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Decision 02-08-064 August 22 2002

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Investigation into the Natural Gas Procurement Practices of the Southwest Gas Company.	Investigation 01-06-047 (Filed June 28, 2001)

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DECISION FINDING SOUTHWEST GAS'S PROCUREMENT PRACTICES FROM JUNE 1, 1999 TO MAY 31, 2001 UNREASONABLE

Summary

We determine that the failure of Southwest Gas (Southwest) to either use its gas storage or to secure contracts for winter delivery of gas at rates equivalent to the cost of gas that could have been stored during the Summer of 2000 constitutes an imprudent managerial action. This makes a portion of Southwest's costs incurred in acquiring gas unreasonable.

We find that the failure of Southwest to fill its storage to at least 50 percent of its capacity departed from the standard practices of California gas companies and left Southwest exposed to the volatility of 2000-2001 winter gas markets. This led to higher gas costs over this period than are reasonable. We therefore disallow the recovery of $2,691,675 in gas acquisition costs that Southwest should refund to their customers in proportion to their use of gas during the October-March 2000-2001 heating season.

Background

From January 2000 to June 2001, natural gas prices across the country rose to unprecedented levels, and the price of gas at the southern California border was at times the highest in the country. Consequently, the gas procurement rates charged by the regulated gas utilities in California increased to very high levels during this period. Gas prices hit their highest levels during the Winter of 2000-2001, at times spiking to nearly thirty times the price of a year earlier. This occurred during the winter heating season when gas usage by core customers reached its highest level and led to very high consumer bills.

While the gas procurement rates for all of the regulated gas utilities in California increased, the Commission received an unusually high number of complaint letters from the customers of Southwest, particularly from its Southern

Division.[1] We received a petition from the citizens of Victorville with over 20,000 signatures, expressing complaints and even outrage over the high natural gas rates being charged by Southwest.

From December 1997 to December 2000, the gas procurement rates for Southwest's Southern Division had been set at $2.21 / decatherm (Dth). In October 2000, Southwest requested permission to change its gas procurement rates on a monthly basis to reflect more accurately its current costs of gas, just as other California gas utilities do. The Energy Division reviewed this request and approved it on November 1, 2000. On December 1, 2000, Southwest increased its procurement rates for its Southern Division to $8.62 / Dth, an increase of nearly 300%. In January, February, and March 2001, the procurement rates jumped again to $12.96 / Dth, $15.76 / Dth, and $15.76 / Dth, respectively. Needless to say, this 7-fold increase in gas procurement rates had a dramatic effect on Southwest's customer's bills, especially since the increases occurred during the winter, when gas usage was high. Over the Winter of 2000-2001, Southwest's procurement rates increased to an even greater degree than the rates for Pacific Gas and Electric Company (PG&E), Southern California Gas Company (SoCalGas), or San Diego Gas & Electric Company (SDG&E).[2]

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[1] Southwest operates in two divisions in California, the Northern and Southern divisions. In the Northern Division, Southwest serves about 18,000 customers near Truckee and Lake Tahoe. In the Southern Division, Southwest serves about 105,000 customers in San Bernardino County.

[2] In fact, as of April 30, 2001, Southwest still had a substantial undercollection in its purchased gas account. This means that Southwest's procurement rates had not collected all of their gas costs as of April 30, 2001.

Procedural Background

In response to these developments, the Commission opened Investigation (I.) 01-06-047 on June 28, 2001. The order instituting the investigation required Southwest to explain its procurement practices, to justify the rapid increases in gas costs, and to provide detailed information on its gas costs for the period June 1, 1999 through May 31, 2001. The Commission ordered Southwest to file a report on its gas purchasing activities and these matters on July 18, 2001.

On August 22, 2001, an Administrative Law Judge's (ALJ) ruling set a prehearing conference (PHC) for August 31, 2001 in Victorville and posed a series of questions for Southwest concerning how its gas procurement activities fit into the larger context of regional gas markets.

At the August 31 PHC, the Office of Ratepayer Advocates (ORA) and the County of San Bernadino (County) and the City of Big Bear Lake entered formal appearances in the proceeding and participated with Southwest in discussions concerning the management of the proceeding. In addition, because of the intense public interest and public attendance at the August 31 PHC in Victorville, Commissioner Wood and ALJ Sullivan elected to hold a public participation hearing (PPH) to accommodate those in attendance.

A September 13, 2001 ruling set the scope and schedule for this proceeding. In response to a request of ORA, a November 14 ruling modified and extended the proceeding's schedule.

SWG served opening testimony on October 15, 2001. ORA and the County served responsive testimony on December 14, 2001. Southwest served rebuttal testimony on January 14, 2002.

A PPH was held at the City of Big Bear Lake on January 8, 2002. A PPH was also held in Apple Valley on January 9, 2002.

Evidentiary hearings were held on January 22, January 23 and February 1, 2002 in San Francisco. A closing argument was held on February 1, 2002 before Commissioner Wood and ALJ Sullivan. With the filing of reply briefs on March 8, 2002, the proceeding was deemed submitted.

The Standard for Prudent Managerial Action

The standard in a reasonableness review of managerial action is settled, and there is no dispute between Southwest, ORA, and the County on the standard for reviewing the gas purchasing actions of Southwest in the period from June 1, 1999 to May 31, 2001. In a reasonableness review:

> "Utilities are held to a standard of reasonableness based upon the facts that are known or should be known at the time. While this reasonableness standard can be clarified through the adoption of guidelines, the utilities should be aware that guidelines are only advisory in nature and do not relieve the utility of its burden to show that its actions were reasonable in light of circumstances existent at the time. Whatever guidelines are in place, the utility always will be required to demonstrate that its actions are reasonable through clear and convincing evidence."[3]

Thus, the reasonableness of a particular management action depends on what the utility knew or should have known at the time that the managerial decision was made, not how the decision holds up in light of future developments. The Commission has affirmed this standard of review in numerous decisions over the last twenty years:

> "The term 'reasonable and prudent' means that at a particular time any of the practices, methods, and acts engaged in by a utility follows the exercise of reasonable judgment in light of facts known or which should have been known at the time the

[3] D.88-03-036 (1988 Cal. PUC LEXIS 155,*7; 27 CPUC2d 525).

> decision was made. The act or decision is expected by the utility to accomplish the desired result at the lowest reasonable cost consistent with good utility practices. Good utility practices are based upon cost effectiveness, reliability, safety, and expedition.
>
> "A 'reasonable and prudent' act is not limited to the optimum practice, method, or act to the exclusion of all others, but rather encompasses a spectrum of possible practices, methods, or acts consistent with the utility system needs, the interest of the ratepayers and the requirements of governmental agencies of competent jurisdiction."[4]

The standard of reasonableness does not derive from the consequences of managerial action, but the soundness of the utility's decision-making process that led to the decision and the consequences:

> "Thus, a decision may be found to be reasonable and prudent if the utility shows that its decision making process was sound, that its managers considered a range of possible options in light of information that was or should have been available to them, and that its managers decided on a course of action that fell within the bounds of reasonableness, even if it turns out not to have led to the best possible outcome. As we have previously stated, the action selected should logically be expected, at the time the decision is made, to accomplish the desired result at the lowest reasonable cost consistent with good utility practices."[5]

At times, the Commission has noted that this standard can prove difficult to apply. In applying this standard of review to amendments to existing contracts concerning the supply of electric power, the CPUC has noted:

> "Although different approaches may be preferable in other circumstances, for purposes of the review of amendments to

[4] D.87-06-021 (1987 Cal. PUC Lexis 588, *28-29, 24 CPUC 2d 476).

[5] D.89-02-074 (1989 Cal. PUC Lexis 128, *11, 31 CPUC 2d, 236).

> existing contracts, as required in this case, we have found the following approach to be useful. We have first examined the goals that the utility hoped to achieve in the negotiations and have evaluated whether that goal was reasonable. We then compared the actual outcome with the goal. Finally, we considered whether a reasonable and prudent utility would have taken other steps to come closer to achieving the utility's goals."[6]

More generally:

> "The reasonable and prudent act is not limited to the optimum act, but includes a spectrum of possible acts consistent with the utility system need, the interest of the ratepayers, and the requirements of governmental agencies of competent jurisdiction." [7]

On the other hand:

> "The greater the level of money, risk and uncertainty involved in a decision, the greater the care the utility must take in reaching that decision;"[8]

And:

> "The burden rests heavily upon a utility to prove with clear and convincing evidence, that it is entitled to the requested rate relief and not upon the Commission, its staff, or any interested party to prove the contrary."[9]

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[6] D.89-02-074 (1989 Cal. PUC Lexis 128, *14, 31 CPUC 2d, 236).

