APPENDIX C

BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

Application of Southern California Gas Company for Authority to Update its Gas Revenue Requirement and Base Rates. (U 904-G)	Application 02-12-027 (Filed December 20, 2002)
Application of San Diego Gas & Electric Company for Authority to Update Its Gas and Electric Revenue Requirement and Base Rates. (U 902-M)	Application 02-12-028 (Filed December 20, 2002)
Investigation on the Commission's Own Motion Into the Rates, Operations, Practices, Service and Facilities of Southern California Gas Company and San Diego Gas & Electric Company.	Investigation 03-03-016 (Filed March 13, 2003)

SETTLEMENT AGREEMENT
REGARDING PHASE 2 BASE MARGIN ISSUES

Keith W. Melville
Glen J. Sullivan
101 Ash Street
San Diego, CA 92101
Attorneys for Southern California Gas Company
and San Diego Gas & Electric Company

Laura J. Tudisco
505 Van Ness Avenue
San Francisco, CA 94102
Attorney for Office of Ratepayer Advocates

Marcel Hawiger
Robert Finkelstein
711 Van Ness Ave., #350
San Francisco, CA 94102
Attorneys for The Utility Reform Network

Norman Pedersen
Scott LeHecka
Hanna and Morton LLP
444 South Flower Street, Suite 2050
Los Angeles, CA 90071-2922
Attorneys for
Southern California Generation Coalition

James Weil
P.O. Box 1599
Foresthill, CA 95631
Advocate for Aglet Consumer Alliance

Sheryl Carter
71 Stevenson Street, Ste. 1825
San Francisco, CA 94105
Representative for
Natural Resources Defense Council

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SETTLEMENT AGREEMENT
REGARDING PHASE 2 BASE MARGIN ISSUES

Pursuant to the California Public Utilities Commission ("Commission") Rules of Practice and Procedure, Rule 51.3, the Commission's Office of Ratepayer Advocates ("ORA"), San Diego Gas & Electric Company ("SDG&E"), Southern California Gas Company, ("SoCalGas"), The Utility Reform Network ("TURN"), Aglet Consumer Alliance ("Aglet"), the Natural Resources Defense Council ("NRDC") and the Southern California Generation Coalition ("SCGC") [collectively referred to hereafter as "Joint Parties"] respectfully submit this Settlement Agreement for Commission approval. In the Settlement Agreement, the Joint Parties provide to the Commission a recommended resolution of the majority of the issues that have been designated for consideration in Phase 2 of this proceeding for both SDG&E and SoCalGas.

Certain Phase 2 matters are not resolved by this Settlement Agreement, and are left to be resolved by the Commission on a litigated basis unless resolved by subsequent settlement agreement. The unresolved matters are in the area of performance indicators

and performance incentives, which for SDG&E currently include electric reliability, customer service, and employee safety and for SoCaGas currently include customer service and employee safety. Accompanying this Settlement Agreement is the Motion of the Joint Parties requesting that the Commission adopt the terms of this Settlement Agreement in its decision in Phase 2 in Application (A.) 02-12-027 and A.02-12-028.

Attached to this Settlement Agreement and incorporated as integral parts of the Settlement Agreement are proposed tariff sheets for SoCalGas' and SDG&E's preliminary statements consistent with the terms of this Settlement.

