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# Natural Gas Procurement Program

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Status Report to the  
Board of Trustees

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October 20, 2008

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## Natural Gas Procurement Program

### OVERVIEW

At the September 2008 meeting of the Board, Walter Knorr, Vice President/Chief Financial Officer and Comptroller, presented the Natural Gas Cost Management Policy. Among other things, the policy authorizes natural gas purchases for fiscal years 2010 and 2011, with certain restrictions. The policy stipulates that a detailed report will be made to the Board each month describing all natural gas purchases.

A strategy for procuring natural gas within the policy framework was developed with assistance from our external advisors, Nicor Enerchange and Larry Altenbaumer. The purpose of the strategy is to provide budget certainty and to reduce the cost of energy for the period 2009 through 2011.

The strategy has two primary components - (i) a rolling 36-month series of regularly timed purchases, and (ii) an opportunistic purchase program based on aggressive pricing targets.

- i. The rolling program is designed to even out over time the University's exposure to the spot market and the risk of price spikes; it functions similar to a "dollar-cost averaging" investment strategy. Initiation of this program likely will begin in November 2008.
- ii. The opportunistic purchases program is based on a strike price framework. Nicor Enerchange has approval to purchase up to 50% of requirement when gas prices are equal to or below the aggressive strike price targets. These targets were set with a goal of reducing gas costs by \$10 million in fiscal year 2010 and \$15 million in fiscal year 2011, compared to the expected \$61 million cost in fiscal year 2009.

### PROGRESS TO DATE

Significant progress has been made in securing natural gas at a fixed price for fiscal years 2009-2011. All transactions have been reviewed by the *Natural Gas Cost Management*

Committee (“Committee”) and were executed using forward fixed-price purchase contracts with Nicor Enerchange. No futures contracts or other derivative products were employed.

### FORWARD PURCHASE SUMMARY

Through October 16, 2008	FY 2009 <sup>1</sup>	FY2010	FY2011
100% Volume Requirement (MMBTU)	5,765,821	5,833,883	5,833,883
Volumes Committed To Date (MMBTU)	5,189,240	3,811,613	628,890
Percent Committed Volumes (%)	90%	65%	11%
Budgeted Landed Price <sup>2,3</sup> (\$/MMBTU)	\$10.44	\$9.59	\$9.59
Landed Price for Committed Volumes <sup>2</sup> (\$/MMBTU)	\$9.59	\$8.21	\$8.68
Savings To Date From Budget <sup>4</sup> (Millions)	\$4	\$5	\$0.6

1. *FY2009 forward purchase program does not include July.*
2. *Landed Price = field price + basis + Nicor Enerchange fee + NGPL fees.*
3. *For purposes of this summary, “Budgeted Landed Price” for fiscal years 2010 and 2011 reflects landed pricing equal to fiscal year 2009 committed price.*
4. *For purposes of this summary, “Budget” for fiscal years 2010 and 2011 is based on fiscal year 2009 landed pricing and reduced volumes compared to fiscal year 2009.*

## GOING FORWARD

Previously, the Committee agreed to the opportunistic strategy to “jump start” the natural gas procurement process and to take advantage of dramatic improvements in the market. At the next meeting of the Committee, the following activities will be discussed:

1. Continuation of the opportunistic purchase program –
  - a. Monitor natural gas prices relative to the aggressive monthly strike prices previously established for FY 2010 and FY 2011.
  - b. Purchase additional volumes as appropriate.
  - c. Establish sunset provisions. Going forward, the Utilities organization would seek renewal of this program on a quarterly basis.
2. Initiation of the regular purchase program on a rolling 36-month cycle. These regular purchases would be independent of any purchases executed through the opportunistic program.

## COUNTER-PARTY RISK

Counter-party risk arises from the possibility that the commodity supplier or the transportation service provider will default on their obligations to the University.

