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Decision 02-06-023 June 6, 2002

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of Southern California Gas Company Regarding Year Six (1999-2000) Under Its Experimental Gas Cost Incentive Mechanism and Related Gas Supply Matters. (U 904 G)	Application 00-06-023 (Filed June 15, 2000)

David B. Follett, Judith L. Young, and John R. Ellis, Attorneys at Law, for Southern California Gas Company, applicant.
Patrick L. Gileau, Attorney at Law, for the Office of Ratepayer Advocates and Marcel Hawiger, Attorney at Law, for The Utility Reform Network, intervenors.
Stephen E. Pickett, Douglas Kent Porter, Gloria Ing, and Kevin J. Lipson, Attorneys at Law, for Southern California Edison Company and Norman A. Pedersen, Attorney at Law, for the Southern California Generation Coalition, protestants.

O P I N I O N

1. Summary

In Phase 2 of this proceeding, we turn to the question of whether to extend the Gas Cost Incentive Mechanism (GCIM) for Southern California Gas Company (SoCalGas), and, if so, whether modifications of the mechanism are appropriate. Following two days of hearings and extensive briefing, we conclude that the public interest is served by extending the GCIM and by adopting changes agreed to by SoCalGas, the Commission's Office of Ratepayer Advocates (ORA) and The Utility Reform Network (TURN). The changes aim generally at reducing consumer costs of gas. We also approve the Settlement Agreement (with one proposed change dealing with storage) entered into by SoCalGas, ORA and TURN that, among other things, caps the amount of shareholder award that can be recovered under the GCIM and increases consumer benefits beginning in Year Seven of the program. In response to concerns about causes of the extreme border price spikes in 2000/2001, our order today also directs the Energy Division to prepare an Order Instituting Investigation for our consideration. This application is closed.

2. Background and Procedural History

The Commission in Decision (D.) 94-03-076 approved a GCIM for SoCalGas. The GCIM is a ratemaking mechanism designed to provide regulatory controls of greater benefit to ratepayers than annual reasonableness reviews. We modified certain aspects of the SoCalGas GCIM in D.96-01-003 and D.97-06-061. The GCIM is structured to provide an incentive for SoCalGas to invest in its Gas Acquisition Department and make sound gas purchasing decisions. This was done by granting SoCalGas 50% of savings it achieved by purchasing gas below market price benchmarks and by disallowing 50% of gas costs above the benchmarks.

D.94-03-076 further directed the Commission Advisory and Compliance Division (duties of which have since been assumed by the Energy Division) to issue an evaluation of the GCIM program by August 1, 1996. For a number of reasons, the report did not issue. On June 8, 2000, the Commission in D.00-06-039 ordered the Energy Division to conduct such a study to guide the Commission in whether to extend operation of the GCIM. The Energy Division report was issued on January 4, 2001.

The SoCalGas GCIM requires the utility to file an application by June 15 of each year to address the reasonableness of its operations and provide information regarding the GCIM results for the prior 12 months ending March 31. This is the sixth such application, and it covers the period from April 1, 1999 through March 31, 2000. In Phase 1 of this proceeding, we reviewed ORA's audit of Year Six GCIM results and concluded that SoCalGas had acquired gas for its customers at savings of $24.2 million during the relevant period. We authorized SoCalGas to recognize a shareholder award of $9.7 million under the GCIM formula.

In Phase 2 of this proceeding, Commissioner Bilas directed the parties to consider whether the GCIM should be extended and, if so, what modifications to the mechanism would be desirable in light of the Energy Division evaluation.

Following prehearing conferences and meetings among the parties, a proposed Settlement Agreement dealing with Phase 2 issues was filed on July 5, 2001 by SoCalGas, ORA and TURN. The settlement is opposed by Southern California Edison Company (Edison) and by the Southern California Generation Coalition (SCGC). Other parties that did not join the settlement but took a neutral stance during hearing include Pacific Gas and Electric Company (PG&E), El Paso Natural Gas Company (El Paso), and the California Industrial Group / California Manufacturers and Technology Association.

Parties were invited to submit written testimony on Phase 2 issues and on the proposed Settlement Agreement. Two days of hearing were conducted on November 27 and 28, 2001. Final briefs were filed on February 1, 2002, when Phase 2 of this application was deemed submitted for decision by the Commission.

3. The Energy Division Evaluation

Much of the testimony at hearing and many of the terms of the proposed Settlement Agreement centered on the evaluation report prepared by the Commission's Energy Division. The report is a comprehensive 37-page analysis of the history, function and results of the GCIM. It was made part of this record as Tab D of SoCalGas direct testimony (Exhibit 1).

As the report notes, the GCIM is intended to benefit core customers. Core customers are those who lack alternatives to natural gas service, such as residential and small commercial customers. Noncore customers are large businesses capable of switching from natural gas to alternative fuels such as oil and propane. Noncore customers typically are large commercial and industrial firms and utility electric generators.

The Energy Division evaluation notes that the Commission has advocated the use of incentive regulation for energy utilities since the early 1990s. The Commission adopted gas cost incentive mechanisms for San Diego Gas & Electric Company in 1993, SoCalGas in 1994, and PG&E in 1997. The Energy Division states:

> "Prior to the implementation of these mechanisms, the Commission conducted annual reasonableness reviews of the utilities' gas procurement costs. Gas utilities had little incentive to take risks to attempt to lower gas procurement costs. Their only incentive to take 'reasonable' measures to keep gas costs low was the threat of the annual reasonableness review. Gas costs, if found reasonable, would simply be recovered from ratepayers, with no rewards for utilities doing an exceptional job." (Evaluation, at 4.)

