

# Joint IEPR and Electricity & Natural Gas Committee

3/10/09 CEC Workshop

**DOCKET**

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## NATURAL GAS PROCUREMENT AND HEDGING

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**SMUD**

SACRAMENTO MUNICIPAL UTILITY DISTRICT

The Power To Do More.<sup>SM</sup>



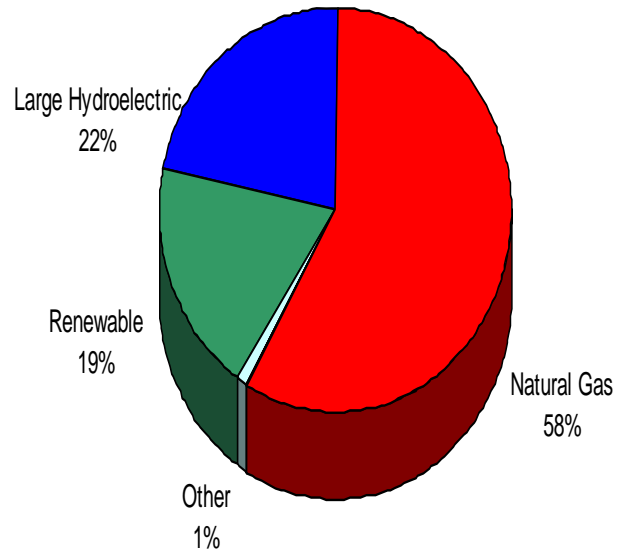
# SMUD FACTS

- 6<sup>th</sup> largest municipal utility in the U.S.
- Serves over 600,000 customers for electric service only.
- As a municipal utility, SMUD is owned by its customers, therefore, interests align 100%.
- Goal: Provide reliable service at reasonable and stable rates.



# SMUD Resource Mix

Forecast of 2009 Resource Mix (MWh)