1. **Supply** - the forward purchase contracts for natural gas are with Nicor Enerchange, who stands between the University and the originating field suppliers. Nicor Enerchange is contractually responsible for covering damages if it fails to deliver the nominated amount of gas to the University’s specified delivery points. Nicor Enerchange is owned by Nicor, Inc. The most recent Value-Line report for Nicor Inc. indicates that its financial position is relatively strong. Currently, Nicor, Inc.’s senior debt is split-rated: AA (high grade/high quality) by S&P and A1 (upper medium grade) by Moody’s. Nicor does not appear to have been measurably impacted by recent issues in the credit market. *Therefore, the assessment is that there is not significant counter-party risk with Nicor Enerchange.*
2. **Transportation** – the natural gas is transported between the gas fields and the University by Natural Gas Pipeline Company of America (“NGPL”). NGPL is a

subsidiary of Kinder Morgan and owns in whole or in part over 10,000 miles of interstate pipelines. Counter-party risk with NGPL is being reviewed more thoroughly. *There currently is no expectation that counter-party risk from NGPL is significant.*

## **FEES**

Nicor Enerchange provides the University market advice, transaction execution, analytical and other services under an existing agreement that runs through June 2011. It also acts as the University's agent in procuring natural gas. Nicor Enerchange charges the University 2.75¢ / MMBTU for providing these services (recently reduced from 3.00¢ / MMBTU). Based on fiscal year 2009 annual consumption of approximately 6.3 million MMBTU, the annual fee for providing a broad scope of services is approximately \$175,000.

NGPL provides natural gas transportation services to the University. NGPL has a variety of charges that typically are in the range of 60¢ to 70¢ / MMBTU.

## **DETAILED REPORT**

The detailed report to the Committee is attached.

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# Natural Gas Procurement Program

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Status Report to the  
Natural Gas Cost  
Management  
Committee

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October 20, 2008

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## Natural Gas Procurement Program

### Overview

- A rolling three-year program of purchases is being implemented to reduce the University's exposure to the spot market and the risk of price spikes.
- 90% of FY09 requirements have been met through forward purchases with approximately a \$4 million improvement over budget. The remaining 10% will be purchased as needed on the spot market.
- 61% of FY10 requirements and 11% of FY11 requirements have been met to date with savings compared to budget<sup>1</sup> of \$5 million and \$0.6 million, respectively.
- Remaining FY10 and FY11 requirements will be met through two strategies:
  1. Opportunistic purchase of up to 50% of annual requirement when gas prices are equal to or below the aggressive strike prices. Aggressive strike prices were set based on reducing the expected \$61 million natural gas cost in FY2009 by \$10 million in fiscal year 2010 and \$15 million in fiscal year 2011.
  2. Regularly timed purchases generally unrelated to strike price.
- Counter-party risk is being continually monitored. The University's supplier is Nicor Enerchange. The University should have relatively low risk related to non-performance by the originating gas suppliers since Nicor Enerchange is between the University and the suppliers, and they are responsible for covering damages if they fail to deliver the nominated amount of gas to a specified delivery point. The most recent Value-Line report for Nicor Inc. (the holding company) shows financials relatively strong. Currently, Nicor, Inc. is rated AA and does not appear to have been impacted by recent issues in the credit market.
- Nicor Enerchange provides the University market advice, transaction execution, analytical and other services under an existing agreement that runs through June 2011. Nicor Enerchange charges the University 2.75¢ / MMBTU for providing these services (recently reduced from 3.00¢ / MMBTU). Based on a budgeted annual consumption of

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<sup>1</sup> The "budget" for FY 2010 and 2011 is based on the same volumes as budgeted for FY 2009 and the landed prices for the committed volumes for FY 2009.

approximately 6.3 million MMBTU, the annual fee for providing a broad scope of services is approximately \$175,000.

