BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Determine Issues Relating to the California Utilities' Procurement of Natural Gas Supplies from Liquefied Natural Gas Sources.	FILED PUBLIC UTILITIES COMMISSION NOVEMBER 1, 2007 SAN FRANCISCO, CALIFORNIA RULEMAKING 07-11-001

ORDER INSTITUTING RULEMAKING TO DETERMINE ISSUES RELATING TO THE CALIFORNIA UTILITIES' PROCUREMENT OF NATURAL GAS SUPPLIES FROM LIQUEFIED NATURAL GAS SOURCES

1. Summary

This Order Instituting Rulemaking (OIR) will examine issues relating to whether and how the largest California utilities should enter into procurement contracts for natural gas from Liquefied Natural Gas (LNG) suppliers on the West Coast.[1] The purpose of this OIR is to help ensure that there will be adequate supplies of natural gas at reasonable prices to meet California's long-term needs.

[1] Our reference to "LNG suppliers" is a general reference to entities selling natural gas derived from LNG, such as a marketer selling such natural gas at the California border. Our reference to the "West Coast" is a general reference to the West Coast of Baja California, Mexico, California, Oregon, Washington, and British Columbia, Canada. We do not express herein any preference for any particular proposed LNG facility on the West Coast. In addition, we do not express any judgment herein as to how many LNG terminals on the West Coast may be necessary.

We will examine under what circumstances the large California utilities should enter into specific, long-term procurement contracts with LNG suppliers. Alternatively, the utilities could purchase natural gas from marketers regardless of whether or not any of the natural gas comes from LNG supplies.[2] In analyzing these issues, we will examine whether, through long-term procurement contracts for natural gas from LNG suppliers, the California utilities can ensure the reliability of the LNG-sourced natural gas and that their ratepayers will receive economic benefits from these contracts. Finally, considering that certain of the California utilities have affiliates in the LNG business or with a financial interest in a particular LNG project, we will examine the process under which those California utilities may request proposals for LNG-supplied procurement contracts and the procedures under which we will decide whether or not to pre-approve the California utilities' procurement contracts.

In the present rulemaking, the Commission is naming as Respondents the following California utilities: Pacific Gas and Electric Company (PG&E), San Diego Gas & Electric Company (SDG&E), and Southern California Gas Company (SoCalGas). We are requiring them to respond to the issues set forth herein. PG&E and SDG&E should file comments addressing their potential procurement of LNG-sourced natural gas for their core natural gas customers' needs, and, in a separate section of their comments, for their electric generation needs. The Commission encourages Southern California Edison Company (SCE)

[2] Once LNG is regasified, it is like other natural gas and may be part of the supply portfolio of a marketer.

to address the pertinent issues herein in terms of its potential procurement of LNG-sourced natural gas. The Commission invites all other interested parties to file initial comments on the issues and/or reply comments to the initial comments of the California utilities and other parties.

2. Background

When our Commission and the California Energy Commission (CEC) adopted in 2003 the Energy Action Plan (EAP I), we stated that our goal was to:

> Ensure that adequate, reliable, and reasonably-priced electrical power and natural gas supplies, including prudent reserves, are achieved and provided through policies, strategies, and actions that are cost-effective and environmentally sound for California's consumers and taxpayers.
>
> EAP I at p. 2.

To meet California's energy needs, EAP I envisioned a "loading order:" First, we should optimize all strategies for increasing conservation and energy efficiency to minimize increases in electricity and natural gas demand. Second, for new generation, we should maximize the use of renewable energy resources and distributed generation. Third, because the preferred resources require both sufficient investment and adequate time, we should rely upon additional clean, fossil fuel, central-station generation. Natural gas is the cleanest fossil fuel, and, therefore, California is very dependent upon it for fuel for electric generation, industry and agriculture, as well as for residential and commercial use (such as heating homes and businesses.)

California's significant energy efficiency and conservation efforts and increasing reliance on renewable energy sources have in the past and will in the future limit increases in demand for natural gas in California. Nevertheless, we

recognize that the out-of-state natural gas producing basins in North America, which supply most of the natural gas to California,[3] also supply natural gas to the other States, as well as Canada and Mexico. Therefore, California is affected by the overall demand for natural gas in North America and the sufficiency of supply to meet that demand. A shortage of natural gas supplies in California or throughout North America could result in curtailments and have substantial effects on the price of natural gas and electricity in California.

