ALJ/km/jn

Decision 82 08 018 AUG 4 - 1982

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of SAN DIEGO GAS & ELECTRIC COMPANY for Authority to Decrease its Electric Rates and Charges in Accordance with the Energy Cost Adjustment Clause in its Electric Tariff Schedules, as modified by Decisions 91269 and 91277 in OII 56 dated January 29, 1980.	Application 59945 (Filed September 18, 1980)

Jeffrey Lee Guttero, William L. Reed, and Stephan A. Edwards, Attorneys at Law, and Luce, Forward, Hamilton & Scripps, by Charles A. Bird, Attorney at Law, for San Diego Gas & Electric Company, applicant.

Kreindler & Kreindler, by Paul M. Bernstein, Attorney at Law, for Stockholders of San Diego Gas & Electric Company, intervenor.

Gray, Cary, Ames & Frye, by Marilyn L. Huff, Attorney at Law, for The San Diego Union and John W. Witt, City Attorney, by William S. Shaffran, Deputy City Attorney, for the City of San Diego, interested parties.

Michael B. Day, Attorney at Law, and Robert Weissman and Ray Charvez, for the Commission staff.

I N D E X

OPINION

I. Summary

In early 1978, San Diego Gas & Electric Company (SDG&E) found itself with excess fuel oil supplies. In response, SDG&E entered into the following series of oil exchanges with United Petroleum Distributors, Inc. of Houston (UPD):

1. April 29, 1978 - 750,000 barrels (bbls.) of fuel oil to be returned by UPD between June and September 1, 1980.
2. May 1, 1978 - 540,000 bbls. of fuel oil to be returned by UPD between June 1 and September 1, 1980.
3. September 28, 1978 - 330,000 bbls. of fuel oil to be returned by UPD between August 1 and December 1, 1980.
4. November 20, 1978 - 800,000 bbls. of fuel oil to be returned by UPD between July and December 31, 1979.

This decision reaches several conclusions with respect to the manner in which the exchange by SDG&E of 2.4 million bbls. of oil worth more than $30 million was negotiated and executed. SDG&E had no administrative procedures effectively in place to govern the negotiations and execution of fuel exchange contracts of the scope and character of the UPD agreements. In the absence of such procedures, middle level management employees acted beyond the scope of their authority and proper supervision was neglected. SDG&E did not take reasonable steps to ensure that UPD was a creditworthy partner for an exchange of the magnitude involved in these transactions, either initially or during the negotiation of later exchanges for additional amounts of oil. Further, SDG&E acted unreasonably in releasing shipments of oil to UPD prior to the approval and execution of written exchange agreements and prior to obtaining adequate security for the quantities of oil transferred to UPD.

SDG&E unreasonably entered into additional exchanges of oil with UPD even after being alerted to the precarious financial condition of UPD and its affiliates. In entering into a renegotiated exchange agreement with UPD, SDG&E unreasonably failed to require UPD to demonstrate its ability to meet its obligations under the agreement and, in addition, unreasonably failed to evaluate the effect of the renegotiated agreement upon UPD's financial interest in the exchange.

In sum, we conclude that SDG&E negotiated and executed the UPD fuel oil exchanges in an imprudent manner and that the expenses and losses sustained by SDG&E with respect to these exchanges were unreasonably incurred. We order that no part of the losses or expenses sustained by SDG&E with respect to these exchanges shall be recovered in rates at any time. In this connection, we note that in November 1980 SDG&E announced a $26 million loss on the UPD transactions charged to earnings, with an additional $4.6 million loss taken in 1981. Therefore, the total UPD receivable of $30.6 million has been accounted for as a loss.

Finally, we direct SDG&E to reduce its Energy Cost Adjustment Clause (ECAC) balancing account by $4,436,710 to reflect expenses that were imprudently incurred by SDG&E in December 1979 in buying 107,000 bbls. of oil from TOSCO. During essentially the same time frame, SDG&E waived its rights to receive 500,000 bbls. of oil at no cost from TOSCO under an agreement related to the UPD transactions. Secondly, SDG&E ultimately purchased the same oil which it was previously entitled to receive at no charge at a time when the best available information indicated that SDG&E had no forecasted need for the oil. All expenses asssociated with the purchase of the 107,000 bbls. are disallowed since they were imprudently incurred.

II. Procedural History

SDG&E filed this application for a fuel offset rate decrease on September 18, 1980. Six days of hearing, commencing December 2, 1980, were held in Los Angeles and San Diego. In addition to the ECAC issues raised by the rate decrease proposal, testimony regarding a number of fuel oil exchange agreements between SDG&E and UPD was scheduled for presentation. Phase I of Application (A.) 59945 was submitted on December 11, 1980, subject to the receipt of concurrent opening and closing briefs on February 6 and February 27, 1981, respectively.

On December 30, 1980, the Commission issued an interim opinion, Decision (D.) 92558, which set new electric and gas rates for SDG&E and granted a $1.2465 million adjustment to fuel expenses recommended by the Commission staff's (staff) Revenue Requirements witness to account for the effect on oil inventory pricing of the oil released in the exchange transactions. Further decisions regarding the transactions themselves were reserved pending completion of the investigation into the exchanges.

On February 5, 1981, the staff filed a Motion to Alter or Rescind Administrative Law Judge (ALJ) Johnson's Ruling of December 10, 1980, which ruling had limited the witnesses the staff intended to call in this proceeding. On May 5, 1981, the Commission announced D.92984 which granted the staff's motion and reopened the proceeding for further hearings in Phase II of A.59945, including testimony from witnesses called by the staff. In February 1981, a class action lawsuit was filed against SDG&E, alleging inadequate disclosure of potential losses associated with the UPD exchange transactions and seeking an unspecified amount of damages. Between hearings in Phases I and II of A.59945, counsel for plaintiffs in this litigation (shareholder intervenors) intervened and actively participated throughout Phase II. Settlement of the class action suit was announced by SDG&E on April 27, 1982.

During the period of discovery prior to the reopening of hearings in Phase II of the proceeding, on September 25, 1981, the staff filed a Motion to Compel the Production of Documents, directed at obtaining additional records relating to the exchanges that SDG&E had withheld when it responded to the staff data request. On September 28, 1981, the presiding ALJ granted the staff motion and ordered production of the requested information.

On November 30, 1981, hearings reopened in this proceeding and continued for 10 additional days in December 1981 and January and February 1982. The matter was submitted on February 18, 1982, pending the filing of concurrent briefs on April 19, 1982.

III. Statement of Facts

A recounting of the salient facts involved in the SDG&E-UPD transactions is essential to a full understanding of the issues presented in the proceeding. (A chronology of relevant events is attached as Appendix A.)

Beginning in early 1978 and continuing throughout the remainder of the year, SDG&E entered into four fuel oil exchange agreements with UPD as a means of reducing its inventory of fuel oil to permit the burning of unanticipated amounts of natural gas as powerplant fuel. The four basic fuel exchanges consisted of the following agreements to transfer oil from SDG&E's inventory:

1. April 29, 1978 - 750,000 barrels (bbls.) of fuel oil to be returned by UPD between June and September 1, 1980.
2. May 1, 1978 - 540,000 bbls. of fuel oil to be returned by UPD between June 1 and September 1, 1980.
3. September 28, 1978 - 330,000 bbls. of fuel oil to be returned by UPD between August 1 and December 1, 1980.
4. November 20, 1978 - 800,000 bbls. of fuel oil to be returned by UPD between July and December 31, 1979.

Prior to its commitment to the first two oil exchanges, SDG&E, which had not previously transacted business with Edward Fourticq, who controlled UPD, checked the credit of its proposed exchange partner in the following manner: (1) a Dun & Bradstreet Report on UPD was acquired; (2) SDG&E's representatives determined from UPD's banker in Houston that UPD had a line of credit available in the low "eight figure" range; and (3) various contacts in the oil industry provided pertinent information. Furthermore, by letter dated April 14, 1978, Fourticq, on behalf of E & H Investments, Inc. (E & H), which assertedly had a continuing interest in the success of UPD, offered to obligate E & H to hold its 45% share of the United Castle Coal Company (UCC) coal mine as security for UPD's performance of the two proposed exchange agreements.

Between April 29 and May 1, 1978, certain SDG&E personnel agreed to two fuel exchanges with UPD involving 750,000 and 540,000 bbls. of oil. Such agreement was apparently reached in the absence of the two men responsible for supervision of such transactions, George Reiss, the then Supervisor of Fuel Acquisitions, and Robert Belt, Senior Vice President, Administration, who returned from a trip to Indonesia on May 2, 1978. The two transactions were arranged over the telephone; and the first oil from SDG&E's inventory was loaded on ship on May 11, 1978, for delivery to UPD before the execution of supporting documents. Following his return from the Orient, Reiss concluded that the interests of SDG&E would be better protected if further collateral for the first two exchanges were negotiated. Between May 1 and May 15, 1978, Reiss sought such collateral for the following reasons: (1) UPD was an exchange partner with which SDG&E had not done business in the past; (2) the size of the exchange transaction was quite large; and (3) some uncertainty existed regarding the nature of UPD's assets. By letter dated May 15, 1978, Fourticq confirmed the second exchange, offered collateral in the form of a stock pledge and a corporate guarantee, and made certain representations about his own net worth. On June 7, 1978, Reiss signed the May 15 letter and secured SDG&E's collateral for the first two exchanges in the form of UPD's corporate guarantee of the underlying obligation as well as a negative pledge not to alienate 45% of the stock held in UCC, the Virginia coal mine.

SDG&E had delivered about 1.29 million bbls. of oil, with an inventory value of over $20 million, to UPD. In mid-1978 UPD sold the exchanged bbls. in New York at $10-$11 per bbl. In August 1978 R. Lee Haney, Supervisor, Financial Services, expressed concern over the status of SDG&E's collateral interests provided by UPD to support the first two exchanges. In response to Haney's concerns, SDG&E sent a team of representatives to Houston in early September 1978 to investigate the financial viability of UPD and its affiliated companies as well as to attempt to improve SDG&E's collateral position. Upon review of UPD's financial viability and based upon Fourticq's representations, SDG&E's negotiating team concluded that opportunities existed for improvement of SDG&E's collateral position and that UCC was a viable entity.

During this time, SDG&E still found itself in an excess fuel oil situation and was investigating means for disposing of additional oil. SDG&E's management agreed in late September 1978 that a third exchange with UPD would provide an opportunity to transfer additional oil and a chance for SDG&E to strengthen its collateral position. On September 28, 1978, SDG&E and UPD entered into the so-called "Combined Agreement", which consolidated the first two exchanges with the third transaction. Contemporaneous with the execution of the "Combined Agreement", SDG&E delivered an additional 330,000 bbls. to UPD.