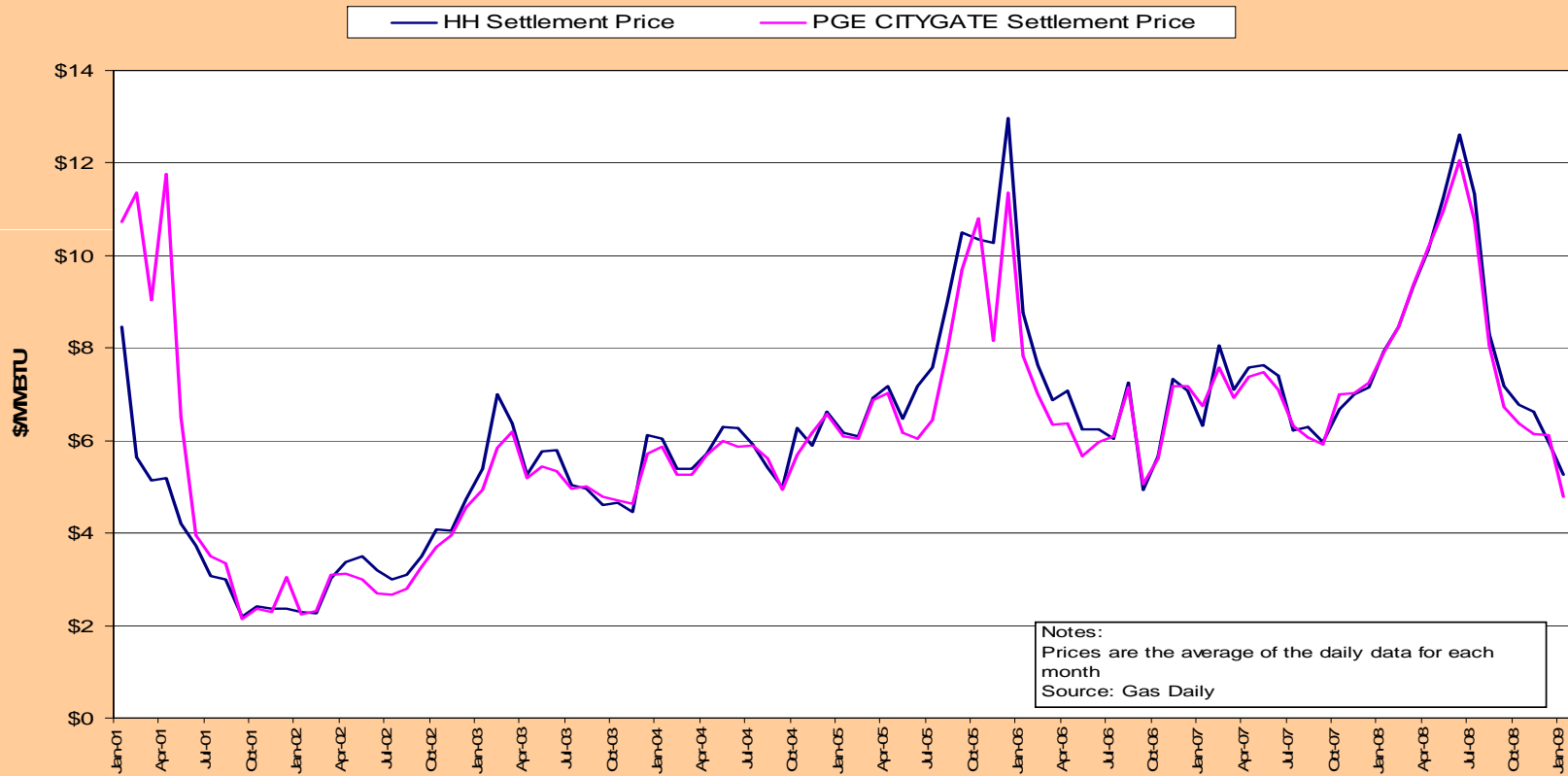


- Annual retail revenue of \$1.3 billion
- Annual power & gas budget of over \$600 million