## **Recommendations**

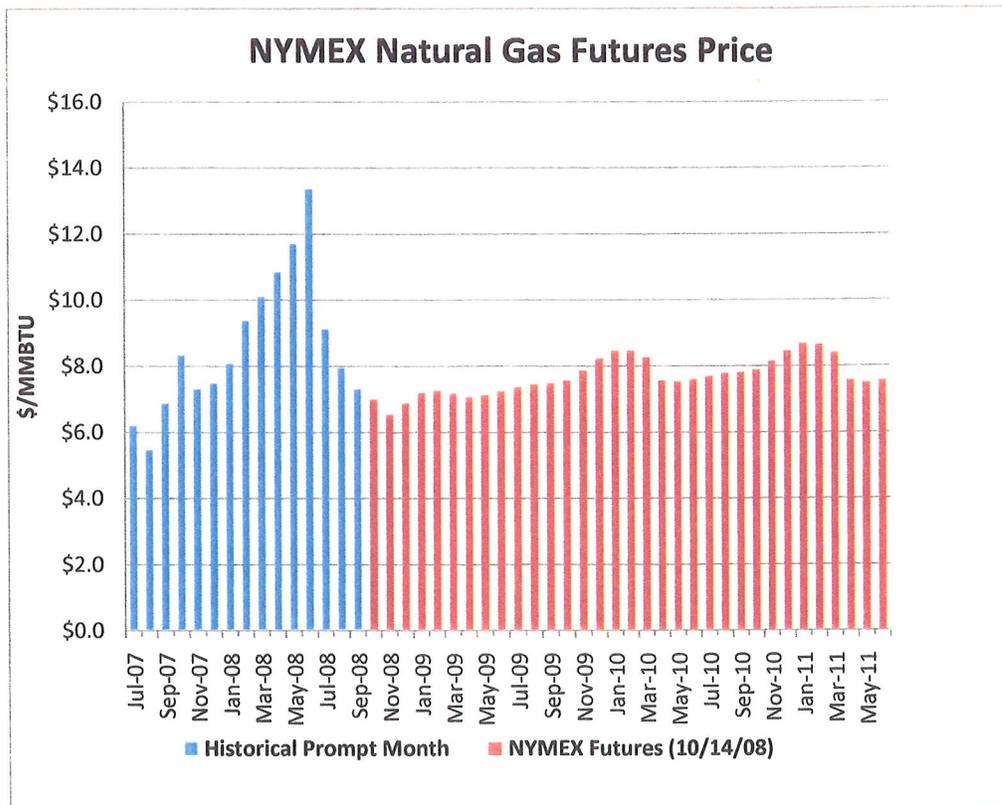
Previously, the Natural Gas Cost Management Committee approved using a strike price or opportunistic strategy to “jump start” the natural gas procurement process and to take advantage of relative improvements in the market. The Committee is being asked for approval for authority to: (i) continue the opportunistic strategy, and (ii) implement a second, more permanent approach to procurement. The following recommendations are submitted for approval:

### **1. Purchase Opportunistically –**

- a.** Continue to monitor natural gas prices relative to the aggressive monthly strike prices previously established for FY 2010 and FY 2011.
- b.** Purchase additional volumes up to a maximum of 50% of monthly requirement whenever monthly prices reach the strike price. Execution of individual purchase transactions falling within this framework would not require specific approval by the Committee.
- c.** Grant approval for this strategy through December 31, 2008. Going forward, the Utilities organization would seek renewal of this approval each quarter.

- 2. Purchase on Regular Intervals –** Initiate a regular purchase program on a rolling 36 month cycle. These regular purchases would be independent of any purchases executed through recommendation 1, above.

# Natural Gas Pricing Background Information



## HIGHLIGHTS

### Positive

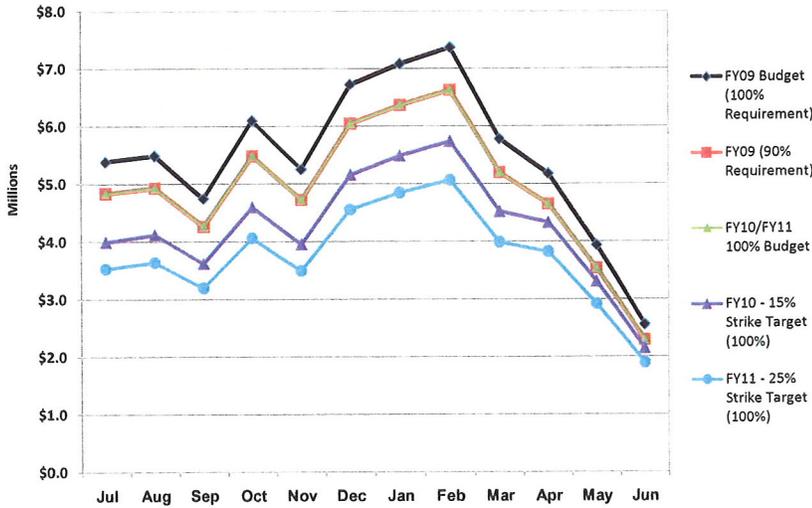
- Weather has been moderate - little disruption due to hurricane activity (other than Gustav); the fall season has been relatively mild.
- The global economic slowdown has reduced demand.