I.
INTRODUCTION AND BACKGROUND

SoCalGas filed A.02-12-027 and SDG&E filed A.02-12-028 on December 20, 2002. These applications requested an increase in authorized base rate revenues for each utility for Test Year 2004. The applications also addressed the potential continuation and modification of their currently-effective performance based ratemaking ("PBR") mechanisms applicable to base rate (or "distribution") operations, including a mechanism for setting authorized base rate revenues for years after 2004 and prior to the next cost-of-service Test Year. The assigned Administrative Law Judge ("ALJ") consolidated the applications in light of the similarities of the filings, including many of the same witnesses, use of the same ratemaking calculations or "models," and the fact that the two companies are operated in large part by the same management. On March 13, 2003, the Commission issued a companion Order Instituting Investigation (I.) 03-03-016, stating that the proceeding will "determine whether the companies are properly organized, managed and controlled so as to provide safe, reliable and cost effective gas and/or gas and electric retail service to their customers." (I.03-03-016, mimeo, p. 3.) On April 2, 2003, Assigned Commissioner Wood issued a Ruling Establishing Scope, Schedule and Procedures For Proceeding ("Scoping Memo"). On May 22, 2003, the Assigned Commissioner and ALJ issued a further ruling, modifying the procedural schedule and deferring PBR issues to a second phase of the proceeding.

Hearings in Phase 1 were held from October 7 to November 14, 2003. On December 19, 2003, separate settlements of Phase 1 issues for SoCalGas and for SDG&E were filed. Phase 1 was also subject to full briefing on a litigated basis, and to a comment process on the settlements filed in Phase 1. At the time the instant Settlement Agreement is signed and filed, a decision in Phase 1 is still pending for SoCalGas and SDG&E.

In Phase 2, SoCalGas and SDG&E served updated prepared testimony on February 6, 2004, subject to subsequent errata. On April 2, ORA served its prepared testimony in Phase 2. On April 16, prepared testimony in Phase 2 was served by each of the following interested parties: Aglet, TURN, SCGC, NRDC, and Coalition of California Utility Employees ("CCUE"). On May 14, 2004, SoCalGas and SDG&E served prepared rebuttal testimony. Hearings in Phase 2 were held from June 1 to June 10, 2004.

During and immediately following Phase 2 hearings, the parties who had sponsored testimony in Phase 2 began intensive discussions of potential settlement positions. On July 2, 2004, SoCalGas, SDG&E, ORA, Aglet and TURN sent to all parties a Notice of Settlement Conference, which was held on July 12, 2004 at SoCalGas' and SDG&E's office in San Francisco, California. This Settlement Agreement is the product of those discussions.

II.
LITIGATION POSITIONS OF THE PARTIES

The litigation positions of the parties in Phase 2 are summarized below. Nothing in this Settlement Agreement is intended to modify the litigation positions of the parties as set forth in full detail in their testimony and briefs. The positions summarized below do not cover the positions of the parties on performance indicators and performance incentives because those matters are not resolved by this Settlement Agreement.

SoCalGas and SDG&E's positions

SoCalGas and SDG&E proposed indexing authorized revenues for 2005 and other subsequent years should start from the Phase I settlement base margin; excluding for SoCalGas: gas commodity, interstate transportation, Catastrophic Event Memorandum Account ("CEMA"), Hazardous Substance Cost Recovery Amount ("HSCRA"), Self Generation Program Memorandum Account ("SGPMA"), California Alternate Rates for Energy ("CARE"), Direct Assistance Program ("DAP"), Demand Side Management ("DSM"), Public Goods and Other Research, Development and Demonstration ("RD&D"), Pension, Commission-imposed and Post Retirement Benefits Other that Pensions ("PBOP") costs; and excluding for SDG&E: generation, transmission, San Onofre Nuclear Generating Station ("SONGS"), CEMA, CARE, DSM, Pension, Commission-imposed and PBOPs costs. Gas: CEMA, HSCRA, SGPMA, CARE, DAP, DSM, Public Goods and Other RD&D, Pension, Commission-imposed and PBOPs costs.

SoCalGas and SDG&E proposed a formula that indexed margin per customer by "inflation less productivity." SDG&E would no longer be at shareholder risk/reward for the level of electric sales and gas throughput. Inflation would be measured using utility-specific price indices ("GUPI" for gas and "EDPI" for electric), weighted for each utility according to the mix of labor, non-labor O&M, and capital-related costs authorized for each in the Phase 1 decision. Applicants proposed a productivity factor of 1.16% for SoCalGas and for SDG&E's gas authorized revenues, and 0.47% for SDG&E's electric authorized revenues, with no stretch factors.

