



STATE OF CALIFORNIA

RESOURCES AGENCY

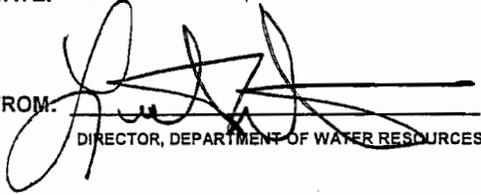
NOTICE TO STATE WATER PROJECT CONTRACTORS

NUMBER: 06-06

DATE: 11-28-04

SUBJECT: State Water Project (SWP)
Natural Gas Hedging Program

FROM:


DIRECTOR, DEPARTMENT OF WATER RESOURCES

The purpose of this notice is to provide information on the State Water Project (SWP) Natural Gas Hedging Program established in 2005. The Hedging Program was developed in cooperation with the water contractors and was a performance objective in the Department of Water Resources' (DWR) 2005 Strategic Business Plan to reduce the risk of volatile power rates. DWR enters into natural gas commodity futures trading activities to better manage the costs of energy in an effort to maintain stable power prices and mitigate significant price spikes. This program was implemented through two power purchase contracts (Duke Contracts)¹ in which the price of power would be based upon the price of natural gas. The Duke Contracts represent approximately 13 percent of the overall SWP power needs. The last of these contracts expires December 31, 2015. DWR has contracted with a commodities broker, AG Edwards, Inc., to provide natural gas commodity hedging services.

DWR has developed specific protocols to administer the program. The protocols are detailed in the SWP Energy Risk Policy but are described briefly as follows:

Programmatic: Hedge 5 percent per month up to 30 percent² total for 31-36 months forward. This provides a dollar-cost averaged based cost, purchased in a forward time frame, that is less volatile as it is not so readily influenced by current events such as weather, geopolitical events, natural gas storage levels, etc.

Discretionary: Hedge up to a total of 85 percent (cumulative of all hedges) with no more than 10 percent a month to build upon the programmatic hedges when market conditions are considered favorable.

Defensive: Price points that require hedges to be placed in order to keep the overall cost of the hedging program below a certain threshold (currently the amount budgeted for the gas hedging program in Table 2: "Net Power Pumping Cost").

¹ These contracts were originally with Duke Energy but have been subsequently assumed by Morgan Stanley.

² The percentage amount represents the percentage of the Duke Contracts' natural gas needs.

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Hedging Deposit and Advance

To establish hedging accounts for DWR's program, the commodities broker (AG Edwards) required a deposit to provide for commodity market margin requirements. In order to provide the deposit, the water contractors advanced the funds to DWR. When DWR established the program in 2005, the water contractors advanced an initial deposit of \$10 million. The deposit advance was acquired, at the recommendation of the water contractors, through billings to the water contractors in the Variable Operations, Maintenance, Power and Replacement invoice, and the initial allocation among the water contractors was based on the energy required to deliver maximum Table A. In 2006, DWR expanded the program to allow for longer-term hedges to capture better forward pricing. The growth and development of this program necessitated an additional deposit advance of \$10 million, for a total of \$20 million. At that time, DWR decided to change the allocation basis, at the recommendation of the water contractors. The entire \$20 million was reallocated utilizing an average, weighted 50 percent based on the average of actual energy used for water deliveries for the years 2001 through 2005 and weighted 50 percent based on the projected energy required to deliver maximum Table A. The additional \$10 million deposit advance will be obtained through billings to the water contractors in the Variable OMP&R invoice. The allocation among the water contractors and each contractor's share of the \$20 million is shown in Attachment 1.

The advance will be kept until the expiration of the final Duke contract on December 31, 2015 or the program is terminated. If, during the term of the program, it is determined that the amount of the advance needs to be adjusted to meet changing operational or commodity market requirements, DWR, after consultation with the water supply contractors, may adjust the amount of the advance. At the conclusion of the program, each water contractor's share of the \$20 million (or adjusted balance) will be returned to the water contractors along with any unpaid interest.