[7] D.90-09-088 (1990 Cal PUC Lexis, 847, *23-25, 37 CPUC 2d 488, 499), based on language in D.87-06-021, and quoted with approval in D.98-09-040 (1998 Cal. PUC Lexis 972 *34-35).

[8] Ibid.

[9] Ibid.

Thus, although the utility need not show that it has undertaken the optimal act, it must show that its course of action was reasonable and that the utility took care in making its decision. Finally, it is the utility, not the staff or interested parties, that faces the burden of showing with clear and convincing evidence that its course of action was reasonable and therefore entitled to compensation.

Issue 1: Were the Actions of Southwest Prudent?

The central issue before us is whether the gas procurement decisions of Southwest meet the Commission's standard for reasonableness. As one might expect, the positions of the parties to this proceeding are radically different – Southwest claims its actions were reasonable, while ORA and the County argue that Southwest's failure to store more gas in advance of the Winter of 2000-01 was unreasonable.

Southwest: Gas Procurement was Reasonable

To show the reasonableness of its gas procurement and storage policies, Southwest states that it maintained a "measured decision-making process, under which it has revised its procurement and storage decisions as market conditions changed, in order to procure gas for its customers at the lowest possible overall cost."[10] As evidence of the reasonableness of its policies, Southwest points out that it has procured gas for its customers "at lower per-unit costs than two of California's large LDCs [local distribution companies] during the review period, with the exception of the six-month period of December, 2000 through May, 2001."[11]

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[10] Southwest, Opening Brief, p. 7.

[11] Ibid.

Southwest describes its decision-making process as consisting of evaluating 1) historical price data; 2) current market information; and 3) forecasts of what gas prices are expected. To show the past effectiveness of these principles, Southwest details a series of actions that it took between 1993 and 1998 to demonstrate its responsiveness to changing conditions in the natural gas market. These include Southwest's ending of its wholesale customer relationship with PG&E and its negotiation of a comprehensive wholesale agreement with SoCalGas. Southwest contends that these decisions, along with previous decisions to avoid holding long-term firm capacity on interstate gas pipelines, enabled Southwest's customers to avoid an estimated $3.9 million in Interstate Transition Cost Surcharges. Both PG&E's and SoCalGas's customers paid such transition charges.

Southwest claims that its decision not to use storage extensively was consistent with Commission policies that direct gas companies to use forecasts of gas prices to guide their use of storage. Southwest notes that between 1993 and 2001, "gas prices were higher in winter only 5 of those 9 years."[12] Southwest states that D.93-02-013 admonishes utilities to make gas storage decisions on a forecast basis, and that Southwest makes "storage decisions on the basis of historic conditions, current market conditions, and forecast future conditions, rather than simplistically doing the same thing every year without regard to market conditions."[13]

To justify its decision to store only modest amounts of gas in advance of the 2000-2001 heating season, Southwest notes that the historic range for gas

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[12] Ibid., p. 9., citing Exh. 2, 43-44.

[13] Southwest, Opening Brief, p. 10.

prices was no greater than $2.00-$5.00/MMBtu, and that "Never in California's history had gas prices exceeded $5.00/MMBtu."[14] During the Summer of 2000, gas prices reached a record high of $7.00/MMBtu, and Southwest anticipated that they would drop during the fall and winter. Since Southwest could meet its gas demands from flowing gas supplies without using storage and both futures prices and forecasts "universally predicted prices dropping the coming winter,"[15] it declined to fill its gas storage.

Southwest also defends the reasonableness of its managerial actions by examining the results of its gas procurement decisions. Southwest states that its procurement costs "(1) beat the market by approximately 12.4%, or $10.8 million in total gas costs; (2) were lower on average than the gas procurement costs of both PG&E and SDG&E and were only approximately 6 cents/MMcfd higher than SoCalGas; and (3) would have earned a shareholder reward of approximately $5.4 million dollars if Southwest had been operating under a GCIM [gas cost incentive mechanism] identical to SDG&E's."[16]

Southwest further argues that its gas procurement actions are consistent with Commission adopted gas policies. In particular, Southwest claims that the Commission has established policies favoring cost minimization over price stability, and disfavoring the use of long-term fixed-price procurement contracts. Southwest cites D.89-04-080:

> "We expect utilities to demonstrate least cost purchasing practices, given the need for supply security. We reiterate our

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[14] Ibid., p. 10.

[15] Ibid., p. 11.

[16] Ibid., pp. 12-13.

> view that a well-managed portfolio will balance supply and cost considerations, and will provide a menu of supply arrangements with differing price, contract length, and other terms."[17]

And:

> "We have discussed our view that price stability should not be a primary goal for core and core-elect customers in order to promote lower cost supplies."[18]

Further, Southwest quotes a Commission 1994 decision that while imposing a disallowance on PG&E states:

> "Subsequently, in D.89-04-080, we relegated the goal of price stability to a secondary priority behind supply security and cost minimization."[19]

Similarly, Southwest discusses Commission decisions that discourage the purchase of gas through long-term contracts and concludes that despite these contracts' ability to provide price stability, the Commission disfavors such contracts. As a result, Southwest concludes that Commission policy is one of placing the highest priority on low prices, not stable prices. Southwest views its actions as consistent with these policies.

Southwest further asserts that not only its procurement actions, but also its utilization of storage was consistent with Commission policy. In particular, Southwest argues that the "two criteria the Commission imposes are (1) certainty

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[17] D.89-04-080 (1989 Cal PUC Lexis 284, *6, 31 CPUC 2d 533), as cited in Southwest, Opening Brief, p. 14.

[18] Ibid, *17-18, as cited in Southwest Opening Brief, p. 15.

[19] D.94-03-050 (1994 Cal. PUC Lexis 221, *181-182, 53 CPUC 2d 481) as cited in Southwest, Opening Brief, p. 16.

of gas supply; and (2) lowest possible overall cost."[20] Southwest notes that certainty of gas supply is not an issue for Southwest because it can meet peak winter needs from flowing gas without taking gas from storage. Concerning the criteria of lowest possible cost, Southwest argues that it "used its reasoned decision-making process to analyze historical gas prices, current market prices, and forecasts of future prices, in order to make gas procurement and storage decisions based on all available information."[21] Southwest states that applying the same storage criteria as it had used in the past led to storage amounts of "0.17 Bcf [11%] (2000), 1.4 Bcf [93%] (1999), 1.4 Bcf [93%] (1998), 1.1 Bcf [73%] (1997) and .75 Bcf [50%] (1996)."[22] Finally, Southwest notes:

> "Neither historical gas prices, current prices during the Summer of 2000, nor any gas price forecasts would have put a reasonable gas purchaser on notice that gas prices would jump more than tenfold by the end of Winter 2000/2001."[23]

Southwest concludes that the evidence of this record demonstrates the reasonableness of Southwest's procurement costs.

ORA: Southwest's Failure to Store Gas was Imprudent

ORA contends that Southwest's procurement actions were imprudent. First, ORA states the Commission's storage policy "directed gas utilities to use

[20] Southwest, Opening Brief, p. 25.

[21] Ibid., p. 27.

[22] Ibid., p. 27.

[23] Ibid., pp. 28-29.

storage to benefit core customer in terms of both reliability and price."[24] ORA argues that an application of this policy is readily seen by examining the actions of SoCalGas, SDG&E, and PG&E. ORA notes that each has a Commission-authorized storage target for its core customers and that each utility "sets monthly storage targets and winter month-end minimums to ensure that the storage is being utilized for the benefit of the core."[25] ORA contrasts this practice with that of Southwest, stating, ". . . from May through September 2000, traditional injection months, Southwest injected no gas at all into storage."[26] Thus, ORA views the actions of Southwest as inconsistent with Commission gas storage policies, particularly as applied by other gas utilities.

