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Decision 03-02-033 February 13, 2003

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Southern California Edison Company (U 338-E) for Approval of Fuel Hedging Cost Recovery.	Application 02-03-016 (Filed March 13, 2002)

Michael D. Montoya, Attorney at Law,
for Southern California Edison Company, Applicant.
James E. Scarff, Attorney at Law, for the Office of
Ratepayer Advocates.

OPINION ON FUEL HEDGING COST RECOVERY

I. Summary

We find that the $208.8 million balance in Southern California Edison Company's (SCE) Risk Management Memorandum Account (RMMA) is reasonable and qualifies as recoverable costs. This balance shall be transferred to SCE's Settlement Rate Balancing Account (SRBA) for recovery. SCE shall submit an advice letter that closes the RMMA and deletes the RMMA from its tariff.

II. Background

On October 2, 2001, SCE and the Commission entered into a Settlement Agreement, settling the matters at issue in Southern California Edison Company, Plaintiff, vs. Loretta M. Lynch, et al., then pending before the United States District Court for the Central District of California in Case No. 00-12056-RSWL (Mcx).

The Settlement Agreement lays out a framework for the restoration of SCE's investment grade credit rating. As part of that framework, the Settlement Agreement identified the need to mitigate procurement-related obligation risks. Section 2.4 of that Settlement Agreement states:

> In order to facilitate SCE's restoration to investment grade creditworthiness by making the rate at which Procurement related Obligations are recovered more predictable, SCE intends to apply to the CPUC for its approval of SCE incurring up to $250 million in Recoverable Costs during the Rate Repayment Period to acquire financial instruments and engage in other transactions intended to hedge fuel cost risks associated with SCE's Utility Retained Generation (URG) and Qualifying Facilities (QF) and interutility contracts. The CPUC has indicated that it will reasonably promptly schedule proceedings and consider such request on an expedited basis. Pending such determination by the CPUC, SCE shall record such costs in a tracking account.

On October 5, 2001, the District Court entered judgment approving the Settlement Agreement. On that same date and pursuant to the Settlement Agreement, SCE filed Advice Letter 1579-E to establish RMMA for tracking costs incurred from hedging 2002 and 2003 fuel cost risks. On October 17, 2001, SCE clarified its proposed RMMA tariff via Advice Letter 1579-E-A. These RMMA advice letters became effective October 5, 2001, pursuant to the Commission's November 29, 2001 Resolution E-3761.

III. Issues

Natural gas prices can be extremely volatile. For example, the price of gas at Henry Hub (Louisiana), the most liquid trading point in the United States, varied from a low of $1.74/million British thermal unit (MMBtu) to a high of $10.50/MMBtu over the past two years. The spot price of gas at the Southern California Border (SoCalBorder) varied from a low of $1.26/MMBtu to a high of

$55.00/MMBtu while the SoCalBorder "bid week"[1] price used in the formula of most SCE QF contracts to determine the price paid to QFs for energy varied from $1.75/MMBtu to $16.06/MMBtu during the same period. To put this volatility in perspective, a $1 increase in the price of gas at the SoCalBorder results in a $130 million increase in SCE's annual payments to qualifying facilities (QFs).[2]

SCE and the Office of Ratepayer Advocates (ORA) agreed at the August 1, 2002 continued prehearing conference (PHC) that the issues in this proceeding are whether the $208.8 million cost SCE incurred from hedging 2002 and 2003 fuel cost risks is reasonable and whether the cost is recoverable.[3] Consistent with that agreement and pursuant to Rule 6.3 of the Commission's Rules of Practice and Procedure (Rules), the Assigned Commissioner issued a Scoping Memo and Ruling identifying the agreed-upon issues for hearing. There are no other issues.

IV. Discussion

In Decision (D.) 87-06-021, we defined reasonable to mean that at a particular time any of the practices, methods, and acts engaged in by a utility follows the exercise of reasonable judgment in light of facts known or which should have been known at the time the decision was made. The act or decision

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[1] The Bid Week Price is the average of prices reported to market publications for transactions occurring during the week before a given month for constant gas deliveries for the following month.

[2] QFs are independently owned power producer or cogenerators that meet certain operating, efficiency, and fuel-use standards set forth by the Federal Energy Regulatory Commission (FERC).

[3] The initial PHC was held on May 30, 2002, at which time ORA requested and received an extension of time to conduct discovery and to prepare testimony.

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

We have used this standard to address the reasonableness of utility contracts throughout the years, such as in San Diego Gas & Electric Company's Southwest Power Link arrangement.[5] We use this same standard in our evaluation of SCE's 2002 and 2003 hedging options and costs.

ORA has provided testimony, but neither affirms nor disavows the reasonableness of SCE's hedging expenses or reasonableness of the proposed cost recovery.[6] The purpose of its testimony is to "lay out the background in this proceeding,"[7] which is also set forth in the application. Irrespective of its informational testimony, ORA recommends that:

- SCE and ORA collaborate to actively manage SCE's QF hedging portfolio.

[4] 24 CPUC2d 476 at 486 (1987)

[5] 31 CPUC2d 236 (1989).