### Negative

- The weakness of the US dollar is a factor in energy prices, evidenced primarily in crude oil. However, natural gas prices tend to follow trends in crude oil price.
- Lower prices have begun to discourage exploration. Canadian producers have reduced their production by 12% versus 2007 levels.
- National storage levels are down.

# Budget and Procurement Strategy

Natural Gas Purchases Budget Comparison



- Budgeted prices based on NYMEX prices from July 2008.

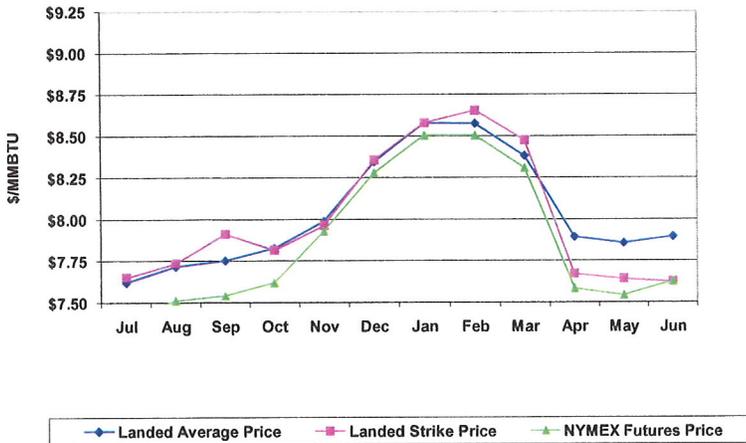
- Main goal of procurement strategy is to achieve budget certainty at reduced cost.

- FY 2009 forward procurement plan completed.

- FY2010 / FY2011 forward procurement under way.

- NICOR Enerchange serving as advisor and counter-party to purchases.

FY 2010 Natural Gas Prices

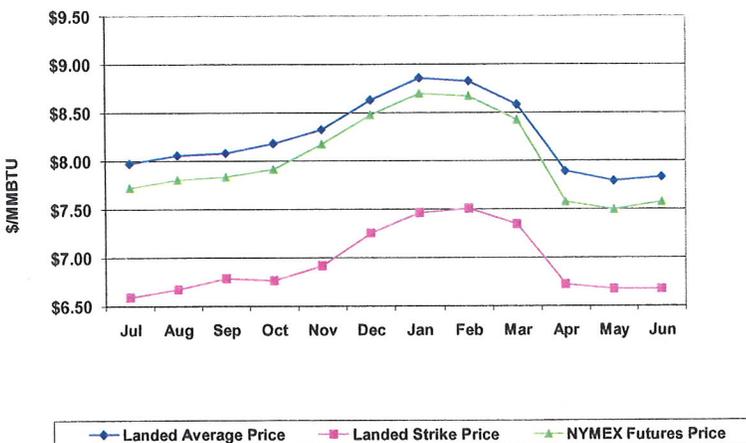


- Landed Average prices based on NYMEX Futures Price plus Basis between Mid-Continent and University (Tier1) and Basis between Texok and University (Tiers 2 and 3) plus transportation.

- Landed Strike Price for FY2010 equal to targeted \$10 million reduction from FY2009 landed prices. Once strike price is met, can buy up to 50% of requirement.

- NYMEX Futures Price based on contract prices at Henry Hub, La.

