



BOARD LETTER APPROVAL



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DATE: March 28, 2017

SUBJECT: Extend the Term of Existing International Swap Dealers Association Master Agreements and Related Custody Agreements for an Additional Ten Years

SUMMARY

Transmitted for your consideration is a Resolution, approved as to form and legality by the City Attorney. The Resolution, if adopted, would approve the amendment of the existing International Swap Dealers Association (ISDA) Master Agreements and the related Custody Agreements to extend their term for another ten years.

The ISDA Master Agreement is a standard financial industry enabling agreement for financial risk mitigation products, including the financial contracts for natural gas authorized in Section 10.5.3 of Los Angeles Administrative Code (LAAC) that established LADWP's natural gas hedging program. It contains terms and conditions including provisions as to payments, representations, covenants, events of default, termination, credits, and collateral posting relating to financial hedge transactions. In addition to the ISDA Master Agreement, a tri-party Custody Agreement is required as part of the credit provisions of the Master Agreement for holding collateral to secure each counterparty's respective obligations arising under the Master Agreement.

Currently, LADWP has five ISDA Master Agreements that are in compliance with the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) requirements; one expired in March 2017, the remaining four Agreements will expire during the period from October 2017 to April 2018.

City Council approval is required.

RECOMMENDATION

It is recommended that the Board of Water and Power Commissioners (Board) adopt the attached Resolution authorizing the execution of the amendments to extend the term of the existing ISDA Master agreements and the related Custody Agreements.

LADWP Staff recommends the extension of the contract term of the current ISDA Master Agreements with existing counterparties instead of issuing another Request for Qualifications (RFQ) for the following reasons:

- The current pool consists already of a diversified group of 11 counterparties that were vetted through a competitive process wherein 18 counterparties applied when the RFQ was issued. The counterparties were: J. Aron & Company, Macquarie Cook Energy LLC, Merrill Lynch Commodities, Inc., Morgan Stanley Capital Group Inc., Royal Bank of Canada, Bank of America, N.A., JPMorgan Chase Bank, N.A., Citibank, N.A., BP Corporation North America Inc., Wachovia Bank, N.A., and Barclays Bank PLC.
- Financial Services Organization (FSO) has evaluated each of the 11 counterparties in the current pool and determined that most of them still qualify to provide natural gas services as required by LADWP with the exception of three banks, namely, Bank of America, N.A., JP Morgan Chase Bank, N.A., and Barclays Bank PLC. Bank of America, N.A. acquired Merrill Lynch Commodities, Inc. in 2009. JP Morgan Chase and Barclays Bank PLC are no longer providing commodity financial risk mitigation products to public sector clients.
- Additionally, since the financial crisis in 2009, the number of high credit quality market participants providing financial risk mitigation products including financial contracts for natural gas has declined. The implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) in recent years further reduced the number of firms providing commodity financial risk mitigation as they have exited the business. As a result, an RFQ would most likely be responded to by the same firms in the existing pool of counterparties.
- Finally, significant staff and financial resources from FSO, outside counsel, and consultants were employed to negotiate these agreements a decade ago. The material terms of the agreements are still valid and applied today. Extending the term of the enabling contracts with the remaining eight counterparties at this time for another ten years will save LADWP significant staff time and costs.

ALTERNATIVES CONSIDERED

LADWP's natural gas hedging program utilizes both fixed-price physical contracts (spot and forward) and financial contracts as tools to implement the program. A fixed-price physical contract is simply an agreement to purchase a specific quantity of natural gas from a supplier, at a fixed price, to be delivered at a predetermined location for a day or over a period of time. A financial contract, on the other hand, allows LADWP to lock in the forward natural gas price and volume without taking physical delivery.

Due to limited suppliers of physical gas, a hedge portfolio comprised solely of physical natural gas contracts may cause a large exposure to individual suppliers. Similarly, LADWP may be forced to work with the same suppliers to sell any committed gas volume at less competitive prices, in the event of a pipeline related problem resulting in a natural gas curtailment. Hedging with financial contracts allows LADWP to spread out its hedge

exposure to more and relatively higher credit-rated counterparties, thus providing needed diversification from the limited natural gas suppliers while mitigating some delivery risk resulting from events such as a natural gas curtailment.

FINANCIAL INFORMATION

LADWP established a natural gas hedging program that includes natural gas financial transactions utilizing ISDA Master Agreements in order to lock in the price of natural gas at the date of execution for future settlements with the goal of reducing the volatility in the cost of natural gas projected for consumption in the production of electricity to serve retail customers.

The projected expenditures for and volumes of natural gas used in the production of electricity to serve LADWP's retail customers have been incorporated in the Power System's current financial plan. On average, the Power System's fuel budget for natural gas is approximately \$200 million per year.

There is no external cost in transacting financial transactions other than premiums, if options are purchased. In addition, an escrow account needs to be in place when collateral is required to be posted, at which time; LADWP will pay fees to the custody bank based on the custodian's fee schedule, which are estimated to average \$1,000 per year per escrow account. Financial transactions for natural gas hedging program are budgeted and funded under the Power Revenue Fund.

The ISDA Master Agreements with qualified financial counterparties are scheduled to expire starting March 2017. The extension of the terms of the existing ISDA Agreements, if approved, will continue to provide a diverse pool of qualified counterparties to participate in competitive biddings for natural gas financial transactions beyond 2017 as LADWP continues to implement its natural gas hedging program.