On December 9–10, 2003, our Commission and the CEC jointly sponsored a two-day workshop entitled "Natural Gas Market Outlook 2006-2016," in which the undisputed data and presentations established that North American production of natural gas could not keep up with the forecasted demand for natural gas in North America. Therefore, many of the participants supported the need for LNG facilities on the West Coast.

On January 22, 2004, the Commission issued an OIR in Rulemaking (R.) 04-01-025 (January 2004 OIR) to ensure reliable, long-term natural gas supplies to California at reasonable rates. In the January 2004 OIR at p. 7, we noted that with the exception of the natural gas producing basins in the Rocky Mountains, the forecasts indicated decreasing production and declining proven reserves in most of the producing basins in the United States. In addition, Canadian imports were projected to be sharply lower. We relied upon the data from the workshop and official reports by the United States Department of

[3] More than 85 % of the natural gas consumed in California is imported from out-of-state producing basins and transported over interstate pipelines to California.

Energy's Energy Information Administration (EIA) and Canada's National Energy Board (NEB) in finding that there was a need for LNG supplies.

In Phase I of R.04-01-025, we issued Decision (D.) 04-09-022, which, among other things, ordered the California natural gas utilities to provide open access to new supplies of natural gas from LNG terminals. In D.04-09-022 at p. 23, we also recognized that Sempra LNG, an affiliated company of SoCalGas and SDG&E, has been developing an LNG import terminal in Baja California, Mexico, and that other Sempra affiliates operated the pipelines in Baja California, Mexico and would market natural gas from that import terminal. We, therefore, found in D.04-09-022 that it was necessary to have the Commission review the utilities' plans for entering into LNG-related procurement contracts. (*Id.* at 40-41.) Since that time, a PG&E affiliate has entered into an agreement, wherein it would have equity interest in a proposed interstate pipeline, known as the Pacific Connector Gas Pipeline, which would transport LNG-supplied natural gas from a proposed LNG import terminal in Coos Bay, Oregon to Northern California.[4] Sponsors of the Pacific Connector Gas Pipeline and the LNG import terminal have just recently applied for certificate authority from the Federal Energy Regulatory Commission.[5]

The Commission's and CEC's Energy Action Plan II, issued in October, 2005 (EAP II), found that "California must also promote infrastructure enhancements, such as pipeline and storage capacity, and diversify supply

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[4] *See* PG&E Corporation's April 12, 2006 press release at http://www.pgecorp.com/news/press_releases/Release_Archive2006/060412press_release.shtml

[5] See 72 Fed. Reg. 53549 (September 19, 2007).

sources to include liquefied natural gas (LNG)." EAP II at 12-13. In D.04-09-022, we had addressed the procedures for the utilities to seek pre-approval of contracts for interstate pipeline capacity, which will continue to be essential for supplying California with most of its natural gas supplies. In the present OIR, we will address the process for seeking pre-approval of the natural gas utilities' procurement contracts with LNG suppliers. Although the present OIR is focused primarily upon LNG supply related issues, nothing in this OIR should be interpreted as relieving the California natural gas utilities' obligation to have sufficient firm capacity rights on interstate pipelines to meet their customers' needs. Moreover, the Commission is fully committed to the other policies in EAP I and EAP II, including diversification of supplies to include more natural gas from the producing basins in the Rocky Mountains, the enhancement of infrastructure with additional storage facilities, and the loading order's priorities of promoting energy efficiency, conservation and renewable energy sources. These other matters are being addressed or will be addressed in other proceedings.

The Commission's current concerns about the adequacy of long-term natural gas supplies are heightened based upon the EIA's February, 2007 report entitled "Annual Energy Outlook 2007" (AEO2007)[6] and the CEC's North American Natural Gas Review (NANGR), a report recently prepared by the

[6] The 10-page AEO2007 can be found on the EIA's website at: http://www.eia.doe.gov/oiaf/aeo/gas.html

CEC's staff and presented at the California Natural Gas Stakeholders Working Group Meeting at the CEC on September 6, 2007.[7]

The EIA forecasts, among other things, the following:

- "Total natural gas consumption in United States will increase from 22 trillion cubic feet in 2005 to 26.1 trillion cubic feet in 2030" (AEO2007 at 1);
- "Much of the growth is expected before 2020, with demand for natural gas in the electric power sector growing from 5.8 trillion cubic feet in 2005 to 7.2 trillion cubic feet in 2020" (AEO2007 at 1);
- "With U.S. natural gas production remaining relatively constant, imports of natural gas are projected to rise to meet an increasing share of domestic consumption" (AEO2007 at 6);
- "Most of the expected growth in U.S. natural gas imports is in the form of LNG" (AEO2007 at 6); and
- "net imports of natural gas from Canada are projected to fall from 3.3 trillion cubic feet in 2005 to 1.2 trillion cubic feet in 2030." (AEO2007 at 7.)

