Decision **ALTERNATE DRAFT DECISION OF ALJ WEISSMAN**
(Mailed 9/28/2005)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Establish Policies and Rules to Ensure Reliable, Long-Term Supplies of Natural Gas to California.	Rulemaking 04-01-025 (Filed January 22, 2004)

ORDER MODIFYING DECISION 04-01-047 IN RESPONSE TO THE PETITION OF THE PACIFIC GAS AND ELECTRIC COMPANY

Summary

In response to events stemming from Hurricane Katrina, on September 13, 2005, Pacific Gas and Electric Company (PG&E) filed a petition requesting that the Commission authorize, on an emergency basis, a modification of Decision (D.) 04-01-047.[1] That decision, among other things, approved the current version of PG&E's Core Procurement Incentive Mechanism (CPIM). PG&E argues that emergency action is needed to protect its core gas customers from natural gas price spikes in the coming winter and in subsequent winters.

Core customers are residential, small business and other customers that have elected to purchase natural gas from PG&E. The CPIM rewards or penalizes PG&E based on its success in keeping its purchases of gas for core

[1] That decision was in Rulemaking (R.) 02-06-041. PG&E served its petition on the parties to that proceeding.

customers at or below a monthly market benchmark price. PG&E asserts that the requested modification would allow the company to undertake an expanded level of hedging of its natural gas purchases on behalf of its core gas customers. Hedging is a form of price insurance that, in this case, would guarantee that the price exposure of core customers for the hedged portion of core gas supply would not exceed a certain level. As is true with all insurance, there is a cost involved in obtaining this protection.

The day after PG&E filed its petition, the assigned administrative law judge issued a ruling setting an extremely expedited schedule for this matter. PG&E and other natural gas utilities had to file comments on September 19, 2005. Other parties were given two more days to file their comments, and reply comments were due September 23, 2005. Numerous parties answered the call, and provided their recommendations for ruling on PG&E's proposal.

In this decision, we decline to approve or reject PG&E's confidential hedging plan. Instead we expand the tolerance band for PG&E's CPIM during the 2005-2006. This will provide greater protection for PG&E shareholders and greater flexibility for the utilities' managers as they attempt to find the right mixture of flowing gas, physical hedges, and financial hedges to protect core customers during the volatile conditions that we all expect to prevail during the coming winter.

We want PG&E and other utilities to employ hedges to the extent they are likely to be beneficial to core customers. It is critically important that the utilities have the flexibility, in the coming months, to make those hedging decisions quickly and that they not be constrained by specific, pre-approved hedging plans. By expanding the tolerance band, we provide the shareholders with greater protection, so that the utility will not hesitate in acquiring appropriate hedges.

Background

The CPIM as approved in D.04-01-047 provides PG&E with a direct financial incentive to procure gas supplies and transportation at the lowest reasonable cost by determining shareholder rewards or penalties based on comparisons of total gas costs to a monthly market-based benchmark. PG&E's performance is calculated annually and any incentive award or penalty is then recorded in the Core Sub-accounts of the Purchased Gas Account (PGA).

Because CPIM is linked to monthly gas price benchmarks, PG&E argues that it has limited incentive to fix the prices of natural gas for an extended period of time, or to expend dollars to hedge a significant portion of the company's natural gas purchases on behalf of core gas customers. Nonetheless, PG&E has hedged its core gas purchases to some extent both this year and last. What concerns the company is that if its spending on hedges (option premiums) exceeds the upper level of the applicable CPIM deadband, then its shareholders face the risk of penalty. Of course, the shareholders also face the possibility of reward if the hedges enable the company to realize a cost of gas below the monthly index price.

The Proposal

PG&E seeks support from the Commission for the company to increase its investments in hedges for gas needed this winter and in following years. PG&E points out that the CPIM covers only a 12 month period, and does not provide a mechanism for tracking multi-year hedges. Nonetheless PG&E asks the Commission to retain the CPIM, partially because its enactment led to the elimination of reasonableness reviews. However, to accommodate the need for additional hedging, PG&E is requesting that the following new Ordering Paragraphs be added to D.04-01-047:

> (1) To provide much-needed supplemental protection from possible dramatic natural gas price increases in the wake of Hurricane Katrina, PG&E is hereby authorized to purchase hedges in 2005. The level of the hedges and the expiration dates thereof are specified in the Gas Hedging Plan attached as a confidential Addendum to PG&E's Petition for Modification dated September 13, 2005.
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> (2) The costs associated with these approved hedges shall be paid by core customers. PG&E shall establish a specific core subaccount in the PGA to track these costs.
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> (3) All payouts associated with these hedges shall flow directly to PG&E's core gas customers in the year which the payout occurs. PG&E shall establish a specific core subaccount in the PGA to track the payouts.
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> (4) Neither the costs nor the payouts associated with these hedges will be shared by PG&E's shareholders.