The GCIM establishes a benchmark cost of gas intended to emulate actual market conditions on a monthly basis. For the most part, the benchmark has been based on southwest gas price indices published in the publications *Natural*

Gas Intelligence, *Inside FERC Gas Market Report* and *Natural Gas Week*, and these indices in turn reflect a weighted combination of basin or border prices. A tolerance band, or deadband, is placed above and below the benchmark cost to provide flexibility in gas procurement. Savings and losses to shareholders and ratepayers are neither shared nor incurred when they are within the tolerance bands.

The Energy Division concludes that gas purchases made under the GCIM "are definitely far more favorable to ratepayers than those made when reasonableness reviews were in effect." (Evaluation, at 20.) During the first six years of the program, gas was procured at savings of $42 million below the benchmark prices, net of the shareholder incentives. Because SoCalGas receives awards based on these savings, it has had an incentive to expand its Gas Acquisition Department and to engage in cost-saving gas procurement methods. These methods include sales of core gas to other parties, hub transactions that provide parking, loaning and wheeling services for negotiated fees, and financial instrument transactions, including futures contracts and swaps.

The Energy Division analysis concludes that there are other advantages to the GCIM. Among them:

- Under the GCIM, the utility is able to focus on the current gas market rather than trying to justify the reasonableness of decisions in anticipation of hindsight review. SoCalGas also has the flexibility to take reasonable risks, knowing there could be a sharing of financial rewards or penalties associated with these decisions. Because the utility is not primarily concerned about Commission staff discovering information regarding potential disallowances, the Energy Division states that there is better communication between ORA and SoCalGas regarding purchasing and gas accounting practices and operations.

- There has been a significant reduction in the manpower and resources devoted to regulation of gas procurement activities. Previously, the annual reasonableness review consumed thousands of hours of review and extended for years after the costs in question were incurred. Today, SoCalGas presents detailed reports to the ORA and the Energy Division on a monthly basis, and the annual audit generally is completed within a year.

- According to the Energy Division, the GCIM is superior to alternative methods of regulation. A return to reasonableness reviews would eliminate much of the incentive that the company has to reduce gas procurement costs. Eliminating the core procurement function of SoCalGas could lead to higher costs for consumers. Substituting a forecast of gas costs in the base rate instead of relying on the GCIM is undesirable because, according to the Energy Division, "gas forecasting is a notoriously inaccurate business." (Evaluation, at 30.)

In summary, the Energy Division concludes that the GCIM provides a regulatory mechanism superior to reasonableness reviews, has encouraged innovations in procurement practices that have reduced costs for consumers, and there has been no curtailment of service to core customers. With that said, however, the Energy Division also recommends that the Commission consider modifications to the GCIM. These recommendations include the following:

- Reduce the potential size of the shareholder award from its current level of 50% and increase the lower tolerance band from its current level of ½% so that greater savings would be required before the sharing formula takes place.

- Modify the percentages of savings shared by ratepayers and shareholders so that initial gains go primarily to ratepayers while more difficult gains are allocated progressively to shareholders.

- Eliminate the New York Mercantile Exchange (NYMEX) component of the GCIM benchmark, since use of this alternative weighting for gas futures has declined in recent years.

- Consider incentives to encourage purchases from the least-cost basin and to encourage optimal use of storage injections and withdrawals for price advantage.

4. Proposed Settlement

With the Energy Division evaluation before them, SoCalGas, ORA and TURN negotiated a proposed Settlement Agreement that they contend resolves all issues in Phase 2 of this proceeding. The proposed Settlement Agreement is appended to this decision as Attachment A.

The settlement provides that the GCIM, as modified, would continue on an annual basis until modified by further Commission order. The settlement adopts several modifications premised on those proposed by the Energy Division. The most significant modifications would (1) increase the tolerance band below the benchmark from ½% to 1%, (2) reduce the percentage of savings below the benchmark tolerance band that customers would share with shareholders, and (3) limit the maximum amount of savings customers would share with shareholders.

Under the existing mechanism, savings greater than ½% below the benchmark are shared equally between customers and shareholders. Under the settlement, the sharing bands below the benchmark, as a percentage of annual gas commodity benchmarks, would be as follows:

Sharing Band	Ratepayer %	Shareholder %
0% - 1%	100%	0%
1% - 5%	75%	25%

5% and above	90%	10%

Additionally, under the settlement, the shareholder award in any given year would be capped at 1½% of actual annual gas commodity costs.

The settlement also modifies the GCIM to provide that, beginning in Year Nine, SoCalGas will include the shareholder benefits of the GCIM from the most recent monthly report in the utility's core monthly gas pricing advice letter submitted to the Energy Division, with copies to ORA. Under the existing GCIM, shareholders do not share the savings until after approval of the utility's annual application, resulting in a lag of one to two years after savings were realized.

The settlement further establishes physical gas storage inventory targets for SoCalGas and formalizes the utility's goal of making maximum use of its interstate transportation capacity. Finally, the NYMEX system is eliminated as a benchmark index.

The settlement would have a significant impact on the Year Seven shareholder award. The SoCalGas application and ORA's audit of the Year Seven GCIM, which ended on March 31, 2002, are being considered by the Commission in another proceeding, Application (A.) 01-06-027. In that proceeding, dealing with a chaotic year of soaring gas prices, SoCalGas asserts that it was able to procure gas at $223.6 million below the GCIM benchmark. It stated that the shared savings under the mechanism totaled $212.2 million, and that shareholders thus would be entitled to an incentive award of $106.1 million. Under the settlement agreement in this proceeding, however, SoCalGas agrees to apply the 1½% cap on shareholder awards to Year Seven, thus reducing the award to $30.8 million. This would have the effect of increasing benefits to ratepayers from about $106 million to about $181 million.

