Decision 03-08-064 August 21, 2003

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of Southern California Gas Company (U 904 G) Regarding Year Eight (2001-2002) of Its Gas Cost Incentive Mechanism.	Application 02-06-035 (Filed June 17, 2002)

OPINION REGARDING YEAR EIGHT OF THE GAS COST INCENTIVE MECHANISM

Summary

Today's decision addresses the Year Eight Gas Cost Incentive Mechanism (GCIM) application filed by Southern California Gas Company (SoCalGas) on June 17, 2002.

The decision finds that SoCalGas reasonably managed its gas acquisitions and operations in Year Eight within the context of the GCIM that existed at the time, and that the calculation and amount of the shareholder award is correct. Pursuant to the GCIM modifications adopted in Decision (D.) 02-06-023, SoCalGas is awarded a shareholder award of $17,388,157 for Year Eight.

Due to the ongoing activities in the Order Instituting Investigation (I. or investigation) 02-11-040, the finding of reasonable management shall not prejudge what the Commission may find or conclude in I.02-11-040, and the SoCalGas shareholder award shall be subject to refund or adjustment as may be determined by the Commission in I.02-11-040.

Procedural and Factual Background

The GCIM is a ratemaking mechanism that SoCalGas uses to purchase natural gas on behalf of its core customers. SoCalGas was first authorized to use the GCIM in D.94-03-076 [53 CPUC2d 663]. Most recently, in D.02-06-023, the GCIM was modified and SoCalGas was authorized to continue the use of the GCIM on an annual basis until modified or terminated by the Commission. SoCalGas' application describes the results of operations under the GCIM structure for its gas acquisition activities for Year Eight, the period from April 1, 2001 through March 31, 2002.

On June 17, 2002, SoCalGas filed its Year Eight GCIM application. Southern California Edison Company (SCE) filed a protest to SoCalGas' Year Eight GCIM application on July 26, 2002. The Office of Ratepayer Advocates (ORA) filed a response to the application on July 25, 2002. On August 5, 2002, SoCalGas filed a reply to SCE's protest.

On December 20, 2002, ORA served its Monitoring and Evaluation Report on the Year Eight GCIM.

A prehearing conference was held on November 6, 2002 to discuss whether the issues raised by the protestant should be examined in this application or elsewhere, and to determine the procedural schedule for processing this application. At that prehearing conference, the administrative law judge (ALJ) mentioned that D.02-06-023 had approved the settlement agreement in Phase II of A.00-06-023, the Year Six GCIM proceeding; that the Commission was considering opening an investigation into the gas border price spikes at its November 7, 2002 business meeting, and that the investigation could possibly be the forum for addressing SCE's concerns about the GCIM structure. On November 21, 2002, the Commission adopted I.02-11-040, initiating its investigation into the possible causes of high gas border prices for the period March 2000 through May 2001.

On January 16, 2003, the scoping memo and ruling was issued for this proceeding.[1] The scoping memo and ruling described I.02-11-040 and stated:

> Based on the action taken in I.02-11-040, the issues raised by SCE in its protest to this application will be addressed in I.02-11-040. As a result, there are only two remaining issues that need to be addressed in this proceeding. The first issue is whether the calculation of the shareholder award for Year Eight under the GCIM is correct or not. The second issue is whether SoCalGas' acquisition operations during Year Eight were reasonable within the context of the authorized GCIM.
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> As noted at the November 6, 2002 prehearing conference, the first issue is straightforward, and is derived by examining ORA's Monitoring and Evaluation Report dated December 20, 2002. No one contests the way in which the shareholder award was calculated for Year Eight.
>
> The second issue is also addressed in ORA's Monitoring and Evaluation Report. Although SCE has raised concerns about the way in which the GCIM is structured, and whether SoCalGas' operations amounted to market power, anticompetitive behavior, or was a cause of the high gas prices experienced in later 2000 through spring 2001, I.02-11-040 will provide a forum for addressing those concerns. Consequently, the second issue can be addressed without waiting for I.02-11-040 to be resolved.

The scoping memo and ruling also determined that no evidentiary hearings would be held because no one disputes how SoCalGas' shareholder

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[1] A revised scoping memo and ruling was issued on March 18, 2003, and a further revised scoping memo and ruling was issued on May 21, 2003.

award was calculated, and because SCE's concerns about the GCIM will be addressed in I.02-11-040.

Position of the Parties

A. SoCalGas

The Year Eight GCIM application of SoCalGas reports on the reasonableness of its gas supply and storage operations for the period April 1, 2001 through March 31, 2002. In accordance with D.94-03-076, D.97-06-061, D.98-12-057 and D.02-06-023, SoCalGas requests that the Commission approve a shareholder award of $17.4 million.