As part of its petition, PG&E submitted a confidential hedging plan for expedited review and approval by the Commission. PG&E asked that the Commission approve the hedging plan as part of its decision granting the requested modification of D.04-01-047. Approval of the plan would authorize PG&E to spend up to a specified limit on option premiums to protect core customers from additional increases in natural gas prices over the next five winters, commencing with the coming winter of 2005-2006.[2]

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[2] As an alternative to its preferred multi-year approach, PG&E also proposes, in Part V.B, below, a one-winter hedging authorization, limited to the coming winter (2005-2006) only. This alternative would defer to a future Application the issue of protecting PG&E's core gas customers against increased prices in succeeding winters (after 2005-2006). Although PG&E presented and supports the alternative, one-year proposal, PG&E urged the Commission to adopt the multi-year approach as being in the best interests of PG&E's core gas customers.

PG&E proposed that the costs and benefits of these hedges be excluded altogether from CPIM calculations. Both costs and benefits would flow entirely to PG&E's core gas customers, outside the CPIM. The confidential hedging plan attached to the petition describes the hedging products and the annual volumes to be hedged.

PG&E specifically requested that the expanded hedging authority be extended to include, not just the coming winter of 2005-2006, but also the subsequent four winters, and that this expansion of PG&E's hedging authority over the next five years is warranted by the exigent circumstances in the wake of Hurricane Katrina. PG&E states that it also intends to propose, via a separate application to be filed within the next several weeks, a more comprehensive, long-term hedging plan for the winters after 2005-2006.

PG&E argues that adoption of the current hedging proposal would require only one relatively minor, one-time modification. PG&E seeks authority to change the CPIM accounting procedures to allow PG&E to exclude option premiums and any other related hedging costs associated with the supplemental hedging plan from the CPIM. PG&E would establish separate Core Sub Accounts in the PGA to track the costs and payouts associated with the purchase of hedging instruments under this plan. All costs and payouts from the hedges authorized in the supplemental hedging plan would accrue directly and entirely to core customers. In contrast to the treatment of hedges under the CPIM, shareholders would bear no costs and receive no benefits associated with the hedges. PG&E shareholders also would forego any reward for the 2004-2005 CPIM year (Year 12). All other aspects of the CPIM would remain unchanged.

The Exigent Circumstances

There is no disputing PG&E's assertion that since it hit the U.S. mainland on August 29, 2005, Hurricane Katrina has had a major adverse impact on natural gas markets, contributing to significant increases in the price of natural gas throughout the United States. Although production levels in the supply basins serving PG&E in the Southwest and in Western Canada have not been affected, natural gas supplies and futures have experienced significant price increases in the wake of Hurricane Katrina.

Hurricane Katrina struck the heart of the natural gas and oil producing region of the Gulf of Mexico and caused a major disruption in energy markets. A large proportion of offshore gas and oil production initially was shut in, and there was significant damage to the onshore infrastructure as well.[3] The upward effects on prices were immediate and significant. Gas prices for the coming winter rose above $12.00 per MMBtu (or per Dth) on the New York Mercantile Exchange (NYMEX), and created the substantial possibility of further multi-dollar per MMBtu increases due to the resulting loss of gas production.

PG&E reports that Hurricane Katrina disrupted sixteen percent of the gas production for the United States, and about seven percent remains shut in as of the date of this document. It is not yet known when and to what degree this gas production will resume.

The problems caused by Hurricane Katrina have come on the heels of several years of sustained high gas prices. Prices for natural gas already had been on an upward trajectory since early 2002. The pace of growth in demand

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[3] *See* Foster Natural Gas Report, Issue No. 2556 (September 1, 2005).

has exceeded supply during that time, and is forecast to continue to do so for the next several years.

After the approach of Hurricane Katrina, winter natural gas prices on NYMEX rose literally overnight by twenty percent, from around $10.00 to $12.00 per MMBtu. The prices for gas in the supply areas accessed by PG&E (the U.S. Southwest and Western Canada) rose in similar proportion.