5. Evidence at Hearing

At hearing, SoCalGas presented the testimony of three of its employees and a consultant. ORA and TURN each presented one witness to testify in support of the proposed settlement. Edison presented the testimony of a consultant, as did SCGC, to testify in opposition to the settlement. The Commission received 24 exhibits into evidence. Nine of the exhibits were received under seal to conform to a nondisclosure agreement negotiated between SoCalGas and Edison.

Johannes Van Lierop, SoCalGas Director of Regulatory and Business Analysis, credited the GCIM with giving core customers the advantages of a highly motivated procurement agent and continued regulatory oversight from the Commission, the ORA and the Energy Division. Van Lierop testified that the proposed settlement would provide further benefits to consumers by increasing their share of gas cost savings. Opposition to the settlement, he said, comes from noncore customers who believe that efforts on behalf of core customers contributed to the high cost of gas for noncore businesses in the winter of 2000/2001. He denied that SoCalGas was responsible for the high costs and attributed much of the problems of noncore customers to their failure to use available storage capacity as a hedge against later spot prices for gas.

James P. Harrigan, Director of Gas Acquisition for SoCalGas, testified that the GCIM has benefited the utility's five million core customers by aligning core ratepayer and shareholder interests and encouraging the utility to focus on lowering gas costs. Harrigan said that over the first seven years of the program, savings of $299 million below the GCIM benchmark have been realized and, if the settlement is adopted, residential and small business customers will have realized $235 million of those savings. He presented an analysis showing that during the high-price period of November 2000 through March 2001, SoCalGas customers paid an average cost of gas of 65 cents per therm, compared to a PG&E average of $1.02 and an SDG&E average of $1.07. (Customers are billed on a per-therm basis, with a therm representing an amount of energy equal to 100 standard cubic feet of natural gas.)

On cross-examination, Harrigan acknowledged that the total of gas loans and repayments that SoCalGas negotiates with noncore and other customers is known only to SoCalGas, but he denied that this permits manipulation of the market because the volume of such transactions is minimal. He also acknowledged that individual members of the Gas Acquisition Department are paid bonuses based on the department's overall savings, but he defended this as an important incentive in reducing gas costs.

TURN's testimony was received by stipulation. In it, Senior Attorney Michel Peter Florio said that TURN supports the settlement agreement because it increases Year Seven benefits for core customers, establishes winter storage targets to enhance system reliability, and balances ratepayer and shareholder interests during normal and volatile years. Florio stated:

> "TURN is no fan of deregulation of vital utility services. Nevertheless…[w]here reliable benchmarks exist to allow the measurement of utility performance compared to other market participants, a mechanism such as the GCIM allows the best of both worlds. The utilities are motivated to compete against other market participants, but at the same time ratepayers are assured of long-term protection through regulation and the ability to modify the mechanism as needed." (Exhibit 18, at 7.)

ORA project manager R. Mark Pocta testified that ORA supports the proposed settlement because, among other things, it assures that the utility will remain an aggressive buyer of natural gas for core customers with the incentive to minimize core procurements costs. Pocta said that the GCIM is superior to hindsight reasonableness reviews, which he described as a "heads you win, tails I lose" process for the utility.

On cross-examination, Pocta acknowledged that the current GCIM might permit excessive shareholder awards during a period like Year Seven when gas prices are unexpectedly high. He said that ORA in all likelihood would have opposed a GCIM award to shareholders of $106 million in Year Seven, but that the settlement resolves that question by imposing a cap on shareholder awards and reducing the Year Seven shareholder award to $30.8 million.

Consultant Catherine E. Yap testified in opposition to the settlement proposal on behalf of California generators represented by SCGC. She said that the GCIM should be modified to encourage SoCalGas to purchase gas at or below prevailing market prices, rather than relying on hub services and financial trades to reduce overall cost of gas. She also criticized the lack of a sunset provision for the GCIM, noting that the Commission had previously denied a recommendation to continue the procedure indefinitely.

Similarly, economist Paul R. Carpenter, testifying on behalf of Edison, faulted the GCIM for relying on wholesale physical and financial transactions with noncore customers rather than encouraging the utility to acquire gas at the lowest possible cost on behalf of core customers. Carpenter stated that the GCIM, both in its current form and in settlement form, encourages perverse incentives and market manipulation through the utility's monopoly position in its storage services, intrastate transmission, and core procurement. Moreover, he said, since noncore customers are on the other side of swaps or other ancillary transactions that benefit core customers, consumers ultimately pay for this benefit when electric generators and others pass on the costs to consumers through increased prices.

SoCalGas sought to rebut the testimony of Yap and Carpenter through the testimony of Van Lierop and economist Jeffrey J. Leitzinger. They testified that the high price of gas in winter 2000/2001 was caused by factors beyond the control of SoCalGas, in particular, unusually cold weather, reduced supplies of hydroelectric power, increased electric generation gas load, the rupture and shutdown of an El Paso pipeline, and inefficient use of gas storage by generators. As to market influence, they testified that SoCalGas represents only 3% to 4% of the total volumes on which the benchmark indices are based. They testified that Carpenter had provided no analysis or data to support a claim that SoCalGas has market power or a monopoly position that it can exercise to enhance GCIM recoveries.

6. Discussion

At the outset, we note that the two parties critical of the GCIM – Edison and SCGC – do not oppose incentive-based regulation of the gas procurement activities of SoCalGas. Neither do they urge a return to annual reasonableness reviews in place of the GCIM. For the most part, neither Edison nor SCGC opposes the changes proposed in the Settlement Agreement. Essentially, they urge more changes than those agreed to by the settling parties. Edison, in particular, urges the Commission to conduct a more exhaustive review of the GCIM and modification, as necessary, to provide additional safeguards to protect the interests of noncore entities.

