Decision 07-06-013 June 7, 2007

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of PACIFIC GAS AND ELECTRIC COMPANY (U 39 G), for Approval of a Long-Term Core Hedge Program for Core Natural Gas Supplies.	Application 06-05-007 (Filed May 5, 2006)

ORDER ADDRESSING APPLICATION AND ACCEPTING MOTION FOR ADOPTION OF SETTLEMENT

Summary

This decision resolves the application of Pacific Gas and Electric Company (PG&E) for approval of its proposal to develop confidential plans for purchasing hedging and other financial instruments that concern its core gas supplies. We accept a settlement filed by PG&E, The Utility Reform Network (TURN), the Division of Ratepayer Advocates (DRA) and Aglet Consumer Alliance (Aglet) in this matter.

Background

PG&E filed this application in May 2006 seeking approval of a program that would permit PG&E to recover the cost of gas hedging in rates. PG&E proposes to recover the costs dollar-for-dollar without including the costs in its Core Procurement Incentive Mechanism (CPIM) and without being subject to retroactive reasonableness review. PG&E's application does not present a specific plan for hedging but seeks approval of an annual process for receiving that authority. The Commission has already approved PG&E's proposals for purchasing hedging instruments during the 2005-2006 and the 2006-2007 winter seasons in D.05-10-015 and D.06-08-027. These orders encouraged PG&E to purchase hedging instruments and approved confidential treatment of its purchasing plans. The effect of these decisions was to give prior approval to a detailed hedge plan with the goal of protecting utility gas rates from increases due to price spikes in wholesale gas markets.

The subject application seeks authority to purchase gas hedges for seven years following a pre-approval of its annual plan by way of an annual expedited advice letter process. PG&E's proposal would permit it to spend ratepayer funds on hedging instruments. Ratepayers would assume all costs of these purchases and receive all of the benefits in terms of stable rates. That is, these purchases would be accounted for outside the CPIM, which imposes some risk on and provides some rewards to PG&E depending on whether PG&E gas purchases are more or less expensive than a market-based benchmark. In these ways, this application is similar to PG&E's proposals adopted in D.05-10-015 and D.06-08-027. PG&E's proposal in this application differs from those past proposals in that it anticipates a collaborative review process with non-utility parties to agree to an annual hedging purchasing plan and to forego an application process in favor of an expedited advice letter process. PG&E's application does not seek approval of a specific plan for the 2007-2008 winter season or any other.

DRA filed a protest to PG&E's application. The Commission subsequently held a prehearing conference at which several parties stated their intent to participate in the proceeding to address concerns they have regarding PG&E's proposal. The Commission issued a scoping memo and ruling on August 30, 2006.

PG&E, DRA, TURN and Aglet subsequently engaged in settlement discussions and filed a motion to adopt settlement on December 20, 2006. Lodi Gas Storage, Inc. (LGS) opposes the settlement, as does the School Project for Utility Rate Reduction and ABAG Public-Owned Energy Resources (jointly, SPURR). The Commission held an evidentiary hearing on February 14, 2007, at which SPURR and LGS cross-examined a panel of witnesses who signed the settlement. The ALJ determined that portions of the settlement are confidential and were entered into the record of the proceeding under seal.

The parties filed opening briefs on March 9, 2007. The brief filed jointly by the settling parties included an appendix titled "Report by Dr. Charles R. Plott," which was submitted by Southern California Edison Company in R.01-010-024. This appendage to the brief is extra-record evidence that addresses matters of substantial controversy in this proceeding. It should not have been filed and its contents are stricken and not considered part of the record in this proceeding. The parties filed reply briefs on March 19, 2007, at which time the matter was submitted.

