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Decision 87 10 043 OCT 16 1987

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Investigation into procurement and system reliability issues deferred from D.86-12-010.	I.87-03-036 (Filed March 25, 1987)

OPINION

On March 25, 1987, we initiated this investigation into the natural gas procurement and system reliability issues deferred from Decision (D.) 86-12-010. As announced in the March order, we deferred hearings on these issues until the conclusion of our proceeding (I.86-06-005) to implement our new gas rate design. That case has now been submitted, and the purpose of this order is to address the scope of the procurement hearings which will be our next order of business, and which we expect will begin shortly after our implementation decision in I.86-06-005. In deciding the scope of those hearings, this order will consider the comments which have been filed on several issues, as directed in the March order.

I. PG&E's Proposal on Commodity Pricing Flexibility

The March 25 order which initiated this investigation followed a hearing before the Commission en banc on February 20, 1987. At that hearing Pacific Gas and Electric (PG&E) unveiled a proposal to sell certain excess core gas supplies to some noncore customers at prices below the weighted average cost of gas (WACOG) for its noncore portfolio. PG&E sweetened its proposal by including a requirement that the discounted noncore sales be coupled with similarly discounted sales to the core portfolio. To be eligible for this program, core suppliers would have to provide, in PG&E's judgement, "stable and competitive" prices for the core portfolio. PG&E would limit its sales of these excess core supplies to its own powerplants, the EOR market, and other utilities, plus any other customer groups approved by the CPUC.

Our March order discussed our first impressions of the pros and cons of the PG&E plan, and requested comments from interested parties. Numerous parties filed comments.

The Opposition. The PG&E plan was opposed by all commenters except the Public Staff Division (PSD) and Toward Utility Rate Normalization (TURN). The opposition included Southern California Gas (SoCal), a regulated distribution company; San Diego Gas & Electric (SDG&E) and the City of Long Beach (Long Beach), wholesale distributors; El Paso and Transwestern, the interstate pipelines supplying southern California; the California Manufacturers Association (CMA) representing large industrial users; a coalition of public power agencies in southern California (Muni UEGs); Hadson and Western Gas Marketing (WGM), gas marketers; the California Cogeneration Council (CCC); and producer interests from the Southwest, California, and Canada (Chevron, Arco, Tenneco/Conoco, Exxon, Shell Canada, and the Canadian Producer Group [CPG]).

A theme continually sounded by the opposition is that the PG&E plan will allow PG&E to use its market power over Canadian producers to restrict competition in the California gas market. Because PG&E has the first call on the entire capacity of its Pacific Gas Transmission (PGT) pipeline, the opposition fears that PG&E could use the flexible pricing proposal to keep PGT full with gas for the core and with "excess" core supplies to be sold at a discount into the most price-sensitive part of the noncore market. Some commenters felt that even the opening of PGT to non-discriminatory transportation would not remove PG&E's potential ability, under its proposal, to monopolize PGT's capacity. One possible result of such a restriction could be a decline in interest in bidding into PG&E's spot gas program: even TURN and PSD acknowledged this potential problem, and recommended that one-half of PG&E's noncore UEG load be excluded from the program in order to maintain a viable spot gas bidding program. A related concern is that PG&E would be able to use its market power over producers to insulate it from having to discount its transmission rates in order to move gas. When a customer threatened to switch to an alternate fuel, PG&E could force Canadian producers to provide the discount needed to keep that customer, rather than discounting its own transmission rate. Thus, PG&E would be under less pressure to cut its own costs--cost-cutting which would benefit all ratepayers.

The producer interests also remarked that the prospect of PG&E's market power would tend to discourage producers from committing long-term supplies to the PG&E market, including PG&E's core portfolio. Large gas consumers such as CMA and CCC criticized the limited applicability of PG&E's program as discriminatory, and noted that it would target the cheapest gas to the most price-sensitive noncore users, and to the core, leaving the more expensive noncore gas for the less elastic noncore users. SoCal warned that the plan would open about 80% of its noncore market to competition from PG&E's discount gas, and that if large amounts of PG&E gas displaced gas from SoCal's suppliers, SoCal's ratepayers could bear additional take-or-pay costs. Transwestern echoed these concerns.

The opposing parties cite numerous factual uncertainties clouding the PG&E proposal, and thus request that the Commission set the proposal for hearing, if we do not reject the plan outright.

Support from PSD and TURN. The PSD and TURN recommend that the program be approved on a limited, one- or two-year, trial basis, with certain modifications. They support the idea because of the real, immediate benefits which it offers for core customers. They do offer a number of "fine-tuning" modifications, including the limitation on sales to PG&E's UEG market, mentioned above. The PSD also recommends that SoCal Gas be allowed to offer a similar program, that transportation revenues from off-system sales should benefit all customer classes, and that PG&E should seek even greater core benefits, if that is acceptable to the program's suppliers. TURN also commented that additional core benefits are possible.

PG&E's Response. PG&E filed a response to some of the comments submitted by other parties. PG&E offers to limit the amount of eligible UEG load to 20 percent of total annual UEG use or 100 percent of the noncore market, whichever is less, in response to the concern expressed by PSD and TURN. The utility asserts that it does not view the limit on the customer classes eligible for the program as discriminatory; rather, the limitation is designed to restrict the program to those customer classes unlikely to elect to purchase gas from the core portfolio. Thus, the program should not impede the benefits which core customers may realize from the development of a large core-elect class.

PG&E disagrees strongly with the accusations that its proposal is anti-competitive; indeed, it argues that the program will increase competition in the noncore market, by putting downward pressure on the price of gas sold to eligible customers. PG&E discounts the possibility that the program might allow it to monopolize Canadian gas sales to noncore customers, arguing that the limitations on eligible customers remove this possibility.

PG&E's response emphasizes the benefits which the program offers to its efforts to assemble a core portfolio with competitive, long-term prices. PG&E argues that suppliers who offer stable, competitive prices to core customers should have access to the noncore market, so long as this access does not reduce the attractiveness of the core portfolio to noncore customers.

Alternatives. Several parties proposed alternatives to the PG&E plan. El Paso suggested a "release" program, whereby PG&E could release excess core supplies, at its discretion, into other markets. Unlike the PG&E plan, the gas suppliers would retain control of the price and other conditions under which the released gas would be sold. The suppliers would credit sales of released gas against any take-or-pay obligations of the core portfolio. El Paso argues that such a program would provide PG&E with the portfolio-management benefits of its own proposal, but without that plan's coercive elements.

SoCal asked the Commission to approve its own "flexibility" proposal. SoCal believes that it may have the opportunity in the near future to purchase firm gas supplies on terms other than a short-term, best-efforts basis, at prices below the present and forecasted price of spot gas. SoCal seeks the ability to sell these supplies in the noncore market to the extent that they are in excess of current core demand. The company proposes to sell these excess incremental volumes at cost plus 75% of the difference between the cost of these supplies and the spot price of the noncore portfolio. The markup would be credited to the core portfolio as a direct benefit for core customers, so long as the price of the incremental supplies remained below the spot price. In what SoCal calls the "unlikely" event that spot prices fall below the cost of incremental supply, core customers would have to absorb the full amount of costs not recoverable from the noncore market. Even with the markup, the incremental supplies would be cheaper than spot supplies and thus marketable to noncore customers. Unlike the PG&E plan, which is targeted only to certain noncore customers, SoCal proposes to roll these cheaper-than-spot gas supplies into the noncore portfolio available to all noncore customers. Finally, SoCal claims that its proposal may offer additional benefits in its efforts to manage the core portfolio: the plan would promote stable longer-term relationships with core suppliers, and would offer to these suppliers the attraction of an additional market during times of reduced core demand. Objections to the SoCal proposal have been filed by Tenneco/Conoco and by Southern California Edison (Edison). Tenneco/Conoco object to the preference which SoCal would grant to the excess core volumes over spot supplies bid into SoCal's monthly spot gas bidding program. Tenneco/Conoco warns that the SoCal program could be the vehicle for SoCal to favor purchases of gas through its affiliates such as PITCO. Edison objects to providing the core with three-quarters of the benefits which the utility realizes in selling excess supplies into the noncore market. Edison argues that the benefits should flow to the noncore market, because it is the existence of that market which allows the excess core supplies to be marketed.