The CEC's NANGR forecasts that just over the next 10 years, there will be an increase in North American natural gas demand from approximately 70,000 million cubic feet per day (MMcf/d) to approximately 88,000 MMcf/d. (NANGR at 8), and it relies upon LNG on the West Coast to help meet the increase in North American demand. (NANGR at 15.) In analyzing the EIA's AEO2007 forecast in the increase in U.S. power generation demand for natural gas, the CEC's NANGR observes that the EIA's forecasted increase from 2010 to 2017 is underestimated. (NANGR at 13.)

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[7] The CEC's report was one of the reports that can be found on the CEC's website at: http://www.energy.ca.gov/naturalgas/index.html#090607

The CEC's NANGR further points out that in each of the past five years, the EIA has substantially decreased its forecast for North American production available to the U.S. from the EIA's forecast from the previous year. (NANGR at 37). This is very significant considering that when we issued the January 2004 OIR, we relied, in part, upon the EIA's Annual Energy Outlook 2004, in determining the need for LNG. Thus, the EIA's forecast for North American production available to the U.S. has decreased in each of the three annual reports it has issued since the time that we issued our January 2004 OIR.

These reports add to our concern as to the adequacy of future natural gas supplies and the potential effects they may have on energy prices. The Commission has the power and the obligation under Article XII, Section 6 of the California Constitution and Sections 451, 701 and 761 of the California Public Utilities Code to actively supervise and regulate natural gas public utilities in California and to do all things which are necessary to ensure adequate and reliable public utility service to California ratepayers at just and reasonable rates. (*See Camp Meeker Water System, Inc. v. Public Utilities Com.* (1990) 51 Cal. 3d 850, 861-862; *Sale v. Railroad Commission* (1940) 15 Cal.2d 607, 617.) Pursuant to this authority, the Commission is instituting this rulemaking proceeding to help ensure that California has access to adequate supplies of natural gas at a reasonable price.

3. Issues in this OIR

We require the California utilities, which are Respondents herein, to address the following matters, and we invite all interested parties to address these matters, respond to the utilities' comments and/or otherwise participate in this proceeding. We specifically encourage SCE to participate and address the

pertinent issues in terms of its potential procurement of LNG-sourced natural gas.

3.1. Specific, Long-Term Procurement Contracts with LNG Suppliers

Presently, California utilities procure natural gas from producers and marketers either in producing basins or at some other market center (e.g., the California border at Topock). So long as the natural gas meets the natural gas utilities' quality specifications and the utilities' terms and conditions (e.g., favorable price, quantity, and length of commitment), the utilities may be indifferent to the actual source of the supply of the marketer.

LNG supplies compete on a global basis. As the EIA reported, "the U.S. LNG market is expected to be tight until 2012, because of supply constraints at a number of liquefaction facilities, delays in the completion of new liquefaction projects, and rapid growth in global LNG demand." (AEO2007 at 6.) Therefore, in light of the tight LNG supply, the Commission requests comments upon whether or not Respondent utilities should enter into specific, long-term procurement contracts with LNG suppliers.

We are particularly interested in commenters addressing issues relating to whether or how California ratepayers can benefit from long-term procurement contracts with LNG suppliers and whether such contracts can be negotiated to guarantee reliable gas supplies at a reasonable cost. Or, alternatively, would California ratepayers benefit more by allowing the utilities to continue to purchase natural gas from marketers without regard for whether the supply is domestic or LNG?

In terms of reliability, we have the following questions: If some supply sources are expected to be more reliable than others, can or should long-term

procurement contracts for LNG-derived gas identify and dedicate the supply source? Can or should the long-term procurement contracts prohibit or limit the diversion of the LNG supply to other markets? Can or should the long-term procurement contracts narrowly define and limit the *force majeure* events or provide that the supplier is responsible for providing alternative supplies to the extent there is a *force majeure* event? What other reliability-related issues need to be considered in a long-term procurement contract for LNG? What will the likely price impact be of including terms and conditions that increase the reliability of LNG supply?