6.1 Continuation of the GCIM

During the first six years of the GCIM, core ratepayers received gas at a cost $42 million below benchmark prices. In Year Seven, with skyrocketing prices in the winter 2000/01 months, SoCalGas was able to procure gas at an overall rate $223 million below benchmark. Most of these savings were passed on to ratepayers through retail gas prices that were substantially less than those charged by other California gas utilities.

These gains were accomplished without adversely affecting reliability. Indeed, the evidence shows that reliability has been enhanced by the Commission's guidelines on gas storage and core procurement activity and by the continuing review process conducted by our staff. ORA states that it is convinced that the savings generated through the GCIM are the result of the in-house expertise and risk management tools that SoCalGas was encouraged to develop on the promise that the company would share in the savings. "Put simply," ORA states, "this is a program that has achieved all of the Commission's goals and should be continued." (ORA Opening Brief, at 7.)

We agree. While the sheer size of the proposed GCIM shareholder award in Year Seven has been the most targeted issue in this record, the settling parties have sought to deal with that by proposing a cap on the shareholder award for Year Seven and for all future years, including those in which prices are extraordinarily high.

Edison criticizes the GCIM, but it offers no persuasive evidence in this proceeding to support its speculation that the GCIM creates "perverse" incentives for SoCalGas to increase gas prices at the California-Arizona border. In Year Seven, Edison contends that higher gas prices in the winter of 2000/01 were caused in part by SoCalGas' reliance on 9.2 billion cubic feet (Bcf) in hub loan repayments as a substitute for storage. As ORA notes, however, the effect on prices of the 9.2 Bcf in hub repayments pales in significance to the 100 Bcf of increased demand by electric generators like Edison during this period. Moreover, the record shows that the hub transactions were voluntary and that no noncore customer has complained about a SoCalGas hub transaction or border purchase.

The record suggests that factors other than hub repayments contributed to high prices in winter 2000/01. These factors include an explosion on the El Paso pipeline in August 2000 and other reductions in El Paso capacity that reduced deliveries to Southern California by 20 Bcf.[1] Colder than normal winter weather in Southern California increased heating load by 38 Bcf over average. By far the greatest factor affecting supply and demand was the unprecedented electric generation load. As a result of dry hydroelectric conditions, electric generation load during the third quarter of 2000 was 50% higher than average.

The evidence shows that SoCalGas engaged in trading activities designed to minimize core gas costs by making better use of two fixed assets that core ratepayers pay for: storage and interstate transportation capacity. Using core assets, the Gas Acquisition Department minimized its actual gas costs primarily by engaging in two types of trading activities: the "winter hedge program," which involved hedging instruments and reduced actual gas costs by about $70 million, and by short-term physical and financial trades, including sales of gas at the California border, which reduced gas costs by about $134 million.

Edison's suggestion that the core did not properly fill its storage in Year Seven is contradicted by the evidence. The Gas Acquisition Department has a Commission-established storage inventory capacity of 70 Bcf and aimed to get within 5 Bcf of full capacity storage by November 1, including gas repayable by the end of December. SoCalGas met its storage target with 68.6 Bcf of gas in

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[1] We take official notice that the Commission has argued before the Federal Energy Regulatory Commission (FERC) that the spike in price was caused in large measure by the withholding of capacity on the El Paso system by a marketing affiliate of more than one-third of the pipeline's capacity. The Commission told FERC that spot prices at the California border began returning to more historical levels following the expiration of El Paso's contract with its affiliate in May 2001.

storage, filling almost 85% of the capacity reserved for the core. By contrast, noncore storage inventory at the beginning of November 2000 (exclusive of wholesale core volumes) was only about 3 Bcf and filled only about 12% of the unbundled storage capacity that noncore entities had contracted.

Edison engages in antics with semantics when it claims that "GCIM profits in Year Seven were $223.6 million." (Edison Opening Brief, at 3.) The facts are that the net cost of gas for SoCalGas core customers was $223.6 million below the benchmark price for gas during Year Seven, and any reference to "profits" under the GCIM is a misnomer. If the Settlement Agreement is approved, SoCalGas shareholders will share $30.8 million of the $223.6 million in net cost savings, and the remainder will benefit core customers.

Finally, Edison's complaints about the Gas Acquisition Department's use of financial instruments, both hedges and swap transactions, on behalf of core customers seems inappropriate when Edison has asked for authorization to hedge its own fuel costs of up to $250 million as part of a recent settlement with the Commission. (*Southern California Edison Company v. Loretta M. Lynch, et al.*, No. CV-00-12056-RSWL (C.D.Cal. entered 10/5/01).

We conclude that Edison's objections to the GCIM are speculative at best and are not supported by the evidence in this proceeding. Similarly, Edison has not persuaded us that yet another investigation of the GCIM is necessary. The Commission has investigated this incentive mechanism through its Energy Division evaluation and an ORA audit, and it continues to do so in this Year Six proceeding and in the Year Seven audit being considered in A.01-06-027.

The evidence at hearing overwhelmingly supports continuation of the GCIM with the modifications proposed by SoCalGas, ORA and TURN.

6.2 Settlement Agreement Changes

The Settlement Agreement jointly sponsored by SoCalGas, ORA and TURN incorporates most of the changes proposed by the Energy Division in its Evaluation Report. According to ORA, the settlement both "assures that the utility will remain a viable, aggressive buyer of natural gas for core customers with the incentive to minimize core procurement costs" and "keeps regulation of core gas costs under the purview of the Commission" to assure that ratepayers remain protected. (Exhibit 22, at 1-2.)