Arlon Tussing, on behalf of the Canadian Producer Group, put forward the most comprehensive and far-reaching alternative: the deregulation of noncore procurement. Transwestern also recommended this alternative, although its presentation was less detailed. Tussing argues that the Commission's unbundling of gas rates, plus the development of a nationwide competitive market for gas as a commodity, has resulted in the procurement of gas for the noncore market becoming a competitive business. He then questions whether a regulated utility should be in such a business, and points to the possibilities for cross-subsidies and unfair dealings between a utility's natural monopoly transmission and distribution functions and its competitive noncore procurement service. He cites the PG&E proposal as an example of the potential for such discrimination. Tussing proposes a three-part plan for noncore procurement in this competitive environment: first, the separation of the utility's noncore procurement service into an unregulated affiliate; second, equal access for affiliates and nonaffiliates to the regulated utility's transmission and distribution services;

and, third, the deregulation of noncore procurement activities. Tussing points out that the equal access provision would go a long way toward resolving the issues of access to storage and interstate pipeline capacity, as the utility would no longer have as strong an interest in protecting these assets for the sole benefit of the regulated company. It would also give the utility an incentive to offer workable transportation programs. Clearly, what Tussing has proposed is an important and comprehensive view of one possible approach to noncore procurement, a perspective which has ramifications that go far beyond the more limited question of approving or disapproving PG&E's commodity pricing flexibility proposal. Moreover, we view the PG&E proposal as more properly a proposed refinement to the utility's core procurement activities, as its focus is allowing core gas suppliers access to the noncore market. CPG has requested that we ask for comments on the Tussing alternative as a part of this investigation, and, as explained later in this order, we will do so, in the context of our review of the regulation of noncore procurement. In considering the PG&E commodity pricing flexibility proposal, we will consider Tussing's remarks on the plan's discriminatory aspects as supporting the similar comments of many other parties.

Discussion. Assembling the core portfolio is, in our opinion, one of the central challenges facing the gas utilities as they move into an era in which competition is playing an increasingly important role in allocating gas supplies. Our responsibility toward core ratepayers, who have no easy alternative to using gas, mandates that we should provide the utilities with the necessary tools to assemble a core portfolio meeting the three objectives which we recently outlined in D.86-12-010: certainty of supply to meet core peak requirements, price security greater than found in the spot market, and attaining these objectives at the lowest possible cost (see D.86-12-010, pp. 67-84). In our view, one of the important tools in this effort may be providing core

allow the utility to provide its core suppliers with access to the noncore market, and yet would ensure equitable access for other suppliers as well.

In approaching this goal we must consider what is discriminatory in the PG&E proposal. We share the strong suspicions of many commenters that PG&E's proposal could result in the exclusion of other suppliers from the Pacific Gas Transmission pipeline. Despite PG&E's offer to limit the amount of powerplant load eligible under the program, the potential for sales to the EOR market or to southern California utilities is plainly large. Although the exact numbers have yet to be developed in this case, we suspect that, under the PG&E program, sales of gas from PG&E's A&S affiliate could easily consume the limited amount of interruptible capacity available on PGT. This would severely restrict the ability of Canadian suppliers independent of A&S to market gas in California. The potential for PG&E to control access to the PGT pipeline could provide it with an incentive to overestimate its core requirements, and might allow the utility to escape competitive pressure to discount its own transmission rates. In addition, the PG&E program would make the discounted core supplies available only to certain price-elastic groups of noncore customers. We concur with the CMA that PG&E has provided no sound cost basis which would justify the eligibility limitations. The limitations which PG&E has imposed on the program, and which the program may impose on access to the PGT pipeline, run counter to the efforts of both state and federal regulators to encourage "open access" to the competitive gas supply market.

SoCal's flexibility proposal also offers the possibility of portfolio management benefits for the utilities' core procurement efforts. The SoCal plan avoids the discriminatory eligibility limitations of the PG&E proposal, by providing that the excess core supplies will be sold into the noncore portfolio, and thus will be available to all noncore customers at the noncore

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and, third, the deregulation of noncore procurement activities. Tussing points out that the equal access provision would go a long way toward resolving the issues of access to storage and interstate pipeline capacity, as the utility would no longer have as strong an interest in protecting these assets for the sole benefit of the regulated company. It would also give the utility an incentive to offer workable transportation programs. Clearly, what Tussing has proposed is an important and comprehensive view of one possible approach to noncore procurement, a perspective which has ramifications that go far beyond the more limited question of approving or disapproving PG&E's commodity pricing flexibility proposal. Moreover, we view the PG&E proposal as more properly a proposed refinement to the utility's core procurement activities, as its focus is allowing core gas suppliers access to the noncore market. CPG has requested that we ask for comments on the Tussing alternative as a part of this investigation, and, as explained later in this order, we will do so, in the context of our review of the regulation of noncore procurement. In considering the PG&E commodity pricing flexibility proposal, we will consider Tussing's remarks on the plan's discriminatory aspects as supporting the similar comments of many other parties.

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suppliers with access to the noncore market for volumes that are temporarily in excess of core requirements. Such access can assist the utilities in securing adequate supplies to cover core peak requirements, while minimizing costs by allowing the utilities to offer suppliers the opportunity for high load factor takes. These potential benefits convince us that it may well be appropriate to reconsider our current guideline which prevents a utility from selling anything other than short-term gas to noncore customers[1]. From this perspective, PG&E's proposal may offer important benefits for core gas ratepayers, benefits which go beyond the obvious discounts for the core portfolio which are linked to the program's noncore sales. The program's access to the noncore market provides PG&E with an attractive inducement for suppliers to provide gas to the core portfolio at stable, competitive prices.

However, we also believe that this access must be carefully structured, must not result in discrimination against other noncore suppliers, and must not diminish the supply options available to gas users on the PG&E system. Taking a longer-term perspective, we recognize the importance of allowing equitable access to the California market if we are to encourage gas producers to commit supplies to this market. Many of the commenters, including the CPG's Tussing, have raised what we feel are important concerns about the potential for the PG&E proposal, and to a lesser extent the SoCal plan, to impair competitive access to the California market. What we would like to find is a way to

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1) We note that this rule, set forth on page 87 of D.86-12-010, appears to contradict the discussion in the accounting rules (pp. 152-159), which seems to allow excess long-term supplies to be transferred into the noncore portfolio. Furthermore, as we will discuss at length below, the accounting rules are unclear on the conditions under which such transfers can take place.

allow the utility to provide its core suppliers with access to the noncore market, and yet would ensure equitable access for other suppliers as well.

In approaching this goal we must consider what is discriminatory in the PG&E proposal. We share the strong suspicions of many commenters that PG&E's proposal could result in the exclusion of other suppliers from the Pacific Gas Transmission pipeline. Despite PG&E's offer to limit the amount of powerplant load eligible under the program, the potential for sales to the EOR market or to southern California utilities is plainly large. Although the exact numbers have yet to be developed in this case, we suspect that, under the PG&E program, sales of gas from PG&E's A&S affiliate could easily consume the limited amount of interruptible capacity available on PGT. This would severely restrict the ability of Canadian suppliers independent of A&S to market gas in California. The potential for PG&E to control access to the PGT pipeline could provide it with an incentive to overestimate its core requirements, and might allow the utility to escape competitive pressure to discount its own transmission rates. In addition, the PG&E program would make the discounted core supplies available only to certain price-elastic groups of noncore customers. We concur with the CMA that PG&E has provided no sound cost basis which would justify the eligibility limitations. The limitations which PG&E has imposed on the program, and which the program may impose on access to the PGT pipeline, run counter to the efforts of both state and federal regulators to encourage "open access" to the competitive gas supply market.

SoCal's flexibility proposal also offers the possibility of portfolio management benefits for the utilities' core procurement efforts. The SoCal plan avoids the discriminatory eligibility limitations of the PG&E proposal, by providing that the excess core supplies will be sold into the noncore portfolio, and thus will be available to all noncore customers at the noncore

WACOG. However, we recognize the valid concern, raised by Tenneco/Conoco, that SoCal's program might discourage spot gas suppliers from bidding into SoCal's noncore portfolio, if core suppliers were allowed separately to meet or beat the bid price, without participating in the competitive process themselves. In addition, we wonder about the price risk to which SoCal's program would expose core ratepayers. The core would benefit from sales of excess core supplies if spot prices remain above the cost of core gas; however, SoCal proposes to charge the core for the losses which result if spot prices fall below the cost of core supplies. Obviously, it is difficult to judge the magnitude of this risk; however, we do note that one of our guidelines for core procurement is price security greater than expected in the spot market. SoCal's program may expose core ratepayers to benefits and costs which fluctuate with the spot market.

El Paso's "release" program appears to meet many of the objections which have been raised to the PG&E and SoCal proposals. Under the El Paso proposal, the core suppliers would retain control of the disposition of the excess core volumes; the suppliers could bid the excess into the utility's noncore portfolio, or attempt to find an alternative market. Leaving such control with the suppliers should address the concerns about the impact of these excess volumes on pipeline capacity availability (especially on PGT), or on the spot gas bidding programs. A "release" program could provide the important portfolio management benefit of take-or-pay relief for the core portfolio. What the utilities would lose with such a program, in comparison with the PG&E or SoCal plans, appears to be the direct benefits to the core which would flow from the utility purchasing the excess core supplies at a discount from the prevailing noncore WACOG. El Paso frames the issue well in stating that the Commission has the hard choice of deciding whether these core credits outweigh the risks in the utilities' proposals. In the comments which we will order below, we would like to see El Paso explain in further detail how such a program would work. For example, would the "release" conditions have to be embodied in every utility-supplier purchase contract?