SoCalGas and SDG&E proposed an adjustment to index costs otherwise covered by miscellaneous revenues derived from tariffed charges that would not be escalated, including Service Establishment Charge ("SEC"), reconnection charge and returned check charges. They proposed annual retroactive true-up for estimated vs. actual customer growth, and annual true-up prospectively-only for forecast vs. actual inflation.

SoCalGas and SDG&E proposed a PBR earnings sharing mechanism that has the same bands and sharing percentages as SoCalGas' existing mechanism (which now applies only if recorded rate of return ("ROR") exceeds authorized ROR), but that would apply symmetrically if recorded ROR were below as well as above authorized ROR.

SoCalGas and SDG&E proposed a cost-of-capital mechanism identical to SDG&E's currently effective Market Indexed Cost Adjustment Mechanism ("MICAM") mechanism, but moving the six-month measurement period to March-August from April-September.

SoCalGas and SDG&E proposed to maintain their currently-effective Z-factor treatment, except not to apply a deductible feature to legislatively-imposed mandates.

ORA

ORA agreed with the scope of the application of PBR as proposed by SoCalGas and SDG&E.

ORA proposed an indexing formula that was equal to the forecast for Consumer Price Index–All Urban Consumers ("CPI") times total margin subject to the PBR mechanism, with no explicit adjustment for customer growth or productivity.

In the event a formula like that proposed by SoCalGas and SDG&E were adopted, ORA proposed to use a productivity factor of 1.16% for gas and 1.0% for electricity.

ORA proposed that earnings sharing should apply only to earnings in excess of authorized ROR. It proposed to apply to SoCalGas and SDG&E the sharing bands currently effective for SDG&E, except that shareholder shares would be capped at 75% for all bands above 175 basis points above authorized ROR.

ORA proposed to retain existing Z-factors (except Criterion #6), including $5 million deductible for legislative mandates.

ORA proposed that the next Test Year be 2009, with the possibility that this date could be extended by the Commission at a time closer to 2009.

TURN

TURN agreed with the scope of PBR proposed by SoCalGas and SDG&E, except for proposing that SDG&E's tree trimming costs should be subject to a one-way balancing account and an exception to PBR base margin.

TURN proposed no adjustment of post-test year authorized base margin if the next Test Year were 2006. Otherwise, TURN proposed use of the same method as proposed by ORA of adjusting base margin by forecast CPI times total base margin.

TURN also proposed that if instead an indexing formula such as that proposed by SoCalGas and SDG&E were adopted, a stretch factor of 0.5 to 1.0% should be added to industry-average productivity.

In the event of adoption of a formula of CPI times total base margin for more than two years, TURN recommended an earnings sharing mechanism of 50/50 ratepayer/shareholder for earned ROR in excess of 100 basis points above authorized ROR. If an indexing formula like that proposed by SoCalGas and SDG&E were adopted, TURN recommended application to SoCalGas and SDG&E of the earnings sharing mechanism currently applicable to SDG&E.

TURN made no recommendation for cost of capital or Z-factors in its testimony.

TURN recommended a TY of 2006 if possible and if not, then a TY of 2008.

Aglet

Aglet took no position in testimony on exclusions from base margin that would be subject to adjustment in years after test year 2004.

Aglet supported indexing using the formula proposed by ORA of forecast CPI times total base margin. Aglet opposed truing up forecast CPI to recorded CPI, either retroactively or prospectively. Aglet took the position that if margin per customer indexing were adopted as proposed by SoCalGas and SDG&E, the added amount per customer should be only 0.798 of the cost per existing gas customer and 0.5887 of the cost per existing electric customer.

Aglet proposed there be no earnings sharing mechanism.