ORA argues that Southwest's storage of so little gas in 2000 necessitated that it "rely almost entirely on flowing supply to meet winter demand, procuring gas primarily on the monthly and daily spot market."[27] In particular, ORA argues that since Southwest was relying so heavily on gas future prices as a predictor of winter gas prices, Southwest should have reduced exposure to potential price volatility either by putting gas in storage or buying a contract for the future delivery of gas. Moreover, ORA notes that the savings from not storing gas versus the prices predicted on the futures market were "minor at best."[28]

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[24] ORA, Opening Brief, p. 3.

[25] Ibid., p. 3.

[26] Ibid., p. 3, citing Exh. 100, pp. 3-7.

[27] Ibid., p. 5.

[28] Ibid., p. 6, citing Exh. 200, p. 15.

ORA, citing D.94-03-050, notes that Southwest's "purported reliance on its interpretation of Commission decisions or policies is not dispositive of the reasonableness of its actions."[29] In particular, ORA argues that reliance on Commission policies does not relieve Southwest from the responsibility to justify specific decisions. Moreover, ORA notes that the Commission policy concerning gas storage is nuanced, seeking to provide both reliability and price stability for customers, while giving the overarching direction to utilities to use the storage for the benefit of core customers.

Finally, ORA states that Southwest's failure to use financial instruments to hedge the price volatility of its gas portfolio during the review period demonstrates that Southwest lacks "appropriate risk management policies."[30] ORA notes that SoCalGas, PG&E, and SDG&E use financial tools to hedge their gas supply costs. ORA concludes that by failing to use financial instruments to hedge, by failing to utilize storage, and by failing to hold interstate transmission capacity, Southwest was "ill prepared to mitigate gas price increases experienced during the second year of the review period."[31]

County: Failure to Store Gas was Imprudent and Risky

The County also concludes that Southwest's gas procurement policies were unreasonable, and not mandated by Commission policies. The County argues that Commission policy does not require that gas utilities rely exclusively on the spot market. In particular, the County notes that Commission policy "has

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[29] Ibid., p. 6

[30] Ibid., p. 7.

[31] Ibid., p. 8.

also encouraged utilities to consider hedging strategies to protect against episodes of high prices."[32] The County further states that the record in this proceeding shows that other California gas utilities have used hedging strategies successfully.[33] Finally, the County states that the Commission has supported "a geographic diversity in the utilities' core purchases."[34] Thus, the County does not believe that Southwest's actions were consistent with Commission policy, but that they were inconsistent with a Commission policy that "encouraged the California utilities to purchase a diversified portfolio of supplies for their core customers."[35]

The County also contends that the Commission's gas storage policies seek to provide the certainty of gas supplies and to do so at the lowest possible overall costs. The County notes the Commission's directives that set gas storage targets for SoCalGas, SDG&E and PG&E, and argues that Southwest should have known these policies and followed similar storage practices. The County notes that the "Commission applies these storage policies to all other gas utilities and even to small third-party marketers: core storage had to be filled prior to winter in order to provide supply certainty."[36] In particular, the County argues that under current gas policy, any utility or marketer, regardless of size, should store gas to insure certainty of supply for its customers and to contribute to the peak period reliability of the system.

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[32] County, Opening Brief, p. 10.

[33] Exh. 200, p. 5.

[34] County, Opening Brief, p. 11.

[35] Ibid., p. 112.

[36] Ibid., p. 16.

The County further contends that Southwest's actions prior to the Winter of 2000-2001 were not required by Commission policy and clearly unreasonable for several reasons. First, the County states that Southwest failed to start the winter with adequate gas in storage or under forward contracts. The County argues that this action was inconsistent with Commission policy that encouraged the use of storage and was a departure from Southwest's past practices.

Second, the County states that Southwest "ignored the price function of storage."[37] The County analyzes the data presented by Southwest and finds that winter prices are on average "significantly higher in the winter than in the summer"[38] and concludes that failing to store gas was imprudent.

Further, the County argues that Southwest failed to inject gas into storage even when it was economic to do so. The County states that the "record shows that in April and June 2000, Southwest decided not to inject, even though its monthly analyses calculated that the expected savings from not storing gas were less than $0.05 per Dth."[39] The County additionally states that the future prices for December and January gas were high enough to support injecting gas in May. The County therefore concludes "In these three months [April, May and June], Southwest could have injected about 1.1 Bcf of gas."[40]

The County also notes with disapproval Southwest's failure to purchase future contracts to offset the risks that arose from the decision to forego injection during the spring. The County states:

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[37] Ibid., p. 17.

[38] Ibid., p. 18.

[39] Ibid., p. 18, referencing Exh. 200, pp. 15-16,

[40] County, Opening Brief, p. 19.

> "Once Southwest decided not to store gas in a particular month, the utility should have purchased winter supplies equal to the foregone injections at the lower prices that prevailed when it made the decision not to inject gas into storage. . . . By doing nothing, Southwest abrogated its responsibility to ensure certainty of supply for its core customers, and essentially lost any ability to mitigate the risk of high prices during the coming winter, as Southwest's Mr. Hester conceded."[41]

The County also contends that the Commission should disregard Southwest's discussion of the Commission's policies concerning the storage of natural gas. The County points out that the Commission has not recently examined Southwest's storage policies. Moreover, the County points out that in a recent Commission examination of gas storage practices, "All of the other wholesale customers in the state (SDG&E and the Cities of Palo Alto and Long Beach) filed reply comments indicating that they had either filled their contracted storage, or took other steps to assure the adequacy of their core supplies to meet peak winter needs."[42] The County concludes "Southwest is a large and sophisticated company – among the ten largest gas distribution companies in the U.S. – and they do not need to be micro-managed by the Commission" and therefore should "apply a little common sense in interpreting the Commission's decisions."[43]

The County also makes several arguments to rebut Southwest's defense of the reasonableness of its gas procurement decisions through comparisons with the prices charged by other utilities. The County points out "SoCalGas' tariffed

[41] County, Opening Brief, p. 20, citing Tr. 229, 232.

[42] County, Opening Brief, p. 21.

[43] Ibid., p. 22.

core gas costs were almost 50% lower than Southwest's during the energy crisis months of December 2000 through May 2001."[44] The County also points out "During the year ending May 2001, Southwest's gas costs in southern California were 155% and 84% higher than its cost of gas in Nevada and Arizona, respectively."[45] The County also argues that the Commission should discount comparisons with SDG&E, the gas utility with core gas costs closest to those of Southwest. The County notes that because of greater heating needs, the per capita bills in the Big Bear District and Victorville were much higher than those in San Diego.

Finally, the County takes issue with Southwest's claim that its tariffed gas costs were lower than SDG&E's in 17 of 24 months during the record period. The County argues: "These comparisons are virtually meaningless, due to the fact that for 18 out of the 24 months in the review period, Southwest operated under a completely different scheme for recovering its gas costs than the other gas utilities to whom it is comparing itself."[46] In particular, the County notes that from June 1999 through November 2000, Southwest's tariffed gas costs was fixed at 22.932 cents per therm, while SDG&E's prices were changed monthly to more closely track actual costs.

[44] Ibid., p. 23.

[45] Ibid., p. 23.

[46] Ibid., p. 24.

Discussion – Flaws in Southwest's Gas Purchasing Policy Constitute Imprudent Action

We conclude that Southwest's gas procurement and storage policy constitute imprudent managerial action. Southwest's failure to either use more of its storage capacity or to secure stable prices through futures contracts left its customers exposed to a highly volatile gas market in the months with the greatest heating demand. The County rightly notes that the Commission has encouraged gas utilities to use hedging strategies to protect against high prices and price spikes. The actions of Southwest to forego use of its storage capabilities and simultaneously to refrain from the purchase of a futures contract led to an unjustifiable failure to protect its customers with a hedge against high gas prices.

Southwest misinterprets Commission gas procurement pronouncements when it concludes that the Commission's heavy emphasis on least-cost purchasing practices, as opposed to price stability, provides support for its actions. First, we note that the Commission decisions cited by Southwest and noted above do not eliminate price stability as a goal of Commission policy. Consider, for example:

> "Subsequently, in D.89-04-080, we relegated the goal of price stability to a secondary priority behind supply security and cost minimization."[47]

Although price stability is secondary to cost minimization, the Commission determined that it remained a priority. Despite Southwest's contentions, this

[47] D.94-03-050 (1994 Cal. PUC Lexis 221, *181-182, 53 CPUC 2d 481).

statement provides no support for a policy that either blindly fills storage or blindly relies on spot markets.