SoCalGas' Annual Report for Year Eight, which was attached to SoCalGas' application, notes that "SoCalGas' core customers have realized the benefit of gas purchases below the GCIM Benchmark in seven of the past eight years." (A.02-06-035 Application, Attachment A, p. 2.) SoCalGas' Annual Report also states:

> "In summary, the GCIM provides an incentive for SoCalGas to efficiently use the retail core's interstate pipeline and storage rights to deliver reliable, low-cost supplies. Reliability is achieved by constructing a portfolio of natural gas supplies that is diversified by contract type, geographic region, and supplier. SoCalGas uses tools available to a typical trading organization, including purchases, sales, loans, parks, wheels, derivatives, exchanges, and transportation contracts. These tools enhance reliability and allow SoCalGas to make economic use of assets, when not directly needed for reliability, to lower overall gas costs to its core customers." (A.02-06-035 Application, Attachment A, pp. 4-5.)

B. SCE

SCE contends that the original intent of the GCIM was to provide a procurement incentive so that SoCalGas has an incentive to purchase gas supplies at or below prevailing market prices. SCE asserts that over time, the GCIM has been modified to include incentives that are not related to gas procurement, but rather are incentives relating to SoCalGas' use of transportation assets and financial instruments. SCE contends that by including the profits from the use of transportation assets and financial instruments as part of the GCIM formula, the GCIM "creates perverse incentives, harms noncore customers, and has a detrimental impact on California energy markets." (SCE Protest, p. 3.) SCE also argues that the GCIM, "in its current form, encourages and approves of actions by SoCalGas that raise natural gas prices to benefit company shareholders at the expense of core and noncore gas and electric customers." (Id.)

SCE points out in Year Eight, SoCalGas beat the benchmark by $190 million, a savings that is close to the amount reported for Year Seven. Although this amount will be reduced due to the settlement adopted in D.02-06-023, SCE asserts that until the perverse incentives are eliminated from the GCIM, the GCIM continues to be flawed.

SCE also contends that:

> In many ways, the GCIM formula puts SoCalGas in the combined position of an interstate pipeline and a market affiliate, i.e., one that can use transportation assets along with its dominant position in commodity markets at the California border to benefit its shareholders through the GCIM mechanism. In fact, the GCIM is worse because it not only permits, it encourages SoCalGas to utilize its transportation assets to maximize "benefits" to core ratepayers. Indeed, the anticompetitive effects caused by

> this very dangerous combination is the very reason FERC's regulations continue to carefully separate transportation services from sales of natural gas and to evaluate all new regulations to ensure that they continue to treat interstate transportation and natural gas marketing as distinct economic and commercial services. (SCE Protest, p. 4, footnotes omitted.)

SCE believes that hearings are necessary so that the Commission and the parties can examine the activities of SoCalGas during Year Eight "to determine whether the requested award was the result of the exercise of market power or other anticompetitive behavior by SoCalGas." (SCE Protest, p. 6.)

C. ORA

At the time ORA filed its response to SoCalGas' Year Eight application, ORA was planning to submit its Monitoring and Evaluation Report for Year Eight on October 31, 2002. ORA agrees that hearings may not be necessary for this proceeding, and notes that ORA's report will include an audit of SoCalGas' Purchased Gas Account costs, an analysis and verification of the GCIM calculations, and an evaluation of how the GCIM is operating.

ORA's Monitoring and Evaluation Report for Year Eight was served on December 20, 2002. This report states that ORA "conducted a comprehensive audit of the GCIM Year Eight results submitted by SoCalGas in its Application." (ORA Monitoring and Evaluation Report, Dec. 20, 2002, p. 1-3.) The report also states that the cost savings below the GCIM benchmark were confirmed, and that the shareholder award amount of $17.4 million was verified. Based on the results of ORA's audit, ORA recommends that SoCalGas be authorized to recover a shareholder award of $17.4 million.

Discussion

The GCIM is the structure which replaced the Commission's reasonableness reviews of SoCalGas' gas purchases and gas storage decisions on behalf of its core sales customers.[2] The GCIM is designed to provide SoCalGas with a financial incentive for making efficient gas purchasing decisions. The incentive is created by establishing a benchmark against which SoCalGas' gas supply purchases for its core and core subscription customers are measured. The benchmark is based on a combination of monthly gas price indices.