Scope of Proceeding

In the scoping memo issued in this proceeding, the Commission found that the scope of this proceeding would include all issues raised by PG&E's application, including how the proposal might affect or be affected by other regulatory decisions the Commission may wish to make regarding energy procurement. The Commission said it would not consider broader issues relating to alternatives to hedging, such as the utility's purchase of gas through long-term contracts. The parties could, however, address how adopting PG&E's proposal might affect such options as the use of long-term contracts. Other topics that are appropriate for consideration in this proceeding include:

- The benefits to ratepayers of a long-term hedging program;
- The annual amount that PG&E should be authorized to spend and recover from its ratepayers for a multi-year hedging program;
- The amount of gas demand that should be hedged on a long-term basis;
- Whether the Commission should conduct ex-post reviews of hedging activities and the applicable sanctions;
- How PG&E's shareholders and ratepayers should share the costs and benefits of a long-term hedging program;
- Whether hedging core gas demand on a long-term basis is or is not compatible with PG&E's CPIM;
- Whether PG&E's current CPIM should be modified to encourage optimal amounts of hedging;
- The types of financial hedging products that are appropriate for a long-term hedging program;
- How to assure PG&E's long-term hedging program is cost-effective and will produce just and reasonable rates for its ratepayers;
- Whether the Commission should adopt standards concerning the creditworthiness of the counterparties from whom PG&E will purchase its financial hedges;
- Whether PG&E should be allowed to account for hedging costs both within and outside its CPIM;
- How the costs of a long-term hedging program can be recovered from PG&E's ratepayers; and
- Whether PG&E's long-term hedging plans should be confidential.

At the evidentiary hearing, the ALJ inquired of the settling parties as to whether the Commission could lawfully modify the CPIM with the notice it had provided. The scoping memo includes this issue as one that may be addressed in this application. Additionally, PG&E served the application on the parties to R.04-01-025, which includes virtually every party involved in Commission regulation of natural gas utilities. For these reasons, the Commission may lawfully modify the CPIM as the parties propose here.

Settlement Terms

The settlement proposes the following resolution of issues:

Long-Term Core Hedge Program

Financial hedges would be undertaken on a rolling three-year basis via an Annual Plan filing. There will be five Annual Plan filings beginning with the 2007/2008 winter season that will authorize a hedge plan for the current winter season and the subsequent two winter seasons. Thus, the final Annual Plan (year five) will be filed for the 2011/2012 winter season and this plan will run through winter season 2013/2014. Starting in 2009, if any member of the Advisory Group desires to change or modify the program, it can require PG&E to file before the Commission an application or other filing vehicle to continue, modify or terminate the program.

All gains and losses associated with hedging purchases under an approved annual plan would be accounted for outside the CPIM, with all costs and benefits flowing directly and entirely to PG&E's core gas customers. Although PG&E will continue to have authority to transact limited amounts of hedging under the CPIM, 100% of the hedges under an approved annual plan will be accounted for outside the CPIM. Energy Division would have authority to pre-approve an Annual Plan every year by way of an expedited advice letter. The Annual Plan would not be public and would be submitted confidentially. The Commission would agree to conduct no retroactive reasonableness review. The Energy Division would conduct compliance reviews at the beginning and end of the hedge season. This process would be authorized through the winter of 2012-2013 unless PG&E files for authority to retain the program by June 30, 2011 and the Commission approves it by March 31, 2012.

The settlement would also create a "Core Hedging Advisory Group" comprised of PG&E, DRA, Aglet and TURN. The advisory group would meet quarterly to confer about the Annual plans and related hedging operations. PG&E's annual plan would be filed with the Commission following consultation with the advisory group. The advisory group would oversee a market assessment study to determine the risk preferences of PG&E's core procurement customers, which PG&E's ratepayers would fund. Aglet's and TURN's work in the advisory group would be eligible for intervenor compensation.

Modifications to the CPIM

The settlement would also modify the CPIM, which rewards PG&E when its gas purchases are less costly than a market benchmark, and penalizes PG&E when its gas purchases are more expensive than the benchmark. The settlement would modify the CPIM to provide that PG&E may account for any and all hedging activities outside the CPIM.