Under the "Combined Agreement", SDG&E obtained the following additional collateral:

1. 100,000 shares of preferred stock were pledged to SDG&E in support of the first two transactions. The combined agreement increased this pledge to 200,000 shares of preferred stock and also included a pledge of 78.4% of the common stock in UCC.
2. An agreement of all the affiliated companies to become jointly and severally liable to SDG&E under the combined agreement.
3. A pledge to SDG&E of all property related to the mining operation purchased by UPD in the area of the UCC coal mine.
4. A commitment to obtain an appraisal of the UCC coal mine in order to ascertain its fair market value.
5. A pledge to SDG&E of all gas and/or oil properties purchased by UPD with the proceeds of its sale of the oil exchanged with SDG&E.
6. The subordination of intracompany future debts by UPD to SDG&E.
7. The written personal guarantees of Edward and Helen Fourticq as well as Fourticq's son and his wife, Michael and Janet Fourticq.

In return for the additional collateral, SDG&E transferred the 330,000 bbls. of oil to UPD and agreed to share the difference between the cost of the fuel oil to be acquired by UPD to eventually pay back SDG&E and the price UPD obtained originally in selling the exchanged oil to a third party. 55% of the difference between UPD's selling price and its reacquisition cost would be absorbed by UPD and 45% by SDG&E. SDG&E agreed to absorb 45% of any market price increase on oil with respect to all three transactions, i.e. SDG&E assumed retroactively an obligation which was not present in the first two exchanges. While executing the third exchange, SDG&E's management established the policy that any future exchanges with UPD must be fully collateralized.

In November 1978 SDG&E still had excess fuel oil. Under an agreement dated November 20, 1978, SDG&E delivered 800,000 more bbls. of oil to UPD - in what has come to be known as the Fourth Exchange Transaction. In accordance with the policy requiring full collaterization of any future oil exchanges with UPD, SDG&E received a letter of credit from Fourticq in the amount of $4,385,000. This letter of credit covered the first installment (330,000 bbls.) of the 800,000 bbl. fourth exchange. The letter of credit was returned to UPD when UPD assigned to SDG&E UPD's rights under a contract that it had with a refiner, TOSCO, for delivery of 800,000 bbls. of oil to UPD by TOSCO. Some SDG&E executives felt that the assignment gave SDG&E even better security than the letter of credit given their understanding of the assignment that TOSCO was obligated to provide the oil to SDG&E without recourse even if UPD did not pay for the oil.

Whether or not the agreement/assignment would have been enforceable in court against TOSCO as intended by SDG&E was subsequently rendered moot by SDG&E's waiver of its rights to receive oil from TOSCO under the UPD assignment. During 1979 when the oil from the fourth exchange was scheduled for return to SDG&E, TOSCO did deliver 300,000 bbls. of oil. Then on September 14, 1979, TOSCO sent a telex to SDG&E indicating that it understood that SDG&E required no more fuel oil in 1979 and would therefore terminate deliveries under the assignment unless SDG&E responded within seven days. SDG&E did not respond to the telex.

Although 500,000 bbls. of oil remained outstanding, Reiss believed that SDG&E did not need the oil and that UPD remained liable for the eventual return of the oil even if TOSCO did not provide it. At the time of the waiver of the assignment from TOSCO in the fall of 1979, the oil spot market was on the upswing; and testimony indicates that SDG&E could have made a profit on the sale of residual oil it obtained at that time.

In April 1979 Fourticq requested an opportunity to renegotiate the four exchange agreements because of the precipitous increase in the price of oil and poor earnings performance by UCC due to a continued soft spot market in coal. UPD represented that it could not repay the value owed for the oil on exchange without an extension of time over at least a five-year period. The price of oil had risen to $25-$27 per bbl. on SDG&E's contract price and to $30-$40 per bbl. on the spot market. Accordingly, there was little chance that UPD could purchase replacement oil for anywhere near the price ($10-$11 per bbl.) it obtained upon sale of the original oil. A cash option for SDG&E's book value was UPD's only means of attempting to meet its obligations. By an amended agreement executed December 27, 1979, SDG&E agreed to extend the term of the exchange by five years and to allow UPD to meet its obligations by exercising a cash payment option to return the value of the oil at a rate of $16.50 per bbl., SDG&E's book value for the exchanged oil.

In October 1979, one month after SDG&E had waived its rights to 500,000 bbls. of oil from TOSCO at no cost, SDG&E's fuel mix forecasts anticipated a shortage of fuel oil during the first and second quarters of 1980. Fourticq informed SDG&E that he had access to a committed supply of oil from TOSCO at 100,000 bbls. per month in the first and second quarters of 1980. SDG&E determined that this oil was the best alternative available.

At this time SDG&E's long-term contract supplier, Hawaiian Independent Refinery, Inc. (HIRI), was providing reduced contract volumes due to force majeure. Because of some concern that HIRI might rescind its force majeure and require SDG&E to take its long-term contract volume of oil, HIRI was asked to purchase this oil on behalf of SDG&E from TOSCO through UPD so they would be counted as part of the long-term contract quantities. On December 14, 1979, HIRI purchased 100,000 bbls. per month for the first quarter of 1980, with an option for an additional 100,000 bbls. per month for the second quarter.

Thereafter, due to substantial changes in the forecasted need for oil in 1980, SDG&E notified HIRI that it would not exercise its option for the 300,000 bbls. of oil to be delivered in the second quarter of 1980. SDG&E took delivery of 107,000 bbls. in the first quarter, and then, because of changed forecasts, sought to cancel delivery of the remaining 193,000 bbls. SDG&E was informed that a cancellation underlift charge of $964,110.95 would be necessary. Only later did SDG&E learn that this amount had been demanded by and paid to UPD by HIRI in the spring of 1980. Furthermore, only later did SDG&E learn that UPD had collected a markup on the 107,000 bbls. in the amount of $155,407.82. SDG&E has made two adjustments to its ECAC balancing account totaling about $1.4 million.

On April 15, 1980, UPD made its first payment of $1,650,000 ($16.50 x 100,000 bbls.) under the cash option plan negotiated as part of the December 1979 amended agreement. On August 15, 1980, UPD made its second payment of $1,650,000 to SDG&E. On October 30, 1980, UPD advised SDG&E that it would not make its December payment. SDG&E viewed this action as an anticipatory breach of UPD's contractual obligations. Shortly thereafter, SDG&E commenced litigation against UPD.

In sum, SDG&E delivered 2,400,322 bbls. of fuel oil to UPD during the period May 1978 through April 1979; and UPD returned 307,718 bbls. of fuel oil to SDG&E during the period May 1979 through October 1979. UPD also made cash payments to SDG&E of $1,650,000 on April 15, 1979 and August 15, 1980, totaling $3,300,000. The inventory value of the 2.4 million bbls. exchanged totals about $39 million. From UPD, SDG&E received value in the form of oil and cash totaling about $8.4 million. In November 1980 SDG&E announced a $26 million loss on the UPD transactions charged to earnings, with an additional $4.6 million loss taken in 1981. The total UPD receivable of $30.6 million has been accounted for as a loss.

IV. Statement of Issues

Phase II of A.59945 presents the following issues for resolution:

1. Whether SDG&E acted prudently in negotiating and executing the first two oil exchanges with UPD in April and May 1978.
2. Whether SDG&E acted prudently in negotiating and executing the third oil exchange agreement with UPD in September 1978.
3. Whether SDG&E acted prudently in arranging and administering the fourth oil exchange agreement with UPD in November 1978 and its accompanying assignment.

4. Whether SDG&E acted prudently in renegotiating the oil exchange agreements with UPD in late 1979.
5. Whether SDG&E acted prudently in purchasing 107,000 bbls. of oil from TOSCO through HIRI and UPD in the first quarter of 1980.
6. Whether the $1,246,500 balancing account adjustment adopted in D.92558 should be reversed.

V. Positions of the Parties

A. SDG&E

SDG&E maintains that the evidence clearly demonstrates that the first two exchanges were necessary and that its representatives acted consistently with recognized oil industry practices. SDG&E contends that its personnel acted prudently in investigating UPD and obtaining the necessary assurances and collateral to protect its interests. SDG&E argues that in its negotiation and execution of the first two transactions, it was justified in relying on the information supporting the financial viability of UPD and the affiliated companies in the spring of 1978.

With respect to the third exchange transaction, SDG&E argues that it provided an opportunity for SDG&E to strengthen its secured collateral in support of the first two transactions. In September 1978 SDG&E recognized some potential difficulties with the collateral interests provided by UPD to support the first two exchanges. SDG&E maintains that it reacted prudently to this perceived problem. Its negotiating team in Houston took reasonable measures to confirm the financial viability of UPD and its affiliates. As a result of its investigations, SDG&E consciously decided that additional collateral should be pursued. SDG&E acted reasonably in relying on the representations of Fourticq, negotiated the best terms obtainable, and secured improved, additional collateral through the third exchange agreement.

In November 1978 SDG&E still had excess fuel oil. Sales into the spot market would have resulted in a $5-$8 million loss, and other disposal alternatives proved unattractive. SDG&E states that although full collateralization was now required for future transactions with UPD, it had no reason to question the ability of UPD to perform its current contractual obligations or the propriety of entering a fourth oil exchange with UPD. SDG&E therefore exchanged an additional 800,000 bbls. of oil with UPD on the basis that the return of oil was guaranteed by TOSCO, a large and reputable refiner. SDG&E argues that it made every effort to fully collateralize the fourth exchange transaction and that it acted reasonably in relying on a major west coast refiner, which would guarantee delivery of the oil to SDG&E independent of payment by UPD.

It is SDG&E's position that the amended agreement of November 1979 was entered into for the benefit of all parties concerned. SDG&E has several reasons for acceding to Fourticq's request for renegotiation of the existing exchange agreements:

1. SDG&E desired to enhance UPD's ability to perform under existing circumstances and felt that the extension of the agreement to 1985 was to the benefit of both UPD and SDG&E.
2. An amendment could place a limit on the price of oil to be returned at $16.50 per bbl., SDG&E's moving average inventory price (MAP) of the exchanged oil.
3. SDG&E sought to remove its 45% risk of oil price increases negotiated in conjunction with the combined agreement.

4. An amendment could change the delivery schedule of oil to SDG&E from 1979 and 1980 to the years beyond when SDG&E anticipated a need for the oil.

5. Negotiations for an amendment also provided an opportunity for SDG&E to obtain additional collateral in the form of a mortgage and trust deed on the coal mine.

6. SDG&E desired to include an audit provision in the amended agreement.

During 1979 SDG&E claims it took reasonable precautions to obtain the best possible information regarding the financial status of UPD and the affiliated companies. The Thompson-Litton Report was positive regarding the operation and value of the mine, and SDG&E understandably relied on its content in considering renegotiation of the agreements. SDG&E's representatives say they were careful to assess not only the earnings potential of the various assets but also their value upon liquidation to ensure repayment. While such assessments were taking place, various unforeseeable factors impacted the resource markets which had a profound influence on the value and profitability of these assets. Ultimately, renegotiation of the agreements was viewed as beneficial to both parties, given the existing circumstances and the opportunities to improve the respective positions of the parties.