Second, it is clear retrospectively, and should have been clear prospectively, that the use of storage not only provides price stability, but also enables a utility to refrain from purchasing gas in a spiking gas market, thereby helping it to manage gas costs. Southwest's low supply of stored gas as it entered the Winter of 2000-2001 – only 11 percent of its contracted storage capacity – necessitated that Southwest secure gas supplies extensively in gas markets of Winter 2000-2001 even when prices were soaring. Historically, the use of storage has provided not only a hedge against price fluctuations, but also absolutely lower prices. In particular, storage can earn an economic return, not only by delaying investments in pipelines and other transmission facilities needed to meet the winter transmission peak, but also by enabling those holding gas in storage to decline to purchase high-priced gas. Our record indicates that Southwest appeared to view storage as a method for meeting operational needs and providing price stability, but failed to see the necessity of having a cushion of gas to reduce its purchases of gas on the days and weeks when gas prices were peaking.

Third, it is also clear that Southwest's decision to forego the use of storage departed from the practice of other gas utilities operating in California. As the County noted, all of the other major wholesale customers in California – SDG&E, the City of Palo Alto and the City of Long Beach – either filled their contracted storage or took other steps to secure stable supplies. Southwest's departure from the practice of the managers of these other utilities is difficult to understand. All faced the same gas market.

In addition to Southwest's claim that its gas procurement and storage policies were consistent with Commission policy, Southwest also defends the reasonableness of its actions with a detailed explanation of the economic rationale that it used to guide its procurement and storage decisions. Southwest's efforts to explain the economic reasoning that led it to forego the use of storage, however, do not present clear and convincing evidence concerning the reasonableness of its actions.

For example, Southwest examines the price history of the recent past and observes that in 4 of 9 years winter prices were below summer prices. Southwest further notes that prices were unusually high in the Summer of 2000. These facts demonstrate that a policy of filling storage every year is not reasonable. Nevertheless, in the Summer of 2000, future markets were indicating that the Winter of 2000-01 would likely face high prices. In the face of this market indicator, i.e., that winter prices would be about the same as those in summer, it is difficult to understand how economic reasoning caused Southwest to forgo summer injections. Further, the County points out that in the injection months of April, May, and June, there was virtually no difference between the cost of injecting gas for winter retrieval and the price of a contract for future delivery. Thus, there is no clear and convincing evidence that Southwest pursued a reasonable strategy.

In the face of the unprecedented high prices of the spring and summer, it would be reasonable for a manager to conclude that winter could also show unprecedented prices. In this situation, gas storage is not just a way of securing price stability, but is an important component in a strategy that leads to the lowest possible overall cost. Although on any particular day it may be easy to understand how Southwest's reasoning led to a decision not to inject gas when future prices were more economic than the purchase, injection, and future withdrawal of gas, it is not possible to conclude that it was reasonable for

Southwest to let the entire summer pass without either injecting substantial quantities of gas or purchasing attractive contracts for the future delivery of gas.

Southwest's defense that it was following an established gas procurement and storage strategy that had worked in the past is not adequate. Clearly, the procurement and storage strategy contained flaws, and the adverse conditions of Winter 2000-2001 exposed these flaws. The fact that the strategy had worked well in the past only shows that the strategy was equal to the set of circumstances encountered. It does not provide clear and convincing proof that the strategy was reasonable and prudent.

Our consideration of the reasonableness of managerial action depends on the supporting rationale based on the facts known at the time of the decision. With this criterion in mind, the question becomes one of what should the managers have done in the spring of 2000 with the facts then available?

The County and ORA both argue that Southwest should have filled its contracted storage. In retrospect, it is clear that completely filling storage would have been an excellent strategy for the conditions of the Winter 2000-2001. Southwest, however, effectively points out that in the previous four years, it had never filled its contracted storage, and that even if the year 2000 is excluded, the 1996-1999 average of storage was only 77%. In 1996, a year without any pricing crisis, only 50% of the storage was filled. Moreover, the pricing analysis that Southwest conducted showed that the prices of gas in the Summer of 2000 were at unprecedented high levels and that forecasts suggested that they would be no higher and possibly lower in winter. In the face of this information, completely filling the contracted storage would be unreasonable.

Nevertheless, entering winter with only 11% of the storage filled is also unreasonable. The unprecedented high prices of the summer, in combination with futures prices that showed little change in gas prices, indicated that gas markets were entering a period unlike the past. We conclude that a more prudent managerial approach would be for Southwest to fill the contracted storage to at least the lowest level that it had done in the recent past – 50% – or, alternatively, to secure contracts for future delivery of an equivalent amount of gas. A priori, such a strategy would have reduced exposure to high prices to the level of the recent past and balanced the goals of low cost and price stability. A posteriori, such a strategy would have led to lower prices.

Finally, although Southwest's evidence comparing its gas tariff prices with those of other utilities is important in our evaluation of its performance, the evidence presented is not dispositive. For example, Southwest notes that for "21 months of the 24-month review period, Southwest's tariff gas costs were lower than SDG&E."[48] Although accurate, this statement constitutes an "apples to oranges" comparison, for during 18 of the 24 months in the review period, Southwest's gas tariffs were fixed and not subject to adjustments to reflect the costs of purchased gas. Similarly, the County's comparison of Southwest's California gas costs with those of its Nevada and Arizona divisions is also an "apples to oranges" comparison. In particular, the Nevada and Arizona gas did not pass through congested California gas transmission hubs.

Although the comparisons with SDG&E, PG&E, and SoCalGas are relevant, the reasonableness of a utility's actions depends on its own costs and assets. Southwest differs from both SDG&E and SoCalGas, and the reasonableness of Southwest's decision depends on the circumstances and opportunities that Southwest confronted.

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[48] Southwest, Opening Brief, p. 30.

Southwest's argument that under SDG&E's gas cost incentive mechanism it would have generated $10.8 million in shared savings does not provide evidence that its purchasing decisions were reasonable. Indeed, we note that SDG&E, operating under its incentive mechanism, extensively used storage as part of its overall procurement strategy. Thus, SDG&E's managerial actions and its performance under the incentive program do not provide clear and convincing evidence that Southwest has acted reasonably concerning its gas procurement activities in the period under review.

In summary, the Commission has articulated three steps it has used in determining the reasonableness of a utility's decisions.[49] In the first step, we examine the goals that the utility hopes to achieve and evaluate whether that goal was reasonable. On this point, the record indicates that Southwest focused so exclusively on providing low-cost gas, that it failed to attach importance to the goal of price stability that was consistent with Commission policy.

In the second step, we compare the actual outcome with the goal. Here, we find that Southwest filled only 11% of its contracted storage and purchased no futures contracts for gas in the Summer of 2000. These actions undervalued the role of storage and futures contracts in both reducing the costs of gas and providing price stability. The result was that the actual outcome – high and volatile prices – failed to meet either the goal of low-cost gas or the goal of price stability.

In the third step, we consider whether a reasonable and prudent utility would have taken other steps to come close to achieving the goal. Here, we find that SDG&E and the City of Long Beach – also wholesale customers of larger gas

[49] D.89-02-074 (1989 Cal. PUC Lexis 128, *14, 31 CPUC 2d, 236).

utilities – each made extensive use of storage in the Summer of 2000. Thus, we conclude that in facing the market costs and futures prices of gas, it was unreasonable for Southwest to proceed through the Summer of 2000 without either filling 50% of its contracted storage or securing an equivalent amount of gas through futures contracts for delivery during the Winter of 2000-2001. In conclusion, Southwest has failed to show by clear and convincing evidence that its gas procurement and storage actions in the Summer of 2000 were reasonable.

Issue 2: What is the Appropriate Level of Disallowance that Should Result from Southwest's Actions?

Having determined that the actions of Southwest were not reasonable, we must determine what constitutes an appropriate shareholder disallowance. ORA and the County each develop proposed disallowances. Southwest believes that no disallowance is warranted, but presents detailed criticisms of the disallowance recommendations of ORA and the County.

