CITY OF LONG BEACH
Gas & Oil
DEPARTMENT

R-21

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March 7, 2006

HONORABLE MAYOR AND CITY COUNCIL
City of Long Beach
California

RECOMMENDATION:

Receive and file report regarding a long-term natural gas supply agreement with Coral Energy Resources, L.P. (Citywide)

DISCUSSION

On February 14, 2006, the City Council authorized the City Manager to enter into a three-year natural gas supply agreement with one of the following energy companies: BP Energy Company, Occidental Energy Marketing, Inc., or Coral Energy Resources, L.P (Coral Energy). (See attached City Council letter.) As expected, the contract parameters approved by the City Council gave Long Beach Gas and Oil (LBGO) the needed flexibility in negotiations to structure a creative and innovative gas supply package that meets all of the critical objectives for ensuring a competitive and stable price to LBGO's customers for the next three years.

After intense negotiations between LBGO and the three suppliers, LBGO agreed to a three-year gas supply agreement (Agreement) with Coral Energy. The decision was based largely upon Coral Energy's pricing package, which was the most competitive offered by the three companies. In addition, Coral Energy has been LBGO's primary natural gas supplier for nearly five years and has done an excellent job in all phases of supplying LBGO with its gas requirements at very competitive prices.

As shown in the table below, the terms of the Agreement meet or improve upon the negotiation parameters approved by the City Council.

	City Council Parameters	Coral Energy Agreement
Term	April 1, 2006 - March 31, 2009	April 1, 2006 - March 31, 2009
Annual Volume	Up to 10 billion cubic feet	Total supply requirements
Summer Pricing		
Price	CA Border less $0.01	CA Border less $0.04
Ceiling	None	None
Floor	$8.50 / MMBtu	$5.50 / MMBtu
Winter Pricing		
Price	CA Border less $0.01	50% at CA Border less $.04
Ceiling	$15.00 / MMBtu	$10.50 / MMBtu
Floor	$8.50 / MMBtu	$5.50 / MMBtu
Price		50% Fixed at $8.20
Ceiling		N/A
Floor		N/A
Monthly Fee	**$150,000**	**$84,000**

The objectives listed below were the strategic focus that guided LBGO's negotiation of the various aspects of the Agreement.

1. **Most importantly, LBGO customers must be reasonably protected against high natural gas prices.**

   The natural gas price market has greatly increased in the past year, partially caused by Hurricane Katrina which destroyed some major natural gas production facilities. Industry experts are predicting that the tightness of supply and increasing demand will keep prices at similar levels experienced this past year. Even though this past winter was the third warmest in the nation's recorded history and kept demand lower than normal, market prices remained much higher than last year. This is largely due to the United States' decreasing production rates despite record drilling activity, combined with a demand for natural gas that remains largely steady even in the face of steep price increases and the warm winter weather.

   LBGO has built into the Agreement price protection for LBGO's customers when it is most needed, during the peak winter months of November through February. The winter supply will be a portfolio mix of 50 percent fixed priced gas and 50 percent discounted off the monthly market price with a price ceiling. The fixed price portion will be priced at $8.20 per MMBtu, a price <u>over 20 percent lower</u> than the peak cost of gas this past year. The market priced gas will be equal to the monthly market price at the California border discounted by $0.04 per MMBtu with a price ceiling of $10.50.

This pricing portfolio blend will provide LBGO's customers price protection against higher market prices, while still allowing LBGO's customers to realize the benefit of lower commodity prices if the market trends downward. This methodology will once again provide firm assurance for LBGO's customers that natural gas bills will **NOT** reach anywhere near the level experienced during the energy crisis of 2000/2001. In a worst case scenario, the cost of gas for LBGO customers under the new Agreement would be **43 percent lower** than the peak price paid by LBGO's customers in 2001.

2. **The monthly price should be price competitive with the price paid by surrounding gas utilities in Southern California.**

Gas suppliers will not provide gas price indexed to the Southern California Gas (SoCalGas) Monthly Weighted Average Cost of Gas (WACOG). Therefore, LBGO must attempt to negotiate a price tied to a recognized market index that it believes will be competitive with the SoCalGas WACOG.