In terms of economic benefits to its customers, we have the following questions: Can we determine in this OIR that long-term procurement contracts between utilities and LNG suppliers have the potential to be economically beneficial to the utilities' ratepayers relative to long-term contracts for other supplies of natural gas or spot market purchases of LNG? Can fixed prices or indices tied to market centers in the U.S. be used in the long-term procurement contracts? Since current LNG prices substantially exceed those of domestic natural gas at present, would it be more appropriate to consider long-term procurement at some later time? Should California simply await the convergence of domestic and international prices before engaging in long-term contracting, either for LNG or domestic supplies?

We are raising these issues to generally explore issues that are likely to arise if California utilities propose to enter into long-term procurement contracts with LNG suppliers. Obviously, the reliability and economic benefits would turn on the details of the procurement contracts themselves, which would have to be reviewed in the pre-approval process.

3.2. The Pre-Approval Process

In D.04-09-022 at p 40-41, the Commission found that it was necessary to have the Commission review the utilities' plans for entering into LNG-related procurement contracts. We also recognized in D.06-12-029 at pp. 19 and 25, that certain California utilities have affiliates in the LNG business, and it was necessary for the Commission to ensure that the utilities do not discriminate in favor of their affiliates and foreclose a potentially better supply arrangement.

As discussed above, SoCalGas and SDG&E have affiliates, which are constructing an LNG terminal in Baja California, Mexico, expanding pipelines in Baja California, Mexico to transport natural gas from that terminal, and planning to market natural gas from the LNG supply after it is regasified at that terminal. PG&E also has an affiliate with an economic interest in a proposed pipeline from a proposed LNG terminal in Coos Bay, Oregon.

It would be contrary to the above-mentioned decisions and the rules accompanying D.06-12-029, if the Respondent utilities provided any preferential treatment for their affiliates. On the other hand, if their affiliates or marketers utilizing their affiliates' facilities offer the best supply arrangement, we would not want to preclude the utilities from obtaining these benefits for their ratepayers. We request comments upon the following issues concerning the process of entering into LNG procurement contracts.

3.2.1. The Solicitation of Offers for LNG-Sourced Natural Gas

What is the fairest procedure for the Respondent utilities to pursue for soliciting offers from LNG suppliers? In this regard, we would welcome comments upon the type of procedure, how it should occur and the timing of when it should occur, considering that LNG terminals cannot be constructed or

expanded until they meet the environmental, public health and safety requirements or standards of the licensing authorities. If a utility solicits offers for LNG-derived gas supplies, should the solicitation also request bids for natural gas supplies from other sources under comparable terms and conditions? Which procedure is most likely to result in beneficial procurement contracts for the utilities' ratepayers?

3.2.2. The Pre-Approval of the Contracts

Should we follow the same procedures that we typically use for interstate pipeline contracts, where the Respondent utilities confidentially inform the Division of Ratepayer Advocates (DRA), The Utility Reform Network (TURN) and Energy Division about the utilities' plans and efforts in advance of entering into a contract? Should the utilities file advice letters for pre-approval of the procurement contract?

The Commission would benefit from comments on each of the issues stated in this Section 3, but we do not seek comments on LNG in general. We will not be choosing LNG projects or approving specific LNG procurement contracts with any particular supplier in this proceeding. This OIR is narrowly focused upon the LNG-related procurement contract issues. This has been an open matter ever since the time that we issued the January 2004 OIR.

4. Preliminary Scoping Memo: Category of Proceeding

Rule 7.1(d) of our Rules of Practice and Procedure provides that an OIR "shall preliminarily determine the category and need for hearing, and shall attach a preliminary scoping memo." This OIR is preliminarily determined to be "ratesetting," as that term is defined in Rule 1.3(e). Objections to the preliminary categorization of this rulemaking as "ratesetting" shall be filed no later than 10 days after the issuance of this rulemaking.

It appears that there may not be material factual disputes on these issues, which are policy and process issues. Therefore, we expect to decide this matter based upon a written record, with no evidentiary hearing. If warranted by the written comments, the assigned Commissioner or Administrative Law Judge (ALJ) can issue a ruling governing any subsequent procedures after the initial and reply comments are filed.

The scope of this OIR is to (1) provide guidelines over whether and how the Respondent utilities should enter into procurement contracts with LNG suppliers; and (2) provide the process under which the Respondent utilities may seek pre-approval for the procurement contracts with LNG suppliers. These issues are discussed in greater detail in Section 3, above.