Revision of Sharing Bands

The Energy Division had recommended changing the ratepayer/shareholder sharing bands to reflect the relative difficulty of savings. The settling parties found it impractical to prioritize activities of the Gas Acquisition Department by range of difficulty. Instead, they agreed to substantially reduce the amount of potential shareholder benefits under the GCIM. Instead of the current 50/50 equal share when below the lower tolerance band, shareholders would only be entitled to a 25% share when savings are between 1% and 5% under benchmark and a 10% share when savings exceed 5% under benchmark. Conversely, ratepayers retain all of the savings in the 0-1% range, 75% of savings in the 1-5% range, and 90% of the savings that are more than 5% below the benchmark. Finally, shareholder earnings under the GCIM are capped at 1.5% of total gas costs.

ORA notes that in the first six years of the GCIM, savings typically fell within the range of 1-5% below benchmark, and ratepayers and shareholders each received 50% of these savings. Under the settlement, ratepayers would retain 75% of savings and shareholders 25%. ORA states that these revisions are clearly in the public interest "as they increase the benefit to ratepayers while still providing SoCalGas with a sufficient incentive to lower gas costs." (ORA Opening Brief, at 11.)

The settlement makes no change to the higher tolerance band, where costs up to 2% above benchmark are borne by ratepayers and costs over the 2% level are shared equally. ORA notes that in the seven years under the GCIM, gas costs have exceeded benchmark only once, in Year One, and then by a modest amount. Given this history, we agree with ORA and TURN that the risk to ratepayers of retaining the existing higher tolerance band is more than offset by the increased ratepayer benefit under the lower tolerance band.

Core Storage Targets

The settlement requires SoCalGas to meet storage inventory targets, similar to current targets, but with the clarification that the targets in Year Nine and thereafter would include physical gas in storage and not gas to be received through future hub loan repayments. The core November 1 storage inventory target would thus be 70.0 Bcf of physical gas supply in storage inventory with an accepted variance of +5 Bcf and –10 Bcf. If the November 1 target is not met, deliveries must be made to ensure that there is at least 60 Bcf of actual physical gas in the core's inventory prior to December 1 of that year.

ORA explains that the change to a physical storage requirement increases core reliability, since core customers will no longer be dependent upon noncore customers repaying loans in the winter months.

In a letter to the Commission dated May 15, 2002, the Settling Parties indicated that they would be willing to amend the settlement to provide a minimum core November 1 storage inventory target for Year 9 and beyond of 70.0 Bcf of physical gas supply in storage inventory with an accepted variance of

+5 Bcf and –5 Bcf. Our order today conditions approval of the settlement on agreement by the Settling Parties of this change.

Elimination of NYMEX

The settlement eliminates the NYMEX program as a component of the GCIM benchmark, as recommended by the Energy Division. The settlement parties state that there has been much less market participant interest in the NYMEX program. The number of months in which the component has been included in the GCIM was reduced to only one month in Year Seven. The benchmark otherwise will remain unchanged in using monthly published indices from independent publications. Uncontested testimony at hearing described these publications as objective and showed that they represent liquid trading points and are based on hundreds of individual transactions. Also uncontested was testimony that SoCalGas trading activities represent, at most, 3% to 4% of volume monitored by the indices.

Application to Year Seven

An important aspect of the settlement is that SoCalGas has agreed to apply the modified GCIM to the results of the Gas Acquisition Department’s Year Seven performance. As noted earlier, this will reduce the SoCalGas shareholder award for Year Seven from $106.1 million to $30.8 million, with the difference going to ratepayers.

A witness for SoCalGas explained at hearing that the utility “made this concession in recognition of the fact that the interests of both its core customers and its shareholders are best served by the continuation of the GCIM. SoCalGas realized that a protracted regulatory battle within a single year of the program would create uncertainty in current operations and potentially jeopardize the GCIM.” (Exhibit 4, at 17.)

Uncontested Settlement Provisions

The following aspects of the Settlement Agreement have not been challenged or questioned by any party and, on their face, are reasonable and in the public interest:

1. Any transportation acquired by the Gas Acquisition Department in excess of retail core requirements is subject to review.

2. SoCalGas is required to maximize its utilization of firm pipeline capacity.

3. No capacity commitments in excess of two years will be made without consultation with ORA and TURN, and all other capacity commitments will be communicated to ORA and TURN.

4. SoCalGas will be required to file an advice letter to implement amendments to the GCIM required by the consolidation of SDG&E procurement functions, if that is approved by the Commission in a pending application (A.01-01-021).

5. SoCalGas will continue to file annual GCIM applications and ORA will continue to conduct an audit and prepare its annual monitoring and evaluation report.

6.3 Objections to Settlement

SCGC criticizes the Settlement Agreement on grounds that: (1) it provides inadequate incentives to seek the lowest price for purchased gas; (2) it fails to adequately address ratepayer risk associated with large losses; (3) it fails to provide an effective storage target, and (4) it fails to incorporate a sunset provision. These criticisms are without merit.

First, SCGC claims that the GCIM should encourage purchase of gas at the lowest price, rather than rely on "ancillary revenues" to reduce overall cost of gas. The evidence shows, however, that hub services, gas sales and financial transactions are not ancillary to the Gas Acquisition Department's activities but are essential tools and assets that can be used efficiently to benefit core customers. Moreover, SCGC has not shown a failure by SoCalGas to seek the lowest gas price. The Energy Division notes that purchases made in the four years prior to the GCIM were well above San Juan and Permian spot market prices, while purchases under the GCIM "were generally at or slightly below spot gas prices on average." (Energy Division Report, at 21.)

Second, SCGC presents only speculation about the risk to ratepayers if gas procurement costs are significantly above benchmark. The record shows that over the seven years of the program there has been only one year when a loss was incurred (Year 1), and that loss was relatively small. As we noted in analyzing the proposed settlement changes, retaining the sharing formula for costs above the benchmark appears to be a reasonable *quid pro quo* in obtaining substantial ratepayer gains for costs below the benchmark.