ORA

ORA recommends that the Commission disallow $7,269,315 of the gas costs incurred during the review period for Southwest's rates. ORA states:

> "The disallowance is based on savings that would have been generated had Southwest injected gas during its contracted injection months to fill its storage resources for withdrawal in the winter, thus reducing the amount of purchased flowing gas supplies. The disallowance has been adjusted to account for variable storage injection and withdrawal costs, the carrying cost of storage, in-kind fuel, and revenues derived from Southwest's sale of storage capacity during the latter part of the winter of 2000-2001."[50]

[50] ORA, Opening Brief, p. 8, citing Exh. 100, pp. 3-9, app. A.

The ORA methodology assumes average monthly withdrawals over the traditional heating months of November through March, and equal injections during the preceding injection months. ORA also assumes that Southwest's average monthly cost of gas during the winter months would have been "avoided" had Southwest injected adequate gas. ORA uses market index prices to calculate the cost of injecting additional gas. Finally, ORA reduces its disallowance calculation by "the revenues derived from Southwest Gas' sale of storage capacity during the latter part of the Winter."[51]

County

The County recommends a disallowance of $11.7 million. The County develops its estimate by modeling the reduction in Southwest's core portfolio costs that would occur if it had followed the "strategy of using storage injections and withdrawals to levelize its monthly purchases of core supplies."[52] The County further assumes that Southwest should have filled its storage capacity by November 1, 2000 and have drawn it down to 0.17 Bcf by April 1, 2001. The County estimates, using cost indices for both gas injections and withdrawals, that Southwest would have saved $14.4 million is gas procurement costs. The County, noting that Southwest saved customers $2.7 through the brokering of unused storage capacity and through interstate capacity swaps, reduces the proposed disallowance to $11.7 million.

[51] Exh. 100, p. 3-9 and Exh. 100, Appendix A.

[52] County, Opening Brief, p. 25.

Southwest

Southwest contends that the disallowance calculations presented by ORA and the County are fundamentally flawed.[53] Southwest states that ORA's simple policy of filling storage through equal monthly injections and draining storage through equal monthly withdrawals "completely fails to acknowledge the prevailing economic considerations."[54] Southwest hypothesizes that a different pattern of storage injection and withdrawal, i.e., maximal injections July-September with withdrawals in November and December would reduce the proposed disallowance to $2,024,355. Further, Southwest notes that it has never been its practice or Commission policy to require the filling of storage, and that its average injection level of the four winters prior to Winter 2000-01 approximated 77%. Southwest states "If one recalculates ORA's disallowance, taking into account the economic decisions Southwest would have had to make to comply with the Storage Decision, and if Southwest had a 'fill storage at any cost' target of 83% (or any inventory level less than 83%, i.e., 77%) there would be no disallowance."[55]

Southwest reaches a similar result in its analysis of the County's proposed disallowance. Southwest argues that the County also adopts a "fill storage at any cost" premise that is devoid of economic analysis. Southwest further argues that the County's use of market indices to calculate the cost savings is "incomprehensible . . . in the face of a record replete with evidence that

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[53] Southwest notes that its fundamental position is that no disallowance is warranted, but that the "underlying rationale and their calculations would violate the Commission's Storage Decision." Southwest, Opening Brief, p. 33.

[54] Southwest, Opening Brief, p. 34.

[55] Ibid., p. 35

Southwest's procurement efforts have significantly 'beat the market.'"[56] Southwest concludes that if it had conducted a similar analysis for the County's proposed disallowance as it had for ORA, then the County's flawed costs assumptions would have led to "a mathematically similar but deficient result."[57]

Discussion: Disallowance Should Be $2.691 Million; Rebates Due to Customers Based on Consumption in Winter 2000-01.

We find the methodology used by ORA to be both a simple and reasonable way for determining the appropriate disallowance. In particular, we conclude that ORA's methodology, which assumes equal injections over the Summer of 2000 followed by equal monthly withdrawals over the Winter of 2000-2001 is a reasonable model for procurement activities.

Assuming that the prudent course of action for Southwest was to fill its contracted storage completely before the Winter of 2000-2001, ORA's methodology leads to a disallowance of $7,269,315. Because we have determined that it was unreasonable for Southwest to fill less than 50% (or to secure futures contracts for gas amounting to an equivalent amount), we therefore determine that a disallowance of $2,691,675 is warranted.[58]

We find ORA's methodology more reasonable than that proposed by the County. ORA's methodology seeks to levelize the monthly injections and

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[56] Ibid., p. 36

[57] Ibid., p. 36

[58] See Comments of Southwest Gas on the Proposed and Alternate Decisions, Appendix B for a detailed calculation of a disallowance based on filling storage to a level of 50%. Also see Reply of ORA to the Comments of SW Gas and County of San Bernadino on the Proposed Decision and Alternate Proposed Decision.

withdrawals of gas, while the County's methodology seeks to levelize the purchase of monthly core supplies. Since it is not possible on a going-forward-basis to know the pattern of demand for future months, we conclude that it is not possible for a manager to implement the County's procurement and storage strategy, except in a rough or approximate way. Concerning the price of the gas that Southwest could have avoided purchasing in the winter if it had filled storage, the County's methodology prices the gas at the level of market indices, while ORA's methodology assumes that Southwest's avoided purchases would reflect the average that Southwest actually paid during this period (which was less than the indexed prices). Again, we find ORA's assumption more reasonable, for there is no evidence indicating that Southwest paid market prices for the gas it purchased.

Finally, we find Southwest's assumptions about the operation of storage and withdrawal – maximal injections July-September with withdrawals in November and December – to be an unreasonable pattern of operation. In particular, when faced with the skyrocketing price of gas in the Winter of 2000-2001, why would Southwest drain its entire storage in the first two months of the winter? This pattern of storage operation is unreasonable.

In summary, the methodology for calculating a disallowance proposed by ORA is reasonable. However, we base our disallowance on our finding that it would be reasonable either to fill 50% of the contracted storage or to arrange for the delivery of an equivalent amount of gas during the winter via futures contracts purchased in the summer. Using ORA's methodology to estimate the cost savings of filling the storage from the 11% level that Southwest procured to the 50% level of reasonableness, we estimate that Southwest should have saved $2,691,675.[59] We adopt this figure as our disallowance.[60]

Other Issues Raised in the Proceeding

In addition to the central issues concerning the reasonableness of Southwest's actions, this proceeding also addressed a variety of related issues, including Southwest's actions in dealing with customers as the crisis developed and potential steps or policy guidance to prevent this situation from arising again. We address these issues in turn.

Did Southwest Take Adequate Steps to Aid its Customers During the Crisis Period?

As part of this investigation, the Assigned Commission and ALJ posed a variety of questions concerning what steps Southwest took to aid its customers as the billing crisis developed. Southwest testified to the following steps:

1. Southwest changed its disconnection policy, by instructing its customer service staff that disconnection should be considered a last resort. Southwest replaced its policy of mandatory disconnection upon a $25 arrearage with one that disconnected only after $100 in arrearage. In addition, Southwest declined to strictly enforce this policy.
2. Southwest implemented a community-wide public service campaign to educate customers in obtaining financial assistance through the CARE program. This included coordinating with the Placer County Human Services Agency

[59] Exhibit 2A indicates that Southwest spent $67.2 million on gas from November 2000 to March 2001. Thus, a disallowance of $2,691,675 million will reduce winter gas costs by 4.0%.

[60] Exhibit 5 indicates that Southwest's net California income for the 12 months ending September 2001 was $1,433,287. Thus, the adopted disallowance equals approximately 1.9 years of California profits.

and the San Bernardino County Department of the Aging, as well as 25 community service agencies.

3. Southwest expanded efforts to sign up customers for the equal payment and deferred payment plans.
4. Southwest shareholders contributed $45,000 to the Salvation Army's emergency assistance program and $20,000 to the Energy Share program.
5. On January 14, 2002, Southwest filed an advice letter to lower current winter bills.
6. Southwest obtained approval from the Commission to increase the income eligibility level for the CARE program, thereby making CARE available to more of its customers.

In addition, Southwest testified to efforts that it was undertaking to clarify its billing procedures and to make its actions more understandable to its customers.

In response, the County charges that Southwest's customer outreach efforts were inadequate and misdirected. The County states that Southwest's outreach focused on the High Desert communities, rather than Big Bear Valley where difficulties were most acute. In addition, the County asserts that Southwest could have done better. Finally, the County discounts Southwest's recent decrease in gas rates, since this action does not save the customers any money, but simply defers collection to a two-year period commencing April 1, 2002.