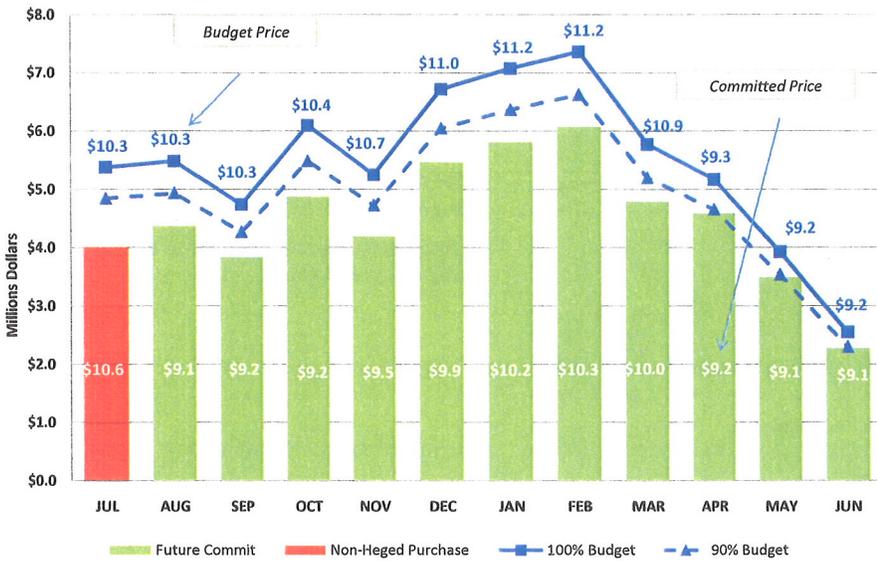
FY 2011 Natural Gas Prices



- Landed Strike Price for FY2011 equal to targeted \$15 million reduction from FY2009 landed prices. Once strike price is met, can buy up to 50% of requirement.

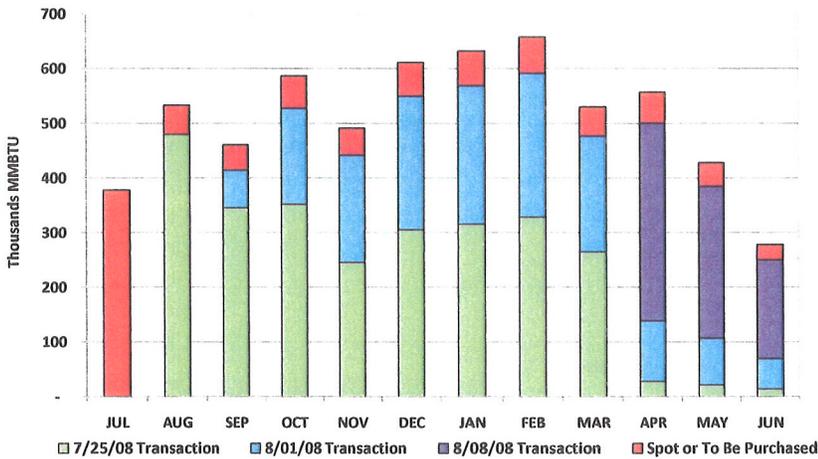
# FY 2009 Summary

### FY 2009 Natural Gas Purchased (90% of Requirement) vs. Budget



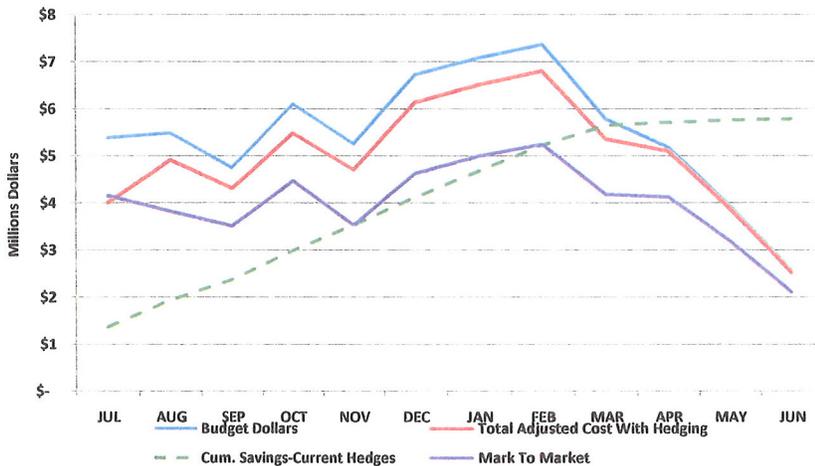
- Budget based on NYMEX prices from July 2008.
- Procurement strategy is to forward purchase 90% of expected required volumes.
- FY 2009 forward purchase plan completed.
- NICOR Enerchange served as advisor and counter-party to purchases.

