SUBJECT: Authorize an increase of $500,000,000 in spending authority for Austin Energy's Energy Risk Management Program for the purchase or sale of financial contracts traded on regulated commodity exchanges, over-the-counter hedging transactions, and related credit, security, and insurance agreements, for a total aggregate amount of spending authority not to exceed $800,000,000.

AMOUNT & SOURCE OF FUNDING: Funding in the amount of $800,000,000 for related expenses associated with the purchase and sale of financial hedging instruments for fuel and power under the Risk Management Program will be provided through the Electric Fuel Charge revenue.

FISCAL NOTE: There is no unanticipated fiscal impact. A fiscal note is not required.

REQUESTING DEPARTMENT: Austin Energy

DIRECTOR'S AUTHORIZATION: Juan Garza

FOR MORE INFORMATION CONTACT: Michael McCluskey, Senior Vice President, 322-6295

PRIOR COUNCIL ACTION: 5/22/03 - Resolution approving pilot hedging program and execution of hedging agreements, and Policy for Energy Risk Management. 6/10/04 - Approval of full scale hedging program.

BOARD AND COMMISSION ACTION: Recommended by the Electric Utility Commission.

PURCHASING: N/A

MBE / WBE: N/A

On May 22, 2003 the City Council approved Austin Energy's (AE) Policy for Energy Risk Management which authorized the use of exchange-traded and over-the-counter financial instruments to hedge the risks of fluctuating prices for fuel and power. The costs of hedging transactions, including associated fees, gains and losses are applied to AE's recoverable fuel expense.

In August 2003, AE commenced a nine-month pilot program that was limited to commitments up to $25 million (approximately 15% of AE's fuel and purchase power requirements at that time) for transactions up to 36 months into the future. The pilot program successfully demonstrated AE's ability to control the volatility of its energy costs using financial hedging instruments. During the pilot AE established and tested new processes and procedures as well as new brokerage and trading agreements. Over 500 financial contracts were successfully traded, settled and accounted for; reducing price volatility on almost a quarter of AE's natural gas requirements over the pilot period. An external review conducted by Risk Management Incorporated (RMI), a nationally recognized energy risk management consulting firm, found AE's program to be in line with industry best practices. As a result, AE recommended and Council approved an expanded risk management program consistent with AE's Policy for Energy Risk Management on June 10, 2004. That authorization provided for $300 million of authority and allowed for transactions up to 60 months into the future.

After completing its first year of expanded operation the program was again reviewed by RMI. During its first year the program traded over 2,900 contracts that increased the levels of protection and extended them over the full five-year time horizon. The hedging program allowed AE to protect its fuel charge during a period of sharply increasing prices and volatility. As with the pilot, RMI found AE's program to be in line with industry best practices, with a strong system of checks and balances, sound segregation of duties, strict compliance monitoring; and good initial objectives.

This resolution increases the expenditure authority for hedging transactions from $300 million to $800,000,000. The increase is necessary to allow AE to maintain an effective hedging program in the face of natural gas prices that have increased by approximately 108% since June 2004. The increased authority will also allow AE to protect a larger portion of its gas requirements over the program's rolling 60 month time horizon.

Under the program AE executes brokerage agreements with qualified energy commodity brokerage firms that are members of the New York Mercantile Exchange. AE executes brokerage agreements with such qualified firms as may be reasonable and necessary to conduct the exchange-traded instrument portion of the energy risk management program. The brokerage agreements enable AE to place orders with any of the brokerage firms in the pool to purchase or sell futures contracts, options and similar financial contracts used for hedging as described in the Resolution and Policy for Energy Risk Management.

In addition, AE executes the International Swaps and Derivatives Association Master Agreement (ISDA Agreement) and such other industry standard contract forms as may be reasonable and necessary with qualified counter-parties. The ISDA Agreement is the standard contract used to implement over-the-counter (i.e., privately negotiated, not implemented through a public exchange) energy risk management transactions between two parties.

AE enters into these agreements or similar industry standard agreements with brokerage firms, financial institutions, investment banks and other appropriate counter-parties in the financial, energy and natural gas industries that meet AE's criteria for reliability of execution, customer services, creditworthiness, and financial stability. As companies meeting these criteria are identified, they are added to the pool of service providers by execution of an approved brokerage or master agreement with AE. When AE desires to enter into a hedging transaction, it considers or solicit offers from the parties in the pool. The specific terms and conditions of an individual energy risk management transaction, such as the quantity and type of hedging contracts purchased or sold, the price, or the duration, are memorialized at the time of the transaction in a separate transaction confirmation.

The brokerage agreements and ISDA Agreement or similar agreements described above provide a framework for the hedging program and do not obligate Austin Energy to enter into any specific risk management transactions. All hedging transactions will be conducted in accordance with the Policy for Energy Risk Management.