Finally, we note that D. 86-12-010, in adopting accounting rules for our new regulatory structure, does discuss the transfer of gas from the core to the noncore portfolio (pp. 152-59). These rules do not directly specify the conditions under which such transfers can be made, except to place the utility at risk in a reasonableness review if such transfers occur at a substantial loss (p. 158). The discussion does set out the following proposed rule:

> "Transfers from the core gas purchase account to the core or non-core portfolio accounts: All gas transferred between the long and short-term gas purchase accounts to the core and non-core portfolio accounts shall be at weighted average cost. If there are transfers from the long-term source account to the non-core portfolio account during an extremely warm year, because there is such low core demand for the gas and the utility cannot avoid taking the gas even under its flexible contract terms, the gas shall be transferred to the non-core portfolio at the current weighted average cost of the long-term source account.
>
> "However, any recovery deficiency in the core portfolio balancing account resulting from sales to the noncore portfolio at a loss shall not be subject to balancing account treatment. The utility may seek recovery of such booked loss in its next annual reasonableness review."

Although this proposal is discussed, the adopted rules (pp. 158, 158a, and 159) do not reflect the results of that discussion. Otherwise, the discussion of procurement policies in D. 86-12-10 is silent on this topic. We welcome comments on the above proposed rule as another option.

Clearly, at this time the Commission has before it a wide range of proposals for the marketing of excess core gas supplies. We firmly believe that core customers will benefit if core suppliers have access to the noncore market. However, that access must be structured to satisfy the discrimination concerns which we have discussed above. Obviously, a "release" program, such as proposed by El Paso, in which the suppliers retain control of the disposition of the excess supplies, would have the fewest problems meeting these concerns. However, we want to encourage the utilities to attempt to design a program in which the utility can resell temporarily excess core supplies into the noncore market. However, the discrimination concerns which we have described above dictate that such a program should adequately address the following issues:

1. Do all short-term supplies, both spot and excess core, have an equal opportunity to bid into the noncore portfolio? If the utility proposes to grant excess core supplies a preference over spot gas, how is that preference justified?

2. If PG&E proposes to purchase and resell excess core supplies into its noncore portfolio, what is the expected impact of such sales on the interruptible capacity available on the PGT system?

3. Currently, all supplies in the noncore portfolio must be sold at the prevailing noncore WACOG. As explained later in this order, the Commission will be reviewing how it wishes to regulate, or deregulate, noncore gas procurement. Clearly, proposals to sell excess core supplies in the noncore market must be consistent with the corresponding plan for the utility's noncore sales.

4. What are the specific criteria for determining which core suppliers are eligible to gain access to the noncore market, and what is the rationale for such criteria? For example, the PG&E flexibility program was open to core suppliers offerring "stable" and "competitive" prices to the core portfolio. Are such criteria useful, and, if so, how specific should they be?

We recognize that the utilities may need a mechanism for flowing excess core supplies into the noncore market immediately upon implementation of the new rate design and regulatory structure that is the focus of I.86-06-005. Therefore, the utilities should file by December 15, 1987, their reformulated proposals for marketing excess core supplies in the noncore market. These proposals must address the issues and the discrimination concerns which we have discussed above. Interested parties may respond to these revised proposals along with their comments on noncore procurement, which, as discussed below, we are asking to be filed on January 15, 1988. If the comments show that hearings on the utilities' revised proposals are necessary, we would hold them in March, 1988.

II. Noncore Procurement and Multiple Supply Portfolios

As we announced in D.86-12-010 (p. 87), we intend to address the future regulation, or deregulation, of noncore procurement in the course of this investigation. The comments of CPG's Tussing have provided us with a comprehensive and provocative view of one possible structure for the utilities' noncore procurement activities. We will begin to examine this issue by granting CPG's request that we solicit comments on Tussing's submittal; these comments should be filed by January 15, 1988. One of the issues which we ask commenters (and, if it so desires, the CPG) to address is how, under the deregulated model of noncore procurement which Tussing advances, might the utility provide its core suppliers with access to the noncore market. As we have noted above, such access could be a valuable tool in the utilities' core procurement efforts. In addition, we invite the respondents and interested parties to use these comments to advance their own proposals for the future of our regulation of the utilities' noncore procurement activities.

SoCal's June 1, 1987, filing of its storage proposal also included requests to change several of the noncore procurement policies which we established in D.86-12-010. In order to increase the attractiveness to noncore customers of electing into the core portfolio for procurement service, SoCal proposes to permit noncore customers to elect core procurement service even if the core WACOG is below spot prices. This opportunity would only occur at semi-annual "openings" of the core portfolio. If core prices are below the spot market, customers electing the core portfolio would have to pay a surcharge equal to the difference between the core WACOG and the market cost of a new one-year supply of gas. There would also be a charge for early termination of core-elect purchases, which would reflect the costs associated with reducing core portfolio purchases. This proposal appears to be a refinement of SoCal's position on the "portfolio switching" issue which we addressed in R.86-06-006 and decided in D.86-12-010 (see pp. 46 and 50-57). Essentially, SoCal wants to allow noncore customers into the core portfolio even when the core portfolio is cheaper than spot prices; the price of admission in such circumstances would be agreeing to pay the full market price for the first year. SoCal's proposal has the goal of increasing the size of the core elect; however, given the price of admission which SoCal would charge, the plan appears likely to increase core election only if customers have the expectation that the core portfolio will be cheaper than spot prices for several years to come. We doubt that many customers will act on such an expectation, given the uncertainties of future gas markets. Furthermore, if the core is cheaper than spot prices for an extended period (the conditions under which the plan would stimulate core election), the addition of more core customers could increase core prices, even with SoCal's proposed entrance fee. SoCal should respond to these concerns in its December 15 filing.

In addition, SoCal asks that it be allowed to create three additional noncore portfolios: a one-year fixed-price portfolio, a long-term (greater than one year) portfolio whose price would be subject to a known escalation formula, and a short-term portfolio with up to 90-day supplies. SoCal's request appears to be a variant of the "multiple supply portfolios" idea which we discussed in D.86-12-010 (pp. 51-53). In that order we indicated a willingness to consider the multiple portfolio idea in this proceeding. SoCal's proposal does differ from our original concept of multiple portfolios, in that SoCal appears to want to create a new portfolio each time it has an "open season" for noncore contracting. This might violate the requirement we set in D.86-12-010 that the price of gas should be the same across portfolios for a given level of price stability and supply certainty. D.86-12-010 stated that "if we do permit the utilities to offer multiple supply portfolios, we will preclude targeting of low-cost supplies by requiring that the price of gas for a given level of price stability and supply certainty be the same across portfolios" (p. 53). Additionally, it is unclear from SoCal's proposal whether it would make gas available to the core under the same terms, conditions, and prices as contained in these noncore portfolios. Again, D.86-12-010 addressed this concern: "for a given level of price stability and supply security, we will require utilities to offer procurement service for all customers, core and noncore, at the same price" (p. 51, emphasis added). SoCal should address these concerns in its December 15 filing, and we invite other parties in their January 15 responses to comment both on SoCal's requested portfolios and on the concept of multiple portfolios which we outlined in D.86-12-010.

Finally, we note that several parties in the rate design implementation proceeding, I.86-06-005, are recommending that the issue of whether the utilities should charge brokerage fees for noncore and out-of-area procurement activities should be treated in this proceeding. If the final implementation decision in I.86-06-005 grants those requests, the utilities should file on January 15, 1988, proposed noncore and out-of-area brokerage fees.

III. The Unbundling of Storage

The Utilities' Proposals. In response to I.87-03-036, both SoCal and PG&E filed proposals to offer unbundled storage services. The two proposals differed markedly.

PG&E has proposed what it describes as an "as-available" storage service which it would make available to noncore procurement and transport-only customers. The service will offer noncore customers improved access to PG&E's noncore portfolio during supply or capacity constraints. Noncore procurement customers who subscribe to the service will receive preferential access to unanticipated storage withdrawals which may be necessary to continue noncore procurement service. PG&E will also use as-available storage service to back-up transmission service to participating noncore customers, in the event of capacity constraints. PG&E intends to negotiate the rate for this service with each customer, within a range from the variable cost of storage injections and withdrawals up to the value of the service. PG&E would reduce the transmission rate of noncore customers who do not elect the service by the variable cost of storage injections and withdrawals. All customers would continue to pay for the fixed costs of PG&E's storage facilities, in recognition that all customers benefit from PG&E's storage operations. The primary benefits which PG&E identifies for noncore customers are load balancing services and improved access to interruptible interstate pipeline capacity.