Hedging Cost Categories

There are two types of cost categories associated with the Gas Hedging Program: 1) settlement gains or losses and 2) administrative costs and investment interest income.

Settlements

As the hedging contracts are settled, realized gains and losses are booked monthly. The expenses are included as part of the net annual power costs in Table 2 and are used in the determination of the Transportation Variable OMP&R charges. This ensures that the water contractors are charged and credited based upon their energy usage required to make water deliveries for that year. The variable rates are determined based on the total power related costs and revenues for the year. The gains and losses also trigger

cash transfers between the AG Edwards account and the Systems Revenue account within the California Water Resources Development Bond Fund.

Administrative Expenses and Investment Interest Income

AG Edwards' administrative expenses and transaction fees are deducted from the gains or added to the losses described above under settlements. Commissions to AG Edwards are deducted from the trading account balance and added as an expense in the determination of net power pumping costs and ultimately the water contractor bills.

There are two accounts held by AG Edwards: a Trading Account and a Restricted Investment Account. The Trading Account is used to maintain sufficient cash to meet the minimum margin requirements for gas hedging. The Restricted Investment Account is used to maintain additional cash reserves to meet the minimum margin requirements for the gas hedging contracts outstanding. The accounts each started out with initial deposits of \$5 million. As more money is required in the Trading Account, DWR must authorize the transfer of monies from the Restricted Investment Account after receiving a request from AG Edwards. The Trading Account and the Restricted Investment Account earn investment interest income at the money market rate in a fund called "Prime Value Obligations Fund - Institutional Shares." Investment interest income earned on these accounts is recorded monthly and is considered to be minimal. The investment interest income will be refunded to the contractors in January of each year. The basis for distributing the investment interest income will be the same basis as how the \$20 million deposit was collected.

DWR will provide quarterly reports on the Gas Hedging Program activities, including reports on administrative costs, investment interest earnings, and a Statement of Net Assets for the account.

If you have any questions, please contact Perla Netto-Brown, Chief of DWR's Division of Fiscal Services, at (916) 653-9836.

**Allocation of Gas Hedging Account Funds to contractors
Based on Actual and Projected Theoretical Energy Requirements**

Water Contractors	Gas Hedging Amount 20,000,000 [\$] [1]	Amounts Collected in 2005 [\$] [2]	Amounts to be Collected in 2006 [\$] [3]
Napa County FC&WCD	28,478	18,438	10,040
Solano County Water Agency	36,515	17,286	19,229
Alameda County FC&WCD Z-7	135,052	72,040	63,012
Alameda County WD	69,480	35,111	34,369
Santa Clara Valley WD	193,925	94,143	99,782
San Luis Obispo CFC&WCD	81,185	57,089	24,096
Santa Barbara CFC&WCD	196,244	103,873	92,371
Dudley Ridge WD	47,046	20,111	26,935
Empire West Side ID	2,263	1,054	1,209
Kern County WA - M&I	97,758	48,776	48,982
- Ag	864,894	379,497	485,397
County of Kings	6,975	3,158	3,817
Oak Flat WD	2,906	1,366	1,540
Tulare Lake Basin WSD	81,669	33,750	47,919
AV-EK WA	759,869	439,455	320,414
Castaic Lake WA	563,064	317,409	245,655
Coachella Valley WD	629,827	445,159	184,668
Crestline-Lake Arrowhead WA	32,193	21,320	10,873
Desert WA	348,374	183,799	164,575
Little Rock Creek ID	17,345	7,150	10,195
Mojave WA	387,517	277,785	109,732
Palmdale WD	128,841	66,199	62,642
San Bernardino Valley MWD	657,737	377,153	280,584
San Gabriel Valley MWD	195,943	105,870	90,073
San Geronio Pass WA	116,294	94,097	22,197
The Metropolitan WDSC	14,222,521	6,712,231	7,510,290
Ventura County FCD	96,085	66,681	29,404
City of Yuba City	-	-	-
County of Butte	-	-	-
Plumas County FC&WCD	-	-	-
Total	20,000,000	10,000,000	10,000,000