Aglet proposed that there be no cost of capital mechanism and that the Commission conduct traditional annual cost of capital proceedings for SoCalGas and SDG&E. If the Commission were to retain MICAM type cost-of-capital mechanisms, Aglet recommended use of changes in yields on 10-year Treasury notes as the measure of changes in interest rates. Aglet generally opposed any Z-factor adjustments between general rate cases.

Aglet recommended 2008 as the next test year.

SCGC

SCGC addressed only SoCalGas rates and service in its testimony. SCGC recommended that if a formula like that recommended by SoCalGas were adopted, there should be a stretch factor in addition to gas industry average productivity of 0.3% in 2004, 0.5% in 2005, and 0.7% in 2006-2008. If the Commission was not willing to adopt such stretch factors, SCGC would then support ORA's recommendation to index by CPI times total base margin.

NRDC

NRDC's principal recommendation was that SDG&E's current rate indexing methodology be terminated and that mechanisms be adopted that allow SDG&E and SoCalGas' to recover in rates an amount exactly equal to authorized base margin regardless of the level of sales/throughput. NRDC expressed a preference for "margin per customer" indexing to achieve this end.

The only other party presenting testimony was CCUE. Because CCUE's testimony addressed only performance indicators and performance incentives, and those matters are not resolved by this Settlement Agreement, CCUEs positions are not summarized herein.

III.
SETTLEMENT AGREEMENT PROVISIONS

1. General Provisions

This Settlement Agreement is premised on Commission approval of both the SDG&E and SoCalGas settlement agreements reached in Phase 1 of this proceeding. If the Commission does not approve both of the Phase 1 settlements or if the Commission orders substantive modifications to either or both of them, then the Joint Parties agree to continue good faith efforts to negotiate mutually acceptable outcomes for all issues covered by this Settlement Agreement. If the Commission does not approve both of the Phase 1 settlements or if the Commission orders substantive modifications to either or

both of them, and Joint Parties fail to agree through good faith efforts on mutually acceptable outcomes for all issues covered by this Settlement, then this Settlement Agreement shall not be binding on the Joint Parties. Agreement to this Settlement Agreement by Joint Parties does not in any way affect or prejudice the positions of Joint Parties with respect to either or both of the Phase 1 Settlements.

Core and noncore gas throughput and sales are currently 100% balanced for SoCalGas. Nothing in this Settlement Agreement is meant to resolve the issue of SoCalGas' risk for noncore throughput through 2008, as this issue is scheduled to be addressed in the next BCAP.

All base rate revenues that are the subject of this Settlement Agreement shall be recoverable by SDG&E and SoCalGas through the operation of revenue adjustment mechanisms, such that the recovery of approved revenue requirements is not affected by the level of actual sales or throughput, except as required by a change in noncore throughput risk in the next BCAP proceeding, should that occur.

Nothing in this Settlement Agreement modifies provisions applicable to SoCalGas adopted in D.97-07-054 and D.98-01-040 for negotiated core service contracts and optional tariffs or in D.00-04-060 for California Red Team negotiated gas service contracts.

The term of this Settlement Agreement shall cover the years 2005, 2006 and 2007; SDG&E and SoCalGas shall each file a test year 2008 general rate case application.

2. Post Test Year Ratemaking

SoCalGas' and SDG&E's annual authorized base margin for each of the years 2005, 2006, and 2007 shall be equal to the previous year's authorized base margin, with exclusions as provided herein, times one plus the forecast percentage change in the Consumer Price Index-All Urban Consumers ("CPI") for the upcoming year over the previous year. The forecast percentage change shall be the October Global Insight CPI

forecast for the upcoming year divided by the forecast for the current year, minus one. No true up of forecast to recorded CPI shall be made, either retroactively or prospectively, for the period through 2007.

Base margin exclusions shall reflect the litigation positions of SoCalGas and SDG&E; tree trimming expenses by SDG&E shall be included in the PBR base margin and not be subject to a balancing account.