SDG&E defends its purchase of 107,000 bbls. of oil through HIRI as necessary and reasonable in light of the circumstances at the time. In September 1979 SDG&E did not forecast a need for oil in the remainder of 1979 or in 1980. Therefore, SDG&E refused delivery of the 500,000 TOSCO bbls. by not responding to the TOSCO telex. Consequently, these bbls. were rolled into the amended agreement executed by SDG&E in December 1979. When SDG&E forecasted a need for oil in November 1979, due to unforeseeable circumstances, the opportunity to take the TOSCO bbls. had passed. By that date the parties were committed to the amendment and those bbls. were not available. SDG&E, in order to ensure continued service to its customers, had no alternative but to procure 600,000 additional bbls. When forecasts in February 1980 indicated no need for the additional oil, all but 107,000 of the 600,000 bbls. were disposed of in order to pass on the lowest cost to the ratepayers. Therefore, SDG&E claims it acted prudently in relying on its forecasts at the time to most effectively manage its inventory for the benefit of its ratepayers.

Finally, SDG&E contends that the balancing account adjustment adopted in D.92558 should be reversed. This recommendation was calculated by applying a last-in/first-out (LIFO) accounting treatment to all the bbls. of oil shipped to UPD on exchange. SDG&E has always used MAP as the method of valuing oil removed from inventory and has never applied LIFO accounting. The basis for the staff LIFO adjustment to the ECAC balancing account was that, although the oil shipped to UPD actually came from SDG&E's inventory, contract deliveries were coming in from SDG&E's supplier at the same time. The staff accountant reasoned that rather than removing oil from inventory at the MAP and allowing higher-priced contract deliveries to be added to inventory, the Commission should impute the delivery of contract supplies directly to UPD. However, the evidence is undisputed that the oil delivered to UPD actually came from SDG&E's inventory.

Furthermore, SDG&E argues that the LIFO accounting treatment proposed by the staff is unprecedented. It had the effect of distorting the actual economics of the transactions in order to maximize the price of fuel exchanged by UPD. SDG&E submits that the

LIFO accounting procedure proposed by the staff and adopted in D.92558 is totally at variance with the Commission's intention as stated in D.92496 issued in Order Instituting Investigation (OII) 56. In its final decision in this matter, the Commission should reverse the procedure adopted in the interim decision and use instead the appropriate accounting treatment for the bbls. shipped to UPD in conformance with D.92496 and generally accepted accounting principles. SDG&E requests that the $1.2465 million which was removed from the ECAC balancing account under D.92558 be placed back into the ECAC balancing account with accrued interest since that adjustment was made.

B. City of San Diego (San Diego)

San Diego asks the Commission to find that the UPD fuel oil exchanges were entered into, renegotiated, and administered in an imprudent manner and that no portion of the costs, expenses, or losses associated with the exchanges should be charged to the ratepayers. San Diego maintains that the combined agreement of September 28, 1979, and the fourth exchange transactions are particularly graphic illustrations of SDG&E's imprudence.

SDG&E's representatives went to Houston in September 1978 to attempt to negotiate additional collateral. San Diego expresses astonishment at what was accomplished by the negotiating team. The "combined agreement" consolidated the first two exchange agreements for 1.29 million bbls. with the third exchange of 330,000 bbls. and subjected SDG&E to a new liability concerning increasing costs of fuel oil. The "combined agreement" stated:

> "If the cost of fuel oil to be acquired by UPD to satisfy its obligations to SDG&E differs from the price obtained by UPD for the fuel oil sold to an unrelated third party, then UPD and SDG&E shall share such difference at a rate of 55 percent absorbed by UPD and the balance 45% by SDG&E."

The "combined agreement" incorporates the letter agreement of May 12, 1978, covering the 540,000 bbl. exchange and the May 15, 1978 letter agreement covering the 750,000 bbl. exchange. Neither the May 12 letter agreement nor the May 15 letter agreement make any mention of the responsibility for increasing fuel oil costs. San Diego argues that as a result of so-called "expert" negotiations in September 1978, SDG&E was now liable for 45% of increased fuel costs for the first, second, and third exchange contracts. In exchange SDG&E received pledges of preferred and common stock in the UCC and some other valueless corporate guarantees. San Diego notes that this "collateral" is apparently not worth much since SDG&E established a $30.6 million contingent reserve to support possible losses in 1980 and 1981. This amount covers the total UPD receivable.

San Diego submits that by incorporating the first two exchanges in the "combined agreement", SDG&E acted imprudently in making itself liable for 45% of the increased fuel costs. San Diego further contends that this liability is the reason that SDG&E negotiated the "amended agreement" of 1979 that allowed UPD to return oil at $16.50 per bbl. rather than at the substantially higher market price. San Diego notes that at about the same time SDG&E was agreeing to the $16.50 per bbl. cash equivalent return from UPD, SDG&E was also agreeing to pay about $36 per bbl. in the SDG&E/HIRI/TOSCO/UPD deal.

San Diego maintain that with respect to the fourth exchange agreement and the TOSCO assignment, SDG&E was imprudent in failing to ensure TOSCO's delivery of 500,000 bbls. of fuel oil in 1979 or, at a minimum, to attempt to negotiate an extension. San Diego reiterates that oil coming from TOSCO was at no charge. To compound the already unbelievable, SDG&E then entered into the December 1979 HIRI/UPD/TOSCO transaction for 300,000 bbls. of fuel oil from TOSCO which less than two months previously was bound to deliver 500,000 bbls. at no cost. San Diego further maintains that SDG&E was imprudent in not checking with TOSCO to determine the status of UPD in the 300,000 bbl. transaction with TOSCO.

C. Shareholder Intervenors

The shareholder intervenors contend that there is no dispute that the first two exchanges totaling 1.29 million bbls. and having an inventory value of over $20 million were unauthorized and were entered into by SDG&E employees contrary to company policy. Necessary executive approval was never obtained, even though the agreements were not executed until June 7, 1978, more than a month after the initiation of the exchanges. Both agreements were signed by Reiss who had no authority to bind SDG&E. Shareholder intervenors argue that this breach of company policy was compounded by three additional factors which clearly demonstrate the imprudence of entering the transaction in the first instance:

1. UPD was a small, thinly capitalized, virtually one-man operation, with whom SDG&E had never before dealt.

2. At the time of the exchanges, the market price of oil was more than 40% lower than SDG&E's cost; UPD received $12.3 million for the $20.6 million worth of oil it received from SDG&E.

3. Most significantly, SDG&E had obtained a Dun & Bradstreet report on UPD in April 1978 which, among other things, reported that UPD had a record of late payments and overdue payables.

In September 1978 SDG&E's representatives traveled to Houston to obtain collateral to protect SDG&E's interest in the first two exchanges. Viewing their efforts with hindsight, the shareholder intervenors conclude that the collateral obtained was comparatively worthless as is evidenced by the fact that UPD and its related companies filed bankruptcy petitions in 1981. The shareholder intervenors maintain that had SDG&E's representatives acted prudently in September 1978, they would unquestionably have determined then that the collateral was wholly inadequate. Instead, SDG&E's representatives simply accepted unverified representations that the "collateral" they obtained in September 1978 had a value in excess of $30 million. It was later learned by SDG&E that Fourticq's personal net worth was nowhere near the represented figure of $9.5 million, that the coal mine was virtually worthless and had never been profitable during any relevant period, and that Fourticq's companies throughout had a negative net worth.

Following his return from Houston, Haney drafted a memorandum in which he raised several concerns about UPD's financial viability. These red flags notwithstanding, SDG&E executed the "combined agreement" on September 28, 1978, and provided UPD with an additional 330,000 bbls. of oil while agreeing to absorb 45% of any market price increase on oil involved in all three exchanges. Shareholder intervenors submit that this plainly demonstrates that in the fall of 1978 SDG&E believed that, because of UPD's shaky financial condition, adequate collateral was essential - so essential that SDG&E gave up an additional $5 million worth of oil and an indeterminate potential loss resulting from a rising market price for oil in order to get the collateral. Shareholder intervenors maintain that, at a minimum, prudence dictated that in view of Haney's prior warnings SDG&E should have conducted a thorough investigation of the bargained-for collateral before entering into the third exchange agreement and accepting 45% of the market risk on the first two transactions. No such investigation was conducted.

After the fall of 1978, SDG&E began to monitor the financial condition of UPD and its related companies. The reports it received - mostly unaudited and invariably late - clearly evidenced a failing enterprise. Throughout the period, the combined UPD financial statements showed that liabilities exceeded assets and that continuing operations were producing losses - both at an accelerating pace. Despite various warnings that UPD was sliding into bankruptcy and despite Haney's concern that it was difficult to assess financial strength without conducting an audit, SDG&E never conducted an audit of UPD. Shareholder intervenors contend that this failure to conduct an audit, given the circumstances, is evidence of imprudence. Even more imprudent in the view of the shareholder intervenors is the fact that from September 1978 and throughout 1979, SDG&E's representatives requested Fourticq to permit SDG&E to conduct an audit of UPD which Fourticq flatly refused. Nevertheless, SDG&E entered into the amended agreement without an audit of UPD.

Shareholder intervenors claim that SDG&E was not only imprudent in September 1978 in accepting unverified representations concerning the value of the collateral, but it was also imprudent in failing to follow up on the representations after the fall of 1978 to determine whether the collateral still existed and, if so, at what value. Thus, at the time it entered into the amended agreement on December 27, 1979, more than a year after Fourticq had represented that the collateral had a value of $30 million, SDG&E believed both that the collateral still existed and still had a value of $30 million. No investigation whatever was made by SDG&E in the interim of Fourticq's personal assets, the value of the coal mine, and the value of the assets of UPD and its related companies. Yet, throughout 1979, SDG&E was well aware that the UPD companies had a combined negative net worth and net operating losses.

Shareholder intervenors argue that it was not until mid-1980, six months after letting Fourticq off the hook and six months after SDG&E might have salvaged some of its loss, that SDG&E took steps to undertake its own valuations of the collateral. In sum, by October 1980 SDG&E learned that (1) the detailed Curfman and Boyd reports showed the coal mine operations to have little value; (2) Fourticq's personal assets were nowhere near their originally represented value; and (3) UPD and its related companies had very little else in the way of recoverable assets. In fact, SDG&E's Controller, Parsley, under a date of October 31, 1980, concluded that the "Value of Collateral" is $4.7 million. Shareholder intervenors conclude that SDG&E's failure to update the collateral in any meaningful way until it was too late to salvage anything from the UPD transactions is yet another example of SDG&E's imprudence.

D. Staff

The staff asks the Commission to recall that SDG&E bears the burden of proof in this proceeding to the extent it is attempting to justify the reasonableness or prudency of its actions with respect to the UPD transactions. The staff brief quotes the relevant language from D.92984:

> "Finally, we note that SDG&E does not want a finding that the oil transaction in issue, and the resulting loss, was imprudent. Accordingly, SDG&E should have every incentive to see that the record is developed with testimony of those with firsthand knowledge. SDG&E has the burden to show the transaction was reasonable, on a full record, if it expects the finding it desires."