A further basis for concern arises from the fact that September is the peak month for hurricane activity. The hurricane season does not end until November 30. Already this year to date, there have been more named tropical storms in the Atlantic Ocean as of September 9 than as of the same date in any year in recorded history. Another hurricane in the Gulf of Mexico that affected gas supply could have a devastating upward effect on prices. Also, PG&E predicts that the current supply outage caused by Hurricane Katrina will reduce pre-winter storage inventories nationally from the previously-forecasted 3,300 billion cubic feet (Bcf), which is generally considered to be adequate for normal winter weather, to levels approaching 3,100 Bcf, or perhaps lower. This lower level of storage inventories would make it very difficult for natural gas markets to meet expected demand should there be a colder than normal winter.

Other externalities – most notably a forecast of (or the actual appearance of) below-normal winter temperatures, even in other parts of North America, as well as increases in the price of other energy commodities, such as heating oil – are also major risks that may drive natural gas prices higher.

According to recent information released by the Energy Information Administration in the U.S. Department of Energy (EIA), Hurricane Katrina also reduced natural gas production on the Gulf Coast, and slightly less than four Bcf per day of the normal 10 Bcf per day remains offline. To date, 92 Bcf of gas production has been lost. The EIA reports that several major processing plants in Louisiana are out of service due to the hurricane, and may remain out of service for as long as six months.[4]

The Administrative Law Judge (ALJ) Ruling

On September 14, 2005, the presiding ALJ issued a ruling setting an expedited schedule for review of the petition. He concluded that, since a rapid decision was needed to inform PG&E's hedging efforts this month, there was insufficient time to provide adequate consideration of PG&E's proposal for multi-year hedging. Accordingly, he directed parties to prepare comments on PG&E's secondary proposal to approve its hedging strategy only for the winter of 2005-2006. We concur with this approach. We understand PG&E's desire to begin hedging for future years, and encourage the company to do so, to the extent that, in its judgment, it is the best thing to do for core customers. However, for the Commission to fully consider and approve a multi-year approach would require an understanding of the facts supporting such a plan, as well as a review of long-term options.[5]

The ALJ also asked parties to comment on a further alternative, under which the CPIM would be suspended during this winter, and all costs would be tracked through a balancing for eventual recovery from ratepayers. All of those

[4] *See* http://tonto.eia.doe.gov/oog/special/eia1_katrina_090705.html

[5] We note that PG&E continues to urge adoption of its long-term hedging proposal, and that The Utility Reform Network (TURN) supports multi-year hedging in its comments. TURN would limit the plan approval to two years beyond this winter, under the assumption that liquefied natural gas (LNG) facilities will be supplying gas to California by 2008, significantly changing the natural gas picture in the state. This is just the type of factual underpinning that we must explore before approving a long-term plan.

commenting on this proposal opposed it, largely due to the assumption that suspension of the incentive mechanism would lead, sooner or later, to the re-imposition of reasonableness reviews, a practice that was, for the most part, suspended with the initial introduction of procurement incentives.[6] The ruling did not propose a return to reasonableness reviews. Parties only feared that it might.

What Other Utilities Plan to Do

As part of the expedited consideration of PG&E's proposal, the ALJ directed the San Diego Gas and Electric Company (SDG&E), the Southern California Gas Company (SoCalGas) and the Southwest Gas Company (Southwest) to file comments reflecting whether or not the Commission should act to change either their procurement practices or their incentive mechanisms for the winter of 2005-2006.

SDG&E and SoCalGas, responding jointly, support PG&E's proposal to remove the costs and benefits of hedging from the CPIM, and have ratepayers fund hedges pre-approved by the Commission. These utilities stated that they do not see a need for any changes to their current procurement practices. However, these utilities state that if the Commission wants them to acquire hedge instruments, they are willing to do so, and offer to submit detailed hedging plans for pre-approval by the Commission.

Southwest reports that it is just now gaining experience with its relatively new Gas Cost Incentive Mechanism (GCIM). The first full GCIM year begins

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[6] In D.97-08-055, when the Commission approved PG&E's CPIM, the Commission was clear that it could still disallow costs if there were conflicts in interest, which motivated the utility to take actions in favor of its affiliate and contrary to its ratepayers' interests.