### FY2009 Purchases (MMBTU)



- Forward purchase program for FY 2009 completed in three transactions.
- 90% of total required volumes committed.
- Remaining 10% non-hedged volumes to be purchased as needed on spot market.

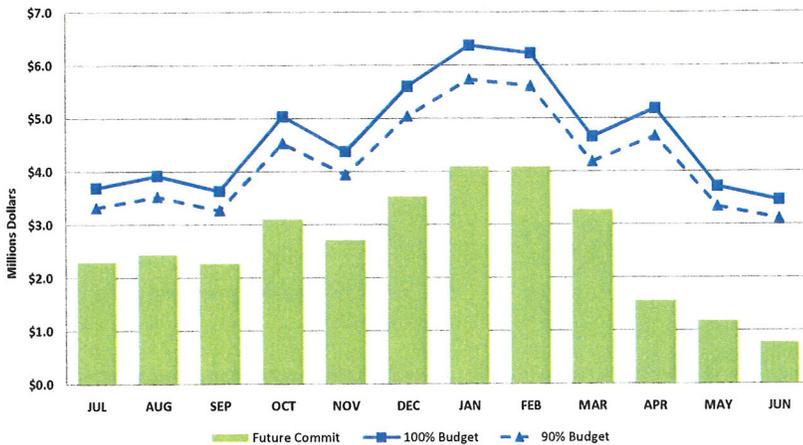
### FY2009 Natural Gas Purchase Cost Status



- July not part of forward purchase program.
- Overall expected savings over FY2009 Budget approximately \$5.7 million including July.
- Hedged savings approximately \$4.4 million excluding July.
- Mark to Market reflects 100% volumes priced at 10/14/08 futures price.

# FY 2010 Summary

FY 2010 Natural Gas Purchased (65% of Requirement) vs. Budget

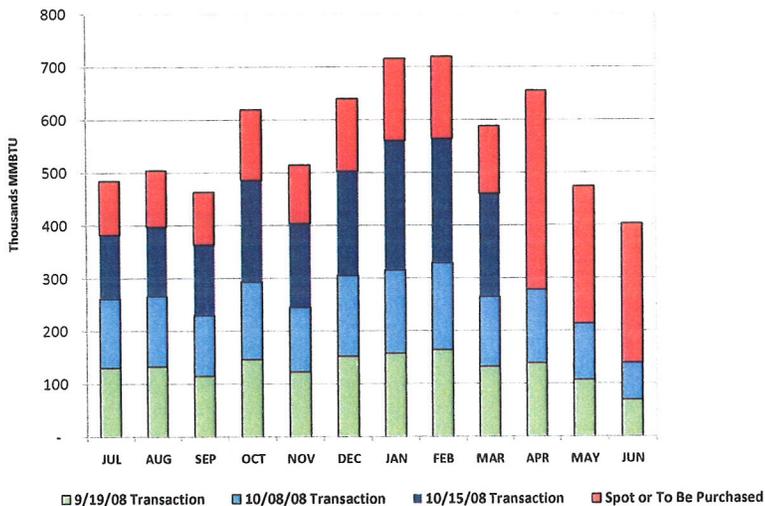


- Budget costs based on committed prices for FY2009.

- Procurement strategy is to forward purchase 90% of expected required FY 2010 volumes.

- NICOR Enerchange serving as advisor and counter-party to purchases.