Only "base margin" as specified in the Phase 1 settlements, and not total revenue requirement, shall be subject to indexing. "Base margin" is the Commission-adopted revenue requirement less Commission-adopted forecast of miscellaneous revenues, and exclusions as proposed by SoCalGas and SDG&E. The exclusions are listed in the attached draft tariffs, Section XI.E. There will be no escalation of authorized revenues to cover any portion of test year 2004 costs forecast to be recovered through miscellaneous revenues and no PBR indexing of tariffed charges that are included in miscellaneous revenue.

Notwithstanding the forecast CPI change, the minimum and maximum authorized adjustments relative to the previous year's authorized base margin will be as follows:

For SoCalGas:

	2005	2006	2007
Minimum	2.0%	2.5%	3.3%
Maximum	3.0%	3.5%	4.3%

For SDG&E:

	2005	2006	2007
Minimum	3.2%	3.5%	3.8%
Maximum	4.2%	4.5%	4.8%

SoCalGas and SDG&E shall file advice letters on or before November 1 of 2004, 2005, and 2006 proposing adjustments in authorized revenue consistent with this Settlement Agreement.

3. Cost of Capital

SoCalGas' current cost of capital mechanism as adopted in D.97-07-054 will remain in effect.

SDG&E's current MICAM cost-of-capital mechanism as last modified in D.03-09-008 will remain in effect with the one modification that the existing six month measurement period will be changed to March – August from April – September.

4. Earnings Sharing Mechanism

For the years 2005 through 2007, a PBR earnings sharing mechanism for each of SoCalGas and SDG&E shall apply in the case of earned rate of return on the applicable rate base ("ROR") exceeding authorized ROR for either of the two utilities individually. There shall be no sharing in the event of earned ROR falling below authorized ROR for either of the two utilities individually. Earnings subject to sharing is net operating income after taxes and adjusted to remove the effects of performance indicator rewards and penalties, DSM rewards, and other earnings related exclusions.

The sharing bands and percentage of sharing in each band (earned ROR in excess of authorized ROR) for each of the two utilities individually shall be as follows:

Sharing Band (Basis Points)	**Shareholders**	**Ratepayers**
0 – 50	100%	0%
51 – 100	25%	75%
101 – 125	35%	65%

126 – 150	45%	55%
151 – 175	55%	45%
176 – 200	65%	35%
201 – 300	75%	25%
301 & Above	Suspension	

If either utility experiences one year of net operating income subject to earnings sharing which results in an earned ROR that is more than 300 basis points higher than that utility's currently authorized ROR, the earnings sharing portion of the PBR mechanism shall be automatically suspended for the applicable utility. Such suspension will trigger a formal regulatory review by the Commission of that utility's PBR mechanism. In the event that either SoCalGas or SDG&E earns an ROR for one year that is 175 basis points or more below its authorized ROR, that utility (or both, if both earn more than 175 basis points below authorized ROR) shall have the option to suspend the PBR mechanism applicable to it and file an application for a formal regulatory review by the Commission of its PBR mechanism.

There shall be no earning sharing applicable to 2004.

5. Z Factors

There will be no change to the current Z-factor mechanisms, with the exception that Criterion #6 no longer applies. SDG&E will incorporate in its CPUC tariff provisions identical to those in SoCalGas' Preliminary Statement Part XI, Section E, but applicable to SDG&E.

6. Performance Indicators

This Settlement Agreement does not cover matters referred to as performance indicators or performance incentives, including the issues of what dimensions of

reliability, customer service or safety should be measured, what the targets for performance on such measures should be, what the rewards and/or penalties for performance should be, and whether there should be any service guarantees or the terms of any such guarantees. Agreeing to this Settlement Agreement does not in any way affect or prejudice the positions of any of the Joint Parties with respect to performance indicators or performance incentives.