November 1, 2005. When designing its GCIM, Southwest incorporated a Volatility Mitigation Program under which the Commission has authorized it to hedge up to 25 percent of its core gas needs. Southwest states that it had originally proposed a 50 percent limit, which it had reduced after negotiations with the Office of Ratepayer Advocates (ORA). The utility reports that in light of recent events, it supports the Commission authorizing Southwest to increase the percentage of hedging for its portfolio up to 50 percent.

Reactions From Other Parties

TURN, ORA, Lodi Gas Storage, Coral Energy, The School Project for Utility Rate Reduction and the Association of Bay Area Governments (SPURR/ABAG), and Accent Energy Group (Accent) all filed comments on the proposal.[7] Only TURN expresses general enthusiasm for PG&E's proposal.

ORA opposes PG&E's proposal. However, ORA recommends that if the Commission finds additional shareholder protection is warranted, the Commission should widenthe tolerance band in the CPIM, instead of moving hedging outside of the mechanism. If the Commission is inclined to grant PG&E's request to remove the costs and potential benefits of its alternative hedging plan proposal from CPIM calculations, ORA recommends that the CPIM rewards be suspended for the next CPIM period commencing November 1, 2005, in addition to the current 2004-2005 CPIM period as proposed by PG&E.

SPURR/ABAG vigorously oppose the PG&E proposal, claiming that PG&E is merely looking for a way to shift all of its procurement risk to its core

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[7] Access, a core and noncore gas marketer, also filed a motion to intervene. Its interest in the proceeding was prompted by PG&E's hedging proposal, which was not expressly part of the initial scope of the proceeding. Access' motion to intervene is hereby granted.

customers. However, if the Commission were to grant the petition at least in part, SPURR/ABAG advocates that we impose the following restrictions:

A. Any hedging plan approved as an exception to the CPIM should cover not more than 30% of overall monthly usage during the period from November 2005 through March 2006. Since, according to PG&E's September 14, 2005 press release, PG&E already has 20% of Nov05-Mar06 usage in storage, that would result in a hedging level not to exceed 50% overall.

B. Any hedging plan approved should be limited to Nov05-Mar06 usage.

C. Any application by PG&E with regard to hedging in subsequent periods (1) must not become effective during the time period covered by the Gas Accord III Decision, and (2) must take as its scope the question of allowing and assisting core customers to manage price spike risk, including the role of core aggregators, rather than simply a narrow review of CPIM in isolation.

D. Prior to the start of each month in the Nov05-Mar06 period, PG&E must announce publicly both the level of hedging employed for that month and the weighted average hedging level. For example, PG&E could announce that "we have hedged 30% of projected commodity usage with a weighted average capped price of $1.40/therm, plus we anticipate pulling 15% to 20% of projected usage from storage."

Accent also opposes the petition, arguing that the Core Aggregation, under which core customers can elect to buy gas from providers other that the utilities, allows customers to manage price volatility. Lodi does not oppose the proposal to hedge for this winter, but recommends that the Commission reserve action on PG&E's request for authority to enter financial hedges beyond this winter until PG&E files its separate application, so as to permit the Commission to fully evaluate all of the hedging options PG&E enjoys, including physical hedges.

Coral expresses concern that PG&E proposal may not represent the most appropriate means by which to stabilize gas costs for PG&E's core procurement customers. Coral urges the Commission to encourage PG&E and the other gas utilities to enter into long-term, fixed price contracts as a part of a portfolio strategy in order to provide greater price certainty and stability for the utilities' core gas sales customers. Coral argues that this can be accomplished under the utilities' existing incentive mechanisms or through carefully considered adjustments to the incentive mechanisms.

TURN offers its "general" support for the PG&E proposal, and despite the admonition to limit comments to consideration of hedging for only the coming winter, proposes that PG&E be allowed to implement its hedging strategy for the following two years (not the four additional years proposed by PG&E). TURN is concerned that it might take too long to process a separate application for future-year hedging, but that conditions may change sufficiently by 2008 to make current hedges for years beyond that point unwise.