SoCal does not propose a service such as PG&E's, because SoCal feels that "there is no practical way to segregate out storage service from noncore sales service." SoCal also notes that it cannot avoid providing balancing service for transportation-only customers, due to its inability to verify immediately the movement of customer-owned gas into its system. Thus, SoCal's opinion is that, on a short-term basis, it is not feasible to operate its storage fields only on behalf of certain noncore customers who may have signed up for an unbundled storage service. SoCal does propose a longer-term storage "banking" service which would utilize any excess storage capacity above its November 1 gas inventory target. SoCal proposes that this service be interruptible in favor of SoCal's "system sales and transportation services", due to limited injection, withdrawal, and transmission capabilities. The utility would charge a two-part rate for the service: a variable rate to cover the cost of injection and withdrawal of gas, and a rental fee based on the amount of the customer's gas in storage. SoCal indicates that these rates would recover something less than the fully allocated embedded cost, due to the incremental nature of the service. Revenues from the "banking" service would be refunded to customers in the next cost allocation proceeding, unless SoCal has not recovered its authorized noncore margin. Thus, SoCal would not be at risk for revenues from this new, untested service.

<u>Comments from other parties</u>. Comments were filed by AEC Oil and Gas Company and Solar Turbines (AEC/Solar), Arco, CMA, Chevron, El Paso, Hadson, Long Beach, the City of Palo Alto (Palo Alto), PSD, Salmon Resources/Mock Resources/Shell Canada (SMS), SDG&E, Edison, the Muni UEGs, Tenneco/Conoco, Transwestern, and WGM.

The PSD provided a unique perspective on the entire matter of unbundling storage. The PSD argued that storage unbundling is both practically impossible and unnecessary. In the PSD's view, utility gas supply systems are integrated entities whose storage and transmission components operate as a unit. Unbundling storage-related costs and allocating these to particular customers is thus virtually impossible. The PSD further argued that the Commission's proposed priority charge mechanism effectively substitutes for unbundled storage by indicating the value placed by customers on service reliability. Thus, the PSD commented, "priority charges might be as close to storage rates unbundling as is practical, or needed." The PSD therefore recommended that the Commission use the upcoming hearings to reexamine its basic assumptions concerning the necessity and desirability of storage unbundling for noncore customers. The PSD does express interest in SoCal's longer-term "banking" proposal, and recommends that further hearings explore this plan, as well as whether entities other than utility customers should have access to storage banking and whether the utilities should charge for prolonged imbalances in transported gas.

While supporting the concept of storage unbundling, Transwestern voiced doubts about the feasibility of providing firm access to unbundled storage. Given that the utility's top priority is providing reliable service to core customers, Transwestern argued that storage service for noncore customers must be interruptible. The only way to determine the quality of this service is for the utilities to offer it on an experimental basis. In Transwestern's view, this would be preferable to a "long conceptual debate" between the utilities and potential storage customers regarding the quality of the service to be offered.

Many of the respondents rejected the utilities' contention that they are unable to provide firm, unbundled storage service to noncore customers. In general, the commenters were particularly critical of PG&E's proposal. For example, CMA stated that PG&E's proposal failed to articulate even the basic concepts associated with unbundled storage. In contrast, SoCal's filing received a more positive evaluation, with most parties regarding its "storage banking" proposal as containing important elements of the type of service envisioned by the Commission. Nonetheless, SoCal was also criticized for failing to unbundle basic storage costs, for inconsistencies in the data and calculations presented, and for a lack of specificity in how its service would operate. Several parties urged the Commission to instruct the utilities to provide fuller information on storage operations before deciding on the availability and use of storage service.

In the opinion of WGM, PG&E has failed to offer any significant access to storage beyond what is currently available and paid for in present rates. Thus, its proposal falls far short of true unbundled storage. The same holds for SoCal's proposal, which, in WGM's opinion, indicates the presence of substantial additional storage capacity beyond that which SoCal proposes to make available for storage banking. WGM further noted that neither utility has demonstrated how service reliability would be improved by its proposal. Given these deficiencies, and the apparent existence of large amounts of unutilized storage capacity, WGML urged the Commission to order the utilities to provide firm and interruptible storage service to noncore customers at reasonable, non-discriminatory rates.

SMS also rejected the contention that firm, unbundled storage service is infeasible. While certain storage services--e.g., load balancing--are inherent in transmission service, SMS argued that other components of storage service clearly can be unbundled. This includes firm storage banking and as-available banking for transmission-only customers. To the extent that utilities are willing to provide load balancing for all customers over an entire cycle of seasonal demand, the distinction between storage banking and load balancing becomes blurred. In SMS's view, SoCal's proposal indicates a willingness to provide this comprehensive form of storage banking/load balancing service. PG&E's proposal, however, envisions a much more limited form of load balancing for the exclusive benefit of core and core-elect customers. Thus, PG&E's storage services should not be priced on an equal cents per therm basis. SMS further argued that storage must be viewed as a component of transmission service, since this is the only way to ensure that noncore and core-elect customers are on equal footing and can choose gas procurement independently of the characteristics of the monopoly distribution system.

Hadson developed the equity issue further, arguing that the key test is whether the utilities would provide independent gas vendors the same access to storage as they provide themselves. Under equal access, customers would have the same reliability of transmission service regardless of where they procure their gas. In Hadson's view, neither proposal satisfies this criteria. PG&E's proposal is flawed because it associates the use of storage with procurement from the core and core-elect portfolios.. Thus, it provides firmer service to customers buying gas from the utility. Hadson believes that SoCal's proposal may have the same intent, citing uncertainties over how SoCal will operate its system under peak load conditions, as well as the utility's stated belief that core-elect procurement carries a higher level of reliability than transport-only service. Given these inadequacies, Hadson urged the Commission to adopt the principle of equal access and parity of transmission reliability as its explicit policy for unbundling storage and interstate pipeline capacity.

Chevron criticized PG&E's proposal for failing to provide a satisfactory analysis of the nature and frequency of the abnormal peak demand for which its entire storage capacity is ostensibly needed. Given proper analysis of these conditions, Chevron argued that noncore customers would likely accept the necessary restrictions on peak period storage withdrawal in return for the benefits which "otherwise-firm" storage access would provide. Chevron also objected to PG&E's unwillingness to provide storage access to gas brokers and/or producers, which it viewed as an unnecessary restriction on storage availability. Finally, Chevron argued that, as a public utility, PG&E has an obligation to manage its assets--including its storage facilities--in a manner consistent with the broad public interest. Fuller use of storage facilities, in Chevron's view, could enhance system flexibility and generate incremental revenues, "if PG&E would only exercise a more positive approach" to such opportunities.

El Paso noted that PG&E's storage filing reveals that two of its three storage facilities--Pleasant Islands and Los Medanos--are devoted exclusively to core requirements. Only McDonald Island can even be considered for noncore storage use. In view of this information, El Paso argues that the only equitable approach would be to allocate all Pleasant Islands and Los Medanos costs to core customers, while splitting only the McDonald Island cost between core and noncore classes.

Edison expressed conceptual support for SoCal's proposal and its suggested two-part charge for storage banking. However, in Edison's view, all or part of the revenues generated from banking services should be used to offset embedded storage costs, with the remainder being used to offset undercollections of the utility's noncore margin requirement. Since demand for storage may exceed the amount available, Edison recommended that a semi-annual blind auction be held to allocate available capacity. To prevent bid prices from being driven up, and capacity rights being awarded to out-of-state entities, Edison argued that participation in the auction be limited initially to wholesale customers and California end-users. Aside from PG&E, Edison was the only party favoring such a restriction on storage access.

Like Edison, CMA criticized the way in which SoCal's proposal allocated the costs and revenues of its proposed service. In CMA's view, the SoCal plan reflects a failure to progress beyond the banking/balancing distinction to a proper unbundling of the costs associated with each service. CMA feels that this is a key point which the Commission must address in the next phase of the inquiry.

Tenneco/Conoco supported the non-discriminatory nature of SoCal's proposed banking service, which would be offered to all parties, including producers and marketers. They also liked the fact that SoCal's storage service--unlike PG&E's--would be available at any time, not just during supply or capacity curtailments. Arco noted that storage banking would provide an important means for purchasers to hedge against future price increases by storing gas at today's prices. AEC/Solar stated that SoCal's proposed service "comes the closest" to providing the type of service required by Canadian producers and California end-users. While it does not unbundle storage costs, AEC/Solar noted that SoCal's proposal does unbundle some excess storage capacity and also indicates a willingness to provide balancing service <u>over the full annual cycle</u>. In AEC/Solar's view, such full-cycle balancing is necessary for end-users to purchase gas during off-peak periods for later delivery.

Among the utilities' wholesale customers, Palo Alto also pointed to the longer-term balancing service proposed by SoCal as a positive feature. In this regard, SoCal's proposal was regarded as coming closer than PG&E's to meeting the legitimate needs of wholesale customers. Palo Alto noted, however, that neither utility has recognized that its own supplies are "wildly out of balance" for much of the year owing to the ordinary operations of storage. Given these imbalances, and the fact that the ability to serve wholesale customers is already built into PG&E's system, Palo Alto argued that wholesale customers should be provided the same balancing flexibility that the serving utility provides for itself.