BACKGROUND

On July 30, 2002, the City Council adopted Ordinance No. 174755, which added Section 10.5.3 to the LAAC establishing the natural gas hedging program. Section 10.5.3 of the LAAC provided the Board the authority to enter into contracts for the purchase and delivery of natural gas and/or financial transactions on behalf of LADWP at terms of up to five years and at a purchase price not to exceed \$7.50 per million British Thermal Units (MMBtu) including broker's fees, if any. Section 10.5.3 also authorized the Board to delegate such authority to the LADWP's General Manager.

On February 28, 2006, the City Council adopted Ordinance No. 177405, which amended LAAC Section 10.5.3 by extending the maximum duration of natural gas financial transactions from five years to ten years from the date of execution, and increased the price cap of the natural gas financial contracts from \$7.50 per MMBtu to \$10.00 per MMBtu in order to provide the flexibility needed to implement a more effective long-term hedging program.

In June 2006, LADWP issued an RFP for natural gas financial hedging product providers. The goal was to establish a new pool of potential providers using ten-year ISDA Master Agreements to be consistent with the duration of financial gas transactions as established in Section 10.5.3 of LAAC. After a comprehensive evaluation and review of all 18 responses, LADWP selected 11 qualified counterparties. The ISDA Master Agreements and the related tri-party Custody Agreements were approved by the Board between February 2007 and April 2008. All agreements are scheduled to expire ten years from the date of execution.

Pursuant to the credit provisions in the ISDA Master Agreement, LADWP and the respective counterparty have agreed to pledge certain eligible collateral to secure their respective obligations upon reaching certain credit thresholds. For this purpose, U.S. Bank, N.A. (the Custodian), the respective counterparty, and LADWP have agreed to the terms of a tri-party Custody Agreement. These Custody Agreements have the same expiration date as the respective ISDA Master Agreement.

In 2010, Congress enacted the Dodd-Frank Act. Under Title VII of the Dodd-Frank Act, Congress authorized the Commodity Futures Trading Commission (CFTC) to regulate certain transactions, as defined under the Dodd-Frank Act, including certain financial transactions in energy commodities. LADWP engages in these transactions as part of its natural gas hedging program to protect customers from excessive price volatility.

In response to the Dodd-Frank Act, two industry associations, the ISDA and the International Energy Credit Association (IECA), developed parallel, standardized amendments to the ISDA Master Agreements to ensure compliance with the CFTC's business conduct rules, record keeping, and reporting requirements; and with respect to counterparties in the European Union, enable counterparty compliance with European Market Infrastructure Regulations. Since the IECA versions are preferred by many energy industry participants, the Board, in May 2015, adopted Resolution 015-203 which approved the use of the IECA amendments to amend each of LADWP's ISDA Master Agreements to ensure compliance with certain Dodd-Frank Act requirements.

As of January 31, 2017, LADWP has successfully amended the Master Agreements with the standard amendments developed by ISDA and IECA with five counterparties in the existing pool as listed below.

No.	Counterparty	ISDA Master Agreement	Custody Agreements	Expiration Date
1	J. Aron & Company	47644A-7	47644B-7 and 47644C-7	October 28, 2017
2	Macquarie Energy LLC (formerly Macquarie Cook Energy LLC)	47641A-7	47641B-7 and 47641C-7	March 15, 2017
3	Merrill Lynch Commodities, Inc.	47649A-8	47649B-8 and 47649C-8	April 1, 2018
4	Morgan Stanley Capital Group Inc.	47642A-7	47642B-7	December 3, 2017
5	Royal Bank of Canada	47648A-7	47648B-7 and 47648C-7	October 28, 2017

The LADWP will continue working with the remaining three qualified counterparties (listed below) in the current pool to amend the existing Master Agreements with the standard amendments developed by ISDA and IECA.

No.	Counterparty	ISDA Master Agreement	Custody Agreements	Expiration Date
1	BP Corporation North America Inc. (to be assigned to BP Energy Company)	47643A-7	47643B-7 and 47643C-7	March 14, 2017
2	Citibank N.A.	47640A-7	47640B-7 and 47640C-7	March 14, 2017
3	Wachovia Bank, N.A. (acquired by Wells Fargo)	47645A-7	47645B-7 and 47645C-7	May 29, 2017

LADWP has resumed its natural gas financial hedging program with the five counterparties that have amended the ISDA Master Agreements to comply with the Dodd-Frank Act.

ENVIRONMENTAL DETERMINATION

In accordance with Section 15060 (c)(3) of the California Environmental Quality Act (CEQA) Guidelines, an activity is not subject to CEQA if it does not meet the definition of a project. Section 15378 (b)(4) states that government fiscal activities which do not involve any commitment to any specific project which may result in a potentially significant physical impact on the environment do not meet that definition. Therefore, amending the existing ISDA Master Agreements and the related Custody Agreements is not an action subject to CEQA.

CITY ATTORNEY

The Office of the City Attorney reviewed and approved as to form and legality the attached Resolution.

ATTACHMENTS

- Resolution
- First Amendment to ISDA Master Agreement
- First Amendment to Custody Agreement (#B)
- First Amendment to Custody Agreement (#C)
- U.S. Bank N.A.'s Schedule of Fees for Services as Custodian
- CAO Report