The settlement would modify the CPIM to provide slightly more benefits to ratepayers in the event that PG&E purchases gas for less than the lower range of the tolerance band. This would be accomplished by assigning a 20% share of savings to shareholders and 80% to ratepayers. Currently, the CPIM assigns 25% of savings to shareholders and 75% to ratepayers. The CPIM would be modified in other ways that DRA believes represent a reasonable "re-adjustment of the balance between shareholder and customer benefits," as follows:

- The current 2.5 Bcf of unsequenced storage withdrawal adjustment would be eliminated, that is, re-included proportionately in the storage withdrawal sequence;
- A firm block of 100 Mdth from the San Juan basin and 100 Mdth from AECO will be the first gas sequenced;
- Five percent of the savings from full tariff rates on any pipeline or storage contracts negotiated on behalf of core customers would offset CPIM gas costs;
- Daily swing purchases currently valued in the benchmark calculation using the NGI daily Topock index will be switched to the NGI daily PG&E Citygate index; and
- If storage is acquired via the Incremental Storage Capacity Request for Offers, the daily benchmark sequence would be adjusted to accommodate the incremental storage injection and withdrawal in a manner that provides all costs and benefits to core customers.

DRA believes these changes present tangible benefits to ratepayers. The potential financial impact of these changes on ratepayers and shareholders is not included in the record of the proceeding.

Pipeline Capacity Provisions

The settlement includes an agreement by DRA and TURN not to oppose certain changes that PG&E intends to make with respect to pipeline capacity holdings on behalf of PG&E's core customers. These proposed changes are not issues in this proceeding.

Consumer Risk Tolerance Study

The parties propose that the Advisory Group determine whether to conduct a study that would measure utility customers' willingness to pay to mitigate gas rate volatility.

In their joint post-hearing brief, the settlement parties state the settlement is reasonable, consistent with the law and in the public interest. They explain that a hedging program is needed to protect PG&E's core gas customers from excessive winter gas bills and refer to past Commission decisions that articulate support for gas hedging programs. They explain that the program should not be administered as part of the CPIM program because a "misalignment" of customer and shareholder interests would result. That is, shareholders might benefit in the event that pricing increased and hedges offset the impact.

The settling parties also strongly advocate for a program that is confidential because PG&E's hedging strategies will be "commercially-sensitive." Disclosing them, according to the settling parties, would compromise the interests of protect ratepayers.

The parties state that hedging is a form of insurance against price shocks.

Most settlement terms conform to the proposal PG&E put forth in its application. PG&E's application does not include some of the proposals included in the settlement, namely, changing the elements of the CPIM, intervenor compensation and participation in future pipeline capacity proceedings. Because the settlement would adopt the essential elements of PG&E's original proposal, we address only the settlement here. Resolution of settlement issues implicitly resolves the elements of PG&E's original proposal.

As SDG&E and SoCalGas observe in their briefs, the terms of this settlement, and the Commission's corresponding order, would apply only to PG&E.

Protests By LGS and SPURR

LGS and SPURR oppose the settlement. LGS does not oppose the utility's plans to purchase hedging instruments but raises concerns about the terms of the settlement. It proposes that instead of allowing PG&E to purchase hedges outside the CPIM, it should modify the CPIM in ways that provide adequate incentives for PG&E to make wise decisions about hedging and account for them within the CPIM. It objects to what it refers to as a "Cone of Silence" under which all hedging information would be confidential and would require that hedging plans be submitted as applications rather than as expedited advice letters. Finally, it would broaden the scope of the proposed study to include alternatives to financial hedging as protections from price spikes.

SPURR mainly raises concerns about the confidential nature of all aspects of this proceeding and future hedge purchases, as the settlement would permit them. SPURR believes secrecy undermines public accountability for an activity for which it assumes no risk. The protections PG&E would receive from the standpoint of public relations come at a high cost to ratepayers, according to SPURR, because ratepayers will never have information about how their funds are spent.

Discussion

The settlement agreement before us establishes a long-term gas hedging program on behalf of PG&E's core gas procurement customers. The settlement agreement is signed by PG&E, as well as by those parties who represent the interests of core gas customers—DRA, TURN and Aglet. LGS and SPURR oppose the settlement agreement.