We determine that Southwest's outreach efforts to customers were reasonable. Southwest implemented a number of different measures to aid customers in the crisis. Southwest's efforts to reach community groups did reach more groups in the High Desert, but that was in part due to the fact that few community service groups are based in Big Bear Valley, and several of those that serve Big Bear Valley are based in the High Desert. In addition, Southwest's decision to change its policies concerning the disconnection of service was a reasonable response to the emerging crisis.

Should the Commission Order a Core Procurement Incentive Mechanism (CPIM) for Southwest?

The County recommends that the Commission develop a CPIM for Southwest "modeled on the PG&E CPIM that has been in place since 1998."[61] The County states that such a regulatory regime would encourage the utility "both (1) to purchase a balanced, diversified portfolio of natural gas supplies and (2) to operate its storage capacity in a way that is most beneficial to its core ratepayers."[62]

We will not adopt a CPIM for Southwest at this time. Our experience with the development of CPIM programs for PG&E, SDG&E, and SoCalGas indicates that such a regulatory regime requires an extensive record and thorough documentation of how the CPIM will operate. We have an insufficient record in this proceeding to propose and adopt such a program.

What other Steps Should Southwest Take Concerning the Procurement of Gas and the Use of Storage?

The County and ORA also made a variety of proposals that seek to improve the operation of Southwest's gas procurement and storage system.

Steps Proposed by the County

The County recommends "Southwest develop alternative sources of supply for its Southern California Division, such as gas purchases off the PG&E

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[61] County, Opening Brief, p. 29.

[62] Ibid., p. 29.

or Kern River pipelines."[63] The County states that the "major barrier to such supply diversification is Southwest's current wholesale transportation contract with SoCalGas, which commits Southwest to being a full requirements transportation customer of SoCalGas."[64] In addition, the County also shows that all of the other gas utilities have made reservations of firm interstate gas transportation capacity, which they use to make basin purchases. The County states that these basin purchases "have provided a hedge against price volatility in California border markets."[65] The County, however, recommends no disallowance based on savings that Southwest could have achieved by purchasing gas in basin markets.

In response to the County's discussion, Southwest points out that the contract with SoCalGas has proved a source of savings over the years. Southwest notes further that there is no policy either requiring or prohibiting full reliance on the California border market. Southwest argues "the record demonstrates overwhelmingly that, for several years prior to Winter 2000/2001, Southwest's customers benefited from Southwest's decisions to procure low cost supplies in the mature and robust California border market."[66] Finally, Southwest cites D.93-06-092, in which the Commission states that SDG&E should

[63] Ibid., p. 30.

[64] Ibid., p. 31

[65] Ibid., p. 11.

[66] Southwest, Reply Brief, p. 25.

analyze “all kinds of gas purchase opportunities”[67] and “procure a mix of gas supplies that offers the best expected value when all outcomes are considered.”[68]

We will not direct Southwest to alter its contract with SoCalGas because Southwest demonstrates that its contract with SoCalGas has proved a source of savings to Southwest and its customers. Moreover, there is no evidence that this contract has constrained Southwest’s purchases of gas in any way.

Similarly, there is no need to alter Commission policy to encourage basin purchases, for current policy supports the purchase of natural gas from diversified sources. We will not order that Southwest make purchases of gas from out-of-state basins nor make any disallowance based on Southwest’s decision to purchase all its gas supplies in California border markets. We note, however, that the record in this proceeding demonstrated that California markets experienced volatility last winter related both to the cost of gas and to the cost of gas transmission capacity. Based on last year’s experience, it would seem clear that any future review of the reasonableness of gas procurement decisions would need to examine any decision to purchase gas entirely from border markets.

Steps Proposed by ORA

ORA makes a series of recommendations for the Commission to consider in addressing Southwest’s gas procurement costs in the future:

“1. Continue its efforts to secure interstate capacity;

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[67] D.93-06-092 (1993 Cal. PUC Lexis 349, *51, 50 CPUC 2d 185), as cited in Southwest, Reply Brief, p. 26.

[68] D.93-06-092 (1993 Cal. PUC Lexis 349, *51, 50 CPUC 2d 185), as cited in Southwest, Reply Brief, p. 26.

> "2. Develop specific storage guidelines and targets to ensure prudent use of its contractual storage capacity;
>
> "3. Develop a gas procurement strategy that includes risk management tools other than relying primarily on fixed-price contracts, such as acquiring long-term transportation capacity, filling storage resources and potentially using financial instruments;
>
> "4. Consider procuring its core gas supply requirements, or a portion thereof, directly from SoCalGas if the Commission approves the gas portfolio consolidation of SoCalGas and SDG&E (Application (A.) 01-01-021);
>
> "5. Continue to offer customer assistance programs such as the Equal Payment Program and the Deferred Payment Plan."[69]

We find the recommendations offered by ORA sensible – Southwest should continue its efforts to secure interstate capacity that will allow it to make basin purchases of gas. Similarly, Southwest should develop a gas procurement strategy that uses risk management tools such as long-term transportation capacity, filling storage, and potentially using financial instruments such as short-term futures contracts. We also endorse Southwest's efforts to market its Equal Payment Program and the Deferred Payment Plan.

We find that Southwest should modify its current storage program to ensure that it enters the winter heating season with storage at least half full. We do not require that Southwest automatically completely fill its storage on a timetable that ignores prices in gas markets. Although company generated storage targets may make some sense, they should not be considered externally

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[69] ORA, Opening Brief, p. 9.

imposed regulations that Southwest should follow independent of market conditions.

We reach no conclusion concerning ORA's recommendation that Southwest consider procuring some of its core gas supplies from SoCalGas. The evidence presented in this proceeding shows that except for the managerial error that led Southwest to fill only 11% of its contracted storage, Southwest has operated in an effective manner, systematically beating many market indices. Thus, we do not join ORA in urging Southwest to relinquish its role in procuring gas for its customers.

County's Motion to Strike Portions of Southwest's Reply Brief or to Set Aside Submission for Taking Additional Evidence (Motion)

On March 18, 2002, the County filed a motion to strike a portion of Southwest's reply brief based on "untested new evidence that Southwest has submitted as an attachment to its reply brief."[70] In the alternative, the County request that the Commission "set aside submission and reopen the record for the purpose of taking additional evidence relevant to the Commission's evaluation of the new evidence that Southwest has presented."[71] The County argues that it is "fundamentally unfair, and a violation of the due process rights of other parties, for Southwest to be able to introduce new factual evidence in its reply brief . . ."[72] The County charges that the evidence concerning futures prices for gas provided by Southwest is based only one date, April 27, which the County

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[70] County, Motion, page 1.

[71] County, Motion, pp. 1-2.

[72] County, Motion, p. 3.

believes is not typical. Nevertheless, "the County emphasizes that it does not view the outcome of this analysis as a major issue in this case."[73] The County concludes its Motion with the specific request that the Commission strike Section I, on pages 31-34, and Appendix I to Southwest's reply brief or set aside submission to reopen the record to take evidence on futures prices on April 24, 25, 26, and 28. On April 2, ORA filed a response recommending the reopening of the record.

On March 29, 2002, Southwest filed a response to the Motion. Southwest supports the option of taking additional evidence, and states that it has no objection to accepting the new evidence offered by itself and the County. Southwest, however, notes that it does not take issue with the County's view that the outcome of this analysis is not a major issue in this proceeding. Finally, Southwest notes that:

> "The County's objection to, and its Motion to Strike, Appendix 1 only applies to two sentences of Section III.I of Southwest's Reply Brief (pages 32-34): (1) On page 33, the last sentence of the second full paragraph (beginning "For illustrative purposes…" and (2) on page 34, the last sentence of the first full paragraph (beginning "If, for example, one examines…"). The remainder of Section III.I does not rely on Appendix 1 and is therefore not properly the subject of the County's Motion to Strike."[74]

We grant the County's motion. First, we agree that introducing this evidence during the reply brief fails to provide the County and ORA an opportunity to either respond or test the reliability or validity of this evidence. Thus, it would be inherently unfair to accept this additional evidence without

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[73] County, Motion, p. 5.