The current gas supply contract with Coral Energy is indexed to the San Juan Basin (New Mexico) price plus a fixed fee of $0.36 per MMBtu to account for pipeline transportation of the gas from the San Juan Basin to the California border. The San Juan Basin price was selected as the index because SoCalGas purchased a large portion of its gas supply from this Basin. While that methodology has provided a competitive price for the past 4½ years, the price differential between the San Juan Basin and the California border has become much more volatile in the past year, ranging from $0.10 to over $0.70 per MMBtu.

With the negotiated discount of $0.04 per MMBtu, it is believed that this contract price will prove to be price comparable with the SoCalGas price on a consistent basis over the next three years.

3. **In exchange for obtaining critical price protection against high winter prices, LBGO would be willing to establish a reasonable price floor throughout the year.**

Without agreeing to price floors, obtaining price ceilings would be either cost prohibitive or would require setting the price ceiling at a much higher level than what we believe LBGO's customers would be willing to risk.

Therefore, while the price floor in the existing Coral Energy agreement is at $3.00 per MMBtu, the current higher market prices require raising the floor to $5.50 per MMBtu. While this is a significant increase, the "risk" is minimal of market prices decreasing to a level below $5.50 for an extended period of time over the next three years. In the past year, the market price has not reached below that level at any time and has been more than double that price at times. So even though market prices may fall below that threshold causing the price floor to take effect, it would seem a reasonable trade-off for LBGO's customers in exchange for the protection against the much greater risk of high natural gas prices.

4. **The length of term should be long enough to obtain favorable pricing while also not restricting longer-term opportunities.**

   The natural gas price market nationwide has a slight downward curve as the expectation is that gas production in the Gulf of Mexico destroyed by Hurricane Katrina will partially come back and that new liquefied natural gas (LNG) supplies will slightly improve the nation's supply situation.

   The Agreement has a three-year term which was a long enough commitment to entice serious interest and favorable price offers from the major gas suppliers. At the end of the three-year term, it might provide excellent timing for LBGO to take advantage of new supply opportunities afforded directly or indirectly from LNG projects locally or in Baja California that may become operational in roughly that time frame.

5. **Continue to utilize storage rights to primarily serve as winter supply security and secondarily for price arbitrage opportunities.**

   The Agreement requires Coral Energy to have LBGO's storage volumes at full capacity going into each winter and places maximum limits on winter volume withdrawals. This will continue LBGO's practice of prudently maintaining storage volumes throughout the winter months at sufficient levels to provide supply security for LBGO's customers. The Agreement also allows Coral Energy the flexibility to manage the storage within those contractual limits so that Coral Energy can take advantage of market price fluctuations. By providing Coral Energy somewhat flexible access to LBGO's storage rights, this provided value to Coral Energy that was then reflected in its favorable contract offer.

6. **Be willing to pay a reasonable fixed monthly fee for gas supply management services.**

   Coral Energy provides gas supply management services for LBGO including storage management, interstate and intrastate volume nominations, daily and monthly balancing, daily and monthly load forecasting, Operational Flow Order management, and coordination with LBGO. The monthly "fee" is considered part of the overall compensation to the supplier and can impact the pricing of other components of the complete package.

   LBGO's goal was to enter into the new Agreement without increasing the monthly fee paid in the existing contract. Negotiations were successful in this regard as the monthly fee in the new Agreement will remain at the same monthly level of $84,000.

This matter was reviewed by Deputy City Attorney Richard Anthony and Budget Management Officer David Wodynski on March 1, 2006.

TIMING CONSIDERATIONS

City Council action is requested on March 7, 2006, as deliveries of gas under the new three-year Agreement will commence on April 1, 2006.

FISCAL IMPACT

Funds associated with the Agreement are budgeted in the Gas Fund (EF 301) in the Long Beach Gas and Oil Department (EN). Payment during the three-year Agreement is limited to revenues in the Gas Fund.

SUGGESTED ACTION:

Approve recommendation.

Respectfully submitted,

Christopher J. Garner

CHRISTOPHER J. GARNER
DIRECTOR OF LONG BEACH GAS AND OIL

CJG:JC
C:\COUNCIL LETTER 3-07-06 CORAL ENERGY

Attachment

APPROVED:

Gerald R. Miller

GERALD R. MILLER
CITY MANAGER