FY2010 Natural Gas Purchases (MMBTU)

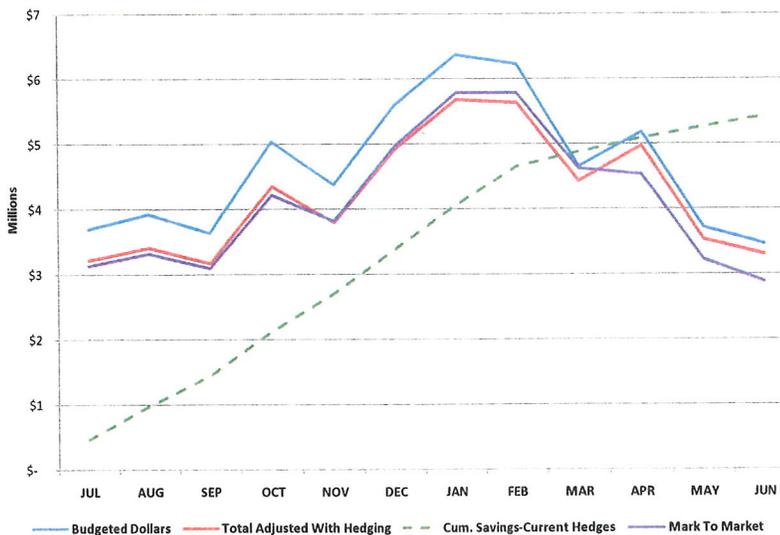


- Committed purchases to date via three transactions.

- 65% of required volumes committed.

- Further transactions will be made on a regular timed basis or opportunistically if natural gas prices reach aggressive strike price levels.

FY2010 Natural Gas Purchase Cost Status

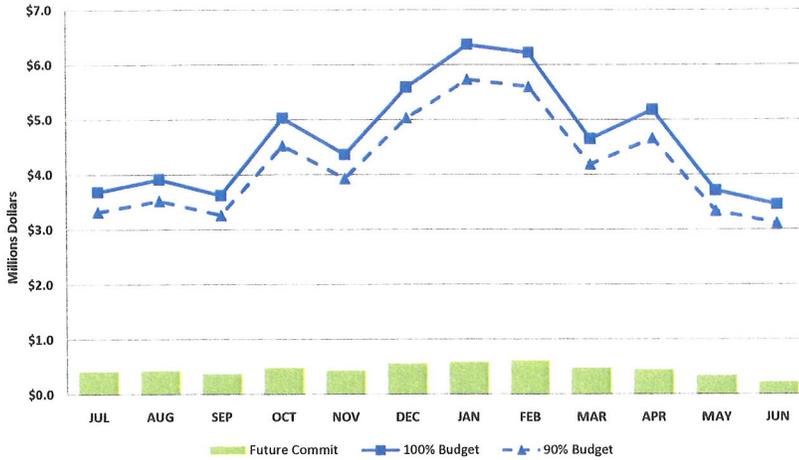


- \$5 million savings compared to FY2009 hedged pricing levels.

- Mark to Market reflects 100% volumes priced at 10/14/08 futures price.