[74] Southwest, Response to Motion to Strike, March 29, 2002, p. 2.

reopening the record. Second, we also agree that this information does not address any major issue in this proceeding. In particular, we found that although Southwest's decision to inject gas on any given day may make narrow economic sense, it was imprudent to let the injection season end without filling at least 50% of its contracted storage or securing futures contracts covering that amount of gas. The exact levels of the futures price in April of gas for delivery in December and January 2000-01 and the cost of gas procurement, injection, and storage on any given day is not central to our determination of the reasonableness of Southwest's managerial actions or to our determination of an appropriate disallowance. For this reason, we determine that it is both fair and efficient to strike the portions of Southwest's reply brief that introduce new evidence.

Comments on Proposed Decision

The proposed decision of ALJ Sullivan was mailed to the parties in accordance with § 311(d) of the Pub. Util. Code and Rule 77.1 of the Rules of Practice and Procedure. Comments and replies were filed by Southwest, the County, and ORA.

Southwest's comments on the PD argue that it has committed no managerial error because a goal of gas-cost minimization drove its storage policies and that gas-cost minimization is Commission policy. As a consequence, Southwest argues that the proposed decision (PD), by considering price stability, retrospectively penalizes Southwest and misapplies the Commission's three-step reasonableness review standard. In addition, Southwest's comments argue that the Commission should use its injection/withdrawal analysis in calculating a disallowance, if one were assessed. Further, Southwest identifies an arithmetical error in the proposed decision's calculation of a disallowance. Finally, Southwest notes in its reply comments that its average net income for the three-year period of 1999, 2000, and 2001 was $1,698,705 as reported to the Commission's Energy Division on Form No. 2. (Southwest notes that the figures for 1999, 2000, and 2001, respectively are $2,162,019, $3,986,366 and a loss of $1,052,270).

Southwest's comments demonstrate that it has fundamentally failed to comprehend Commission policy. Commission policy places primacy on promoting low prices, but does not exclude promotion of stable prices.[75] As evidence, we noted above that hedging is a strategy long accepted by the Commission, both to promote low prices by avoiding the need to buy gas during "pricing spikes" and to promote price stability. Moreover, as the facts of this case make clear, Southwest's strategy actually achieved neither low nor stable prices, nor did Southwest demonstrate that one could have reasonably expected its strategy to achieve such an outcome. Indeed, a prudent managerial strategy that sought to achieve a balance between low prices and stable prices would have better complied with Commission policy and have achieved both lower and more stable prices than the procurement strategy pursued by Southwest. Thus, the PD commits no legal error – it applies the correct policy, it does not retrospectively penalize Southwest by use of a new policy, nor does is misapply the Commission's three-step reasonableness review standard. Further, the PD makes clear that Southwest's proposed methodology for calculating a disallowance is flawed. Finally, we have revised the PD to correct the arithmetical error identified in the PD's calculation of the disallowance.

The County's comments support the PD's legal reasoning that leads to the disallowance. The County's comments argue that the PD lacks a basis for basing

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[75] As mentioned above, D.99-03-050 notes that the Commission "relegated the goal of price stability to a secondary priority." We note that the language explicitly retains price stability as a "goal" and assigns it a "secondary priority."

the disallowance on a 50% use of storage. The County instead argues that the record shows that Southwest, if it had made economic injections during the spring of 2000, would have filled 92% of its storage. Finally, the County argues that ORA's disallowance methodology is flawed because it uses Southwest's average gas procurement costs instead of market prices.

The County's comments fail to note the reasonable basis for the conclusion that Southwest should have filled its storage to at least 50%. The record in this proceeding completely documents the unprecedented price levels and price volatility prior to the winter of 2000-2001. In the face of this uncertainty, we find that a simple (and prudent) managerial strategy would reduce price risks by storing at least as much gas as Southwest had done in the past, particularly since other gas utilities were following such a strategy. Hence, we conclude that Southwest should have filled its storage to at least 50%, its lowest use of storage in the four prior heating seasons.

Similarly, the evidentiary record is not clear that economic criteria would have induces Southwest to fill 92% of its contracted storage capacity. The record shows that such a result depends critically on assumptions concerning the timing of storage decisions and the level of market prices over which reasonable people can disagree. Lastly, the County's criticism fails to note that there is no evidence that Southwest consistently paid market prices for gas. As ORA notes in its reply comments, "actual prices," not market indices, "better reflect the cost of gas that could have been avoided through withdrawals."

ORA's comments note that the PD "properly find[s]" that Southwest "was imprudent in its storage utilization strategy in the summer of 2000." ORA notes that it supports the use of a 5-year historic average in calculating a disallowance. Further ORA notes that it is not necessary to find that Southwest should modify its storage guidelines to ensure it enters winter season with storage at least half full.

As noted above, basing a disallowance on a 50% use of storage is reasonable. In addition, although we concur with ORA that it is "not necessary" for our adoption of a disallowance to find that Southwest ensure that it enters the winter season with storage at least half full, we believe that it is reasonable to adopt this minimum target.

Findings of Fact

1. From December 1997 to December 2000, Southwest's gas procurement rate for its Southern Division was $2.21 per Dth.

2. On December 1, 2000, Southwest increased its rate for procured gas to $8.62 per Dth.

3. In January, February, and March 2001, Southwest increased its rate for procured gas to $12.96 per Dth, $15.76 per Dth, and $15.76 per Dth, respectively.

4. The Commission opened this investigation into the natural gas procurement practices of Southwest on June 28, 2001 in order to examine the reasonableness of managerial actions concerning gas procured in the period from June 1, 1999 through May 31, 2001.

5. There is no dispute among the parties to this proceeding concerning the applicable precedents for determining the standard of review in an investigation into the reasonableness of a utility's actions.

6. The historic range for gas prices in California was from $2.00 to $5.00 per MMBtu.

7. During the Summer of 2000, gas prices reached a high of $7.00 per MMBtu.

8. Southwest holds rights to store up to 1.5 Bcf of natural gas.

9. In the Summer of 2000, Southwest stored .17 Bcf, or 11% of its contracted storage capacity.

10. Southwest stored 1.4 Bcf of gas in 1999 (93% of capacity), 1.4 Bcf in 1998 (93% of capacity), 1.1 Bcf in 1997 (73%), and .75 Bcf in 1996 (50%).

11. Southwest's storage of only .17 Bcf of natural gas in the Summer of 2000 left it largely dependent on monthly and daily spot market prices for flowing gas in the Winter of 2000-2001.

12. Southwest did not use financial instruments such as futures contracts to hedge the price of winter gas during the Summer of 2000.

13. Currently, Southwest secures all of its gas from California gas markets.

14. The Commission sets gas storage targets for SoCalGas, SDG&E, and PG&E.

15. Southwest's tariffed gas costs were lower than SDG&E's in 17 of the 24 months of the period under review.

16. SoCalGas's tariffed gas costs were almost 50% lower than Southwest's tariffed costs during the energy crisis months December 2000 through May 2001.

17. Commission policy places the highest priority on low cost gas and makes price stability a secondary goal.

18. Southwest's gas procurement strategy in 2000-2001 failed to achieve the goal of providing low cost gas.

19. Southwest's gas procurement strategy in 2000-2001 failed to provide stable customer prices.

20. Unlike Southwest, wholesale customers including SDG&E, and the City of Long Beach made extensive use of gas storage in the Summer of 2000.

21. Southwest failed to show by a clear and convincing evidence that its gas procurement actions in the Summer of 2000 were reasonable.

22. The decision of Southwest to not fill at least 50% of its contracted storage or to secure futures contracts covering an equivalent amount of gas constitutes imprudent managerial action.

23. ORA's methodology reasonably estimates the gas costs that Southwest could have avoided by increasing its storage of gas in the Summer of 2000.

24. Using ORA's methodology, we calculate that if Southwest had filled its storage to 50% of its contracted storage capacity, Southwest could have avoided $2,691,675 in gas procurement costs during the Winter of 2000-2001.

25. The methodology proposed by the County for calculating disallowances makes operating assumptions that managers could follow only in an approximate way.

26. The index methodology proposed by the County for calculating the cost that Southwest could have saved through the use of storage overstates the potential savings because the methodology fails to reflect Southwest's demonstrated ability to purchase gas at prices below the index.

27. The methodology proposed by Southwest to calculate disallowances rests on unrealistic assumptions concerning the timing of gas purchases and gas use that understate the savings that stored gas can produce.

28. Southwest introduced new evidentiary material in its reply brief that it should have offered earlier in the proceeding.