SoCalGas' Year Eight application states that it was able to purchase gas at $189,794,664 below the GCIM benchmark. The actual cost of all the purchases subject to the GCIM was $1,290,296,698 and the benchmark cost was $1,480,091,362. Pursuant to the GCIM revisions adopted in D.02-06-023, SoCalGas requests a shareholder award of $17.4 million.[3]

ORA conducted a review, audit, and evaluation of the Year Eight GCIM results, which is contained in ORA's Monitoring and Evaluation Report for Year Eight. This analysis confirmed the gas volumes purchased, storage and gas sales, hedging activities, the benchmark price, volumetric interstate transportation costs, interstate reservation costs, and the capacity levels nominated and the actual volumes delivered by pipeline. In summary, ORA's analysis verified the following:

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[2] Prior to D.94-03-076, the Commission reviewed SoCalGas' gas purchases and operations in annual reasonableness reviews. (See 53 CPUC2d at p. 665.)

[3] The shareholder award amount of $17.4 million reflects the modification to the GCIM in D.02-06-023 which capped the shareholder award to 1.5% of the actual annual gas commodity cost.

- The Year Eight GCIM resulted in total shared savings of $189,794,664 based on the difference between the actual cost of gas and transportation of $1,290,296,698 and the benchmark index of $1,480,091,362.

- The total savings before the mandatory cap was applied would have been $164,070,281 to ratepayers, and $25,724,383 to SoCalGas' shareholders.

- Under the GCIM as modified by D.02-06-023, the shareholder award is $17,388,157 and the remainder of the shared savings of $172,406,507 is retained by ratepayers.

We first address the concerns raised by SCE in its protest to SoCalGas' application. At the November 6, 2002 prehearing conference, the issues raised by SCE were recognized, and the ALJ discussed how these issues were being addressed in Phase II of A.00-06-023 and in the investigation the Commission was considering opening. Following the adoption of the settlement in D.02-06-023, and the opening of the investigation into the cause of gas border price spikes, the January 16, 2003 scoping memo and ruling was issued. The scoping memo and ruling recognized that D.02-06-023 had hearings, and resolved the issues of whether the GCIM structure should be extended for Year Seven and beyond, and whether the GCIM should be modified. The Commission also declined in D.02-06-023 to consider another investigation of the GCIM.

The scoping memo and ruling also noted that I.02-11-040 opened an investigation into the cause of gas border price spikes. Among the issues that the investigation will look at are whether the utilities' affiliates or parent companies' financial positions caused the utilities to take actions that may have increased gas costs, and whether the GCIM created perverse incentives to increase or manipulate gas prices at the California border, and whether the GCIM enables the utilities to exercise market power or anticompetitive behavior. The scoping memo and ruling also stated that based on D.02-06-023 and I.02-11-040, the issues raised by SCE were either resolved in D.02-06-023 or will be addressed in I.02-11-040.[4]

Thus, there are only two remaining issues that need to be addressed in this proceeding. The first issue is whether the calculation of the shareholder award for Year Eight under the GCIM structure, as modified by D.02-06-023 is correct or not. The second issue is whether SoCalGas' acquisition operations during Year Eight were reasonable within the context of the authorized GCIM.

With regard to the first issue, SCE does not dispute the calculation of SoCalGas' request for a shareholder award of $17.4 million for Year Eight. Although SCE has raised concerns about the GCIM structure, those concerns are being addressed by the Commission in I.02-11-040 or have been addressed in D.02-06-023. ORA's Monitoring and Evaluation Report has verified that the amount and calculation of the shareholder award amount for Year Eight is correct.

The second issue is whether SoCalGas' acquisition operations during Year Eight were reasonable within the context of the authorized GCIM. Although SCE has raised concerns about the GCIM structure and whether it creates perverse incentives, those concerns are to be examined in I.02-11-040. If the investigation reveals that the respondents' conduct contributed to the gas price

[4] SCE's Protest acknowledges at page three that it presented evidence in the Year Six GCIM about SoCalGas' actions in Year Seven, which SCE contends "raised the price of natural gas to all California energy consumers."

spikes at the California border during the time period of the investigation, I.02-11-040 states that the Commission may modify or eliminate the GCIM, reduce the amount of the shareholder award for the period involved, or order the respondents to issue a refund to ratepayers to offset the higher rates that were paid.

ORA's Monitoring and Evaluation Report for Year Eight analyzed and evaluated the reasonableness of SoCalGas' gas operations for the period. ORA's report for Year Eight concludes "that the GCIM continues to provide favorable benefits to SoCalGas' natural gas procurement customers." (ORA Monitoring and Evaluation Report, p. 1-4.) The report also notes that the "GCIM encourages the utility to employ appropriate risk management tools and utilize thoughtful, pragmatic procurement practices," and that "SoCalGas' gas procurement customers realized the benefits of these incentives through lower gas procurement costs consistent with past historical prices." (Id.) ORA also states that it "is convinced that the GCIM is the single most important factor in assuring that SoCalGas effectively manages its gas procurement costs and ultimately achieves cost savings during both volatile and stable market conditions." (Id., p. 1-5.)