Respondents are required to file written comments on these issues. Interested parties, including SCE, are invited to file comments on these issues. Respondents and interested parties may file replies to the initial comments.

Pleadings shall conform to the requirements of Rules 1.5 and 1.6 and shall be filed with the Commission's Docket Office and served according to the schedule below.

5. Schedule

We adopt the following as the preliminary schedule, which may be changed, if necessary, by an assigned Commissioner Ruling or an ALJ Ruling:

OIR issued	November 1, 2007
Respondents' and Interested Parties' Initial Comments filed	January 24, 2008
Respondents' and Interested Parties' Reply Comments filed	March 20, 2008

6. Ex Parte Communications

Ex parte communications in this rulemaking are governed by Rule 8.2(c), Rule 8.3 and Rule 8.5.

7. Parties and Service List

PG&E, SDG&E and SoCalGas are named as respondents to this rulemaking. We serve this order on parties to Rulemaking (R.) 04-01-025.

We encourage broad participation in this rulemaking. Those persons served will not automatically be placed on the service list. Those who seek party status or wish to monitor this proceeding may do so by informing the Commission's Process Office (process_office@cpuc.ca.gov) of his or her intent to participate and providing the following information no later than November 20, 2007:

1. Name and organization represented, if any;
2. Address;
3. Telephone number;
4. E-mail address; and
5. Assignment to the party, state service, or information only category.

After the service list is established, persons may be added as parties as directed by the assigned ALJ. Any party that plans to request intervenor compensation for its participation in this rulemaking shall file its notice of intent to claim intervenor compensation no later than December 4, 2007.

All filings in this proceeding may be made electronically according to Resolution ALJ-188 and served consistent with Rule 1.10. Consistent with those rules, a hard copy of all pleadings shall be concurrently served on the assigned ALJ.

Any party interested in participating in this OIR, who is unfamiliar with the Commission's procedures, should contact the Public Advisor's Office in San Francisco at (415) 703-2074 or (866) 836-7825, or e-mail public.advisor@cpuc.ca.gov or in Los Angeles at (213) 576-7055 or (866) 849-8391 or e-mail public.advisor.la@cpuc.ca.gov.

IT IS ORDERED that:

1. A rulemaking is initiated on the Commission's own motion to provide guidelines over whether and how the Respondent California utilities should enter into procurement contracts with LNG suppliers, and to provide the process under which the Respondent utilities may seek pre-approval for the procurement contracts with LNG suppliers. These guidelines may also be applicable to LNG-related procurement contracts by other California utilities, as well.

2. California's largest natural gas public utilities, Pacific Gas and Electric Company (PG&E), San Diego Gas & Electric Company (SDG&E), and Southern California Gas Company (SoCalGas) are made Respondents to this proceeding. Southern California Edison Company (SCE) is encouraged to participate.

3. The Executive Director shall cause this Order Instituting Rulemaking (OIR) to be served on Respondents PG&E, SDG&E and SoCalGas. The Commission's Process Office shall serve this OIR on the service list for Rulemaking 04-01-025.

4. The Commission's Process Office shall create an initial service list based on the written requests received by November 20, 2007, and shall post this initial service list on the Commission's website no later than seven days thereafter. Parties may obtain the service list from the Commission's website www.cpuc.ca.gov or by contacting the Process Office at (415) 703-2021.

5. Any party that plans to request intervenor compensation for its participation in this rulemaking shall file its notice of intent to claim intervenor compensation no later than December 4, 2007.

6. Respondents PG&E, SDG&E and SoCalGas shall file, and other interested parties, including SCE, may file, initial comments responding to the issues set forth in Section 3 of this OIR. Comments shall conform to the requirements of the Commission's Rules of Practice and Procedure and initial comments shall be filed with the Commission's Docket Office and served no later than January 24, 2008. Reply comments responding to the initial comments shall be filed and served no later than March 20, 2008.

7. The category of this rulemaking is preliminarily determined to be "ratesetting" as that term is defined in Rule 1.3(e) of the Commission's Rules of Practice and Procedure. Objections to the preliminary categorization of this rulemaking as "ratesetting" shall be filed no later than 10 days after the issuance of this rulemaking.

8. The assigned ALJ, in consultation with the assigned Commissioner, may make any necessary adjustments to the schedule and service list for this proceeding.

9. *Ex parte* communications in this rulemaking are governed by Rule 8.2(c), Rule 8.3 and Rule 8.5.

This order is effective today.

Dated November 1, 2007, at San Francisco, California.

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