The Commission earlier approved PG&E's proposals for purchasing hedging instruments during the 2005-2006 and the 2006-2007 winter seasons in

Decisions (D.) 05-10-015 and D.06-08-027. These orders encouraged PG&E to purchase hedging instruments and approved confidential treatment of its hedging plans. We found that it was in the best interests of ratepayers for PG&E to take proactive steps to mitigate natural gas prices. Nothing has changed. The effect of these decisions was to give prior approval to a detailed hedge plan with the goal of protecting utility gas rates from increases due to price spikes in wholesale gas markets.

We find the settlement agreement presented to us is substantially similar to the core gas hedging plans we have already approved. In D.05-10-015, we encouraged PG&E to file for authority to adopt a long-term hedging plan. Taking this cue, PG&E filed the instant proceeding and the subsequent settlement agreement. The settlement agreement seeks authority to purchase gas hedges for seven years following a pre-approval of its annual plan by way of an annual expedited advice letter process. Ratepayers would assume all costs of these purchases and receive all of the benefits in terms of stable rates. The settlement agreement includes a collaborative review process with non-utility parties to review the annual hedging purchasing plan and to forego an application process in favor of an expedited advice letter process.

The settlement agreement calls for an annual budget for options and the authority to hedge with swaps for a certain level of coverage. In testimony presented by PG&E, PG&E states that it will be purchasing "call options on monthly indexes for natural gas traded in over-the-counter markets" and "fixed-for-floating swaps." We expect that the settlement agreement we are authorizing today will be consistent with PG&E's testimony.

The budget for options contained in the settlement agreement is less than we previously authorized in D.06-08-027 for the 2006/2007 winter season. The physical amount of gas allowed to be hedged through the use of swaps is less than that authorized under D.06-08-027 and the notional value (volume of gas multiplied by the swap price) of these swaps will be less than that previously authorized.

D.06-08-027 authorized PG&E to spend up to $14 per core customer for the 2006/2007 winter season. This cost cap did not apply to swaps. Our review of the settlement agreement leads us to conclude that the per customer impact of the settlement agreement should be approximately equal to that previously authorized.

The settlement agreement contains a provision that requires PG&E, in consultation with the advisory group and the Commission's Energy Division about conducting a market assessment study regarding the risk preferences of PG&E's core gas customers. If the Advisory Group determines that such a study is warranted, then PG&E shall contract for a study to be performed by March 30, 2009. The goal is to determine the dollar amount core customers might be willing to spend on hedging to mitigate the impacts of commodity price volatility. We welcome the results of this study and believe it will be useful in our future deliberations.

Rule 12.1(d) of the Commission's Rules of Practice and Procedure holds that the Commission will not approve settlements, whether contested or uncontested, unless they are reasonable in light of the whole record, consistent with law, and in the public interest. We find that the settlement agreement filed by PG&E, DRA, TURN and Aglet meets these criteria.

The settlement agreement's key features conform with recent decisions adopted by the Commission authorizing hedging for the gas utilities (D.05-10-015, D.05-10-043 and D.06-08-027). The annual budget, the types of instruments proposed to be used, and the winter program focus are substantially similar to previously authorized plans. This assures us that the agreement is both consistent with the law and is reasonable.

The parties who most commonly represent PG&E's core procurement customers are signatories to the settlement agreement. This gives us assurance that ratepayers' interests will be protected. While protests to the settlement were filed by LGS and SPURR, neither party opposes hedging per se, nor the proposed changes to CPIM. Instead these parties question the confidential treatment of the hedging program, the advice letter approval process for it, and membership in the hedging advisory group. We find it in the public interest to protect core ratepayers from volatile natural gas prices. We find the settlement proposes a reasonable process to give core ratepayers' representatives meaningful opportunity to review and, if necessary, protest PG&E's annual hedging plans.

We conclude that the settlement agreement is in the public interest.

