Settlement Agreement
PUBLIC VERSION

Regarding PG&E Long-Term Core Hedge Program Application (A.06-05-007), the Core Procurement Incentive Mechanism (CPIM), and Transportation Capacity held on behalf of Core Customers

December 15, 2006

The undersigned Settling Parties agree to the following principles:

1. Long-Term Core Hedge Program:

1.1 The Long-Term Core Hedge Program (Program) rolling horizon will be three years, beginning Spring 2007.

1.2 The Program will be conducted outside of PG&E's Core Procurement Incentive Mechanism (CPIM). Costs of the hedging program will be recovered through PG&E's monthly core procurement advice filings. The cost of option premiums will be amortized in customer rates over a multi-month period. Each year, prior to the winter heating season, PG&E will confer with the members of the Core Hedging Advisory Group (discussed in Part 2, below) regarding the exact number of months over which this cost will be amortized in customer rates.

1.3 The Program provides for an annual budget of [redacted] for options and authority to hedge with swaps for a level of coverage [redacted] average daily core gas demand, as described below.

1.4 This Settlement Agreement also allows PG&E to file an expedited advice letter requesting that additional option funds and/or swaps be authorized in light of extreme or unexpected market conditions. These provisions are specified in Section 4.1, below. The expedited advice letter process is described in Section 2.7, below.

1.5 Options included in Program.

1.5.1 PG&E will be authorized to spend [redacted] total on options for each year to be identified within each Annual Implementation Plan (Annual Plan or Plan). Of this annual total, [redacted]

1.6 Swaps included in the Program

1.6.1 PG&E will be authorized to hedge with swaps as follows:

1.6.1.1 [redacted]

1.6.1.2 [redacted]

1.6.1.2.1 [redacted]

1.6.1.2.2 [redacted]

1.6.2 If market conditions are such that a different product mix is warranted, with concurrence of the Core Hedging Advisory Group, PG&E can present a modified portfolio structure to the Commission for approval via the Annual Implementation Plan.

1.7 Hedge Execution Period: [redacted] The specific execution protocol will be subject to annual review and modification by the Core Hedging Advisory Group (as described in Part 2, below), in conjunction with the Annual Plan.

1.8 Study of Customer Risk Preference

Within three months after a decision approving this Settlement Agreement, PG&E shall hold a meeting of the Advisory Group to discuss the parameters of a Request for Proposals to conduct a market assessment study regarding the

risk preferences of PG&E's core gas customers. The goal of such a study will be to obtain a quantitative estimate of the consumer risk tolerance of PG&E's core gas customers, or the amount PG&E's core customers might be willing to spend on hedging to mitigate the impacts of commodity price volatility. The Advisory Group shall evaluate the proposals and recommend whether a study should be performed. The Energy Division also shall be included in these discussions. If the Advisory Group determines that such a study is warranted, then PG&E shall contract for a study to be performed within the first two years of the Core Gas Hedging Program (by March 30, 2009). PG&E shall include the results of the study, together with any recommendations flowing from the study, in a report to the Advisory Group due before June 30, 2009. All of the third-party costs of a study shall be booked to the hedging subaccount of the Purchased Gas Account, and recovered from PG&E's core procurement customers.

1.9 Winter Program Focus

The hedging Program adopted under this Settlement Agreement is focused on financial instruments used to hedge PG&E's gas purchases on behalf of its core gas customers during the winter heating season, outside the CPIM. The members of the Core Hedging Advisory Group (discussed in Part 2, below) will be free, however, to discuss and consider the desirability of portfolio hedging outside of the CPIM done in connection with gas purchases made at other times of the year.

2. Core Hedging Advisory Group and Process for Developing the Annual Plan

2.1 The Commission's order approving this Settlement will authorize the establishment of a Core Hedging Advisory Group (Advisory Group). The Advisory Group initially shall consist of PG&E, Aglet Consumer Alliance (Aglet), the Division of Ratepayer Advocates (DRA), and The Utility Reform Network (TURN). Membership in the Advisory Group shall be limited to non-market participants who represent the interests of PG&E's core gas customers, and additional members beyond the initial membership shall be subject to approval by PG&E.

