliers.

Summary - The City hired an independent firm with extensive expertise in the fields of both energy and financial matters, Recon Research (Recon). The purpose in hiring Recon was to provide the City an unbiased view of the sagacity of entering into a gas prepay transaction from a financial risk/reward perspective as well as from a natural gas strategic standpoint. The conclusion of Recon's report states:

> "The Long Beach gas prepaid purchase program appears to be a low risk transaction which can bring substantial benefits to the City's gas utility. It is an innovative use of the City's municipal bonding authority which is allowable under IRS regulation, and which should provide stable and costadvantaged gas flows for baseload natural gas demands of LBGO."

There are simply no other gas supply alternatives to the natural gas prepay transactions that provide similar cost savings, long-term supply security, minimal risk, and guaranteed competitive market price. Failure to take advantage of this program will leave LBGO and its customers subject to the uncontrolled market commodity prices, which are potentially millions of dollars greater than otherwise available under the prepay transaction. In addition, the prepay transaction will provide a source of funding for LBGO's pipeline replacement program that would otherwise need to be funded through a combination of reduction of money transferred to the General Fund and a surcharge upon LBGO's customers.

Accordingly, the City Council is being requested to adopt the attached resolution, which authorizes the issuance of the bonds for this transaction, and approves all related documents and contracts. A copy of the Preliminary Official Statement (which is the offering document sent to potential investors) is also attached for the City Council's review and consideration.

This matter was reviewed by Deputy City Attorney Richard Anthony on August 10, 2007 and by Budget and Performance Management Manager David Wodynski on August 13, 2007.

City Council action is requested on August 21, 2007, as it is strategically desirable to issue the bonds prior to September when numerous competing natural gas prepay bond issuances are scheduled to come to market. The added competition for financing will reduce the obtainable savings for LBGO.

Annually, LBGO purchases approximately $75 million of natural gas commodity on behalf of its customers. The proposed gas prepay transaction will result in estimated annual cost savings of $5 to $7 million, or approximately $150 to $200 million over the next 30 years.

Approve recommendation.

A RESOLUTION OF THE CITY COUNCIL OF THE CITY OF LONG BEACH AUTHORIZING AND APPROVING THE ISSUANCE OF BONDS BY THE LONG BEACH BOND FINANCE AUTHORITY; AUTHORIZING AND APPROVING CONTRACTS, AGREEMENTS AND OTHER DOCUMENTS AND ACTIONS RELATING THERETO, AND DELEGATING AUTHORITY TO OFFICERS IN CONNECTION THEREWITH

CHRISTOPHER J. GARNER
DIRECTOR OF LONG BEACH GAS AND OIL

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DIRECTOR OF FINANCIAL MANAGEMENT

NAME
TITLE

APPROVED:

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