Discussion

The CPIM, most recently modified and approved in D.04-01-047, guides and provides financial incentive to PG&E's Core Procurement Department in its gas procurement practices. The CPIM provides PG&E the incentive to procure natural gas at the lowest possible cost as compared to monthly gas price benchmarks. Its structure establishes evaluation criteria for PG&E's annual gas procurement costs. In applying the mechanism, the Commission adds up the allowed monthly benchmark dollars over the CPIM period and compares that sum to PG&E's actual costs for the year to determine PG&E's performance. A tolerance band around the benchmark defines the range of costs that is considered reasonable and these costs are recovered entirely from ratepayers. If

PG&E's actual gas costs, as measured against the CPIM benchmark, are outside the upper (+2%) and lower (-1%) limits, PG&E shares with ratepayers the savings or losses as compared to the costs outside the tolerance band. Ratepayers and shareholders share penalties for gas costs that are above 2% on a 50/50 basis, and share savings attributed to gas costs lower than 1% of the benchmark on a 75/25 basis.

PG&E asserts that "there is limited flexibility under its CPIM to fix the prices of natural gas for an extended period of time, or to expend dollars to hedge a significant portion of the Company's natural gas purchases on behalf of core gas customers." (Emergency Petition, p. 4.) PG&E also alleges that the company's risk of a major financial penalty for hedging large portions of the portfolio can be significant under the current CPIM. Therefore, PG&E is recommending that its hedging plan be excluded altogether from the CPIM, i.e. all costs and potential gains or losses would flow entirely to ratepayers.

At issue in this instance is whether we should encourage PG&E and other core-serving gas utilities to increase the use of gas price hedges for the coming winter, and if so, how we should express that encouragement. There is little dispute that current natural gas prices are volatile, and that prices have climbed, in recent weeks, to extremely high levels. Properly applied hedges will protect consumers against the highest prices. At the same time, because price hedges add cost, their use virtually ensures that consumers will not experience the lowest possible cost for gas service.

Utilities should always strive to reduce gas cost, but should not expose consumers to great risk in pursuit of the lowest price. Every utility should serve its core customers through a mixture of flowing gas and gas hedges. The latter can be physical hedges in the form of storage and supply contracts, or they can be financial hedges that do not lead directly to more consumable gas, but insure against extreme price spikes.

Utilities need storage to meet winter demand. They must inject throughout the injection time period from spring through fall. As SPURR-ABAG points out, current gas costs are much greater than they were just three years ago. While it is as important as ever to continually replenish core storage supplies, this form of physical hedge may no longer be enough. When supplies are tight, and there is every reason to assume that they will continue to be for some period of time, it makes sense to look for opportunities when the forecast of future prices somewhat lower and then to lock in those lower prices for a portion of the projected load through long-term contracts or price hedges.

Deciding when and how utilities should acquire specific additional hedges is not a call that regulators are well equipped to make, particularly in an expedited time frame. The regulatory process lacks the flexibility, and regulatory staffs often lack the expertise and access to information necessary to make a skillful determination related to fleeting gas purchase opportunities. This is one of the strongest reasons for establishing gas procurement incentive mechanisms and allowing utilities to apply expert judgment in making these marketplace decisions.

How is the Commission to know whether or not PG&E has offered a good hedging plan, let alone the right hedging plan? TURN argues that it does not really matter whether the plan is either good or right:

> "TURN believes that PG&E's proposal represents a rational approach to the situation, although not necessarily the only rational response. We are faced with difficult choices, none of which are especially appealing. Rather than wasting precious time debating among the various unpleasant options, TURN believes that the best approach is to act quickly to authorize the

> utilities to pursue whatever approaches appear best suited to their individual situations. With winter fast approaching and market volatility likely to continue for some time, there is simply no time to wait." (TURN's Response, pp.1-2.)

What is missing from this suggestion is an explanation of whose judgment of the "best suited" approach should apply. TURN does not offer (nor does PG&E, for that matter) facts or argument to support a conclusion by this Commission that PG&E's proposed hedging plan is the best one, or even a particularly good one. The Commission would be left to approve the proposed plan simply because it is one that PG&E proposed. Presumably, if the utility proposed a vastly different plan, we would be compelled to approve that one, as well.

ORA states the problem well:

> "Under the PG&E application, the regulator is placed in the unenviable and inappropriate position of dealing with an application in which it has the least amount of market information to make the ultimate decision. This approach also implicitly relegates PG&E to an advisory role on matters related to its hedging plan. If advice on the hedging plan is ultimately what the Commission seeks, then the Commission may wish to contact Wall Street investment banks for second and third opinions before taking on the accountability for PG&E's hedging plan and exposing ratepayers to 100% of the risk. The PG&E application ultimately represents a very unfortunate turn of events given the structure and intent of the CPIM, especially given that PG&E can make (and could have already made) the decisions concerning the additional hedging request within the CPIM structure." (Opening Comments pp. 6-7.)