2.2 The purpose of the Advisory Group will be to advise PG&E regarding design and implementation of PG&E's portfolio hedging program on behalf of core gas customers. The Advisory Group will not have decision making authority. The scope of the Advisory Group will be limited to hedging the natural gas portfolio on behalf of PG&E's core gas customers.

2.3 Consistent with the Commission's treatment of procurement review groups for electric procurement, parties eligible to receive intervenor compensation awards in this or other gas proceedings should be eligible to seek compensation for their work as Advisory Group participants. The Settling Parties recommend

that the Commission use the same intervenor compensation standards previously established in D.05-01-055 (Finding of Fact 48) and D.02-10-062 (Finding of Fact 28), by finding that participation in the Advisory Group makes a significant contribution to effective implementation of the Commission's decision, and that parties eligible to receive intervenor compensation awards in this proceeding should be eligible to seek compensation for their work in the Advisory Group and in the on-going review of core winter gas hedging advice letters described in this Settlement.

2.4 Starting in 2007, the Advisory Group will meet at least once each calendar quarter. Other meetings may be called by PG&E or by a majority of the other members of the Advisory Group. The Advisory Group will consider and discuss issues related to PG&E's core winter gas hedging program plans and operations.

2.5 PG&E will provide reasonable advance notice to all Advisory Group members regarding the content of any advice letter PG&E intends to file related to core gas hedging.

2.6 Each year, PG&E will develop a Plan consistent with the parameters in this Settlement Agreement, and will consult with the members of the Advisory Group during the first quarter of every calendar year, prior to filing the Plan with the Energy Division for approval. The Plan is intended to finalize confidential winter gas hedging parameters, including but not limited to the following: [redacted]

2.7 After consulting with the Advisory Group, PG&E will file the Plan via an expedited advice letter, on a confidential basis. The expedited advice letter procedure should allow 10 days for protests and comments and three days for replies, and seek Commission approval through an Energy Division resolution or letter. Once approved, there will be no reasonableness review of winter hedges, as long as the hedges are compliant with the approved Plan (see Section 5.1, below).

2.8 During the initial three-year term, each member of the Advisory Group specified herein retains the right to protest any PG&E advice letter filing seeking Commission approval of the Plan, if that entity believes that the Plan fails to conform to the parameters in this Settlement. The parties agree that they will meet and confer in good faith to resolve any differences with respect to any such protest.

2.9 Starting with the Plan for the Winter 2010 – 2011 (after the initial three-year term), each of the members of the Advisory Group reserves the right to protest any PG&E advice letter filing seeking Commission approval of the Plan.

2.10 Absent Commission approval of a Plan by April 1 of the prompt year, the Parties agree that the default Plan for that prompt year will be the Plan as approved for the immediately preceding year. The default Plan will remain in effect until a successor Plan is approved by the Commission.

2.11 Risk Reporting

PG&E shall provide a quarterly report to the Advisory Group that details its total risk over the next three-year period as measured by TeVaR (time to expiration value at risk) at the 95% confidence level. TeVaR results shall be provided for each month in the prompt year and by hedge month for Years 2 and 3.

3. Program Term:

3.1 After the initial three-year term, the Program will continue on an annual basis, unless a member of the Core Hedging Advisory Group notifies the other members of its desire to modify the Program in the manner set forth below.

3.1.1 Starting in 2009 and each year thereafter, any member of the Core Hedging Advisory Group may notify the other members by February 1 of its desire to negotiate changes or modifications to the Program.

3.1.2 Upon notice by a member of the Core Hedging Advisory Group (Notice), the members of the initial Core Hedging Advisory Group agree to meet and confer in good faith, in an effort to develop Program modifications acceptable to all parties.