Long Beach, a wholesale customer of SoCal, identified the three primary issues involved in the unbundling of utility storage. The first is determining the type of service to be provided. In Long Beach's view, wholesale and noncore utility customers will derive maximum benefit from unbundled storage with direct access to storage facilities. The service which provides such access is storage "banking". The second issue is determining the amount of unbundled storage capacity which can be made available. In this regard, Long Beach disputed PG&E's claim that its entire storage capacity is needed to meet peak day core demand. Using data from PG&E responses to WGML's questions, Long Beach estimated that PG&E may have excess storage capacity which could be made available to wholesale and noncore customers. SoCal may have underestimated the amount of "excess" storage capacity on its system as well. The third issue is the cost associated with unbundled storage. Long Beach noted that the storage banking service proposed by SoCal is not a "new" service at all, but rather an existing service which is being transferred from the control of the distribution utility to the individual customer. SoCal proposes that the "cost" of this "new" service be allocated in addition to the fully embedded cost of storage. In effect, SoCal's proposal does not unbundle the costs of storage at all. Moreover, the service is to be provided on an "as available" basis only, and thus will have much less value to customers than "firm" storage.

For SDG&E, the key issue is control of the storage service. SDG&E regards access to unbundled storage as particularly important for wholesale customers, who have the responsibility to serve retail users who include captive core customers. SDG&E feels that this responsibility requires that it be given control, "within reasonable and prudent operating constraints," over how storage is used to serve its customers. Unbundled storage service could be made available to noncore and transportation customers as well as wholesale users, but SDG&E feels that only wholesale customers have a right to independent utilization of storage facilities. SDG&E comments that the simplest means to unbundle storage would be to allow it to control a portion of SoCal's storage system equal to the portion of SoCal's storage costs which SDG&E now pays in its demand charge.

Discussion. We have found the comments on the utilities' proposals to be extraordinarily useful in helping us to focus on the issues involved in establishing an unbundled storage service. We concur with Transwestern's view that we should avoid a long conceptual debate on storage unbundling, and that we should proceed immediately to implement a storage program, which can be refined in the future as we acquire experience with it. We believe that in this order we can establish a conceptual framework for an unbundled storage service. We can then sharply limit the matters which will require hearings, to focus on the operational and implementation details of the program, as described in the Assigned Commissioner's Ruling issued in this proceeding on October 1, 1987. After hearings on these revised proposals in December, 1987, we hope to have a storage program that can begin upon or shortly after the implementation of our unbundled rate design.

The utilities' storage facilities increase the reliability of service for all gas users, including transportation-only customers who benefit from the ability of storage to balance loads and to increase the availability of interruptible interstate pipeline capacity. Storage withdrawals also can serve as a source of supply during peak demand periods or supply interruptions, and can provide continued deliveries when the pipeline system faces capacity constraints. Thus, storage functions to improve the reliability of both supply and capacity. Our new rate design has sought to unbundle rates for noncore customers based on a separation of the costs of procuring gas supplies from the costs of the pipeline capacity necessary to transport gas. Ideally, in the noncore customer class we should undertake a detailed separation of the costs of supply-related storage activities and facilities from those that are capacity-related. However, it may be impossible to do so, given the integrated nature of the utilities' storage operations; none of the filings in this proceeding have encouraged us to make such an effort.

Nonetheless, this conceptual appreciation for the varied functions of storage does help us in structuring how to offer a storage service for noncore customers. We have noted that storage allows the utilities to increase their capacity to move gas to all customers during short-term periods when demand peaks. In our unbundled rate design, we have established a priority charge which will determine each noncore customer's access to capacity during such short-term periods of constraint. Presumably, noncore customers who pay higher priority charges will receive better access to the capacity benefits of storage. Thus, for the short-term capacity benefits which storage provides, we concur with the PSD's perspective that the priority charge can substitute for unbundled storage rates. This view is also consistent with CMA's position that we should not at this time attempt to unbundle the "balancing" services which storage provides. With the priority charge, customers can pay for the level of overall transmission reliability which they need; the utilities' integrated storage operations will help to provide whatever level of capacity priority is purchased.

We have also noted that storage can provide supply benefits. For example, cheap gas purchased during the low-demand summer season can be stored to serve as an economical source of gas supply during the peak winter season. Gas in storage can protect customers against the failure of suppliers to perform, or can smooth irregularities in gas production which customers purchase directly. The longer-term "banking" service which SoCal proposes seems to us to be the kind of storage service appropriate for parties most interested in the supply benefits of storage. In addition, because SoCal's banking proposal would use storage capacity that is currently in excess, the program seems likely to have the minimum impact on storage operations for core customers, and would provide the desirable benefit of increased utilization of that excess capacity. Finally, we note that the comments elicited considerable conceptual support for the SoCal banking proposal, with most of the criticism focusing on the details of how the program would work. Therefore, we will require SoCal and PG&E to file more detailed proposals for an unbundled storage banking service based on the concept which SoCal has presented. We want the details of the banking plan to be the focus of the hearings on storage; parties should not attempt to relitigate the appropriateness of the concept of storage banking, which we feel is well-justified by the initial round of proposals and comments. The Assigned Commissioner's Ruling of October 1, 1987, has adequately presented the major issues which we think need to be addressed in implementing a storage banking service; these issues should be the focus of the testimony filed both by the utilities and by interested parties. The utilities will serve by October 30, 1987, testimony supporting revised storage proposals based on the SoCal banking proposal and consistent with the above discussion. Other parties will serve their testimony on November 20, 1987. The hearing will begin on December 7, 1987, under the schedule set forth in the October 1 ruling, a copy of which is attached to this order as Appendix A.

IV. Interstate Pipeline Firm Capacity Rights

With respect to the interstate pipeline capacity needed to complete gas transportation transactions, the Commission has previously indicated a desire to explore options for increasing the availability of such capacity for end-users (see I.87-03-036, pp. 5-6). At the same time, the Commission recognizes that interstate capacity allocation is primarily a function of federal regulation, exercised by the Federal Energy Regulatory Commission. The "first-come/first-served" policy adopted by the FERC in Order No. 436 does not permit assignment or brokering of capacity. The FERC is currently faced with requests from shippers of natural gas to permit the brokering of interstate capacity in a secondary market. In addition, the FERC is reviewing its staff's proposals for an auction system of allocating capacity. Either one of these methods would presumably increase to some extent end-users' access to interstate capacity. The Commission is interested in learning the direction which the FERC intends to take with respect to capacity allocation. However, the Commission is also interested in contributing to the dialogue at the federal level on the appropriate means of allocating capacity, and in facilitating the development of a common position among the California parties on this important issue.

Accordingly, the Commission will proceed with its previously announced plan to hold a workshop to discuss the options available for allocating or sharing interstate capacity. This workshop will be independent of these procurement hearings, and will hopefully serve to illuminate preferred options which California utilities and end users can recommend to the FERC. The notice setting the workshop date will be issued by the Legal Division, which will moderate the workshop, within the next 60 days. Upon the conclusion of the workshop, the Legal Division shall report to the Commission on the recommended means of sharing or allocating interstate capacity, and the Commission shall advise the FERC of the outcome of the workshop.

V. Firm Interutility Transportation

On May 29, 1987, the Commission issued D.87-05-069, establishing a system for the interutility transportation of gas in California. The interutility transportation service approved in that order has a priority inferior to that of retail transportation for noncore customers. Several of the participants in the interutility transportation case urged us to provide a firmer service. D.87-05-069 discussed two possible means for improving the reliability of interutility service. The first is to allow interutility service priority parity with intrautility, retail transportation. This would allow an interutility transporter to pay a priority charge which would determine his/her place in the curtailment order in comparison with both retail and other interutility shippers. The second means is to provide access to gas storage. As this order discusses, providing storage access will be the first order of business in this proceeding, and we hope to have a storage banking program in place in the near future. Thus, in the near future, interutility shippers can seek access to storage if they desire to firm up the reliability of their service. Therefore, we see no need for further action on this issue at this time. We would like to gain some experience with the new structure of the industry and our new unbundled rate design before we address allowing interutility shippers to have priority parity with retail transporters. In addition, we note that firm interutility service would do a shipper little good without firm interstate pipeline capacity, which, as we have discussed above, remains unavailable due to federal policy constraints[2]. Therefore, we will not deal with this issue until it ripens with the completion of the implementation proceeding and the availability of firm interstate capacity.