The contention that the settlement fails to provide an adequate storage target is misplaced. The storage target is 70 Bcf by November 1, with an acceptable variance of +5/-10 Bcf. If that target is missed, the settlement requires that sufficient deliveries be made to reach at least 60 Bcf by December 1. Additionally, as noted, we have conditioned our approval of the settlement on the Settlement Parties' acceptance of a +5/-5 Bcf variance.

Finally, the record does not suggest the need for a sunset provision. The GCIM will continue to require an annual application from SoCalGas and an annual audit by ORA. The Commission, of course, retains the discretion to modify or terminate the program at any time.

We reject SCGC's suggestion that Gas Acquisition Department dealings are comparable to those of the Enron Corporation. Enron was unregulated. By contrast, SoCalGas is regulated by the Commission, and Gas Acquisition Department activities are monitored by ORA and the Energy Division. SoCalGas provides confidential monthly reports of all its transactions to ORA, and ORA performs an extensive annual audit of those activities in each annual GCIM proceeding. At hearing, SoCalGas demonstrated that its trading practices are limited by an Energy Risk Management Oversight Committee.

6.4 Other Issues

SoCalGas, troubled by the extensive discovery sought by Edison, urges the Commission to limit Edison's role in GCIM proceedings, particularly the Year Seven proceeding in A.01-06-027. We agree with Edison that such a proposal is not properly resolved in this proceeding and is contrary to the Commission's intent that noncore interests be considered in GCIM evaluations. SoCalGas may make its discovery objections known in A.01-06-027 if necessary.

SCGC asks the Commission in this decision to consider the Larkin and Associates report, issued in July 2000, suggesting an imbalance penalty against SoCalGas shareholders for over-nomination days when the hub is in a "net-in" position. As SoCalGas notes, however, the Commission in a decision issued in December 2001, approved a Comprehensive Settlement Agreement that effectively adopted the objectives of the Larkin recommendation. (*Re Gas Industry Restructuring*, D.01-12-018.)

7. Conclusion

For the reasons set forth above, we find that the SoCalGas GCIM should be continued as modified by the terms of the Settlement Agreement sponsored by SoCalGas, ORA and TURN. We further find that the Settlement Agreement is reasonable in light of the whole record, is consistent with the law, and is in the public interest. Accordingly, the joint motion for adoption of the Settlement Agreement is granted, provided the Settling Parties have no objection to a change in Year 9 and beyond to provide for an accepted variance of +5 / -5 Bcf.

8. Change in Categorization

In Resolution ALJ 176-3041, dated June 22, 2000, the Commission preliminarily categorized this proceeding as ratesetting and preliminarily determined that no hearings were required. In his Scoping Memo of August 21, 2000, Commissioner Bilas determined that hearings would not be required in Phase 1 of this proceeding, but that a determination as to hearings would follow as to Phase 2. Our order today confirms the categorization of ratesetting but changed the determination to state that hearings were required for Phase 2 of this proceeding.

9. Comments on Proposed Decision

The proposed decision of the administrative law judge in this matter was mailed to the parties in accordance with Section 311(d) of the Public Utilities Code and Rule 77.1 of the Rules of Practice and Procedure. SoCalGas, ORA and TURN filed comments in support of the proposed decision. Edison and SCGC filed comments opposing the proposed decision. SoCalGas, ORA and TURN filed reply comments.

Edison claims that Finding of Fact 9 – "Edison offers no persuasive evidence to show that the GCIM creates perverse incentives for SoCalGas to increase gas prices at the California-Arizona boarder" – is erroneous. In fact, Edison alleged that the GCIM creates perverse incentives but then failed to substantiate that allegation with evidence. ORA and TURN rebutted the allegation with testimony and other evidence showing that the GCIM benefits core ratepayers and does not adversely impact noncore customers. There is no error in the proposed decision's finding of a lack of persuasive evidence by Edison.

Edison also takes issue with Finding of Fact 10: "Edison's allegation that the core did not properly fill its storage in Year Seven is contradicted by the evidence." First, as the proposed decision explains, SoCalGas met its minimum core storage target. In contrast, noncore customers filled only 12% of their storage capacity. As TURN notes, Edison itself acknowledged that SoCalGas met its minimum storage target. (Edison Comments, at 7.) Moreover, Finding of Fact 10 is not premature, as claimed by Edison, since it was Edison that raised the issue of Year Seven storage in this proceeding.

Both Edison and SCGC criticize the proposed decision for disregarding allegations about a SoCalGas information advantage. SoCalGas demonstrated at hearing that relevant information about total gas in its storage system was posted on the utility's GasSelect website and was available to all market participants.

SCGC alleges, without reference to evidence, that SoCalGas has a monopoly position in storage services, intrastate transmission and core procurement that gives it "the power to dominate, if not manipulate, the gas market in Southern California." The allegation is speculative and unsupported by the record. At hearing, SoCalGas, TURN and ORA negated this allegation of market power, which had been raised by Edison, and Edison subsequently dropped the allegation.

ORA notes, and we agree, that the comments of Edison and SCGC do little more than reargue the positions taken in their briefs. Under Rule 77.3 of the Rules of Practice and Procedure, comments "which merely reargue positions taken in briefs will be accorded no weight and are not to be filed."

10. Order Instituting Investigation

While we do not believe that the evidence presented by Edison and SCGC should change the outcome of this proceeding, we do agree that further investigation is warranted into the causes of the extreme border price spikes in December 2000 through spring 2001. As TURN points out, however, this type of investigation is inappropriate in a SoCalGas-specific application proceeding.

Our order today directs the Commission's Energy Division to prepare an Order Instituting Investigation into the 2000/2001 border price spikes for our consideration. This inquiry should include, but not be limited to, the activities of all major trading entities in and at the California-Arizona border for the years 2000 and 2001 and the impact of those activities on California's energy crisis.