[6] RT Volume 1, 21 at lines 8-13.

[7] RT Volume 1, 21 at lines 17-18.

- SCE's QF hedging be integrated with its overall portfolio management of electricity and natural gas price risks.
- Any additional expenditures resulting from modifying the hedge agreed upon by SCE and ORA be deemed reasonable.
- SCE work collaboratively with ORA if it desires to hedge QF-related risk in 2004.

ORA's testimony addresses future hedging costs and proposes an approach to be used prospectively. Unfortunately, ORA does not address the identified issues and its recommendations apply to issues outside of the scope of this proceeding. Hence, we must reject consideration of ORA's testimony and recommendations in determining whether SCE's hedging costs in its RMMA are reasonable and whether such cost should be recoverable.

a. Hedging Options

With only SCE testifying on the reasonableness of its hedging options, that testimony must reasonably substantiate that SCE hedging options was the appropriate vehicle to avoid volatility in gas prices and to create more certainty regarding its QF payments and procurement related obligations.

SCE identified swap contracts and hedging options as viable means to stabilize its gas prices. Swap contracts would require SCE to pay a fixed price each month for a specified volume of gas. In exchange, the counter party to swap contracts would pay SCE the SoCalBorder index price for gas each month for the same volume. Although cash settlements would occur each month, there would be no physical gas changing hands. As the price of gas fluctuates, the contract becomes more or less valuable. If the price of gas falls, SCE would be required to post collateral. This collateral could consist of either cash or a letter of credit.

Hedging options do not have any collateral requirements. However, SCE must pay up front. In return, SCE receives the difference between the gas price and a strike price multiplied by the volume of gas covered by hedging options if the price of gas rises above that strike price for the period covered by those options.

SCE selected hedging options because it was not able to post any collateral for swap contracts. In support of its selection of hedging options, SCE explains that its ratepayers have already received benefit. For example, on February 8, 2002, Moody's Investment Service (Moody's) assigned a (P)Ba2 rating to $1.5 billion of secured credit facilities being arranged by SCE. In the publicly released rationale of its rating, Moody's stated that it views the cash flows of procurement related obligations to be fairly predictable because most of the volatility has been eliminated or reduced by actions of SCE and others, such as SCE hedging its exposure to natural gas price increases.

We recognize that SCE's financial situation in 2001 precluded SCE from posting collateral (cash or letter of credit) for swap contracts. That is because SCE was nearing bankruptcy by incurring a large debt burden to purchase power. If SCE had tried to post collateral, it is possible that such an action would have been deemed a termination event under the forbearance agreements between SCE and its bank lenders, thereby enabling the lenders to accelerate the repayment of $1.65 billion of SCE's then outstanding bank borrowings.

SCE's 2002 and 2003 hedging options did limit its exposure to high gas prices while retaining the benefit of any price decrease without being required to post collateral, a condition it was not in a position to satisfy. That exposure amounted to $208.8 million, as represented by the balance in its

RMMA. In light of the financial facts known at the time of its decision to participate in hedging options over swap contracts, SCE exercised reasonable judgment in utilizing hedging options.[8]

b. Recoverable Cost

SCE submitted testimony under seal to support the reasonableness of the $208.8 million cost it incurred from hedging. SCE deems such information confidential because it is not currently available to the general public and, if disclosed, would provide competitors an insight into SCE's hedging strategy and bargaining position. If disclosed, it would also place SCE and its ratepayers at a disadvantage in seeking future hedging options. The Administrative Law Judge (ALJ) affirmed that this information is confidential and ruled that SCE's confidential information should remain sealed and not be disclosed to anyone other than Commission staff except on the execution of a mutually accepted non-disclosure agreement or further order or ruling of the Commission, the ALJ, or the assigned Commissioner.

We scrutinized SCE's sealed testimony to determine how much of the RMMA balance should be recoverable. That sealed testimony provides substantial information on the details of the volumes hedged, price-per-option, transaction structure, and competitive quotes. Based on that sealed testimony and informed judgment, we find that the entire cost in the RMMA complies with the reasonableness criteria set forth in D.87-06-021. SCE should be authorized to recover its $208.8 million hedging cost.

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[8] This decision does not alter our determination in D.02-10-062 that the utilities do not require an investment-grade credit rating in order to procure.

SCE seeks authority to transfer its hedging costs deemed reasonable to the SRBA from the RMMA. Its recommendation is based on Resolution E-3765. That resolution established a Procurement Related Obligation Account (PROACT) and associated ratemaking structure, including treatment of hedging costs recorded in the RMMA as "Recoverable Costs" in the operation of the PROACT. That resolution also provides for all recoverable hedging costs to be recorded in the SRBA until the Commission renders a final decision with respect to SCE's URG ratemaking proposal in Application 00-11-038. Consistent with Resolution E-3765, the hedging balance in the RMMA should be transferred to the SRBA and the RMMA should be closed.[9]

V. Procedural Matters

SCE requested that this matter be categorized as ratesetting and states that no hearings are necessary. By Resolution ALJ 176-3084, dated March 21, 2002, the Commission preliminary determined that this was a ratesetting proceeding and that no hearings were expected. Subsequent to that resolution, ORA filed a protest. A PHC was held on May 30, 2002, and continued to August 1, 2002. An evidentiary hearing concluded on October 28, 2002. The parties opted not to file briefs. This matter was submitted on November 4, 2002.