VI. Sequencing

We are aware that certain parties to our natural gas proceedings are interested in having the Commission revisit the guidelines under which the utilities sequence their purchases of

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2) Shippers of California-produced gas are, of course, an exception to this remark; such shippers would not be moving their gas over an interstate pipeline.

gas from their long-term, dedicated suppliers. For example, in the rate design implementation proceeding, I.86-06-005, the presiding Administrative Law Judge struck a considerable body of testimony related to sequencing. The last time this Commission issued detailed guidelines on sequencing was in December, 1984, in the fall 1984 gas offset proceedings. What motivated that review was the dramatic increase which the FERC's Order 380 produced in the utilities' ability to purchase gas on a least-cost basis. Since that time, other dramatic changes have occurred in how the utilities purchase gas, principally the tremendous growth in the volumes of gas--much of it from non-traditional suppliers--transported by California utilities and their end-users. The increase in gas transportation has resulted in a decline in the utilities' traditional purchases from the pipelines' system supplies. We have been asked on several occasions since December, 1984, to revise the 1984 guidelines. Each time we have refused, preferring to leave the details of sequencing policy to utility management, subject to our subsequent review for reasonableness. We have done so in recognition of the need for utility managers to be able to respond flexibly to the changing circumstances in the gas industry, which from time to time may require significant departures from the Commission's guidelines for sequencing gas purchases. Utility managers have more detailed knowledge of their suppliers' circumstances than is generally available to this Commission, and they might be hamstrung in their ability to respond quickly and flexibly to changing conditions if they had to seek Commission approval for every change in the sequencing order. Thus, we have emphasized that the sequencing guidelines are <u>guidelines</u>, not hard-and-fast rules, and have warned the utilities that they must justify as appropriate to their circumstances, and to the ratepayers' best interest, both their adherence to, as well as their departures from, the guidelines.

Sequencing guidelines are only one part of overall core procurement policies, especially since the utilities appear to be entering an era in which they will be purchasing gas for the core under a larger number and a wider variety of purchase arrangements than in the past. In the future now unfolding, the opportunities for core purchases will be far greater than just the in-state sources and traditional pipeline suppliers who are covered by the current sequencing rules. Therefore, we will ask for comments on whether and how we should review core procurement policies, including, but not limited to, our sequencing guidelines. The threshhold question which we want to see addressed is whether any more detailed guidelines are needed beyond the general core procurement policies set forth on page 84 of D. 86-12-010. If the answer to this question is "yes", the next issue is whether the guidelines should be any more specific than providing for a general methodology for activities such as sequencing: for example, the 1984 sequencing guidelines used an "average cost" methodology for PG&E and an "incremental cost" method for SoCal Gas. At this level of detail the Commission may also wish to consider the appropriate mix of long, short, and intermediate term contracts in the core portfolio. Finally, at its most detailed, a review of core procurement might decide how to change the details of the 1984 sequencing guidelines to adapt to today's circumstances, and might involve the Commission in the preapproval of new long-term gas purchase contracts. The comments on core procurement policies should focus on this question of how detailed an investigation is needed. These comments should also be filed on January 15, 1988.

Findings of Fact

1. Providing core suppliers with access to the noncore market for volumes that are in excess of core needs can be an important tool in the utilities' core procurement efforts.

2. In the long run, providing equitable access to the California market will encourage gas producers to commit supplies to this market.

3. PG&E's commodity pricing flexibility proposal could result in the exclusion of other suppliers from the Pacific Gas Transmission pipeline.

4. PG&E's ability to control access to the PGT pipeline could allow it to escape competitive pressures on its transmission rates.

5. PG&E has provided no cost justification for the eligibility limitations of its program.

6. SoCal's "flexibility" proposal avoids the discriminatory eligibility requirements of the PG&E plan.

7. SoCal's program could, however, discourage suppliers from bidding into its spot gas buying program, and might expose core customers to unacceptable price risks.

8. A "release" program, such as suggested by El Paso, would deny core customers the benefits of selling excess core supplies in the noncore market, when core prices are below spot prices.

9. The Tussing study submitted by the CPG is a comprehensive and provocative view of one possible future for noncore procurement.

10. SoCal's request to create a number of additional noncore portfolios is a variant of the "multiple supply portfolios" idea which we advanced in D.86-12-010, and which we decided to consider in this proceeding.

11. It is desirable to avoid a long conceptual debate on unbundling storage, and to proceed to implement a storage program from which experience can be gained.

12. The utilities' storage fields increase the reliability of service for all gas users in California, including transportation-only customers.

13. Storage can increase the capacity of the utilities' systems to deliver gas, and can also function as a source of supply.

14. Because of the integrated operations of the utilities' gas systems, including their storage facilities, it would be very difficult to separate the costs of supply-related storage functions from those that are capacity-related.

15. For the short-term, capacity-related benefits of using storage to balance supplies and deliveries, the priority charge we have adopted can substitute for unbundled storage rates.

16. The longer-term, more supply-related benefits of storage could be made available through a storage "banking" program, such as the one proposed by SoCal.

17. A banking program would use storage capacity that is currently in excess, and could be structured to have minimum impact on storage operations for core customers.

18. The Assigned Commissioner's Ruling of October 1, 1987, sets forth the issues that must be addressed in order to implement a storage banking program for noncore customers.

19. The availability of unbundled storage banking will provide interutility shippers with a means to firm up their service.

20. The sequencing guidelines which are now "on the books" are increasingly outdated, due to the significant increase in gas transportation on the utilities' systems.

21. The sequencing guidelines are not hard-and-fast rules, and the utilities must justify their adherence to the guidelines as well as their departure from them.

Conclusions of Law

1. SoCal and PG&E should reformulate their "flexibility" proposals in order to address the concerns that their plans may be discriminatory.

2. The Commission should consider in this proceeding a broad range of options for the future of the utilities' noncore procurement activities.

3. At this time it is appropriate to hold hearings focused on the operational and implementation details of SoCal's proposed storage "banking" service.

4. The allocation of interstate pipeline capacity is primarily a function of federal regulation, and current FERC policies do not permit the assignment or brokering of this capacity.

5. The Commission needs comments from the respondents and interested parties on whether to revisit the matter of the overall guidelines for the purchase of gas for the core portfolio.

O R D E R

IT IS ORDERED that:

1. The respondents may file by December 15, 1987, reformulated proposals for marketing excess core supplies into the noncore market. These proposals shall describe how the new program addresses the four issues noted in the text of this decision. Interested parties may file comments on these proposals by January 15, 1988.

2. CPG's request that we solicit comments on the paper "Noncore Gas Procurement in California: A Free-Market Alternative", prepared by Arlon R. Tussing and Connie C. Barlow on behalf of the CPG, is granted. These comments are due January 15, 1988, and commenters may use this forum to advance their own proposals for the future of our regulation of the utilities' noncore procurement activities.

3. SoCal shall address in its December 15 filing the concerns discussed in this order regarding its "portfolio switching" proposal and its request to establish additional noncore

portfolios. Other parties may comment on these proposals by January 15, 1988. All respondents and interested parties may address in their January 15 comments the concept of "multiple supply portfolios" which we outlined in D.86-12-010.

4. If the final order in I.86-06-005 defers the issue of out-of-area and noncore brokerage fees to this proceeding, the respondents should file by January 15, 1988, their proposed brokerage fees.

5. Hearings on SoCal's storage "banking" proposal shall be held according to the schedule and the scope of issues presented in the Assigned Commissioner's Ruling of October 1, 1987.

6. The notice setting the date for the workshop on interstate pipeline capacity shall be issued by the Commission's Legal Division within 60 days from the effective date of this order.

7. Respondents and interested parties may file comments by January 15, 1988, on whether the Commission should revisit the matter of core procurement policies, including sequencing guidelines.

8. All comments submitted in this proceeding shall be filed in the original and 12 copies with our Docket office and served on all parties of record in this investigation.

This order is effective today.

Dated October 16, 1987, at San Francisco, California.

STANLEY W. HULETT
President
DONALD VIAL
FREDERICK R. DUDA
G. MITCHELL WILK
Commissioners

Commissioner John B. Ohanian, being necessarily absent, did not participate.

I CERTIFY THAT THIS DECISION WAS APPROVED BY THE ABOVE COMMISSIONERS TODAY.

Victor Weisser

Victor Weisser, Executive Director

and, third, the deregulation of noncore procurement activities. Tussing points out that the equal access provision would go a long way toward resolving the issues of access to storage and interstate pipeline capacity, as the utility would no longer have as strong an interest in protecting these assets for the sole benefit of the regulated company. It would also give the utility an incentive to offer workable transportation programs. Clearly, what Tussing has proposed is an important and comprehensive view of one possible approach to noncore procurement, a perspective which has ramifications that go far beyond the more limited question of approving or disapproving PG&E's commodity pricing flexibility proposal. Moreover, we view the PG&E proposal as more properly a proposed refinement to the utility's core procurement activities, as its focus is allowing core gas suppliers access to the noncore market. CPG has requested that we ask for comments on the Tussing alternative as a part of this investigation, and, as explained later in this order, we will do so, in the context of our review of the regulation of noncore procurement. In considering the PG&E commodity pricing flexibility proposal, we will consider Tussing's remarks on the plan's discriminatory aspects as supporting the similar comments of many other parties.