Findings of Fact

1. During the first six years of the GCIM, core ratepayers received gas at a cost $42 million below benchmark prices.

2. In Year Seven of the GCIM, SoCalGas procured gas at an overall rate $223 million below benchmark.

3. Savings under the GCIM below benchmark are shared on a 50/50 basis by ratepayers and by shareholders.

4. The sharing mechanism provides an incentive for SoCalGas to seek to procure gas for core ratepayers at the lowest overall cost.

5. Gas purchases made under the GCIM are more favorable to ratepayers than those made when reasonableness reviews were in effect.

6. SoCalGas, ORA and TURN have proposed a Settlement Agreement that would increase core ratepayers' share of GCIM savings and would cap the sharing revenue available to shareholders.

7. The Settlement Agreement incorporates most of the changes into the GCIM recommended by the Commission's Energy Division in its evaluation report.

8. Edison and SCGC do not oppose incentive-based regulation of the gas procurement activities of SoCalGas.

9. Edison offers no persuasive evidence in this proceeding to show that the GCIM creates perverse incentives for SoCalGas to increase gas prices at the California-Arizona border.

10. Edison's allegation that the core did not properly fill its storage in Year Seven is contradicted by the evidence.

11. SCGC's criticisms of the proposed Settlement Agreement are without merit.

12. SoCalGas has failed to show that this proceeding is the proper forum to resolve discovery disputes that may or may not occur in A.01-06-027.

Conclusions of Law

1. The public interest is served by extending the GCIM and by adopting changes to that incentive mechanism sponsored by SoCalGas, ORA and TURN.

2. The Settlement Agreement sponsored by SoCalGas, ORA and TURN is reasonable in light of the whole record, consistent with the law, and in the public interest.

3. The joint motion to approve the Settlement Agreement should be granted, provided the Settling Parties do not within 10 days object to a change in Year 9 and beyond to provide for an accepted variance of +5/-5 Bcf.

4. The protests of Edison and SCGC should be dismissed.

5. The Energy Division should be directed to prepare an Order Instituting Investigation into the 2000/2001 border price spikes for our consideration.

O R D E R

IT IS ORDERED that:

1. The joint motion by Southern California Gas Company (SoCalGas), the Office of Ratepayer Advocates, and The Utility Reform Network to approve the Settlement Agreement, appended hereto as Attachment A, is granted; provided, however, that unless a settling party objects in writing within 10 days, the Settlement Agreement is amended to state that the minimum core November 1 storage inventory target for Year 9 and beyond is 70.0 Bcf of physical gas supply in storage inventory with an accepted variance of +5 Bcf and –5 Bcf.

2. SoCalGas is directed to amend its tariff for the Gas Cost Incentive Mechanism (the GCIM) to incorporate the changes set forth in the Settlement Agreement.

3. SoCalGas is authorized to continue to procure gas for core customers pursuant to the terms of the GCIM, as amended.

4. The protests of Southern California Edison Company and the Southern California Generation Coalition are dismissed.

5. Resolution ALJ 176-3041 is amended to show that hearings were required for Phase 2 of this proceeding.

6. The Commission's Energy Division is directed, within 60 days, to prepare for Commission consideration an Order Instituting Investigation into the border price spikes experienced in the period of December 2000 through spring 2001.

7. Application 00-06-023 is closed.

This order is effective today.

Dated June 6, 2002, at San Francisco, California.

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

ATTACHMENT A

SETTLEMENT AGREEMENT AMONG
SOCALGAS, ORA, AND TURN
ON THE GCIM

This Settlement Agreement has been entered into by and among Southern California Gas Company ("SoCalGas"), the Office of Ratepayer Advocates ("ORA"), and The Utility Reform Network ("TURN").

This Settlement Agreement addresses modifications to SoCalGas' Gas Cost Incentive Mechanism ("GCIM") for Year 7 and beyond, except as otherwise specified. This Settlement Agreement will promptly be submitted under joint motion of the parties to the California Public Utilities Commission ("Commission") for approval.

- **Continuation of the GCIM.** As modified herein, the GCIM will continue on an annual basis until further modified or terminated upon Commission order.

- **Starting in Year 8, the NYMEX Program will be eliminated as a benchmark index.**

- **Additional interstate transportation will be flowed through as a ratepayer cost as long as total transportation does not exceed transportation necessary for retail core load.** Any transportation acquired in excess of that required for retail core load in a given month is subject to review in connection with the GCIM audit on an annual basis. Additionally, the 10% Border guideline is eliminated.

  SoCalGas will maximize its utilization of firm interstate capacity, and its purchases from the basin and mainline receipt points. Capacity utilization is deemed reasonable if SoCalGas nominates at least 95% of its unreleased rights in a given month. In determining transportation necessary for retail core load, consideration will be given to performance of the interstate pipeline capacity including cuts and pipeline maintenance. All commitments for capacity will be communicated to the ORA and TURN. No commitments in excess of two years will be made without consultation with the ORA and TURN.

All related transportation costs associated with the additional core capacity will be treated similar to other gas commodity charges and included in the Purchased Gas Account. The fixed costs would be recoverable from customers, and basin purchases would be measured in the GCIM similar to other basin purchases.

- **Non-SoCalGas Receipt Points as a Result of the El Paso Reallocation.** These transactions will be separately tracked and the value of interstate capacity dedicated to the core associated with the sale of gas at these receipt points will flow entirely to SoCalGas' core ratepayers. In recognition of these new El Paso Natural Gas Company ("El Paso") receipt points (*i.e.*, PG&E-Topock, Mojave-Topock) allocated to SoCalGas, the GCIM benchmark will be adjusted to include the new points. Similar to the current monthly border benchmark, the new points will be indexed to mutually agreed upon publication(s) and will be volume weighted by actual purchases and sales. If an index is not available for a delivery point, a mutually agreed upon substitute index (*i.e.*, % of another SoCalGas border index) will be utilized.