# Gas Prices

HH & PGE CITYGATE Settlement Prices 2001-2008



# Gas Hedging

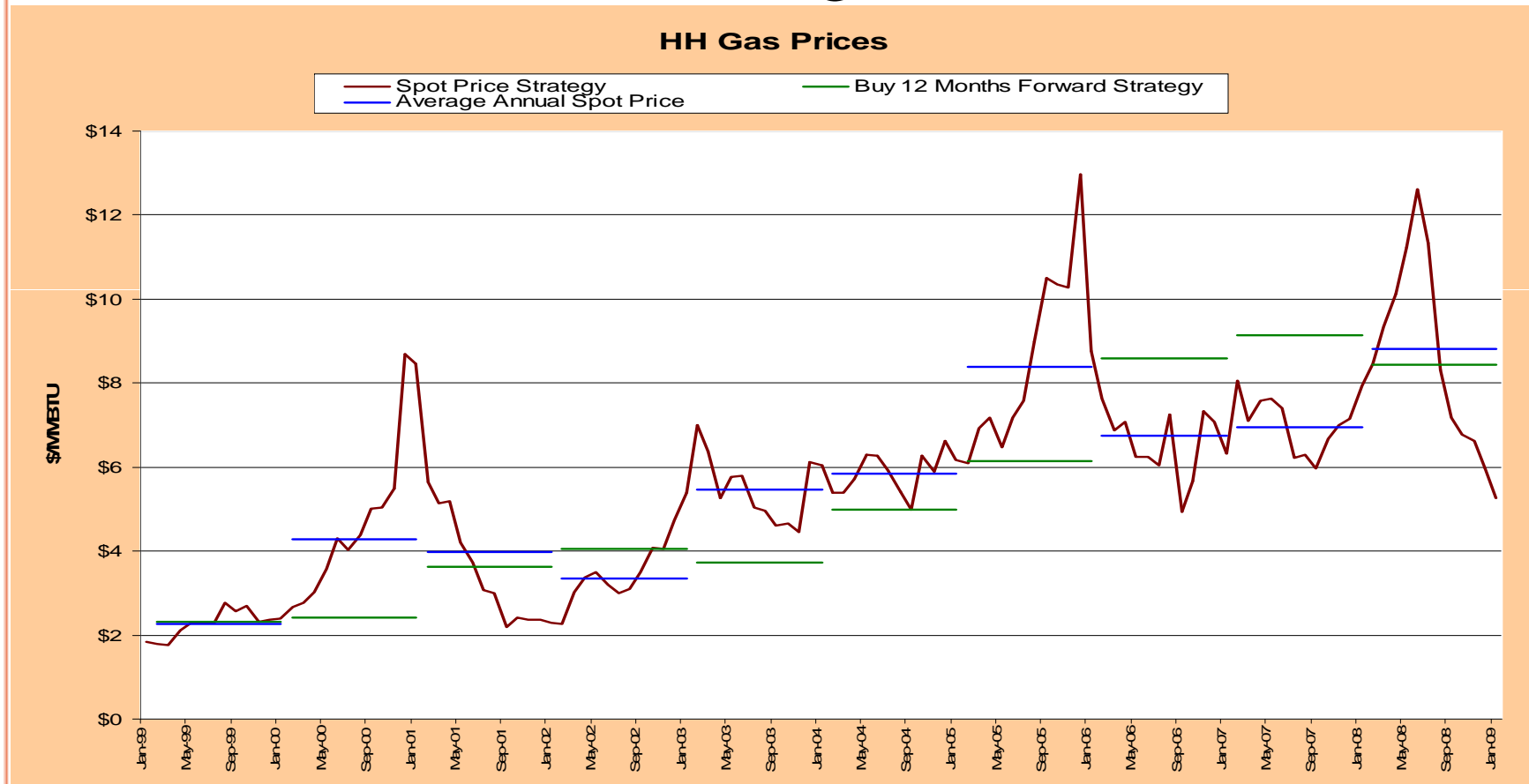
Objective: Increase financial certainty by stabilizing cost, where

$$\text{Cost} = \text{Price} \times \text{Volume}$$

Action: Reduce open positions by locking in price



# Comparison of Gas Procurement Strategies



# Hedging Instruments

- Physical and financial
- Multi-year / seasonal purchases
- Storage injection / withdrawal
- Gas reserves



# Key Considerations and Challenges

- Balance between price certainty and cost
- Collateral Requirements
- Default Risk
- Accounting Treatment and Reporting





# Policy Issue: Balance between Price certainty and cost

## Price Certainty

- Cost stability/predictability may be favored for household and business budgeting
- Economy of Scale to hedge
  - A few large customers have the capability to do so independently
  - Most small commercial and residential customers will not have the necessary capability



# Policy Issue: Balance between Price certainty and cost

## Cost

- Hedging has a cost
- Acts like an insurance policy by limiting cost exposure
- Is not intended to represent the lowest cost alternative



# Collateral Requirements

Significant collateral/margin calls could be made as a result of marking-to-market (MtM) forward positions with counter parties.

Examples:

- Fixed price forward purchase and prices decline
- Fixed price forward sale and prices rise



# Mitigation Factors for Collateral Requirements

- Tiered credit limits
- Netting arrangements
- Counterparty diversification – minimize risk concentration
- Strong balance sheet
- Liquidity facilities including Letters of Credit, non-clearing house (NYMEX) transactions; which could be costly
- Diligent modeling and stress testing



# Default Risk

- Counterparty financial weakness
  - Longer term transactions - more time for potential counterparty credit deterioration
  - Market turbulence



# Mitigation Factors for Default Risk

- Contractual protection – termination rights
- Collateral Requirements
- Limit setting
- Diligent Monitoring of credit



# Accounting treatment and reporting requirements

- FASB and GASB – fair valuation and effectiveness testing of hedges determines impact on income statement.
- Use of standard products, independent forward price forecasts, and the matching of hedge terms with the risk to be hedged can lessen effort.



# Q&A