Discussion. Assembling the core portfolio is, in our opinion, one of the central challenges facing the gas utilities as they move into an era in which competition is playing an increasingly important role in allocating gas supplies. Our responsibility toward core ratepayers, who have no easy alternative to using gas, mandates that we should provide the utilities with the necessary tools to assemble a core portfolio meeting the three objectives which we recently outlined in D.86-12-010: certainty of supply to meet core peak requirements, price security greater than found in the spot market, and attaining these objectives at the lowest possible cost (see D.86-12-010, pp. 67-84). In our view, one of the important tools in this effort may be providing core

suppliers with access to the noncore market for volumes that are temporarily in excess of core requirements. Such access can assist the utilities in securing adequate supplies to cover core peak requirements, while minimizing costs by allowing the utilities to offer suppliers the opportunity for high load factor takes. These potential benefits convince us that it may well be appropriate to reconsider our current guideline which prevents a utility from selling anything other than short-term gas to noncore customers[1]. From this perspective, PG&E's proposal may offer important benefits for core gas ratepayers, benefits which go beyond the obvious discounts for the core portfolio which are linked to the program's noncore sales. The program's access to the noncore market provides PG&E with an attractive inducement for suppliers to provide gas to the core portfolio at stable, competitive prices.

However, we also believe that this access must be carefully structured, must not result in discrimination against other noncore suppliers, and must not diminish the supply options available to gas users on the PG&E system. Taking a longer-term perspective, we recognize the importance of allowing equitable access to the California market if we are to encourage gas producers to commit supplies to this market. Many of the commenters, including the CPG's Tussing, have raised what we feel are important concerns about the potential for the PG&E proposal, and to a lesser extent the SoCal plan, to impair competitive access to the California market. What we would like to find is a way to

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1) We note that this rule, set forth on page 87 of D. 86-12-010, appears to contradict the discussion in the accounting rules (pp. 152-159), which seems to allow excess long-term supplies to be transferred into the noncore portfolio. Furthermore, as we will discuss at length below, the accounting rules are unclear on the conditions under which such transfers can take place.

we would like to see El Paso explain in further detail how such a program would work. For example, would the "release" conditions have to be embodied in every utility-supplier purchase contract?

Finally, we note that D. 86-12-010, in adopting accounting rules for our new regulatory structure, does discuss the transfer of gas from the core to the noncore portfolio (pp. 152-59). These rules do not directly specify the conditions under which such transfers can be made, except to place the utility at risk in a reasonableness review if such transfers occur at a substantial loss (p. 158). The discussion does set out the following proposed rule:

> "Transfers from the core gas purchase account to the core or non-core portfolio accounts: All gas transferred between the long and short-term gas purchase accounts to the core and non-core portfolio accounts shall be at weighted average cost. If there are transfers from the long-term source account to the non-core portfolio account during an extremely warm year, because there is such low core demand for the gas and the utility cannot avoid taking the gas even under its flexible contract terms, the gas shall be transferred to the non-core portfolio at the current weighted average cost of the long-term source account.
>
> "However, any recovery deficiency in the core portfolio balancing account resulting from sales to the noncore portfolio at a loss shall not be subject to balancing account treatment. The utility may seek recovery of such booked loss in its next annual reasonableness review."

Although this proposal is discussed, the adopted rules (pp. 158, 158a, and 159) do not reflect the results of that discussion. Otherwise, the discussion of procurement policies in D. 86-12-10 is silent on this topic. We welcome comments on the above proposed rule as another option.

Clearly, at this time the Commission has before it a wide range of proposals for the marketing of excess core gas supplies. We firmly believe that core customers will benefit if core suppliers have access to the noncore market. However, that access must be structured to satisfy the discrimination concerns which we have discussed above. Obviously, a "release" program, such as proposed by El Paso, in which the suppliers retain control of the disposition of the excess supplies, would have the fewest problems meeting these concerns. However, we want to encourage the utilities to attempt to design a program in which the utility can resell temporarily excess core supplies, at a profit to the core, into the noncore market. However, the discrimination concerns which we have described above dictate that such a program should adequately address the following issues:

1. Do all short-term supplies, both spot and excess core, have an equal opportunity to bid into the noncore portfolio? If the utility proposes to grant excess core supplies a preference over spot gas, how is that preference justified?

2. If PG&E proposes to purchase and resell excess core supplies into its noncore portfolio, what is the expected impact of such sales on the interruptible capacity available on the PGT system?

3. Currently, all supplies in the noncore portfolio must be sold at the prevailing noncore WACOG. As explained later in this order, the Commission will be reviewing how it wishes to regulate, or deregulate, noncore gas procurement. Clearly, proposals to sell excess core supplies in the noncore market must be consistent with the corresponding plan for the utility's noncore sales.

4. What are the specific criteria for determining which core suppliers are eligible to gain access to the noncore market, and what is the rationale for such criteria? For example, the PG&E flexibility program was open to core suppliers offerring "stable" and "competitive" prices to the core portfolio. Are such criteria useful, and, if so, how specific should they be?

We recognize that the utilities may need a mechanism for flowing excess core supplies into the noncore market immediately upon implementation of the new rate design and regulatory structure that is the focus of I. 86-06-005. Therefore, the utilities should file by December 15, 1987, comments describing their reformulated proposals for marketing excess core supplies in the noncore market. This testimony must address the issues and the discrimination concerns which we have discussed above. Interested parties may respond to these revised proposals along with their comments on noncore procurement, which, as discussed below, we are asking to be filed on January 15, 1988. If the comments show that hearings on the utilities' revised proposals are necessary, we would hold them in March, 1988.

II. Noncore Procurement and Multiple Supply Portfolios

As we announced in D.86-12-010 (p. 87), we intend to address the future regulation, or deregulation, of noncore procurement in the course of this investigation. The comments of CPG's Tussing have provided us with a comprehensive and provocative view of one possible structure for the utilities' noncore procurement activities. We will begin to examine this issue by granting CPG's request that we solicit comments on Tussing's submittal; these comments should be filed by January 15, 1988. One of the issues which we ask commenters (and, if it so desires, the CPG) to address is how, under the deregulated model of noncore procurement which Tussing advances, might the utility provide its core suppliers with access to the noncore market. As we have noted above, such access could be a valuable tool in the utilities' core procurement efforts. In addition, we invite the respondents and interested parties to use these comments to advance their own proposals for the future of our regulation of the utilities' noncore procurement activities.

SoCal's June 1, 1987, filing of its storage proposal also included requests to change several of the noncore procurement policies which we established in D.86-12-010. In order to increase the attractiveness to noncore customers of electing into the core portfolio for procurement service, SoCal proposes to permit noncore customers to elect core procurement service even if the core WACOG is below spot prices. This opportunity would only occur at semi-annual "openings" of the core portfolio. If core prices are below the spot market, customers electing the core portfolio would have to pay a surcharge equal to the difference between the core WACOG and the market cost of a new one-year supply of gas. There would also be a charge for early termination of core-elect purchases, which would reflect the costs associated with reducing core portfolio purchases. This proposal appears to be a refinement of SoCal's position on the "portfolio switching" issue which we addressed in R.86-06-006 and decided in D.86-12-010 (see pp. 46 and 50-57). Essentially, SoCal wants to allow noncore customers into the core portfolio even when the core portfolio is cheaper than spot prices; the price of admission in such circumstances would be agreeing to pay the full market price for the first year. SoCal's proposal has the goal of increasing the size of the core elect; however, given the price of admission which SoCal would charge, the plan appears likely to increase core election only if customers have the expectation that the core portfolio will be cheaper than spot prices for several years to come. We doubt that many customers will act on such an expectation, given the uncertainties of future gas markets. Furthermore, if the core is cheaper than spot prices for an extended period (the conditions under which the plan would stimulate core election), the addition of more core customers could increase core prices, even with SoCal's proposed entrance fee. SoCal should respond to these concerns in its December 15 filing.

to permit the brokering of interstate capacity in a secondary market. In addition, the FERC is reviewing its staff's proposals for an auction system of allocating capacity. Either one of these methods would presumably increase to some extent end-users' access to interstate capacity. The Commission is interested in learning the direction which the FERC intends to take with respect to capacity allocation. However, the Commission is also interested in contributing to the dialogue at the federal level on the appropriate means of allocating capacity, and in facilitating the development of a common position among the California parties on this important issue.

Accordingly, the Commission will proceed with its previously announced plan to hold a workshop to discuss the options available for allocating or sharing interstate capacity. This workshop will be independent of these procurement hearings, and will hopefully serve to illuminate preferred options which California utilities and end users can recommend to the FERC. The notice setting the workshop date will be issued by the Legal Division, which will moderate the workshop, within the next 60 days. Upon the conclusion of the workshop, the Legal Division shall report to the Commission on the recommended means of sharing or allocating interstate capacity, and the Commission shall advise the FERC of the outcome of the workshop.

V. Firm Interutility Transportation

On May 29, 1987, the Commission issued D.87-05-069, establishing a system for the interutility transportation of gas in California. The interutility transportation service approved in that order has a priority inferior to that of retail transportation for noncore customers. Several of the participants in the interutility transportation case urged us to provide a firmer service. D.87-05-069 discussed two possible means for improving the reliability of interutility service. The first is to allow interutility service priority parity with intrautility, retail transportation. This would allow an interutility transporter to pay a priority charge which would determine his/her place in the curtailment order in comparison with both retail and other interutility shippers. The second means is to provide access to gas storage. As this order discusses, providing storage access will be the first order of business in this proceeding, and we hope to have a storage banking program in place in the near future. Thus, in the near future, interutility shippers can seek access to storage if they desire to firm up the reliability of their service.