This must not be what TURN had in mind. More likely, TURN is suggesting that it is PG&E that must identify and implement the hedging plan best suited to its situation. This is a proposition with which we agree. The question is how to motivate PG&E to pursue the best approach on behalf of its customers. Rubber-stamping whatever PG&E brings to the door of the Commission is not likely to produce that result. Taking the time to collect the expert opinion necessary to critique the merits of PG&E's proposal is unworkable given the time constraints and issues of confidentiality.

As several parties point out, there is nothing about the CPIM in its current form that would prohibit PG&E from using hedges to the extent it feels it needs to, in order to protect core customers.[8] PG&E's petition is premised on the assumption that its shareholders have no reason to use hedges to protect core customers from high prices when those shareholders face a CPIM penalty if the eventual gas price is not high enough to cover the cost of the hedges. ORA wonders, and PG&E does not adequately explain, why after ten years of operation under the CPIM, including the high gas price years of 2002 and 2001 when prices at the California border at times exceeded the levels expected this winter, the inclusion of financial instruments in the CPIM now is considered to carry the risk of unacceptable penalties.

ORA agrees that the CPIM, given its nature as an annual mechanism, exposes PG&E to risk to the extent that PG&E acquires multi-year hedges due to

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[8] As ORA points out in its comments, The Post-1997 CPIM Agreement provides the most comprehensive description of the general CPIM structure. It specifically includes a Risk Management Clause which states:

> PG&E will be allowed to trade futures, options, swaps, and other financial instruments to manage price and currency risks. These gains and losses resulting from these positions, as well as any transaction costs associated with them, will be included as a cost of gas under the CPIM, but will not be reflected in the benchmark. (PG&E/ORA Post-1997 CPIM Agreement, IV.B., p. 13.)

the volatility of the natural gas market. Nonetheless, the mechanism does allow PG&E to undertake significant hedging. ORA argues that the CPIM "tolerance" band around the benchmark provides PG&E the ability to rely on it to a significant extent for purposes of shareholder risk protection for potential hedging transactions and losses. The tolerance band or "reasonableness range" of 2% is significant. For example, in the most recently ended CPIM Year 11 (covering the period November 1, 2003 through October 31, 2004), the upper end of the tolerance band, based on 2% of the annual benchmark procurement costs, was approximately $30 million.[9] The prior CPIM Year 10 (covering the period November 1, 2002 through October 31, 2003) had an upper tolerance of approximately $27.5 million. Given the recent prices of natural gas and the current NYMEX forward prices, the current expectation would be for the tolerance band in the next CPIM period (November 1, 2005 to October 31, 2006) to greatly exceed these past levels or even the current CPIM tolerance band.

In its Petition, PG&E alleges that "the Company's risk of a major financial penalty for hedging large portions of the portfolio can be significant under the current CPIM" and "if PG&E's spending on hedges (option premiums) exceeds the upper level of the deadband, then PG&E shareholders face the risk of large financial penalties." (Emergency Petition, p. 4.) However, as ORA points out, in the Emergency Petition, PG&E fails to provide any factual evidence to support the specific allegation regarding the actual level of risk of a major financial penalty and what level of penalty it would consider significant under the current CPIM. While the tolerance band amount fluctuates based on the cost of gas in

[9] PG&E Annual CPIM Report for the period November 1, 2003 through October 31, 2004, p.10, Table 1.

the market, it nonetheless provides a significant "cushion" that can be used to cover hedge costs.

As gas costs rise, so does the value of the tolerance band within the CPIM. The hedging costs anticipated by PG&E to protect customers in the coming winter would normally be reflected in the 2005-2006 CPIM calculation. PG&E has not demonstrated why the tolerance band, swollen by the expected high gas costs during that period, would not adequately protect PG&E for its hedge investments.

Although we want to encourage PG&E to make hedge investments, we want the company to be tempered in its approach. It should not purchase hedges that are unlikely to be of value because they cost too much or provide too little protection. It should also realize an appropriate mix between a reliance on hedges and a reliance on the price of flowing gas. In at least the short term, we expect that a need to respect the limits of the tolerance band should push PG&E in the direction of that appropriate mix. It remains for use to determine in future proceedings whether there may be a more effective way to promote appropriate hedging activity.