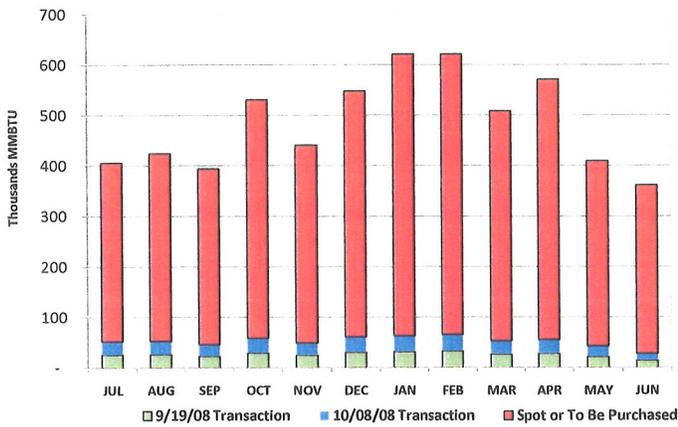
# FY 2011 Summary

FY 2011 Natural Gas Purchased (11% of Requirement) vs. Budget



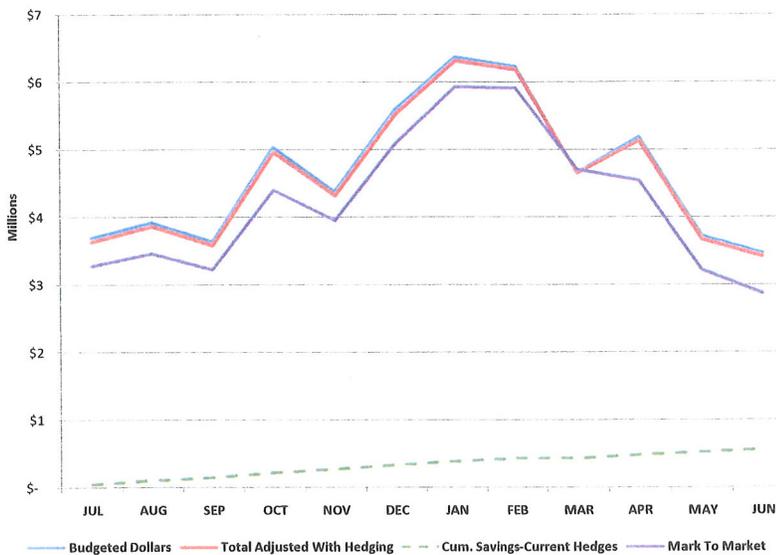
- Budget costs based on committed prices for FY2009.
- Procurement strategy is to forward purchase 90% of expected required FY 2011 volumes.
- NICOR Enerchange serving as advisor and counterparty to purchases.

FY2011 Natural Gas Purchases (MMBTU)



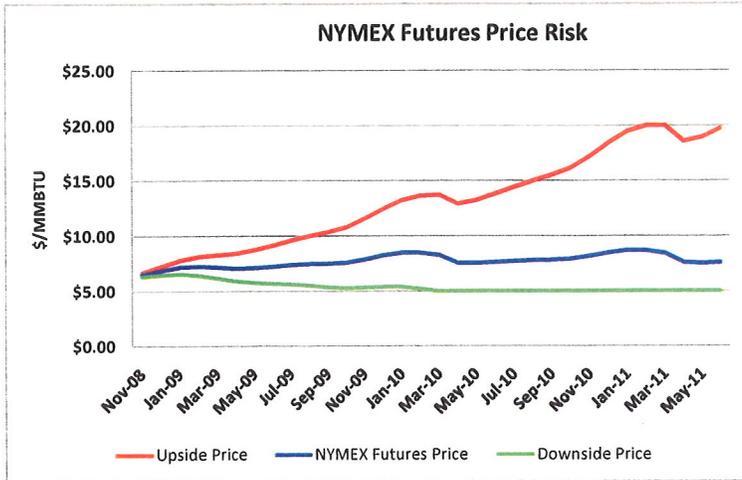
- Committed purchases to date via two transactions.
- 11% of FY2011 required volumes committed.
- Further transactions will be made on a regular timed basis or opportunistically if natural gas prices reach aggressive strike price levels (\$15 million or 25% of FY2009 landed prices).

FY2011 Natural Gas Purchase Cost Status



- \$560 thousand savings compared to hedged pricing levels for FY 2009.
- Mark to Market reflects 100% volumes priced at 10/14/08 futures price.

# Risk Management



- *Upside is based on a reasonable upper bound given recent history. Represents value gained by hedging.*
- *Downside limited by structural cost barrier --- approximately \$5.00. Represents opportunity cost.*
- *Risk envelope is provided to give a sense of possible price change over time*

## Counter Party Risk - NICOR Enerchange

Counter-party risk is being continually monitored. Our single supplier is Nicor Enerchange. The University should have relatively low risk related to non-performance by the originating gas suppliers since Nicor Enerchange is between the University and the suppliers, and they are responsible for covering damages if they fail to deliver the nominated amount of gas to a specified delivery point. The most recent Value-Line report for NICOR Inc. (the holding company) shows financials relatively strong. Currently, NICOR, Inc. is rated AA and does not appear to have been impacted by recent issues in the credit market.