Therefore, we see no need for further action on this issue at this time. We would like to gain some experience with the new structure of the industry and our new unbundled rate design before we address allowing interutility shippers to have priority parity with retail transporters. In addition, we note that firm interutility service would do a shipper little good without firm interstate pipeline capacity, which, as we have discussed above, remains unavailable due to federal policy constraints[2]. Therefore, we will not deal with this issue until it ripens with the completion of the implementation proceeding and the availability of firm interstate capacity.

VI. Sequencing

We are aware that certain parties to our natural gas proceedings are interested in having the Commission revisit the guidelines under which the utilities sequence their purchases of gas from their long-term, dedicated suppliers. For example, in the rate design implementation proceeding, I.86-06-005, the presiding Administrative Law Judge struck a considerable body of testimony related to sequencing. The last time this Commission issued detailed guidelines on sequencing was in December, 1984, in the fall 1984 gas offset proceedings. What motivated that review was the dramatic increase which the FERC's Order 380 produced in the utilities' ability to purchase gas on a least-cost basis. Since that time, other dramatic changes have occurred in how the utilities purchase gas, principally the tremendous growth in the

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2) Shippers of California-produced gas are, of course, an exception to this remark; such shippers would not be moving their gas over an interstate pipeline.

volumes of gas--much of it from non-traditional suppliers--transported by California utilities and their end-users. The increase in gas transportation has resulted in a decline in the utilities' traditional purchases from the pipelines' system supplies. We have been asked on several occasions since December, 1984, to revise the 1984 guidelines. Each time we have refused, preferring to leave the details of sequencing policy to utility management, subject to our subsequent review for reasonableness. We have done so in recognition of the need for utility managers to be able to respond flexibly to the changing circumstances in the gas industry, which from time to time may require significant departures from the Commission's guidelines for sequencing gas purchases. Utility managers have more detailed knowledge of their suppliers' circumstances than is generally available to this Commission, and they might be hamstrung in their ability to respond quickly and flexibly to changing conditions if they had to seek Commission approval for every change in the sequencing order. Thus, we have emphasized that the sequencing guidelines are guidelines, not hard-and-fast rules, and have warned the utilities that they must justify as appropriate to their circumstances, and to the ratepayers' best interest, both their adherence to, as well as their departures from, the guidelines.

Sequencing guidelines are only one part of overall core procurement policies, especially since the utilities appear to be entering an era in which they will be purchasing gas for the core under a larger number and a wider variety of purchase arrangements than in the past. In the future now unfolding, the opportunities for core purchases will be far greater than just the in-state sources and traditional pipeline suppliers who are covered by the current sequencing rules. Therefore, we will ask for comments on whether and how we should review core procurement policies, including, but not limited to, our sequencing guidelines. The threshhold question which we want to see addressed is whether any more detailed guidelines are needed beyond the general core procurement policies set forth on page 84 of D. 86-12-010. If the answer to this question is "yes", the next issue is whether the guidelines should be any more specific than providing for a general methodology for activities such as sequencing: for example, the 1984 sequencing guidelines used an "average cost" methodology for PG&E and an "incremental cost" method for SoCal Gas. At this level of detail the Commission may also wish to consider the appropriate mix of long, short, and intermediate term contracts in the core portfolio. Finally, at its most detailed, a review of core procurement might decide how to change the details of the 1984 sequencing guidelines to adapt to today's circumstances, and might involve the Commission in the preapproval of new long-term gas purchase contracts. The comments on core procurement policies should focus on this question of how detailed an investigation is needed. These comments should also be filed on January 15, 1988.

Findings of Fact

1. Providing core suppliers with access to the noncore market for volumes that are in excess of core needs can be an important tool in the utilities' core procurement efforts.

2. In the long run, providing equitable access to the California market will encourage gas producers to commit supplies to this market.

3. PG&E's commodity pricing flexibility proposal could result in the exclusion of other suppliers from the Pacific Gas Transmission pipeline.

4. PG&E's ability to control access to the PGT pipeline could allow it to escape competitive pressures on its transmission rates.

5. PG&E has provided no cost justification for the eligibility limitations of its program.

6. SoCal's "flexibility" proposal avoids the discriminatory eligibility requirements of the PG&E plan.

7. SoCal's program could, however, discourage suppliers from bidding into its spot gas buying program, and might expose core customers to unacceptable price risks.

8. A "release" program, such as suggested by El Paso, would deny core customers the benefits of selling excess core supplies in the noncore market, when core prices are below spot prices.

9. The Tussing study submitted by the CPG is a comprehensive and provocative view of one possible future for noncore procurement.

10. SoCal's request to create a number of additional noncore portfolios is a variant of the "multiple supply portfolios" idea which we advanced in D.86-12-010, and which we decided to consider in this proceeding.

11. It is desirable to avoid a long conceptual debate on unbundling storage, and to proceed to implement a storage program from which experience can be gained.

12. The utilities' storage fields increase the reliability of service for all gas users in California, including transportation-only customers.

13. Storage can increase the capacity of the utilities' systems to deliver gas, and can also function as a source of supply.

14. Because of the integrated operations of the utilities' gas systems, including their storage facilities, it would be very difficult to separate the costs of supply-related storage functions from those that are capacity-related.

15. For the short-term, capacity-related benefits of using storage to balance supplies and deliveries, the priority charge we have adopted can substitute for unbundled storage rates.

16. The longer-term, more supply-related benefits of storage could be made available through a storage "banking" program, such as the one proposed by SoCal.

17. A banking program would use storage capacity that is currently in excess, and could be structured to have minimum impact on storage operations for core customers.

18. The Assigned Commissioner's Ruling of October 1, 1987, sets forth the issues that must be addressed in order to implement a storage banking program for noncore customers.

19. The availability of unbundled storage banking will provide interutility shippers with a means to firm up their service.

20. The sequencing guidelines which are now "on the books" are increasingly outdated, due to the significant increase in gas transportation on the utilities' systems.

21. The sequencing guidelines are not hard-and-fast rules, and the utilities must justify their adherence to the guidelines as well as their departure from them.

Conclusions of Law

1. SoCal and PG&E should reformulate their "flexibility" proposals in order to address the concerns that their plans may be discriminatory.

2. The Commission should consider in this proceeding a broad range of options for the future of the utilities' noncore procurement activities.

3. At this time it is appropriate to hold hearings focused on the operational and implementation details of SoCal's proposed storage "banking" service.

4. The allocation of interstate pipeline capacity is primarily a function of federal regulation, and current FERC policies do not permit the assignment or brokering of this capacity.

5. The Commission needs comments from the respondents and interested parties on whether to revisit the matter of the overall guidelines for the purchase of gas for the core portfolio. ✓

ORDER

IT IS ORDERED that:

1. The respondents may file by December 15, 1987, testimony describing reformulated proposals for marketing excess core supplies into the noncore market. This testimony shall describe how the new program addresses the four issues noted in the text of this decision. Interested parties may file comments on these proposals by January 15, 1988. ✓

2. CPG's request that we solicit comments on the paper "Noncore Gas Procurement in California: A Free-Market Alternative", prepared by Arlon R. Tussing and Connie C. Barlow on behalf of the CPG, is granted. These comments are due January 15, 1988, and commenters may use this forum to advance their own proposals for the future of our regulation of the utilities' noncore procurement activities.

3. SoCal shall address in its December 15 filing the concerns discussed in this order regarding its "portfolio switching" proposal and its request to establish additional noncore portfolios. Other parties may comment on these proposals by January 15, 1988. All respondents and interested parties may address in their January 15 comments the concept of "multiple supply portfolios" which we outlined in D.86-12-010.

4. If the final order in I.86-06-005 defers the issue of out-of-area and noncore brokerage fees to this proceeding, the respondents should file by January 15, 1988, their proposed brokerage fees.

5. Hearings on SoCal's storage "banking" proposal shall be held according to the schedule and the scope of issues presented in the Assigned Commissioner's Ruling of October 1, 1987.

6. The notice setting the date for the workshop on interstate pipeline capacity shall be issued by the Commission's Legal Division within 60 days from the effective date of this order.

7. Respondents and interested parties may file comments by January 15, 1988, on whether the Commission should revisit the matter of core procurement policies, including sequencing guidelines.

8. All comments submitted in this proceeding shall be filed in the original and 12 copies with our Docket office and served on all parties of record in this investigation.

This order is effective today.

Dated OCT 16 1987 at San Francisco, California.

STANLEY W. HULETT
President
DONALD VIAL
FREDERICK R. DUDA
G. MITCHELL WILK
Commissioners

Commissioner John B. Ohanian, being necessarily absent, did not participate.