The approaching winter brings with it significant uncertainty and the threat of higher prices. It is important to acknowledge these conditions in light of PG&E's specific hedging concerns. ORA offers an alternative approach.

ORA recommends that the Commission widen the tolerance band by increasing it equally to +3% on the penalty side (from the existing +2%) and -2% (from -1%) on the savings side, giving PG&E additional flexibility or "hedge room" to make any additional hedging decisions it deems appropriate for this upcoming winter. This would constitute a 50% increase to the current upside tolerance band and in the current environment would provide substantial additional protection. From an equity standpoint, given the additional risk protection, the ability to generate a reward would also be adjusted. This would be implemented for the upcoming CPIM period commencing November 1, 2005 for the 2005/2006 cycle. Any longer-term proposals or major structural changes regarding the CPIM and multi-year hedging plans can be evaluated in the context of PG&E's upcoming application.

This is a constructive proposal that responds to PG&E's fundamental concern. A widening of the tolerance band would give PG&E a safety net for shareholder risk, yet would preserve the integrity of the CPIM which has worked well over the years to align ratepayer and shareholder interests in making appropriate decisions, without shifting the entire risk to ratepayers. The CPIM can continue to provide the appropriate incentives for PG&E to procure gas for core ratepayers in a manner that is in the best interest of both core customers and shareholders, while significantly reducing the possibility of unreasonably high risks or reward.

PG&E does not oppose ORA's alternative, but continues to believe that the best approach here is to remove the additional hedges from the CPIM altogether. The utility points out that the purpose of the CPIM is to align customer and shareholder risks and interests, and thereby to provide an incentive to PG&E to manage its gas purchases and storage and transportation assets to reduce total gas costs for customers and that its hedging program is a form of price insurance for core customers. PG&E argues that continuing to track hedging costs through the CPIM would create a disincentive for PG&E to acquire this "insurance," since the absolute size of the tolerance band could decrease if market prices were to drop, causing customer and shareholder risks and interest to become misaligned. In addition, by including the hedging costs in CPIM, PG&E states it would have little incentive to attempt to lower costs, since the cost of the insurance is likely to outweigh any savings achieved through the day-to-day trading of gas and management of transportation and storage assets.

The expansion of the tolerance band resolves PG&E's primary concern, by giving the company significantly greater protection against losses resulting from additional hedges. To use PG&E's words, it is a means for realigning ratepayer and shareholder interests by protecting shareholders as the company acts to protect its customers. We are willing to take this additional step because of the exceptional uncertainty we are all facing in the next few months. We are not persuaded that this change would significantly reduce PG&E's incentive to achieve cost savings through day-to-day gas trades and asset management. The company has not explained why it would not do all it can to reduce costs in order to protect itself against a CPIM penalty, to maximize its opportunity to achieve an award, or simply to ensure that its customers face the lowest feasible charges.

For all the reasons discussed above, we will adopt the revised tolerance band as proposed by ORA. We do this because we encourage PG&E to acquire the price hedges it feels best serve ratepayer interests.

This petition, and the response that it has generated, underscore the importance of re-examining the incentive mechanisms in light of current conditions and the potential for high gas prices over the next few years. PG&E has indicated its intention to file an application addressing hedging over the next four years.

The Other Utilities

We thank Southwest, SDG&E and SoCalGas for offering their responses to the PG&E petition and for reflecting on hedging issues as they affect their own procurement plans for this winter. None of these utilities has asked for a modification of its incentive mechanism, although each expressed a willingness to expand its hedging activities, if that was the Commission's desire.

Southwest states that it has recently begun operating under its first GCIM cycle and that it has already implemented its hedging program for the upcoming 2005-2006 period, and thus does not recommend suspension of its existing program. Southwest's GCIM contains a "Volatility Mitigation Program" (VMP) which Southwest is recommending be increased to 50% from the adopted 25%.[10] ORA notes that in recognition of the reduced risk associated with the current VMP treatment, Southwest's GCIM contains a wider tolerance band than that of the other utility incentive mechanisms. In this context, and based on the extremely limited new information available for Commission review in the context of this expedited petition, it is not clear that there is a need to increase the scope of the VMP. Southwest already has significant shareholder protection, which should give it the encouragement it needs to pursue appropriate hedges.