- **Portfolio Combination.** If the Commission approves the consolidation of the SoCalGas and San Diego Gas & Electric Company ("SDG&E") procurement groups, all purchases for SDG&E will be included in SoCalGas' GCIM sharing band structure. Additionally, any charges for pipeline reservation and storage incurred by SDG&E at the time of the combination will be treated in the same manner as SoCalGas' for GCIM purposes. SoCalGas will file an advice letter in order to implement the appropriate amendments to the GCIM required by the consolidation.

- **Sharing Bands.** Gas markets have been relatively stable for six of the last seven years and should stabilize again. However, in recognition of the potential impact of volatile markets on the current GCIM award formula, the following changes to the sharing bands will be made.

The sharing bands above the benchmark will remain unchanged, with no sharing up to 2% above the benchmark and 50 / 50 sharing between ratepayers and shareholders if more than 2% above the benchmark. The mechanism will include a contingency for operational emergencies (*e.g.*, earthquakes, pipeline failures, and other force majeure events). If such emergencies result in costs above the benchmark, then ratepayers would absorb these costs. An alternative daily benchmark could be used to measure these purchases.

- The sharing bands below the benchmark, as a percent of annual gas commodity benchmark, will be as follows:

#	**Sharing Band**	**Ratepayer %**	**Shareholder %**
1	0.0% -1.00%	100%	0%
2	1.00% - 5.00%	75%	25%
3	5.00% & Above	90%	10%

- The shareholder award will be capped at 1.5% of the actual annual gas commodity price.

- **“Mark-to-Market” Accounting**. All GCIM reporting will be done on a “flow month” basis with all activity associated with a particular production month accounted for in that month. Consideration of mark-to-market accounting will be revisited in future years.

- **Annual GCIM and GCIM shareholder benefit.** Beginning in GCIM Year 9, SoCalGas will include the shareholder benefits of the GCIM from the most recent monthly report in SoCalGas' core monthly gas pricing advice letters submitted to the Energy Division, with copies to ORA. SoCalGas will maintain an interest-bearing tracking account associated with the recovery of shareholder benefits. On June 15 of each year, SoCalGas will file its annual GCIM application to the Commission describing in detail the results of the GCIM over the past year. ORA will conduct its annual audit and issue its monitoring and evaluation report by October 15 of each year. Any agreed-upon adjustments in the shareholder incentive award for the past year will be reflected in SoCalGas' next core monthly gas pricing advice letter or as mutually agreed upon by SoCalGas and ORA. If SoCalGas and ORA cannot resolve their differences, if any, concerning recommended adjustments in ORA's monitoring and evaluation report, then the matter will be set for hearing. There will be a reconsideration of the need for an application process in future years.

- **Storage:** SoCalGas is required to meet appropriate storage inventory targets. The core November 1 storage inventory target is 70.0 Bcf of physical gas supply in storage inventory with an accepted variance of + 5 / -10 Bcf. If the November 1 target is not met, however, deliveries must be made to insure that at least 60 Bcf of actual physical gas is reached prior to December 1. The January, February and March minimum month-end targets (equivalent to peak day minimums necessary for serving the core) must be met.

  For GCIM Year 8, it is recognized that the winter storage targets may not be met because of high electric generation demand. For Year 8, if SoCalGas' system receipts are near capacity (approximately 3.4 Bcf/d average during April-October), the November 1 core physical storage must equal at least 80% of SoCalGas total system storage. Under these conditions, SoCalGas will operate under the objective of maintaining physical inventory of 55 Bcf for the core, with the caveat that under extreme (hot) weather conditions that SoCalGas may not achieve this goal. If system receipts average below 3.4 Bcf/d, the targets above apply.

Any deviations from these storage targets should be explained in SoCalGas' annual GCIM filing. The above targets and objectives are not intended to describe or limit the core's rights on the SoCalGas system but instead will be adjusted from time to time as may be necessary or appropriate.

- **Reservations.** This Settlement Agreement represents a negotiated compromise among the parties on a number of issues. If not accepted by the Commission, this Settlement Agreement shall not be admissible in evidence in this or any other proceeding. Nothing contained herein shall be deemed to constitute an admission or an acceptance of any fact, principle, or position contained herein by any party.

  The Settlement Parties have bargained earnestly and in good faith to achieve this settlement. The Settlement Parties intend that the Settlement Agreement be treated as an entire package and <u>not</u> as a collection of separate agreements on discrete issues. Indeed, in order to accommodate the interests of different parties on such an array of diverse issues, changes or concessions in one section of the Settlement Agreement frequently necessitated changes in other sections. In short, the compromises reflected in the various sections of the Settlement Agreement are closely interrelated. Accordingly, the Settlement Parties shall request the Commission to promptly approve the Settlement Agreement without modification. Any material change to this Settlement Agreement shall render the Settlement Agreement null and void.

Agreed to by the undersigned parties on the dates indicated below.

SOUTHERN CALIFORNIA GAS COMPANY

By /s/ JUDITH L. YOUNG
JUDITH L. YOUNG
Title Attorney for Southern California Gas Company

Date July 3, 2001

OFFICE OF RATEPAYER ADVOCATES

By /s/ PATRICK L. GILEAU
PATRICK L. GILEAU
Title Attorney for the Office of Ratepayer Advocates

Date July 3, 2001

THE UTILITY REFORM NETWORK

By /s/ MARCEL HAWIGER

Title Staff Attorney

Date July 2, 2001

(END OF ATTACHMENT A)