Staff feels upon its review of the record evidence that the Commission is compelled to reach the conclusion that the UPD transactions were models of imprudent and unreasonable management. The transactions were, in staff's judgment, initiated without proper executive approval, and without proper regard for recordkeeping or for protecting the assets of SDG&E by means of collateral. Nor did SDG&E do a reasonable job of checking the credit of its exchange partner, UPD, with which it had never before dealt.

Shortly after the insufficiency of the collateral was brought to the attention of SDG&E officials in mid-1978, additional exchanges were entered into, also with insufficient collateral, or with collateral which was allowed to evaporate by inattentive employees. Perhaps most damaging, in staff's view, is the revelation that senior SDG&E officials had access to information regarding its need for fuel oil but did not coordinate their efforts to renegotiate the exchanges with the information they received. Other senior personnel were provided gross misinformation regarding the facts of the exchange transactions and accordingly acted under false assumptions. Management communications were completely unreasonable in the pattern of events that emerges from these transactions. For these and other reasons, the staff submits that a finding of imprudency is warranted by the evidence in this case.

SDG&E's reply is that the exchanges were a reasonable solution to its fuel oil excess problems, a fact which the staff does not dispute. The staff questions the manner in which these exchanges were implemented and with whom they were implemented, not the fact that an exchange was made. The staff asserts that there were three basic errors in the manner in which the first two oil exchanges were planned and executed: (1) the examination of UPD's credit was unreasonably incomplete; (2) no collateral was obtained before the oil was placed on exchange; and (3) SDG&E failed to provide for specific procedures to supervise the creation of such exchange agreements. By agreeing to ship oil prior to the receipt and acceptance of adequate collateral, SDG&E found itself without any bargaining leverage at all. Staff also notes that SDG&E took no action to confirm the truth of the representations made by Fourticq regarding the value of assets held as collateral before Reiss signed the first exchanges on June 7, 1978.

Staff reasons that these failures of commission and omission occurred because SDG&E did not have explicit procedures for supervising and approving fuel oil exchanges in 1978. It established a written procedure in 1978 that any sale of fuel oil of the magnitude of the first two exchanges would have to be approved in advance of shipment of the oil by a senior vice president of SDG&E, normally Belt. These procedures should have been applied voluntarily by SDG&E personnel who were aware of the magnitude of the exchange transaction. It is the contention of staff that when this abnormally large transaction was contemplated a reasonable management would have assured that it was properly supervised.

With respect to the third transaction, several aspects of this exchange are unreasonable in the view of the staff. First, SDG&E's procedures were lax in that SDG&E once again agreed to the exchange and shipped oil prior to the receipt of the collateral. Second, SDG&E not only gave up additional oil with a book value of $5,445,000 to receive collateral it should have obtained for the first exchanges, but it also agreed to assume 45% of any price increase in the oil purchased to repay the exchange obligation. UPD exacted a high toll for collateral which SDG&E could have insisted upon in the first instance if it had only followed reasonable procedures in approving the exchange agreement and the accompanying collateral before shipping the oil.

There were also significant omissions in the review of SDG&E's collateral opportunities. UPD offered to provide a letter of credit for these exchanges while their credit was investigated, but SDG&E officials did not take up the offer. Such a letter of credit from a reputable bank would have been far more secure than any of the collateral actually obtained. In addition, SDG&E officials did not obtain accurate information about UPD and its finances or the ownership of the coal mine which formed a major portion of the collateral.

The record shows that SDG&E continued to make the error of relying on Fourticq's representations for important information regarding the security of the corporate assets on exchange. In the face of significant warning signals that they were dealing, in staff's view, with a stereotypical "wheeler-dealer" with some financial problems, SDG&E did not do the groundwork required to thoroughly check out the real worth of Fourticq before entering into an additional exchange.

With respect to the fourth exchange, staff seriously questions the manner in which the assignment of 800,000 bbls. of TOSCO oil was handled. In oblique response to a management directive that any future transactions with UPD must be fully collateralized, preferably by a letter of credit, SDG&E's personnel secured the fourth exchange oil volumes with an assignment to SDG&E of 800,000 bbls. of oil ostensibly purchased by UPD from TOSCO. By failing to respond to the TOSCO telex of September 14, 1979, SDG&E acceded to termination of TOSCO's assignment obligations.

Even though 500,000 bbls. of oil remained outstanding, Reiss testified that he believed SDG&E did not need the oil and that UPD remained liable for the return of the bbls. eventually even if TOSCO did not provide them. However, staff contends that there is a very great difference between relying on an assignment of oil from an independent refiner and relying on the credit of UPD with whom SDG&E has already gone through so much to adequately secure its assets. The action of SDG&E in failing to object to the TOSCO telex, or to even begin discussion to postpone or otherwise retain the value of the oil assignment, completely vitiated the collateral that the assignment represented. Staff claims that once again the management directive requiring full collateralization had been ignored. SDG&E claims that the renegotiated agreement, with its additional collateral, substituted for the forgotten assignment. Staff notes that the amendment to the agreements came on December 27, 1979, over three months after the telex from TOSCO. It is staff's position that there could have been no reliance on the amended agreement at the time SDG&E intentionally or unintentionally waived the assignment rights.

Staff also concludes that SDG&E acted unreasonably in renegotiating the oil exchange agreements with UPD in 1979. The pattern of misinformation and miscommunication which characterized the renegotiation, combined with the distressing financial condition of UPD revealed by the information SDG&E did have, created a situation where the renegotiation provided little or no benefit to SDG&E; in fact, if performed, the new agreements would have wiped out most of the value of the oil on exchange. Staff emphasizes that the renegotiation was undertaken against the backdrop of a possible UPD default. However, the renegotiations were conducted in such a disorganized and counterproductive manner by SDG&E that staff maintains that no new agreement would have been reached if SDG&E officials had shared their information with each other effectively.

This is pointed out in part by the information which two key members of the negotiating team for SDG&E did not possess. Neither Haney nor Cohn of SDG&E's Legal Department were advised by the Fuel Resources Department of the potential for profitable oil sales by SDG&E in the latter part of 1979. Indeed, Haney indicated that he would have changed his mind about recommending the amendment if he had known this. Nor was Haney ever advised of the need for oil in the first quarter of 1980, during the negotiations in late 1979. Haney once again indicated that if he had known that SDG&E predicted the need for 500,000 bbls. of oil in the first half of 1980, he would not have agreed to the terms of the amended agreement. All indications are that this information was in the possession of Greg Nesbitt of the Fuel Resources Department of SDG&E, who was one of the three key negotiators, and ironically the only one which the staff could not call to testify. It remains unclear to staff why he did not see fit to share this information with Cohn and Haney.

Nor were Cohn or Haney ever provided with an economic analysis of the effect on SDG&E's finances of the proposed amended agreement. This was particularly important with respect to the extension of time for the repayment of the obligation from two to seven years. By so extending the time for repayment, SDG&E incurred prolonged carrying costs in the form of the short-term debt that had been issued to pay for the oil originally. While Haney indicated that internal auditing of SDG&E had analyzed the carrying costs under the existing agreements, no one determined what extra cost the amendment would have. Witness Paul Grove of the staff did perform such a calculation and determined that the additional carrying costs for the extension of the exchange agreements until 1985 would have cost SDG&E an additional $21 million. Witness Frank Ault of SDG&E testified that over $9 million in carrying charges had been expended as of October 1980.

Staff argues that this unexpected cost to SDG&E would wipe out virtually two-thirds of the value of the oil on exchange if UPD took the full period of time to repay the obligation. Yet this fact was apparently not considered by SDG&E's negotiators. The staff submits that entering into such an amendment to the exchange agreements without considering such a salient financial impact on SDG&E is unreasonable.

It was also unreasonable in the eyes of the staff to conduct the renegotiations with the outdated and inaccurate information provided by UPD regarding its own finances. Financial reports promised by Fourticq were almost always late. Furthermore, SDG&E was still accepting without question or independent investigation Fourticq's representations of his own personal wealth and the report of Fourticq's retained appraiser, Thompson & Litton, on the value of the coal mine. Both these estimations proved to be significantly overvalued.

The staff maintains that SDG&E had a number of reasons to find the amended agreement completely unsatisfactory. It did not provide for the anticipated short-term oil demand in early 1980; it incurred significant carrying costs over the life of the agreement, thus wiping out the value of the assets to be returned. It also included the cash option provision, which was almost certain to be exercised owing to the current state of the price of oil versus SDG&E's book value which set the option price, thus eliminating the opportunity to sell excess oil at a substantial profit and reduce the risk to SDG&E. The only benefits of the agreement seem to have been a somewhat greater chance that UPD would perform the agreement. However, staff submits that if SDG&E had simply waited a few more weeks to get the most recent financial information from UPD's auditors, it would have become apparent that default was inevitable.

Staff also finds that purchase of 107,000 bbls. of oil through HIRI/TOSCO/UPD was unnecessary and unreasonable. SDG&E did not need to purchase oil from UPD, HIRI, TOSCO, or any other firm in the first quarter of 1980. First, SDG&E still retained the right to receive 500,000 bbls. of oil under the TOSCO assignment up until December 31, 1979. Secondly, SDG&E incorrectly concluded that it needed additional fuel oil, when in fact it did not. In addition, SDG&E conducted the purchase transaction in an imprudent manner without responsibly protecting its own interests by confirming representations made by Fourticq.

Once SDG&E had made the error of not availing itself of the TOSCO assignment oil, for use or for sale at a profit, it compounded the error by deciding to purchase oil from TOSCO via HIRI and UPD. In fact, it ended up purchasing the very same oil.

Staff submits SDG&E's decision-making process regarding this purchase was a mockery of sound planning and good judgment. SDG&E negotiators did not properly take into consideration the possible need for oil when they decided to enter into the amended agreement. More to the point is that SDG&E's own resource mix forecasts disclosed that there was no need to purchase oil in the first quarter of 1980, as had been assumed. SDG&E's Watkins testified that the primary forecast relied upon by SDG&E for this purchase was one made November 27, 1979 by McKinley of SDG&E. This was an annual forecast of oil inventory shortfall. It did not make a month-by-month prediction; yet SDG&E used it to support a first quarter shortfall. Moreover, the forecast was only 50% probable according to McKinley's own methodology. If the forecast stood alone, perhaps SDG&E would have been justified in relying upon it to purchase more oil. However, placed in the context of the other forecasts available to SDG&E at the time of this purchase, staff maintains that the use of the McKinley forecast was a tragedy. Monthly forecasts throughout the latter period of 1979 did show low levels of oil in inventory at certain points projected in 1980. However, none of those forecasts showed any oil inventory levels below the 1.2 million bbl. minimum standard used by SDG&E during the first quarter of 1980 or even the second quarter. In fact, the December forecast, which came out December 11, shortly after the McKinley forecast, and before the purchase was agreed to, indicated that oil inventories would remain very high throughout the first part of 1980. And the January forecast, available just after the first of the year, showed a large oil excess throughout the year. In fact, the other forecasts were known to SDG&E to have been low because SDG&E had been receiving more P-5 gas than forecasted throughout October, November, and December of 1979. Yet SDG&E acted on the

McKinley forecast on December 14, only days after the more optimistic December forecast, and committed itself to a purchase of 300,000 bbls. from TOSCO through UPD.