The advisory group proposed by the settlement would be comprised of TURN, DRA and Aglet. The stated purpose of the group is to advise PG&E about its annual hedging plans. Membership in the advisory group shall be limited to non-market participants who represent the interests of PG&E's core gas customers. Additional members beyond the initial membership shall be subject to approval by PG&E.

The creation of an advisory group does not require our approval. We applaud PG&E desire to promote a collaborative working relationship with consumer advocates. Neither would our approval of an advisory group change the statutory requirements regarding intervenor compensation. The settlement states that the Commission should find "that participation in the Advisory Group makes a significant contribution to effective implementation of the

Commission's decision." Section 1801 *et seq.* governs the Commission's intervenor compensation program. The statute requires that an intervenor demonstrate a "significant contribution" to a Commission "order or decision." Parties must demonstrate that their participation meets the requirements of the statute in order to qualify for compensation.

PG&E has made a plausible argument for confidentiality in the case of specific plans for hedging investments. If its hedging plans were to be disclosed, the disclosure may compromise PG&E's negotiating leverage, which the Commission has recognized in recent decisions. We agree. The authority granted to PG&E in today's decision must be implemented in a manner consistent with the confidentiality provisions of D.06-06-066 as modified by D.07-05-032. The IOU Matrix attached to D.06-06-066 as Appendix 1 provides that long-term gas hedging plans shall be treated as confidential for three years. The redacted settlement agreement is attached to this order as "Attachment A."

Conclusion

This order resolves PG&E's application by approving the settling parties' motion to approve the settlement filed in this proceeding.

Comments on Alternate Proposed Decision

The draft alternate proposed decision of President Peevey in this matter was mailed to the parties in accordance with Pub. Util. Code § 311(d) and Rule 77.1 of the Rules of Practice and Procedure. Comments were filed on May 28, 2007 by PG&E, Aglet, TURN, DRA, Coral Energy Resources and SPURR. Reply comments were filed five days later by Coral Energy Resources, PG&E, DRA, TURN and Aglet. To the extent changes were necessary as a result of the filed comments, they were made in the body of this order.

Assignment of Proceeding

President Michael R. Peevey is the assigned Commissioner in this proceeding and Kim Malcolm is the assigned Administrative Law Judge.

Findings of Fact

1. The settlement agreement is in conformance with Rule 12.1(d) of the Commission's Rules of Practice and Procedure.
2. The settlement agreement's key features conform to recent Commission decisions authorizing natural gas hedging for the gas utilities.
3. The settlement agreement includes a collaborative review process with non-utility parties—DRA, TURN and Aglet—and review by the Commission's Energy Division.
4. It is in the best interests of ratepayers for PG&E to take proactive steps to mitigate natural gas prices.
5. The annual hedging budget contained in the settlement agreement is less than we previously authorized in D.06-08-027.
6. The physical amount of gas allowed to be hedged through the use of swaps is less than that authorized under D.06-08-027.
7. The per customer impact of the settlement agreement should be approximately equal to that previously authorized in D.06-08-027.
8. The public disclosure of PG&E's hedging plans would compromise the utility's negotiating leverage.
9. The creation of a Core Hedging Advisory Group does not require our approval.
10. The statutory requirements regarding intervener compensation apply.
11. LGS and SPURR oppose the settlement agreement, but do not oppose gas hedging per se.

12. Issues relating to pipeline capacity and future undocketed proceedings are outside the scope of this proceeding.

13. In D.05-10-015, D.05-10-043, and D.06-08-027, the Commission stated that a review of the gas utilities' incentive mechanisms and the treatment of hedging under them would be a useful exercise.

Conclusions of Law

1. The settlement agreement is reasonable in light of the whole record, consistent with law, and in the public interest.

2. The settlement agreement should be approved.

3. The Commission does not need to approve of the creation of an advisory group or other collaborative procedures.

4. Intervenors must demonstrate that they have met the requirements of Section 1801 *et seq.* in order to receive compensation for their work in Commission proceedings.