SDG&E and SoCalGas filed comments together, but have different stories to tell. SDG&E has been acquiring price hedges within the confines of its Performance-Based Ratemaking mechanism. SoCalGas has not been buying hedges, as it functions within its GCIM. Neither asks for changes to its current core procurement practices. However, both companies support a pre-approval process for natural gas hedging activities, stating:

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[10] In addition to the VMP program under which Southwest undertakes hedging activities, Southwest also utilizes storage in accordance with its GCIM requirements, which serves as a further gas price hedge.

> "In such a process the Commission can provide guidance on fundamental issues related to hedging. What does the Commission value more, low cost gas or price stability? If the answer is low cost gas, then limited hedging may be the most reasonable course of action. A portfolio of call options can be an effective way to insure customers against extreme prices. In most years, however, the vast majority of such call options will expire worthless, and the cost of hedges will simply increase the delivered cost of gas. If price stability is more important, a more robust hedging program will be called for, even if it tends to increase the overall average delivered cost of gas…"(Comments, p. 4.)

As stated above, we do not see the merit of pre-approving a specific hedging plan, especially in the expedited timeframe for this winter. We encourage all of the utilities to hedge as it appears most appropriate to protect core customers. SDG&E and SoCalGas have not proposed any specific modifications to their incentive mechanism, and we will adopt none.

Conclusion

PG&E has expressed the desire to acquire additional financial hedges to protect its core customers for natural gas purchase related to the coming winter and beyond. We encourage PG&E and other core-serving utilities to employ a balanced strategy of purchasing flowing gas, as well as physical and financial hedges. While PG&E has not provided solid evidence that its current procurement incentive mechanism fails to protect shareholders for the purchase of appropriate price hedges, we acknowledge the existence of conditions that provide the potential for particularly high gas prices this winter. We expand the tolerance band for PG&E's 2005-2006 CPIM period in order to provide greater shareholder protection in the face of potential price volatility.

With prices at unusually high levels, it is important that any utility pursuing hedges have great flexibility. This will allow the utility to respond to sudden changes in market conditions. The approval of a detailed hedging plan would serve to restrict such flexibility and would require expert market judgment upon which the Commission cannot rely, especially in response to an expedited petition. For these reasons, we will continue to rely on the incentive mechanism, adjusted to provide greater shareholder protection this winter, to guide utility purchases. We will consider further changes to the incentive mechanism to apply to future years in a separate application, which PG&E has announced plans to file.

Assignment of Proceeding

Michael R. Peevey and Susan P. Kennedy are Assigned Commissioners and Steve A. Weissman is the assigned ALJ in this proceeding.

Comments on Draft Decision

To avoid the possibility of significant harm to the public health and welfare, this Commission must act immediately to protect PG&E’s core gas customers from current high gas prices and the potential price volatility spurred by Hurricane Katrina by allowing PG&E to acquire additional price hedges for the approaching winter months. Therefore, pursuant to Public Utilities Code Section 311(f)(9), the Commission concludes that public necessity requires reduction of the otherwise applicable 30-day period for public review and comment on the draft decision, because the public interest in adopting a decision before expiration of the 30-day review and comment period clearly outweighs the public interest in having the full 30- day period of public review and comment.

Comments shall be served no later than noon October 3, 2005, and filed by the close of business on that day. No reply comments will be entertained.

Findings of Fact

1. Current high gas prices and the potential price volatility spurred by Hurricane Katrina suggest that it may be appropriate for PG&E to acquire additional natural gas hedges for the approaching winter months.

2. PG&E is in the best position to determine the appropriate hedging strategy in the short time available.

3. By expanding the tolerance band that is part of the CPIM formula, PG&E should be encouraged to make additional appropriate hedging decision while protecting shareholders.

4. There is insufficient time and information available to the Commission to approve a specific hedging plan for this winter, or to consider a multi-year hedging strategy.

Conclusions of Law

1. The Commission should approve an expanded CPIM tolerance band for the 2005-2006 incentive period as proposed by ORA.

2. In all other respects, the petition for modification should be denied.

IT IS ORDERED that:

1. Decision 04-01-047 is modified to include the following ordering paragraph:

> For the incentive year 2005-2006,the Core Procurement Incentive Mechanism tolerance band shall be increased to +3% on the penalty side (from the existing +2%) and -2% (from -1%) on the savings side.

2. In all other respects, the Petition to Modify Decision 04-01-047 filed by the Pacific Gas and Electric Company on September 13, 2005 is denied.

This order is effective today.

Dated ____________, at Los Angeles, California.