3.1.3 By June 30 following such Notice, PG&E will file an Application or other appropriate vehicle to be agreed upon by the Advisory Group, proposing to continue, modify or terminate the Program. The other parties to this Settlement Agreement reserve the right to protest any PG&E filing seeking Commission approval to continue, modify or terminate the Long-Term Hedging Program.

3.1.4 To give the Commission ample time to act on any proposed changes prior to the following year's implementation, the Settling Parties agree that any proposed modifications to the Program will not go into effect until the implementation period following the date of the Commission decision. For example, any change filed at the Commission by June 30, 2009, and approved by the Commission prior to March 31, 2010, would be implemented in the Winter 2010-2011 Plan.

3.1.5 Unless the Program is previously modified or terminated by the above process, PG&E will file for Commission approval before June 30, 2011, a proposal to continue, modify, or terminate the Program. PG&E will

submit this proposal to the Commission by means of either an Application or other procedural vehicle to be agreed upon by the members of the Advisory Group. If the Commission does not act on PG&E's proposal by March 31, 2012, then the existing Program will remain in effect, through the winter of 2012-13.

3.1.6 Absent Commission action by April 1, following any PG&E filing to continue, modify or terminate the Program, the Settling Parties agree that the default Plan for the upcoming prompt year will be the Plan as approved for the immediately preceding year. The default Plan will remain in effect until a successor Plan is approved or the Program is terminated by the Commission.

4. Plan Adjustments:

4.1 Prior to or during the implementation period (April 1-September 30), if PG&E finds that price protection afforded by the approved Plan is insufficient to meet a minimum level of hedge coverage as recommended by PG&E, or [redacted], then PG&E is authorized under this Settlement Agreement to file an expedited advice letter seeking authorization for additional funds for the purpose of attaining the recommended level of hedge coverage, or additional authority to acquire swaps, as appropriate.

4.2 Prior to filing such an advice letter, PG&E agrees to meet and confer with the members of the Advisory Group.

4.3 The other parties to this Settlement Agreement reserve the right to protest such an advice letter.

5. Reporting and Compliance Review

5.1 Twice yearly, PG&E will file a compliance advice letter. The first such advice letter will be filed after the annual implementation period, and the second after the end of the winter heating season.

5.1.1 Each such advice letter shall describe the general parameters of the Annual Plan. The advice letter also will include as an attachment a confidential compliance report containing information about each transaction executed by PG&E during the implementation period, the date the transaction was executed, and the amount paid. Commission review will be limited to a determination of whether or not PG&E was in compliance with its Plan.

5.1.2 At the conclusion of each year's hedging Plan, after reviewing PG&E's compliance reports for that year, the Energy Division will request that the Commission's Executive Director issue a letter, subject to the results of an annual audit of PG&E's Purchased Gas Account by the DRA, determining whether PG&E was in compliance with its approved Plan. PG&E requests that the letter be issued within two months from the time DRA completes its audit.

5.2 On or about April 1 of each year, PG&E will provide to the Advisory Group and the Energy Division, on a confidential basis, a report of the financial results of its Plan, including but not limited to, the following information: total funds spent on hedging instruments, total losses and gains for each category of hedging instrument, amount of natural gas supplies hedged monthly, and impact of the Plan on utility rates.

5.3 PG&E also will provide monthly summaries of hedging activities and mark-to-market values of the hedges to the Advisory Group and the Energy Division.

6. CPIM:

6.1 DRA and PG&E agree to modify the current CPIM as follows. Unless specifically noted all CPIM modifications will take effect in CPIM Year 15 (2007-2008):

6.1.1 The current tolerance band will remain unchanged (2 percent above the benchmark, 1 percent below the benchmark)

6.1.2 The sharing mechanism will be modified to provide as follows:

6.1.2.1 Above the tolerance band – 50 percent shareholder /50 percent customer (unchanged)

6.1.2.2 Below the tolerance band, 20 percent shareholder/80 percent customer

6.1.2.3 Total shareholder earnings will be capped at the lower of $25 million or 1.5 percent of annual gas commodity costs (unchanged).