29. Acceptance of the evidentiary material introduced by Southwest in its reply brief would be unfair to other parties to this proceeding.

Conclusions of Law

1. Utilities are held to a standard of reasonableness based upon the facts that are known or should be known at the time of decision.

2. As the Commission has previously concluded, a utility must demonstrate that its actions are reasonable through clear and convincing evidence.

3. As the Commission has previously concluded, the term "reasonable and prudent" means that at a particular time any of the practices, methods and acts engaged in by a utility follows the exercise of reasonable judgment in light of facts known or which should have been known at the time the decision was made.

4. As the Commission has previously concluded, a decision may be found to be reasonable and prudent if the utility shows that its decisionmaking process was sound, that its managers considered a range of possible options in light of information that was or should have been available to them, and that its managers decided on a course of action that fell within the bounds of reasonableness, even if it turns out not to have led to the best possible outcome.

5. Southwest was imprudent when it failed to fill at least 50% of its contracted storage in the Summer of 2000 or, in the alternative, to secure an equivalent supply of gas through futures contracts.

6. The Commission should disallow the recovery of $2,691,675 in gas procurement costs of Southwest because of imprudent managerial actions during the review period of June 1, 1999 through May 31, 2001.

7. Southwest should rebate $2,691,675 to its customers based on their consumption during the period November 2000 through March 2001.

8. The Commission should grant the County's Motion to Strike in part by striking Appendix 1 of Southwest's reply brief and the related sentences on pages 33 and 34 identified herein.

9. This proceeding should be closed.

O R D E R

IT IS ORDERED that:

1. Southwest Gas (Southwest) shall reduce its Purchased Gas Account by $2,691,675 to reflect our disallowance of unreasonable gas procurement costs.

2. Southwest shall rebate $2,691,675 plus interest at the prevailing rate in Southwest's Purchased Gas Account to its core customers as a bill credit based on each customer's usage over the year from November 2000 through March 2001.

3. Southwest shall file an advice letter no later than 15 days following the effective date of this decision to provide a refund plan to implement this bill credit.

4. The County's motion to strike portions of Southwest's reply brief is granted to the extent described herein.

5. This proceeding is closed.

This order is effective today.

Dated August 22, 2002, at San Francisco, California.

LORETTA M. LYNCH
President
HENRY M. DUQUE
CARL W. WOOD
GEOFFREY F. BROWN
MICHAEL R. PEEVEY
Commissioners

I will file a concurrence.

/s/ GEOFFREY F. BROWN
Commissioner

We will file a joint concurrence.

/s/ LORETTA M. LYNCH

President

/s/ CARL W. WOOD
Commissioner

Commissioner Geoffrey F. Brown, Concurring:

In the course of discussion of the Southwest Gas Company case, there seemed to be considerable confusion about the standard to be employed in evaluating the reasonableness of a business decision. Many had sought to apply a restitution-type formula whereby the disallowance would be measured in terms of the harm caused by what they believed was an unreasonable business decision. Others sought to mitigate the disallowance given the high cost it represents to the company.

Fortunately the Proposed Decision of ALJ Sullivan sets forth in clear terms the standard the Commission must apply. The ALJ asked this central question: whether in light of all the evidence at the time, the company made a prudent decision in maintaining low natural gas reserves? In that regard a three-step test is applied:

1) What were the goals the company hoped to achieve, and whether that goal was reasonable? In this case the company sought to provide low-cost gas.

2) What was the outcome of effort to achieve that goal? Clearly the company failed. It was subjected to huge wholesale charges on the open market.

3) Would a reasonable and prudent utility have taken other steps to achieve these goals? ALJ Sullivan compared Southwest's reserves in the Summer of 2000 against other utilities in the same position. No other utility exposed itself to the risk Southwest did. In doing that Southwest was abandoning a policy of significant storage of reserves – an average of 77% between 1996 and 1999 and "running bare". It kept reserves at 11% of its storage capacity in the face of rising gas prices. It operated on the assumption that the rise was temporary based on historical patterns. However it left little room for itself if the assumption proved to be wrong.

In determining whether its action were reasonable, the utility carried the burden of proof to demonstrate with <u>clear and convincing evidence</u> that its action were within a range of acceptable options. D.90-09-088 (37 CPUC2d 488,y99, [1990]) It was not required to demonstrate that it made the best possible choice, but instead, that a prudent manager might have chosen the particular option it ultimately implemented.

I do not believe that Southwest has successfully satisfied this rather high standard of proof. The question then becomes what amount of disallowance we should assign to a loss that otherwise would be imposed on ratepayers. The Proposed Decision correctly applied the formula: re-create the set of facts that would have been a minimally acceptable response to Southwest's knowledge that gas prices would rise. ALJ Sullivan did that: Southwest would have been minimally prudent had it filled its reserves up to 50% or had it secured an equivalent amount through future contracts. This would have been consistent with the goal of achieving stability in gas prices and low prices. ALJ Sullivan based this 50% figure on the lowest storage percentage in the years between 1996 and 1999. The extent a 50% reserve would have blunted the eventual gas prices represents the amount of the disallowance. (crediting, of course, the 11% they did hold reserve)

Should this amount be higher? Should the Commission adopt ORA's position and use 77% capacity as the benchmark? Undoubtedly, Southwest would have been better off with 77% capacity than 50%. However, Southwest would not have been unreasonable by placing 50% in the ground and procuring the rest on the open market. After all, what ultimately happened was unprecedented. It is important not to confound hindsight with prudence.

/s/ GEOFFREY F. BROWN
GEOFFREY F. BROWN
Commissioner

San Francisco, California
August 22, 2002

SOUTHWEST GAS INVESTIGATION CONCURRENCE OF LORETTA LYNCH AND CARL WOOD

Although we appreciate the fine work done by the Administrative Law Judge (ALJ) in this matter, we would have supported a larger disallowance based on a different rationale.

The company used only 11% of the storage volumes it had available going into the winter. ALJ Sullivan concluded that the company should be held accountable for the results of its having failed to hedge its price by more fully using its storage assets. The question is, how should the Commission identify the resulting unreasonable expenditures? The ALJ looked at the company's past storage practices and noted that during the prior five years, Southwest did not use less than 50% of its available capacity. Applying a very conservative approach, the ALJ assumed that it would have been reasonable for the company to use 50% of its available capacity during the winter of 2000-2001. He calculated his disallowance by applying that assumption to a computational methodology proposed by ORA. The resulting proposed disallowance is $2.7 million.

We supported an alternative approach for calculating the disallowance, in an alternate that expressed agreement with all aspects of the ALJ's analysis, except for the assumption that a 50% fill rate is reasonable. The fact that Southwest achieved any particular fill level in past years does not provide evidence that its past practices were reasonable or that it would have been reasonable to achieve the same levels during the year in question. Instead, the alternate expressly acknowledged that we cannot, even with the benefit of hindsight, conclude that any particular fill level would have been reasonable. As a proxy for what storage levels Southwest might have achieved if it had pursued a more comprehensive hedging strategy for the winter of 2000-2001, we would have applied an average of the percentage of storage attainment over the preceding five years. The resulting disallowance would have been $5.6 million.

We are concerned that the adopted decision could produce an unintended consequence. Just as Southwest attempted to defend its procurement strategy during the period in question by claiming that the Commission never specifically told the company to store any gas, the company might now offer the claim that the Commission has told it to utilize exactly 50% of its available storage capacity from now on – no more and no less.

We trust that all of my colleagues would join me in concluding that this would be an absurd result. The company remains obligated to do the prudent thing based on conditions in any given year. Southwest is still responsible for developing an appropriate strategy on a year-to-year basis.

While we support the conclusion that Southwest was imprudent in its procurement practices during the review period, we think it is important to recognize that the company did take extraordinary steps to mitigate the impacts of those procurement decisions on its customers during the last winter. At the company's request, this Commission approved a rate reduction intended to provide emergency relief during the last months of the heating season. Southwest voluntarily absorbed the impact of delaying recovery of those costs, by forgoing interest on the undercollection. Southwest clearly does care about its customers, which is why we have confidence that it will endeavor to improve its procurement practices going forward.

/s/ LORETTA M. LYNCH

Loretta M. Lynch
President

/s/ CARL WOOD

Carl Wood
Commissioner

San Francisco, California
August 22, 2002