After reviewing SoCalGas' application and ORA's Monitoring and Evaluation Report for Year Eight, we find that SoCalGas reasonably managed its gas acquisitions and operations in Year Eight within the context of the GCIM that existed at the time. However, since the Commission is conducting an investigation into the causes of high gas border prices from March 2000 through May 2001, today's finding does not prejudge what the Commission may find or conclude in I.02-11-040.

We also find that the calculation and amount of SoCalGas' shareholder award for Year Eight is correct. In accordance with the GCIM modifications adopted in D.02-06-023, SoCalGas is entitled to a shareholder award of $17,388,157 for Year Eight of the GCIM. However, due to the ongoing activities in I.02-11-040, the Commission may adjust the shareholder award for Year Eight if that investigation reveals that the conduct of the respondents to the investigation contributed to the price spikes at the California border during the investigation's time period. Thus, we will award SoCalGas a shareholder award of $17,388,157 for Year Eight of its GCIM, subject however to refund or adjustment, as may be determined in I.02-11-040. SoCalGas is permitted to adjust the Purchased Gas Account to reflect the shareholder award that may be subject to refund or adjustment.

Comments on Draft Decision

The draft decision of the ALJ in this matter was mailed to the parties in accordance with Public Utilities Code § 311(g)(1) and Rule 77.7 of the Rules of Practice and Procedure. No comments on the draft decision were filed.

Assignment of Proceeding

Loretta M. Lynch is the Assigned Commissioner and John S. Wong is the assigned ALJ in this proceeding.

Findings of Fact

1. D.02-06-023 approved the settlement agreement in Phase II of A.00-06-023.
2. The Commission adopted I.02-11-040 on November 21, 2002, which opened an investigation into the possible causes of high gas border prices.
3. The scoping memo and ruling in this proceeding, issued on January 16, 2003, described what had occurred in I.02-11-040, and ruled that no hearings would be held in this proceeding.

4. The GCIM is designed to provide SoCalGas with a financial incentive for making efficient gas purchasing decisions.

5. SoCalGas acquired gas at a savings of approximately $189.8 million below the GCIM benchmark in Year Eight.

6. Pursuant to the GCIM revisions adopted in D.02-06-023, the shareholder award amount is capped at $17.4 million.

7. SCE does not dispute the calculation of the shareholder award of $17.4 million for Year Eight.

8. SCE's concerns about the GCIM structure have been addressed in D.02-06-023 or will be addressed by the Commission in I.02-11-040.

9. ORA's Monitoring and Evaluation Report for Year Eight verified the amount and calculation of the shareholder award.

10. I.02-11-040 states that the Commission may modify or eliminate the GCIM, reduce the amount of the shareholder award for the period involved, or order the respondents to issue a refund to ratepayers.

11. ORA's Monitoring and Evaluation Report for Year Eight analyzed and evaluated the reasonableness of SoCalGas' gas operations for the period.

12. SoCalGas reasonably managed its gas acquisitions and operations in Year Eight within the context of the GCIM that existed at the time.

13. The calculation and amount of SoCalGas' shareholder award for Year Eight are correct.

Conclusions of Law

1. Today's finding regarding the reasonableness of SoCalGas' management of its gas acquisitions and operations in Year Eight shall not prejudge what the Commission may find or conclude in I.02-11-040.

2. In accordance with the GCIM modifications adopted in D.02-06-023, SoCalGas is entitled to a shareholder award of $17,388,157 for Year Eight of the GCIM.

3. Due to ongoing activities in I.02-11-040, the Commission may adjust the shareholder award for Year Eight if that investigation reveals that the conduct of the respondents to the investigation contributed to the price spikes at the California border.

4. SoCalGas should be awarded a shareholder award of $17,388,157 for Year Eight of its GCIM, subject however to refund or adjustment, as may be determined in I.02-11-040.

5. SoCalGas should be permitted to adjust the Purchased Gas Account to reflect the shareholder award of $17,388,157 that may be subject to refund or adjustment.

6. This order should be effective today in order to resolve this matter expeditiously.

O R D E R

IT IS ORDERED that:

1. Southern California Gas Company (SoCalGas) is authorized to adjust the Purchased Gas Account to recognize a shareholder award of $17,388,157 under Year Eight of its Gas Cost Incentive Mechanism.

2. SoCalGas' shareholder award amount of $17,388,157 shall be subject to refund or adjustment as may be determined by the Commission in Order Instituting Investigation 02-11-040.

3. This proceeding is closed.

This order is effective today.

Dated August 21, 2003, at San Francisco, California.

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

I dissent.

/s/ LORETTA M. LYNCH
Commissioner