5. The parties have justified the need for hedging plan confidentiality.

6. The annual hedging plans should be treated as a long-term gas hedging plan in a manner consistent with the confidentiality provisions of D.06-06-066 as modified by D.07-05-032.

7. The decision should be effective immediately so that PG&E may begin implementation of its hedging plan for the upcoming winter season.

8. Application 06-05-007 should be closed.

9. The Commission should issue an Order Instituting Rulemaking addressing the gas utilities' incentive mechanisms and the treatment of hedging under those incentive mechanisms within 180 days of the effective date of this decision.

IT IS ORDERED that:

1. The Motion for Approval of Settlement filed by Pacific Gas and Electric Company (PG&E), Division of Ratepayer Advocates (DRA), The Utility Reform Network (TURN), and Aglet Consumer Alliance is approved.

2. PG&E's annual gas hedging plans shall be treated as a long-term gas hedging plan in a manner consistent with the confidentiality provisions of D.06-06-066 as modified by D.07-05-032.

3. The Commission shall issue an Order Instituting Rulemaking addressing the gas utilities' incentive mechanisms and the treatment of hedging under those incentive mechanisms within 180 days of the effective date of this decision.

4.Application 06-05-007 is closed.

Dated June 7, 2007, at San Francisco, California.

MICHAEL R. PEEVEY
President
DIAN M. GRUENEICH
JOHN A. BOHN
RACHELLE B. CHONG
TIMOTHY ALAN SIMON
Commissioners

I will file a concurrence.

/s/ TIMOTHY ALAN SIMON
Commissioner

Commissioner Timothy Alan Simon, concurring on 31a:

I support the alternate decision of Commissioner Peevey, which approves PG&E's Long-Term Core Hedge Program for Natural Gas Supplies. My judgment is largely based upon the need to protect ratepayers from the risk of excessively high winter gas bills caused by market fluctuations of natural gas prices. The subject hedging strategies were created after the tragic experience of Hurricane Katrina, hence it is prudent to employ such measures.

I am encouraged that DRA, TURN, Aglet, and PG&E have agreed to a settlement of this matter. It is rare that PG&E, DRA, TURN, and Aglet can all agree that a particular policy is in the interest of both ratepayers and the utility.

I also believe that at some point we need to incorporate incentive-based policies into our entire regulatory program. Going forward, I urge this Commission to incorporate performance incentives into all regulatory programs, including financial programs like this. I look forward to the Order Instituting Rulemaking (OIR), now promised in today's order, which will investigate the utilities' performance-based incentive programs broadly, and the issue of hedges specifically.

Finally, I see this program as a prime opportunity for PG&E to meet its supplier diversity goals articulated in General Order (GO) 156. Under GO 156, utilities are encouraged to contract 15%, 5%, and 1.5% for minority-owned, women-owned, and disabled veteran-owned enterprises (WMDVBEs). Furthermore, PG&E has partnered with the Greenlining Institute to take these goals one step further and make a good faith effort to have 20% of all contracts with minority firms by 2010, and increase this goal to 27% by 2015.

In the Commission's 2005 Report to the Legislature reviewing our progress in supplier diversity, we acknowledged that more targeted procurement is needed in the area of financial services. We stated that "Each utility shall make special efforts to increase utilization and encourage entry into the marketplace of WMDVBEs in product or service categories where there has been low utilization of WMDVBEs, such as legal and financial services, fuel procurement, and areas that are considered technical in nature."

There are clearly people with diverse backgrounds, talent, and relevant experience who work in the financial services industry. I urge PG&E to embrace this financial hedge program as an opportunity to contract with more diverse firms within the financial services industry.

In summary, I recognize the importance of having a long-term plan in place today and therefore support PG&E's gas hedging program. It will benefit ratepayers and the utility and protect all Californians against volatile natural gas prices.

/s/TIMOTHY ALAN SIMON
TIMOTHY ALAN SIMON
Commissioner

San Francisco, California
June 7, 2007