Notice of this application appeared in the Commission's March 19, 2002 Daily Calendar. There is no objection to the ratesetting categorization of this

[9] There is a pending application for rehearing of Resolution E-3765. Our actions here do not prejudge any disposition of the application for rehearing. In addition, the United States Court of Appeals has requested that the California Supreme Court accept certification of certain issues related to State Laws. Today's decision is subject to modification if the California Supreme Court issues an opinion that requires modifications to the Settlement.

proceeding. With no opposition to the categorization of this proceeding, we affirm that this is a ratesetting proceeding.

VI. Comments on Proposed Decision

The proposed decision of the ALJ 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. Comments were timely filed by SCE. There was no substantive change to the proposed decision.

VII. Assignment of Proceeding

Carl W. Wood is the Assigned Commissioner and Michael J. Galvin is the assigned ALJ in this proceeding.

Findings of Fact

1. SCE and the Commission entered into a Settlement Agreement, settling the matters at issue in Southern California Edison Company, Plaintiff, vs. Loretta M. Lynch, et al., then pending before the United States District Court for the Central District of California in Case No. 00-12056-RSWL (Mcx).

2. The Settlement Agreement lays out a framework for the restoration of SCE's investment grade credit rating. As part of that framework, the Settlement Agreement identified the need to mitigate procurement-related obligation risks.

3. The Settlement Agreement provides for SCE to apply to the Commission for its approval of SCE incurring up to $250 million in Recoverable Costs during the Rate Repayment Period to acquire financial instruments and engage in other transactions intended to hedge fuel cost risks associated with SCE's URG and QF and interutility contracts. Pending such determination by the Commission, SCE shall record such costs in a tracking account.

4. On October 5, 2001, the District Court entered judgment approving the Settlement Agreement.

5. Resolution E-3761 authorized SCE to establish a RMMA for tracking costs incurred from hedging fuel cost risks effective October 5, 2001.

6. A $1 increase in the price of gas at the SoCalBorder results in a $130 million increase in SCE's annual QF payments.

7. Under swap contracts, SCE must agree to pay a fixed price each month for a specified volume of gas. As the price of gas fluctuates, the contract becomes more or less valuable. If the price of gas falls, SCE would be required to post collateral.

8. Under a hedging option, SCE receives the difference between the gas price and a strike price multiplied by the volume of gas covered by the option if the price of gas rises above that strike price for the period covered by the option. No collateral is required.

9. Moody's views the cash flows of procurement-related obligations to be fairly predictable because most of the volatility has been eliminated or reduced by actions of SCE and others.

10. Testimony regarding the volumes hedged, price-per-option, transaction structure, and competitive quotes to support the reasonableness of the $208.8 million cost SCE incurred from hedging is under seal.

11. Resolution E-3765 provides for all recoverable hedging costs to be recorded in the SRBA.

12. In D.87-06-021, we defined reasonable to mean that at a particular time any of the practices, methods, and acts engaged in by a utility follows the exercise of reasonable judgment in light of facts known or which should have been known at the time the decision was made. The act or decision is expected by the utility to accomplish the desired result at the lowest reasonable cost

consistent with good utility practices. Good utility practices are based upon cost effectiveness, reliability, safety, and expedition.

13. SCE's financial situation in the late 2001 precluded SCE from posting collateral (cash or letter of credit) for any swap contracts.

Conclusions of Law

1. The $208.8 million balance is SCE's RMMA is reasonable and qualifies as recoverable cost.

2. Information placed under seal should remain sealed because, if disclosed, it would provide competitors an insight to SCE's hedging strategy and bargaining position and place SCE and its ratepayers at a disadvantage in seeking future hedging options or swaps.

3. This order should be effective immediately to allow for the expeditious closing of SCE's RMMA.

O R D E R

IT IS ORDERED that:

1. The $208.8 million hedging costs amortized for 2002 and 2003 in Southern California Edison Company's (SCE) Risk Management Memorandum Account (RMMA) is reasonable and qualifies as recoverable costs. This amount shall be transferred to SCE's Settlement Rate Balancing Account (SRBA).

2. SCE shall submit an advice letter within 10 days after the effective date of this order to transfer the $208.8 million balance in the RMMA to the SRBA. SCE shall file an advice letter to close the RMMA, dispose of the balance in the account, and delete the RMMA from its tariff when the Settlement hedging transactions expired, subject to written approval by the Energy Divison.

3. Information placed under seal shall remain sealed except upon the execution of a mutually accepted non-disclosure agreement or further order or ruling of the Commission the Administrative Law Judge, or the assigned Commissioner.

4. The application is granted as set forth above.
5. This proceeding is closed.

This order is effective today.

Dated February 13, 2003, at San Francisco, California.

MICHAEL R. PEEVEY
President
CARL W. WOOD
LORETTA M. LYNCH
GEOFFREY F. BROWN
SUSAN P. KENNEDY
Commissioners