In short, staff submits that SDG&E acted precipitously and without waiting to make sure that the need for oil was really there. That must be considered extremely unreasonable in light of their long experience with oil excesses. The staff also submits that it was unreasonable for SDG&E to accept Fourticq's representations regarding a commitment from TOSCO and regarding the underlift to be charged without speaking to TOSCO directly to confirm same. The failure to do that cost SDG&E over $1,110,000 in underlift fees and a price premium. If SDG&E had checked Fourticq's representations, it would have discovered that he had no firm commitment from TOSCO for oil delivery. SDG&E, with this information, could have instructed HIRI to negotiate directly with TOSCO for the oil.

Accordingly, the staff recommends that all costs associated with the purchase of 107,000 bbls. of oil from TOSCO, i.e. $4,436,710, be disallowed as imprudently incurred expenses and removed from the ECAC account. An additional amount to account for interest should be added to this disallowance, calculated from November 1981 to the effective date of a decision on this matter.

Finally, staff challenges SDG&E's request for reversal of the treatment adopted in D.92558 which reduced SDG&E's ECAC balancing account by $1,246,500 to account for the price of oil released from inventory to UPD as a part of the exchange agreements. The Commission found that pricing the oil let out for exchange at the moving average cost of oil in storage resulted in the value of such oil being below SDG&E's actual cost. This occurred because the oil SDG&E purchased just prior to the exchanges was more costly than the average inventory price of oil then in SDG&E tanks. The staff adjustment valued the oil placed on exchange at the cost of the most recent purchase of oil by SDG&E prior to shipment to UPD. This also prevented an increase in the moving average price of oil charged to ratepayers due to the temporary storage of oil in inventory prior to shipment on exchange.

Staff submits there is no indication other than that the Commission intended that the inventory pricing adjustment issued in D.92558 was to be final on that issue and that only the exchange transactions themselves were to be discussed in the reopened proceedings. Furthermore, the staff submits that as no additional testimony was placed before the Commission, there is no record upon which to alter the previous decision on the inventory pricing adjustment; and therefore no further action on this issue should be taken by the Commission.

VI. Discussion

For purposes of evaluating the reasonableness of SDG&E's management actions in negotiating and executing the various UPD transactions, we will employ the staff-recommended definition of an imprudent act:

> "An imprudent act is one which is unreasonable in light of the circumstances existing at the time of act."

A. The First Two Oil Exchanges

SDG&E has failed to demonstrate that its actions in negotiating and executing the first two exchanges with UPD were prudent at the time of the transactions. Despite the absence of prior business transactions with UPD, SDG&E performed a cursory and insufficient review of UPD's credit. Based upon information from one unidentified oil industry source and unverified banker's representations that UPD had a credit line of perhaps $10 million-$20 million, SDG&E delivered oil to UPD worth more than $20 million. We agree with staff that it would not be very reassuring to a reasonable utility executive to discover that the company with which one is to do business for the first time would need to exhaust its entire line of credit if required to pay off its obligation to the utility. Furthermore, SDG&E personnel simply ignored the Dun & Bradstreet information indicating UPD's past history of late payment problems and failed to report the warning signal to the senior vice president responsible for the transaction. This "red flag" should have induced SDG&E to undertake a more thorough examination of Fourticq's resources before agreeing to the first two exchanges.

We are not persuaded by SDG&E's position that its telephone negotiations and its agreement to ship oil in the absence of formal documentation and collateral was consistent with normal practice and usage in the oil industry. First, SDG&E's proof of normal oil industry practice and usage merely consisted of assertions by two SDG&E employees; this can hardly be construed as convincing evidence of the way business is transacted in the oil industry. Secondly, and more importantly, SDG&E provides no rationale why its actions should be judged according to norms common to the oil industry. SDG&E is a regulated public utility, and it is within that context that the prudency of its management actions will be judged.

We note with particular emphasis that the first two exchanges of 1.29 million bbls. of oil did not require return of the oil to SDG&E for over two years. Even if oil prices were not volatile during this period of time, and even if UPD's then current financial status were healthy, SDG&E should have been cognizant that much could happen in two years to increase the risk of UPD's inability to fulfill its obligations under the exchange agreements. Cognizance by SDG&E of this risk would have dictated the need to secure adequate collateral before agreeing to the exchanges.

However, the decision was made to enter the transactions without collateral. By mid-May 1978 even SDG&E agreed that the oil should not have been released until proper collateral for the oil assets was secured. At that time Reiss requested collateral from UPD because of the size of the transaction, the fact that SDG&E had not previously done business with UPD, and doubts about the nature of UPD's assets. These are all good reasons for seeking collateral, and all these reasons existed prior to the first shipment of oil. We note that even the amended contract covering the first two exchanges and signed in June 1978 contained grossly insufficient collateral: (1) a valueless corporate guarantee, and (2) 45% of the common stock of a coal mine which was losing money steadily. At this time SDG&E did not have a realistic estimate of the value of either the coal mine or UPD itself.

Furthermore, the decision to enter the first two exchanges was made entirely by lower level employees in the Fuel Resources Department of SDG&E. The officers who would have had to be consulted for a sale of oil of this magnitude did not learn of the UPD exchanges until June 1978. There is no evidence to indicate that the risk to SDG&E assets was any less apparent because the $20 million in oil was to be exchanged rather than sold. A transaction of this magnitude should have been supervised by senior SDG&E management personnel.

By failing to thoroughly examine UPD's credit or the value of collateral to be pledged as security, SDG&E acted imprudently in releasing assets worth about $20 million to a small out-of-state oil trader with whom SDG&E had never previously dealt. Furthermore, in entering the largest fuel oil exchange in its history, SDG&E acted imprudently by failing to properly supervise the negotiation and documentation of the transaction.

B. <u>The Third Exchange</u>

Less than four months after the initial exchanges were concluded, Haney, among other SDG&E personnel, determined that the exchanges were undercollateralized and that UPD was having financial problems. In September 1978 SDG&E's negotiating team traveled to Houston to gather financial information about UPD and to seek additional collateral. Prior to this trip the only information available to SDG&E regarding UPD's financial status consisted of a Dun & Bradstreet report, some alleged phone calls to references in the oil industry, and Fourticq's representations.

In Houston SDG&E discovered that UPD sold the 1.29 million bbls. of oil it received from SDG&E at $6 per bbl. less than SDG&E paid for it; the proceeds had been used to purchase a greater interest in a coal mine, to pay off UPD debts, and to purchase certificates of deposit. SDG&E also learned that Fourticq operated his various enterprises in an unstructured manner, freely shifting assets from one to another. Furthermore, it was discovered that the coal mine alone would likely be insufficient to repay the obligation. It was determined that the forecasted earnings of the coal mine were overly optimistic and were not equal to the amounts due SDG&E. SDG&E representatives then concluded that SDG&E needed to have a claim on all of Fourticq's assets to secure its interests and to have effective control over any of them in the event of a default.

Rather than acting to contain its exposure at this point, SDG&E placed additional oil at risk. A further exchange of 330,000 bbls. was made under an agreement dated September 28, 1978, which combined the terms of the first three exchanges into one agreement. Once again, SDG&E agreed to the exchange and shipped oil prior to the receipt of the collateral. SDG&E not only gave up additional oil with a book value of $5.4 million to receive collateral it should have obtained for the first exchanges, but it also agreed to assume 45% of any price increase in the oil purchased to repay the exchange obligation under the first three transactions.

For its assumption of additional risk, SDG&E received further pledges of stock in a coal mine of unverified value and essentially succeeded in perfecting the security it had obtained under the initial exchange agreement. SDG&E now stood in a better position to collect on UPD's obligation from any and all of Fourticq's various operations and enterprises. The question is whether this negotiated benefit was of sufficient value to warrant SDG&E's assumption of even more risk and whether SDG&E should have continued to rely on Fourticq's representations for important information regarding the value of the corporate assets pledged as security for the third exchange.

We are compelled to answer these questions in the negative. Fourticq had admitted that the coal mine was actually losing money and acknowledged that he had recently had a $700,000 bank overdraft. However, SDG&E opted to rely on a packet of financial information provided by Fourticq himself. Hindsight reveals that the information greatly overstated Fourticq's personal net worth, the market value of the UPD entity, and the value and earning capacity of the coal mine. SDG&E chose to accept the representations, ignoring signals which should have triggered a vigorous and independent examination of Fourticq's resources before SDG&E put additional oil at risk. It become quite apparent that the errors made in the initial exchanges, i.e. failure to collateralize the transactions, prompted SDG&E to offer an additional exchange as quid pro quo to UPD for putting up allegedly better collateral - collateral whose true, limited value could have been ascertained through proper investigation. Therefore, we conclude that, based upon information that was available at the time, SDG&E's actions in negotiating and executing the third exchange were imprudent and needlessly placed additional SDG&E resources at risk.

C. The Fourth Exchange
And the TOSCO Assignment

By November 1978, the time of the fourth exchange, SDG&E had recognized UPD's unstable financial circumstances. SDG&E had established a policy that further transactions with UPD required full collateralization in the form of a letter of credit or equal security. SDG&E was further aware that UPD had cash flow problems and was faced with liquidating its already limited assets. Combined UPD financial statements indicated that liabilities exceeded assets and that continuing operations were producing a loss. With 1.5 million bbls. already on exchange with UPD, available information provided SDG&E no reasonable basis to believe that UPD would be a good risk for an additional 800,000 bbls. of oil.

Furthermore, SDG&E's handling of the TOSCO assignment and the violation of SDG&E's directive requiring full collateralization of any transactions with UPD are even more graphic illustrations of imprudent management actions. In late 1978 Reiss approached Haney with Fourticq's latest plan for securing an additional exchange of 800,000 bbls. Fourticq apparently intended to purchase oil-producing property in Kern County, California, and to sell or assign its production to a refiner in return for an assignment of production from the refiner directly to SDG&E. Haney concluded that this scheme could possibly offer the required full collateral, and he communicated his desire to Reiss to review the final documentation before approving it.

Reiss then instructed SDG&E's Legal Department to draft an assignment of an oil purchase agreement. The assignment involved a purchase of oil by UPD from TOSCO. Allegedly, under the assignment, TOSCO was required to provide oil to SDG&E even if UPD did not pay for the oil. This assignment significantly differed from the one originally discussed with Haney. Nevertheless, Reiss sent the assignment directly to UPD without review by Haney of the Financial Department. The fourth exchange dated November 20, 1978 was executed by SDG&E on November 29, 1978. When Haney finally reviewed the assignment in January 1979, he determined that it differed from his original understanding and that it perhaps provided insufficient collateral for the already executed 800,000 bbl. exchange. SDG&E had obtained UPD's letter of credit covering a part of the 800,000 bbls. to hold until the assignment had been executed (in late November 1978) but this letter of credit was returned to UPD before Haney reviewed the assignment documents and reached his alarming conclusion.