6.1.3 The current 2.5 billion cubic feet (Bcf) of unsequenced storage withdrawal will be eliminated and re-included proportionately in the storage withdrawal sequence.

6.1.4 All brokering revenue from unused intra and interstate capacity will be used to offset gas costs.

6.1.5 A firm block of 100,000 decatherms (100 Mdth) from the San Juan Basin and 100,000 decatherms (100 Mdth) from AECO will be the first gas sequenced on any given day.

6.1.6 5 percent of the savings from full tariff rates on any pipeline or storage contracts negotiated (including renewals of existing capacity) on behalf of Core customers will be used to offset gas costs in CPIM.

6.1.7 Daily swing purchases that are currently valued in the benchmark calculation using the NGI daily Topock index plus as-available will be switched to the NGI daily PG&E Citygate index.

6.1.8 If storage capacity is acquired via the Incremental Storage Capacity Request for Offers (RFO), then the daily benchmark sequence will be adjusted to accommodate the incremental storage injection and withdrawal in a manner that provides all costs and benefits to Core customers. Beginning in CPIM year 14 (2006-2007), when gas is injected, the daily benchmark will be adjusted upward by the amount equal to the contracted injection capacity, if any. Beginning in CPIM year 15 (2007-2008), when gas is withdrawn, the daily sequence will be adjusted downward, by the actual amount of incremental storage gas withdrawn on that day, if any.

6.1.9 All other aspects of CPIM will remain unchanged.

6.1.10 Upon Commission approval of this Settlement, the CPIM will continue indefinitely until modified or terminated by the Commission.

7. Pipeline Capacity:

7.1 DRA and TURN will not oppose PG&E's proposal to increase its annual Baja Path Capacity held on behalf of Core customers up to 355 MDth per day. The costs of the annual Baja Path Capacity will be included in the fixed cost component of the CPIM benchmark. PG&E will propose the increased annual Baja Path Capacity either in the 2008 gas transmission and storage rate case, by advice letter or in another proceeding before the Commission.

7.2 PG&E will seek opportunities to acquire small amounts of TransCanada (NOVA, BC, GTN) capacity to eliminate the current mismatches in order to create a more seamless path from AECO to PG&E Citygate. Approval for such capacity additions will be governed by the procedures in D.04-09-022, issued in the Gas Capacity Order Instituting Rulemaking, R.04-01-025. Once approved in accordance with the D.04-09-022 procedures, this capacity will be included in the fixed cost component of the CPIM benchmark.

7.3 PG&E will reduce Core's allocation of Silverado Capacity in the appropriate GT&S rate case, by advice letter, or in another proceeding as California supply contracts expire.

8. This Settlement Agreement is Conditional and Nonseverable:

8.1 This Settlement Agreement is contingent upon Commission approval, except as described in Section 8.2, below. The Settling Parties intend the Settlement Agreement to be interpreted and treated as a unified, integrated agreement. In the event the Commission rejects or modifies this Settlement Agreement, the Settling Parties reserve their rights under Rule 12.4. The Settling Parties agree to use good faith best efforts to support approval of the entire Settlement Agreement without modification.

8.2 This agreement is not contingent upon Commission approval of the pipeline capacity commitments discussed in Part 7, above, because those commitments will not be submitted to the Commission for approval in this docket (A.06-05-007).

Subject to Rule 12 of the CPUC Rules of Practice and Procedure, Rule 601 et seq. of the FERC Rules of Practice, Rule 408 of the Federal Rules of Evidence, and Section 1152 of the California Evidence Code

Agreed to by:

Date: 12/18/06

Roy M. Kuga
Vice President, Energy Supply
Pacific Gas and Electric Company

Date: _____

R. Mark Pocta
Program Manager
Division of Ratepayer Advocates

Date: _____

Marcel Hawiger
The Utility Reform Network

Date: _____

James Weil
Aglet Consumer Alliance

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Date: _____

Marcel Hawiger
The Utility Reform Network

_____

Date: 19-Dec-06

James Weil
Aglet Consumer Alliance