IV.
ADDITIONAL TERMS AND CONDITIONS

A. PERFORMANCE

The Joint Parties agree to perform diligently, and in good faith, all actions required or implied hereunder, including, but not necessarily limited to, the execution of any other documents required to effectuate the terms of this Settlement Agreement, and the preparation of exhibits for, and presentation of witnesses at, any required hearings to obtain the approval and adoption of this Settlement Agreement by the Commission. No Settling Party will contest in this proceeding, or in any other forum, or in any manner before this Commission, the recommendations contained in this Settlement Agreement, except that Parties are free to advocate their litigation positions in litigation briefs filed in this proceeding. It is understood by the Joint Parties that time is of the essence in obtaining the Commission's approval of this Settlement Agreement and that all will extend their best efforts to ensure its adoption.

Joint Parties specifically acknowledge, however, the provisions in Section III above regarding the fact that this Settlement Agreement is premised on approval by the Commission of both settlements pending in Phase 1 and the consequences if the Commission does not approve both of the Phase 1 settlements.

B. NON-PRECEDENTIAL EFFECT

This Settlement Agreement is not intended by the Joint Parties to be precedent regarding any principle or issue in any other proceeding, whether pending or instituted in the future. The Joint Parties have assented to the terms of this Settlement Agreement only for the purpose of arriving at the settlement embodied in this Settlement Agreement. Each of the Joint Parties expressly reserves its right to advocate, in current and future proceedings, positions, principles, assumptions, arguments and methods which may be different than those underlying this Settlement Agreement. The Joint Parties expressly declare that, as provided in Rule 51.8 of the Commission's Rules of Practice and Procedure, this Settlement Agreement should not be considered as a precedent for or against any principle or issue.

The Settlement Agreement explicitly does not establish any precedent on the issue of the form or existence of any mechanism for adjusting authorized revenues for years following a test year, sharing of earnings, or cost-of-capital mechanisms.

C. INDIVISIBILITY

This Settlement Agreement embodies compromises of the Joint Parties' positions in Phase 2. No individual term of this Settlement Agreement is assented to by any Settling Party, except in consideration of the other Joint Parties' assents to all other terms. Thus, the Settlement Agreement is indivisible and each part is interdependent on each and all other parts. Any party may withdraw from this Settlement Agreement if the Commission modifies, deletes from, or adds to the disposition of the matters settled herein. The Joint Parties agree, however, to negotiate in good faith with regard to any Commission-ordered changes in order to restore the balance of benefits and burdens, and to exercise the right to withdraw only if such negotiations are unsuccessful.

As noted above, this Settlement Agreement does not resolve issues in Phase 2 related to performance indicators or performance incentives. The effectiveness of this Settlement Agreement is not conditioned on any particular resolution of performance indicator or performance incentive issues by the Commission.

The Joint Parties acknowledge that the positions expressed in the Settlement Agreement were reached after consideration of all positions advanced in the all testimony sponsored in the proceeding by all parties. This document sets forth the entire agreement of Joint Parties on all of those issues, except as specifically described within the Settlement Agreement. The terms and conditions of this Settlement Agreement may only be modified in writing subscribed by all Joint Parties.

D. ATTACHMENTS

Attachments A (SoCalGas preliminary statement tariff sheets) and B (SDG&E preliminary statement tariff sheets) to this Settlement Agreement are part of the agreement of the Joint Parties and are incorporated by reference.

Dated this 21st day of July, 2004.

AGLET CONSUMER ALLIANCE

By:_____
James Weil
Director

NATURAL RESOURCES DEFENSE COUNCIL

By:_____
Sheryl Carter
Director, Western Energy Programs

OFFICE OF RATEPAYER ADVOCATES

By:_____
Natalie Walsh
ORA Deputy Director

SAN DIEGO GAS & ELECTRIC COMPANY

By:_____
Lee Schavrien
Vice President

SOUTHERN CALIFORNIA GAS COMPANY

By:_____
Lee Schavrien
Vice President

SOUTHERN CALIFORNIA GENERATION COALITION

By:_____
Scott Lehecka
Attorney

THE UTILITY REFORM NETWORK

By:_____
Marcel Hawiger
Attorney

(END OF APPENDIX C)