The assignment was clearly not the equivalent of an irrevocable letter of credit. At a minimum, a legal question existed whether the assignment was enforceable in court against TOSCO and whether TOSCO would be required to supply oil to SDG&E even if UPD failed to pay for it. In the very first transaction entered after the management directive requiring full collateralization of UPD transactions, the policy was violated. We agree with staff that this was an unreasonable result produced by a lack of adequate administrative controls. Given the long and unsettling history of SDG&E's chaotic dealings with UPD, SDG&E's contention that its latest problem with inadequate collateral involved innocent miscommunication rather than imprudent management is wholly devoid of merit and deserves no further comment.

Furthermore, SDG&E failed to provide any rational basis for its decision in September 1979 to waive its rights to the remaining 500,000 bbls. of oil due on assignment from TOSCO. Even assuming that SDG&E did not need the oil and further assuming that UPD remained liable for eventual return of the fourth exchange bbls., if TOSCO's obligations were waived, it makes little sense for SDG&E to waive the security of an assignment of oil from an independent refiner in favor of relying upon UPD's admittedly questionable credit. We must agree with staff that SDG&E's failure to object to the TOSCO telex or to even initiate discussions to postpone or otherwise retain the value of the oil assignment completely eliminated the collateral represented by the assignment. SDG&E had once again acted imprudently in violating the management directive to fully collateralize future UPD transactions.

As staff points out, there is no merit to SDG&E's claim that the agreement renegotiated in late 1979, with its additional collateral, substituted for the forgotten assignment. Since SDG&E executed the amended agreement on December 27, 1979, three months after the TOSCO telex, it could not reasonably have relied on the amended agreement when it waived its rights under the assignment.

The fact that in the fall of 1979 oil spot market prices were rising further compounds SDG&E's imprudence in waiving its assignment rights. Despite SDG&E's effort to characterize the record evidence in a favorable light, the testimony of Reiss clearly indicates that the price of residual oil was in the $25 per bbl. range and afforded SDG&E the opportunity to realize a profit on the sale of such oil. SDG&E provided no plausible explanation why it could not have taken the TOSCO oil in order to reduce the total obligation from UPD and then sold the excess oil with any resulting profit serving to limit the potential exposure from the exchanges secured by insufficient collateral. SDG&E failed to demonstrate that it was prudent in protecting its assets.

D. The Renegotiated Agreement

Against a backdrop of more misinformation and miscommunication as well as UPD's deteriorating financial condition, SDG&E imprudently renegotiated an agreement with UPD which provided minimal benefits to SDG&E; and if performed, it would have dissipated most of the value of the oil on exchange, as demonstrated by staff.

As a result of the renegotiated agreement, Fourticq received a five-year extension of his obligation to return remaining oil on exchange to SDG&E. Fourticq also negotiated a cash option provision which allowed him to return the oil at SDG&E's book value of $16.50 per bbl. It is difficult to find anything of substantive value received by SDG&E in exchange for the renegotiation.

Even if one assumes that the renegotiation increased UPD's chances of performing - an assumption that was not subsequently borne out - this enhanced prospect of performance proved to be of very questionable value. As staff noted, the extension of time necessitated the payment of additional carrying costs on the oil originally purchased by SDG&E and exchanged with UPD. It was unreasonable on SDG&E's part to fail to consider the diluting impact an extension of time would have on the value of oil on exchange. Essentially, SDG&E's perceived benefit of enhanced performance was in reality a detrimental contract term which would result in two-thirds of the value of oil on exchange being wiped out by 1985 - the time repayment was completely due from UPD.

The $16.50 per bbl. cash option provision was negotiated specifically by Fourticq as a means of facilitating his performance. There is hardly any additional value that SDG&E realized as a result of this provision which, in light of then current oil prices, was likely to be exercised. Receipt of oil with the possibility of selling excess oil at a profit would have been preferable, especially in light of forecasts which indicated SDG&E's need for oil in 1980.

Whether removal of SDG&E's obligation to pay 45% of price increases in oil eventually returned by UPD was a benefit to SDG&E is too speculative to determine. Once SDG&E acceded to the cash option provision, the 45% provision was all but rendered academic since it became highly improbable that any oil would be returned by UPD. Although SDG&E argues that the amendment changed the delivery schedule of oil to years when it anticipated a need for the oil, this alleged benefit was also all but canceled by the increased carrying costs on the original oil occasioned by extension of the exchange agreement.

Finally, the additional collateral obtained by SDG&E in the form of a mortgage and trust deed on the coal mine was only as good as the value of the underlying asset. In that regard, by August 1979, Fourticq's prediction that the coal mine would show a $1.6 million profit had turned into the reality of a $2.67 million loss. By October 1979 SDG&E's financial analysts determined that the coal operations could not pay for the SDG&E assets and that liquidation of other holdings to meet the obligations could only be successful if the commodity markets improved in ways which were totally unexpected. This information was available before the renegotiation occurred.

However, SDG&E's representatives negotiated on the basis of outdated and inaccurate financial information provided by UPD and in the absence of critical information in the possession of its own Fuel Resources Department. SDG&E still accepted Fourticq's unverified representations regarding his net worth as well as the valuation of the coal mine prepared by an appraiser retained by Fourticq. Both estimations were significantly overstated. During the renegotiation, SDG&E possessed audited financial statements for UPD and its affiliates for June and November 1978. SDG&E's financial analysts had been informed that updated financial information was due shortly after November 1979. SDG&E pressed forward without this important information with no apparent reason. The information, when finally reviewed by SDG&E after the renegotiation, indicated that in September 1979 the combined UPD companies had a negative worth of $3 million and a $1.5 million operating loss within the preceding three months. It was not until mid-1980, six months after the renegotiation, that SDG&E took some steps to undertake its own valuations of the collateral. SDG&E's conduct in renegotiating the exchange agreements in the absence of up-to-date financial information and independent valuation of collateral was unreasonable and imprudent.

Even more inexcusable was the failure of the Fuel Resources Department to inform the negotiating team of the possibility for profitable oil sales by SDG&E in late 1979. Further, Haney was not told that a short-term forecast indicated SDG&E would require fuel oil in the first two quarters of 1980. According to information available at the time, it was much more advantageous for SDG&E to demand performance or default by UPD rather than concur in an agreement which bound SDG&E to incur costs nearly equal to the value of the oil. Since the opportunity existed to sell any excess oil at a profit, SDG&E had no incentive to delay the receipt of the exchange oil.

The crowning element of this sad saga occurred when members of the negotiating team learned prior to the execution of the renegotiated agreement on December 27, 1979 that SDG&E forecasted a need for oil in early 1980. Even with this information finally in hand, SDG&E did not act to modify the amendment; and the amended agreement delaying scheduled deliveries of oil was signed by SDG&E. SDG&E's argument that the amended agreement, while executed on December 27, 1979, was enforceable against the parties on November 1, 1979, on the basis of either an unsubstantiated oral modification or an esoteric "detrimental reliance" theory has absolutely no basis in fact, law, or logic.

Our review leads us to conclude that the renegotiated agreement was nothing more than a giveaway and an imprudent action in every sense of the word.

E. SDG&E's Purchase of 107,000 Bbls. of Oil Through TOSCO/HIRI/UPD

Any analysis of the prudency of the 107,000 bbl. purchase through TOSCO/HIRI/UPD must begin by focusing on the mechanics of the TOSCO assignment. While SDG&E may have voluntarily waived its rights to the 500,000 bbls. of oil from TOSCO, there is nothing to indicate that TOSCO had the right to unilaterally terminate its obligations upon the failure of SDG&E to respond to its September 14, 1979 telex within seven days. In the absence of a voluntary waiver - and SDG&E's failure to respond to the telex arguably cannot constitute such a waiver - SDG&E still retained the right to receive 500,000 bbls. from TOSCO up until December 31, 1979, when the assignment expired. The fact that SDG&E was considering whether or not to take the TOSCO oil as of October 2, 1979 indicates SDG&E's concurrence with this interpretation.

However, SDG&E made a decision, predicated upon misinformation, to refuse receipt of the oil from TOSCO. The vice president, Watkins, empowered to make the decision not only misunderstood the effect of the 45%-55% risk sharing provision and whether it applied to the TOSCO oil but also had the mistaken belief that SDG&E had no assignment rights to any oil from TOSCO. Rather, he presumed that the only decision was whether or not to take oil from UPD through TOSCO. Watkins failed to revise or renegotiate the TOSCO assignment before its expiration at the end of 1979 because he never completely understood its provisions.

Since SDG&E was forecasting a need for oil in early 1980, there was every reason to seek the TOSCO oil. The 45%-55% split of oil price increases applied only to the first three exchanges. No credible evidence was presented to suggest that this provision should have been a factor in determining whether to take oil under the fourth exchange and the TOSCO assignment. However, due to misunderstandings, oil which SDG&E might have obtained for use or for sale at a profit and without additional cost was lost. The collateral it represented was also lost.

We agree with staff that SDG&E exacerbated its problems by its decision to purchase from TOSCO/HIRI/UPD the very same oil it originally rejected. We also agree that the decision to purchase oil for early 1980 was based upon the McKinley forecast which had limited credibility. Other more reliable forecasts were available to SDG&E which indicated that oil inventories would remain high through the first part of 1980 and that significant gas volumes would be available during the winter for P-5 customers. SDG&E provided no explanation why it ignored oil requirements forecasts two weeks before and after the McKinley forecast which showed no need for first quarter oil.

Furthermore, SDG&E acted unreasonably in failing to check Fourticq's claim that he had a commitment from TOSCO for delivery of 300,000 bbls. of oil. If such an investigation had been performed, SDG&E could have negotiated directly with TOSCO and avoided $1.11 million in underlift fees and price premiums ultimately paid to UPD. We are persuaded by staff's argument that all expenses associated with the purchase of 107,000 bbls. of oil from TOSCO/HIRI/UPD were imprudently incurred and should be disallowed. Accordingly, we will order SDG&E to reduce its ECAC balancing account by $4,436,710. This amount should be further reduced by the interest effect calculated from November 1981 though the effective date of this decision.

Finally, SDG&E argues that to the extent that oil was exchanged SDG&E was able to burn lower-priced natural gas to the benefit of the ratepayer. SDG&E asks the Commission to consider its efforts to benefit the ratepayers when evaluating the $4.4 million penalty recommended by staff. The argument has no merit. The 107,000 bbls. of oil should never have been purchased. With the existence of ample gas supplies no benefit accrued to the ratepayers as a result of the availability of 107,000 excess bbls. of oil. Furthermore, the benefits of burning gas are computed by comparing the prudently incurred costs of storing/disposing oil with the expense of burning gas. In this case, costs associated with purchase of 107,000 bbls. of oil were not prudently incurred.

