Association of Bay Area Governments Publicly Owned Energy Resources

ABAG POWER

Board of Directors

December 11, 2023 Agenda Item 5.d.2.

Natural Gas Program Working Capital Deposits

Subject:

Adoption of Resolution 23-06 to increase the working capital deposit for the natural gas program from 2.0 to 3.0 months of estimated expenses, and to collect the additional month of estimated expenses over a 24-month period beginning either July 1, 2024, or upon the effective date of new member agreements, whichever is later.

Background:

In mid-2018, in an effort to maximize cost savings, a significant programmatic change was recommended by staff and approved by the Executive Committee, resulting in a general gas purchasing strategy that emphasized short-term, index-based purchases, with fixed-price purchases made only by exception and with Committee approval.

This strategy aimed to capitalize on low prices relative to historical norms that generally persisted from about 2013 to 2019. Since then, natural gas market prices have experienced extreme volatility. The causes are varied, and generally accepted to be initially caused by supply and demand mismatches due to Covid-19, but since then, a number of ongoing factors have contributed to heightened volatility – and therefore risk: geopolitical tensions, pipeline maintenance, extreme weather patterns, changes to storage assets, and rising global demand for liquefied natural gas (LNG). This confluence of factors during fiscal year 2022-23 resulted in the highest prices seen since December 2000.

During the last two fiscal years, as a response to market conditions, and at times, an inability to obtain index-based pricing, staff have thrice requested and received temporary authority to enter fixed-priced purchases. In a forward-looking basis, futures prices indicate continued volatility, with average prices in the $5 to $8 range per million British Thermal Units (MMBtu) for fiscal year 2023-24, compared to the historical average of $3 to $5 per MMBtu from 2010 to 2019. ABAG POWER's weighted average cost of gas (WACOG) during fiscal year 2022-23 was approximately $11.60 per MMBtu. PG&E's procurement rate ranged from $1.52 to $13.47 per MMBtu, with an unweighted average of $7.48 per MMBtu.

In addition to the price-based risk, extreme fluctuations in short-term markets have presented a cash flow challenge caused by elevated pricing during a sustained period (i.e., more than three months). This issue is exacerbated by ABAG POWER's levelized billing structure, which invoices participants only for the estimated average monthly expense. This structure temporarily insulates members from market fluctuations, which for many is a significant benefit of the program. The program reserves the right to modify levelized charges mid-year; however, this modification can cause confusion amongst members, disrupt otherwise predictable expense budgeting, and can be difficult to implement in an expedited manner. These aspects work against the value proposition of insulating members from market fluctuations.

Perhaps most importantly, recent extreme volatility has exposed ABAG POWER to the risk of not having sufficient capital to cover recurring expenses. In fact, expenses were higher than revenue during six of the twelve months throughout fiscal year 2022-23, contributing to a deficit of about $2 million during the fiscal year.

Although market prices and volatility have increased substantially over the last decade, total working capital deposits are unchanged since fiscal year 2008-09, totaling approximately $2 million. A listing of current working capital deposits by member is attached; the current policy is to maintain 2.0 months of estimated expenses based on the adopted operating budget. Current deposits amount to 1.9 months of estimated expenses, a deficit of about $70 thousand compared to the adopted policy. Due to the cash flow deficit from fiscal year 2022-23, it is unlikely that the program can fully replenish the working capital balance prior to the upcoming winter, when volatility is typically most extreme.

While natural gas prices have declined and are expected to remain lower than last fiscal year, the sustained volatility in recent years has been extreme, and as a buyer in the short-term markets, the program is exposed to this risk. To address the inherent risk of purchasing primarily based on short-term, index-based transactions, and to react effectively to changes in market trends staff have analyzed and are recommending multiple strategies to mitigate price uncertainty, including increasing working capital deposits, leveraging natural gas storage assets to a greater degree, and procuring fixed-price supply contracts to hedge against volatility.

Given this context, the Executive Committee met on June 15 and August 17, 2023, to discuss, among other things, modifying working capital deposits in a manner that minimized the upfront impact to member jurisdictions, and provided sufficient advance notice to align with the majority of members' fiscal year budgeting process. These discussions have resulted in a recommendation for the Board's consideration to:

- Increase the overall working capital deposits from two months to three months of estimated expenses for the core and non-core programs.
- Maintain the existing requirement of two months of estimated expenses for the renewable natural gas (RNG) program.
- Collect the additional one month deposit over a two-year period beginning either July 1, 2024 (for existing members) or upon the effective date of new member agreements, whichever is later.
    - Working capital deposits will be collected through a separate line item in each monthly member invoice. The rate used to determine the required deposit will be based on the fiscal year 2024-25 operating budget, or the operating budget effective at the time a new member joins.

Staff recommends modifying the working capital deposit requirement for the core and non-core programs but not the RNG program based on the difference in purchase structures likely to occur in each program. Given the current market for RNG supply, purchases are more likely to be structured as fixed-price transactions, particularly for Senate Bill 1383 compliance, therefore there is no risk of volatility. Furthermore, a working capital deposit is only required in certain situations and is intended to satisfy expedited payment terms likely to be required by suppliers. This structure fulfills a different need than the core and non-core programs, where the programs are subjected to a greater degree of volatility. As RNG supply becomes more widely available on 'spot' (short-term, widely available, generally same day) markets, staff will assess whether to bring a similar recommendation to the Board.

Issues:

Increasing the amount of working capital required to be provided a potential barrier to participation for new members. Establishing a two-year collection period for the additional month substantially reduces the barrier caused by an upfront lump sum payment.

Recommended Action:

The ABAG POWER Board of Directors is requested to authorize an increase to the natural gas program's core and non-core working capital deposit requirement from two months to three months of estimated expenses, and to collect the additional month of estimated expenses over a 24-month period beginning either July 1, 2024, or upon the effective date of new member agreements, whichever is later.

Attachments:

- Current Working Capital Deposits by Member (Informational)
- Resolution 23-06 Modification of Working Capital Deposits Requirement to Increase Deposits from Two Months to Three Months of Estimated Expenses

Reviewed:

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