F. The Balancing Account Adjustment Adopted in D.92558

We will reject SDG&E's recommendation to reverse the $1,246,500 ECAC balancing account adjustment adopted in D.92558; no new evidence has been presented to warrant such a reversal. The pertinent language in D.92558 is equally valid today:

> "According to the record, SDG&E supplied some of the UPD exchange oil out of its inventory instead of shipping it direct from its suppliers to avoid under-lift charges resulting from contractual agreements with its suppliers for delivery in San Diego. It is also clear from the record that UPD was to pay the shipping costs related to the exchange oil. The receipt of such oil not only relieved SDG&E from paying any under-lift charges for oil not shipped, but resulted in lower overall shipping costs to UPD. It is equally clear from the record that such oil was placed into storage as a temporary measure pending its early withdrawal to continue its journey to UPD facilities. It is obvious that such temporary storage is markedly different than the usual procedure where oil is placed in storage to be used at some future undetermined date. SDG&E's method of pricing the exchange oil at the moving

> average cost of oil in storage results in an exchange value of the oil which is less than the cost of the oil to SDG&E. This loss is then transferred to the ratepayers through the ECAC procedure. We can discern no valid basis to support such an inequity and will, therefore, adopt the staff's position."

D.92558 was final when issued, and it will remain so.

Findings of Fact

1. On April 29, 1978, SDG&E agreed to exchange 750,000 bbls. of fuel oil to be returned by UPD between June 1 and September 1, 1980.

2. On May 1, 1978, SDG&E agreed to exchange 540,000 bbls. of fuel oil to be returned by UPD between June 1 and September 1, 1980.

3. Previous to the first two oil exchanges, SDG&E had never transacted business with UPD.

4. The initial transactions were negotiated by telephone; the first oil from SDG&E's inventory was loaded on ship on May 11, 1978 for delivery to UPD before the execution of supporting documents and in the absence of collateral securing SDG&E's interests.

5. Prior to its execution of the first two exchanges, SDG&E performed a cursory and insufficient review of UPD's credit.

6. SDG&E ignored Dun & Bradstreet information indicating UPD's past history of late payment problems and delivered more than $20 million in oil to UPD in the absence of collateral.

7. SDG&E did not establish that shipment of oil in the absence of collateral was consistent with normal practice in the oil industry nor did it establish that its actions should be judged by standards common to the oil industry.

8. The first two exchanges of 1.29 million bbls. of oil did not require return of the oil to SDG&E for over two years; the two-year return period increased the risk of UPD's inability to perform its obligations under the exchange agreement.

9. The decision to enter the first two exchanges was made entirely by lower level employees in the Fuel Resources Department; the negotiation and documentation of the first two exchanges were inadequately supervised.

10. In August 1978 SDG&E's personnel expressed concern over the status of SDG&E's collateral interests provided by UPD to support the first two exchanges.

11. In September 1978 SDG&E sent a negotiating team to Houston to investigate the financial viability of UPD and its affiliated companies as well as to attempt to improve SDG&E's collateral position.

12. Prior to the Houston trip, the only information available to SDG&E regarding UPD's financial status consisted of a Dun & Bradstreet report, some vague phone calls to references in the oil industry, and Fourticq's unverified representations.

13. As a result of the Houston trip, SDG&E discovered more about the nature of Fourticq's business operations and determined that SDG&E needed a claim on all of Fourticq's assets to secure its interests.

14. On September 28, 1978, SDG&E and UPD entered into the "combined agreement" which consolidated the first two exchanges with the third transaction and called for delivery of 330,000 bbls. of oil to UPD.

15. Under the third exchange SDG&E delivered additional oil with a value of $5.4 million and agreed to assume 45% of any price increase in the oil purchased by UPD to repay the exchange obligations; in return, SDG&E received further pledges of stock in a coal mine and other additional collateral of limited value.

16. SDG&E, in the fall of 1978, continued to rely on Fourticq's representations for important information regarding the value of the corporate assets pledged as security for the third exchange.

17. The true and limited value of the collateral for the third exchange could have been ascertained by SDG&E through proper investigation.

18. By November 1978, the time of the fourth exchange, SDG&E had recognized UPD's unstable financial circumstances.

19. By November 1978 SDG&E had established a policy that further transactions with UPD required full collateralization in the form of a letter of credit or equal security.

20. On November 29, 1978, SDG&E executed the fourth exchange and transferred 800,000 bbls. of oil to be returned by UPD in 1979.

21. As security for the fourth exchange, SDG&E accepted an assignment from UPD for oil which TOSCO was allegedly obligated to deliver to UPD even if UPD failed to pay for the oil; the assignment was not the equivalent of a letter of credit.

22. In September 1979 SDG&E appeared to voluntarily waive receipt of oil from TOSCO under the assignment.

23. This voluntary waiver vitiated any of the remaining collateral SDG&E had secured for the fourth exchange.

24. SDG&E's waiver of its collateral violated the management directive that all UPD transactions must be fully collateralized.

25. When SDG&E waived its rights to 500,000 bbls. of oil from TOSCO in September 1979, oil spot market prices were rising and presented SDG&E an opportunity for selling excess oil at a profit.

26. On December 27, 1979, SDG&E executed an amended agreement with UPD which extended for five years UPD's obligation to return the exchanged oil and provided for a cash option provision which allowed UPD to return oil at $16.50 per bbl. to SDG&E.

27. In agreeing to the renegotiated agreement, SDG&E sought to obtain additional collateral and to enhance UPD's opportunity to perform its obligations.

28. SDG&E received very little of substantive value in exchange for its agreement to renegotiate the exchange agreements with UPD.

29. The extended delivery schedule, if performed, would have resulted in increased carrying costs to SDG&E which would have wiped out a significant portion of the value of the oil remaining on exchange.

30. SDG&E's representatives negotiated the amended agreement on the basis of outdated and inaccurate financial information provided by UPD. They also lacked critical information in the possession of SDG&E's own Fuel Resources Department.

31. SDG&E provided no plausible explanation for its determination to waive deliveries of the TOSCO oil due under assignment.

32. SDG&E's decision to waive deliveries of the TOSCO oil was based upon misinformation.

33. In light of available information regarding SDG&E's oil requirements, SDG&E did not need to purchase 107,000 bbls. of oil through TOSCO/HIRI/UPD in December 1979.

34. SDG&E failed to check Fourticq's claim that he had a commitment from TOSCO for delivery of 300,000 bbls. of oil.

35. Failure by SDG&E to check Fourticq's representations caused SDG&E to needlessly incur $1.1 million in underlift penalty payments and price premium payments.

Conclusions of Law

1. SDG&E negotiated and executed the UPD fuel oil exchanges in an imprudent manner and the expenses and losses sustained by SDG&E with respect to these exchanges were unreasonably incurred.

2. No part of the losses or expenses sustained by SDG&E with respect to the UPD exchanges, or which may be sustained by SDG&E as a result of litigation arising out of the UPD fuel oil exchanges, should be recovered in rates at any time.

3. The SDG&E ECAC account should be adjusted downward by $4,436,710, plus an additional amount of interest calculated from November 1981 through the effective date of this decision (at the rate applicable to SDG&E's ECAC balancing account) to remove the effects of the oil purchase contract between SDG&E, HIRI, UPD, and TOSCO on the ground that the purchase was unreasonable in light of the options available to SDG&E at the time.

4. SDG&E should establish effective internal control procedures for all fuel oil transactions.

5. SDG&E should make available to the staff all pleadings and discovery material, including interrogatories requests for the production of discovery materials and depositions, and the replies which arise from the litigation related to the UPD exchanges. Those above-mentioned items are to be made available upon the request of the staff in connection with ECAC or general rate case audits.

O R D E R

IT IS ORDERED that:

1. No part of the losses or expenses sustained by San Diego Gas & Electric Company (SDG&E) with respect to the United Petroleum Distributors, Inc. of Houston (UPD) transactions, or which may be sustained by SDG&E as a result of litigation arising out of the UPD fuel oil exchanges, shall be recovered in rates at any time.

2. The SDG&E ECAC account shall be adjusted downward by $4,436,710, plus interest calculated from November 1981 to the effective date of this decision (at the rate applicable to SDG&E's ECAC balancing account) to remove the effects of the oil purchase contract between SDG&E, Hawaiian Independent Refinery, Inc., UPD, and TOSCO.

3. SDG&E shall make available to the Commission staff all pleadings and discovery material, including interrogatories requests for the production of discovery materials and depositions, and the replies, which arise from the litigation related to the UPD exchanges. Those above-mentioned items are to be made available upon the request of the Commission staff in connection with ECAC or general rate case audits.

4. To the extent that relief has not been granted to SDG&E by previous decisions issued in this proceeding, A.59945 is denied.

This order becomes effective 30 days from today.

Dated AUG 4 1982, at San Francisco, California.

I will file a concurring opinion.
/s/ LEONARD M. GRIMES, JR.
Commissioner

JOHN E. BRYSON
President
LEONARD M. GRIMES, JR.
VICTOR CALVO
PRISCILLA C GREW
COMMISSIONERS

Commissioner Richard D. Gravelle, being necessarily absent, did not participate in the disposition of this proceeding.

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

Joseph E. Bodovitz

Joseph E. Bodovitz, Executive Director

CHRONOLOGY OF EVENTS

Beginning of 1978: SDG&E seeks method to dispose of excess fuel oil.

April 4, 1978	Reiss and Belt leave on trip for Indonesia, only preliminary discussions to date regarding exchange. No communications yet with UPD.
April 29, May 1 1978	SDG&E Personnel agree to two fuel oil exchanges with UPD involving 750,000 and 540,000 bbls. of oil.
May 2, 1978	Reiss and Belt return from Far East.
Unknown date in early 1978	Thompson calls Houston banker to confirm line of credit for UPS and SDG&E obtains Dun & Bradstreet report.
May 5, 1978	Decision made to ship oil en route to SDG&E to UPD.
May 11, 1978	First oil loaded on ship from SDG&E inventory for UPD.
May 12, 1978	Fourticq sends letter confirming first exchange.
May 15, 1978	Fourticq sends letter confirming second exchange and offers collateral in the form of a stock pledge and a corporate guarantee. Also makes representations about his own net worth.
June 7, 1978	Reiss signs May 15 letter to assent to agreement.
June 1978	Robert Belt, senior V.P. told of exchange, not advised of D&B report on late payments.
Mid-1978	UPD sells oil on exchange for $10-11 per barrel in New York.

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August 1, 1978	Haney asked to review exchange documents by Nesbitt and Reiss.
August 1978	Series of meetings of SDG&E management, decision is made to seek additional collateral.
Mid-Sept., 1978	Haney and attorney Cohn make first trip to Houston to explore possibility of additional collateral and to learn more about UPD. Fourticq asks for additional oil, $700,000 overdraft is revealed.
Sept. 22, 1978	Haney and Cohn return from first Houston trip, prepare memos indicating need for additional collateral and giving strongly qualified opinion that UPD has the ability to perform the existing agreements.
Late Sept. 1978	SDG&E management meets and agrees to exchange more oil for additional collateral.
Late Sept. 1978	Haney, Cohn, and Nesbitt travel to Houston twice more, Fourticq admits coal mine not making money, describes plan to make it profitable. Final trip to discuss terms of exchange Cohn and Nesbitt only travel.
Sept. 28, 1978	SDG&E, UPD execute combined agreement including third exchange of 330,000 bbls. of oil.
Fall 1978	Meeting in office of Exec. V.P. Thomas Page, decision made that any further exchange with UPD is to be fully collateralized by irrevocable letter of credit or equivalent.
November 1978	Reiss speaks to Haney regarding plan for fourth exchange supported by assignment of oil contract.
Mid-Nov. 1978	Reiss has SDG&E Legal Department draft assignment of oil purchase agreement between UPD and TOSCO.
Nov. 28, 1978	UPD executes oil purchase agreement with TOSCO, including SDG&E drafted assignment.

Nov. 29, 1978	SDG&E V.P. Belt executes fourth exchange agreement with UPD for 800,000 bbls. of oil.
December 7, 1978	Haney receives copy of oil assignment.
January 1979	SDG&E first obtains audited financial statements of UPD and affiliates.
Late '78, early '79	UPD delivers pledged stock certificates of United Castle Coal Co.
May '79	Haney reviews financial statements of UPD and concludes that operations of businesses will not be sufficient to repay the debt without improvement in the commodity markets.
June 19-21, 1979	Haney and Cohn travel to Houston to discuss an amendment to the exchange agreements. Fourticq represents that he will have difficulty paying on the current schedule due to oil price increases and coal price sluggishness.
June 1979	HIRI declares force majeure under oil contract with SDG&E, reduces deliveries.
June 1979	Haney recommends a "big eight" audit of UPD, no action taken.
June 27, 1979	N. Ferrara internal memo indicates it is uncertain where UPD will obtain resources to meet 1980 obligation.
Sept. 14, 1979	TOSCO telex to SDG&E indicating cessation of oil deliveries under assignment unless SDG&E advises otherwise within one week.
Sept. 21, 1979	No action by SDG&E.
Oct. 2, 1979	SDG&E claims to be considering taking TOSCO barrels, no further action taken.
Oct. 26, 1979	Haney memo to Korpan indicating operations cannot pay for the assets on exchange, UPD will be forced to liiquidate assets, net losses for combined companies are growing.

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October 30, 1979	SDG&E advised by HIRI that force majeure will extend to first quarter 1980, SDG&E predicts need to obtain 500,000 bbls. of fuel oil.
November 1979	Haney advised that year-end audited financial reports from UPD will be delivered soon.
Nov. 19, 1979	SDG&E fuel forecast shows no need for first quarter oil.
Nov. 27, 1979	McKinley forecast of 50% probability shows 2-million-barrel shortfall in inventory, no monthly forecast.
Nov. 28, 1979	Cohn claims that negotiations are substantially complete for amended agreement.
December 11, 1979	Forecast shows again no need to purchase 300,000 bbls. of fuel oil from TOSCO via UPD and HIRI in first quarter 1980.
December 14, 1979	Reiss sends telex agreeing to purchase 300,000 bbls. of fuel oil from TOSCO via UPD and HIRI in the first quarter of 1980.
December 17, 1979	UPD officers execute amended agreement in Houston.
December 27, 1979	SDG&E President Morris executes amended agreement.
December 31, 1979	TOSCO assignment expires.
January 2, 1980	Fuel requirement forecast shows large amounts of power plant gas, no need for oil, need to dispose of excess oil.
February 1, 1980	SDG&E declines option for second 300,000 bbls. of oil from TOSCO.
February 5, 1980	SDG&E now looking for ways to dispose of oil excess. Sale to Vision Petroleum of 250,000 bbls. arranged in February.
February 1980	Larry Honick of SDG&E, CPA, assigned to review UPD.

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Mid-February	SDG&E inquires via HIRI of cost to underlift remainder of barrels purchased from TOSCO via UPD.
March 20, 1980	SDG&E pays underlift $964,000 to UPD via HIRI.
Early 1980	SDG&E obtains audited 1979 UPD financial statements, negative net worth for combined companies, and large operational losses.
April 15, 1980	UPD makes first payment under cash option plan of amended agreement, $1,650,000.
May 1980	SDG&E meeting to consider examining methodology used to value collateral of coal mine.
August 15, 1980	SDG&E makes second cash option payment.
September 1980	Boyd report received by SDG&E , highly critical of mine operations, sets low value on reserves.
October 1980	Honick concludes that a loss from the UPD exchanges is now probable.
October 30, 1980	SDG&E advised by UPD that it will not make December payment, SDG&E commences litigation shortly thereafter.

(END OF APPENDIX A)

A.59945
D.82-08-018

COMMISSIONER LEONARD M. GRIMES, JR., Concurring:

The order before us will reduce rates for SDG&E customers by more than $4.4 million because of our finding that the company acted imprudently in buying and exchanging oil during 1979. This is on top of a $26 million loss SDG&E in 1980 and another $4.6 million loss the company took in 1981 flowing from the same series of transactions. Our decision emphasizes what we have said all along -- that no part of the losses or expenses sustained by SDG&E in its unfortunate dealings with United Petroleum Distributors in Houston shall be recovered in rates at any time.

In this decision, we find that SDG&E had inadequate administrative controls governing the negotiation and the execution of its fuel exchange contracts. We find that middle management employees acted beyond their scope of authority in several of the transactions. We find that inadequate credit and financial checks were made of UPD before contracts were executed and that inadequate security was obtained for the oil transferred to UPD. We also find that oil was transferred to UPD at a time when SDG&E should have known it would need the oil shortly. These findings are based on days of hearings by ALJ Jim Squeri and lead staff counsel Mike Day which have been followed with great interest by SDG&E ratepayers and interveners such as the San Diego Union, San Diego City Attorney and some stockholders of SDG&E.

I would like to make a few comments about this decision. First, the rate reduction will not take effect immediately but will be rolled into the company's next fuel cost adjustment with interest. Second, while SDG&E ratepayers are, I am sure, going to be pleased by this rate reduction, I do not think this decision is cause for celebration. This Commission has absolutely no reluctance to protect the ratepayers from negligent actions of the utilities. But it is a sad day both for the utility and ratepayers when mistakes as serious as we have found today occur. Personally, I think the company should be commended for its actions once the gravity of the situation became clear. The company voluntarily wrote off almost the entire loss and agreed that ratepayers should not bear the loss. We have found no evidence of reckless or cavalier actions by the company -- only a disturbing example of what can go wrong when a series of mistakes mushrooms within a large company.

Finally, I think it is important now for the company, the Commission, the ratepayers and the press to put this sad situation behind us. Regardless of our actions today, the company must continue with its long term struggle for financial strength and rate stabilization. Our actions today may detract from these objectives briefly. If any of us continue to focus on these mistakes, the long term goals with which we all agree will never be reached.

LEONARD M. GRIMES, JR., Commissioner

San Francisco, California
August 4, 1982

investigation Fourticq's representations of his own personal wealth and the report of Fourticq's retained appraiser, Thompson & Litton, on the value of the coal mine. Both these estimations proved to be significantly overvalued.

The staff maintains that SDG&E had a number of reasons to find the amended agreement completely unsatisfactory. It did not provide for the anticipated short-term oil demand in early 1980; it incurred significant carrying costs over the life of the agreement, thus wiping out the value of the assets to be returned. It also included the cash option provision, which was almost certain to be exercised owing to the current state of the price of oil versus SDG&E's book value which set the option price, thus eliminating the opportunity to sell excess oil at a substantial profit and reduce the risk to SDG&E. The only positive benefits of the agreement seem to have been a somewhat greater chance that UPD would perform the agreement. However, staff submits that if SDG&E had simply waited a few more weeks to get the most recent financial information from UPD's auditors, it would have become apparent that default was inevitable.

Staff also finds that purchase of 107,000 bbls. of oil through HIRI/TOSCO/UPD was unnecessary and unreasonable. SDG&E did not need to purchase oil from UPD, HIRI, TOSCO, or any other firm in the first quarter of 1980. First, SDG&E still retained the right to receive 500,000 bbls. of oil under the TOSCO assignment up until December 31, 1979. Secondly, SDG&E incorrectly concluded that it needed additional fuel oil, when in fact it did not. In addition, SDG&E conducted the purchase transaction in an imprudent manner without responsibly protecting its own interests by confirming representations made by Fourticq.

Once SDG&E had made the error of not availing itself of the TOSCO assignment oil, for use or for sale at a profit, it compounded the error by deciding to purchase oil from TOSCO via HIRI and UPD. In fact, it ended up purchasing the very same oil.

average inventory price of oil then in SDG&E tanks. The staff adjustment valued the oil placed on exchange at the cost of the most recent purchase of oil by SDG&E prior to shipment to UPD. This also prevented an increase in the moving average price of oil charged to ratepayers due to the temporary storage of oil in inventory prior to shipment on exchange.

Staff submits there is no indication other than that the Commission intended that the inventory pricing adjustment issued in D.92558 was to be final on that issue and that only the exchange transactions themselves were to be discussed in the reopened proceedings. Furthermore, the staff submits that as no additional testimony was placed before the Commission, there is no record upon which to alter the previous decision on the inventory pricing adjustment; and therefore no further action on this issue should be taken by the Commission.

VI. Discussion

For purposes of evaluating the reasonableness of SDG&E's management actions in negotiating and executing the various UPD transactions, we will employ the staff-recommended definition of an imprudent act:

> "An imprudent act is one which is unreasonable in light of the circumstances existing at the time of act."

A. The First Two Oil Exchanges

SDG&E has failed to demonstrate that its actions in negotiating and executing the first two exchanges with UPD were either prudent or reasonable at the time of the transactions. Despite the absence of prior business transactions with UPD, SDG&E performed a cursory and insufficient review of UPD's credit. Based upon information from one unidentified oil industry source and unverified banker's representations that UPD had a credit line of perhaps $10 million-$20 million, SDG&E delivered oil to UPD worth more than $20 million. We agree with staff that it would not be very reassuring to a reasonable utility executive to discover that the company with which one is to do business for the first time would need to exhaust its entire line of credit if required to pay off its obligation to the utility. Furthermore, SDG&E personnel simply ignored the Dun & Bradstreet information indicating UPD's past history of late payment problems and failed to report the warning signal to the senior vice president responsible for the transaction. This "red flag" should have induced SDG&E to undertake a more thorough examination of Fourticq's resources before agreeing to the first two exchanges.

We are not persuaded by SDG&E's position that its telephone negotiations and its agreement to ship oil in the absence of formal documentation and collateral was consistent with normal practice and usage in the oil industry. First, SDG&E's proof of normal oil industry practice and usage merely consisted of assertions by two SDG&E employeees; this can hardly be construed as probative evidence of the way business is transacted in the oil industry. Secondly, and more importantly, SDG&E provides no rationale why its actions should be judged according to norms common to the oil industry. SDG&E is a regulated public utility, and it is within that context that the prudency of its management actions will be judged.

We note with particular emphasis that the first two exchanges of 1.29 million bbls. of oil did not require return of the oil to SDG&E for over two years. Even if oil prices were not volatile during this period of time, and even if UPD's then current financial status were healthy, SDG&E should have been cognizant that much could happen in two years to increase the risk of UPD's inability to fulfill its obligations under the exchange agreements. Cognizance by SDG&E of this risk would have dictated the need to secure adequate collateral before agreeing to the exchanges.