ALJ/MSW/sid

Mailed
FEB 6 1997

Decision 97-02-012 February 5, 1997

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of San Diego Gas & Electric Company to Establish an Experimental Performance-Based Ratemaking Mechanism. (U 902-M)	Application 92-10-017 (Filed October 16, 1992; Petition for Modification filed May 29, 1996)

ORIGINAL

OPINION ON PETITION FOR MODIFICATION

1. Summary

The May 29, 1996 petition by San Diego Gas & Electric Company (SDG&E) for modification of Decision (D.) 93-06-092 is granted. The Gas Procurement performance-based ratemaking (PBR) mechanism approved by that decision is continued in effect, with modification, until the Commission issues an order pursuant to an application for a permanent gas PBR mechanism which SDG&E will file on or before July 31, 1997. The adopted modification changes the Part B benchmark by replacing the use of a simple average of Delivered Price Indices (DPI) with a volume-weighted average.

2. Background

By D.93-06-092, issued on June 23, 1993 in Phase 1 of this proceeding, the Commission approved two experimental PBR mechanisms, one applicable to SDG&E's natural gas procurement activity and the other to its electric generation and dispatch (G&D) operations. Both mechanisms were adopted for two-year terms that began with their implementation on August 1, 1993.

In response to an earlier petition by SDG&E, D.95-04-051 dated April 26, 1995 extended the terms of both PBR mechanisms until at least July 31, 1996. It also provided that if SDG&E filed a request for permanent or replacement PBR mechanisms within 90 days after the latest of evaluation reports ordered by D.93-06-092, the experimental mechanisms would remain in place until the

Commission issued a decision on the merits of such permanent mechanisms. On February 29, 1996 the Commission Advisory and Compliance Division, through its consultant Vantage Consulting, Inc, issued its "Final Evaluation Report" covering both the Gas Procurement and G&D mechanisms.[1] The report was filed in this docket on March 4, 1996 and is the latest report on the first two years of the experiments. SDG&E timely filed its petition to extend the Gas Procurement mechanism on May 29, 1996. This decision addresses only that request. SDG&E's May 24, 1996 petition to extend the term of the G&D mechanism will be considered in a separate order.

3. Petition and Responses

SDG&E seeks to extend the term of the Gas Procurement mechanism until July 31, 1997 or until such time as the Commission acts on an application to implement a more permanent gas PBR mechanism. SDG&E anticipates filing such an application following a collaborative process involving the Division of Ratepayer Advocates (DRA)[2] and other interested parties. Pending action on the permanent mechanism, SDG&E proposes the following for the remaining term of the existing mechanism:

1. Change the Part B benchmark by replacing the use of a simple average DPI calculation with a volume-weighted average.

2. Incorporate gas storage operations in Part B on an experimental basis.

---

1 The Commission Advisory and Compliance Division has been eliminated as part of a Commission reorganization plan. Many of its former energy utility functions are now performed by the Energy Division.

2 During the pendency of this matter, DRA was replaced by the Office of Ratepayer Advocates. For purposes of this decision we will refer to DRA since most of the pleadings and events preceded the change of party.

3. Continue monitoring and evaluation requirements similar to those adopted for the existing mechanism.

DRA filed a response generally supporting the petition. DRA believes the Gas Procurement mechanism continues to provide SDG&E with the appropriate incentives to minimize gas procurement costs to the benefit of ratepayers. DRA supports the proposed change to a volume-weighted DPI average. DRA also supports the concept of including gas storage operations in Part B, although it requested an opportunity to review the details of the latter proposal. DRA proposed that approval of the storage proposal be conditioned upon approval of an advice letter filing by SDG&E to implement such proposal.

Enron Capital and Trade Resources (Enron) filed a response opposing the inclusion of gas storage in the PBR mechanism as well as the proposed change to a volume-weighted benchmark. Enron states that its interest in this proceeding is to ensure that the developing competitive market for natural gas in California is not distorted by SDG&E's purchasing practices, which Enron asserts are driven more by regulatory than by market considerations as a result of the Gas Procurement mechanism. Enron supports SDG&E's plan for a collaborative process to develop an improved gas PBR mechanism.

4. Procedural History

A duly noticed prehearing conference was held on September 5, 1996. Enron withdrew its protest to the gas storage proposal with the understanding that SDG&E would file an advice letter to clarify and implement the storage proposal, to which Enron could then respond as it found necessary. No issues requiring evidentiary hearings were identified, and the matter was submitted subject to further discovery and briefs on the weighted average basin price issue, due October 16, 1996.

By ruling issued on October 8, 1996, the Administrative Law Judge provided the parties an opportunity to address the impact of Assembly Bill (AB) 1890 (Stats. 1996, Ch. 854), if any, on this matter, including whether there is any unintended and inappropriate interaction between the Fuel Price Incentive Mechanism provided in new Public Utilities Code Section 397 and the Gas Procurement mechanism as it exists or as it may be modified.

5. Discussion

5.1 Extension of Experiment

The monitoring and evaluation program established by D.93-06-092 has yielded a series of favorable interim (first-year) and final (second-year) evaluation reports by SDG&E, DRA, and Vantage. These reports have consistently found that the Gas Procurement mechanism works well; is an improvement over traditional regulation; has met the Commission's objectives for the mechanism; and needs only minor modifications at this time. At the same time, there is consensus that the Gas Procurement mechanism adopted in 1993 should be replaced with a better mechanism following a comprehensive review, and that additional time is needed for collaborative efforts to develop such a proposal before it is formally presented to the Commission. Finally, there is no opposition to continuing the experimental mechanism (along with the modifications approved by Resolution No. 3187 dated June 6, 1996) on an interim basis, provided that SDG&E's application for a permanent gas PBR mechanism is filed without undue delay.

At the prehearing conference, SDG&E agreed to file an application by July 31, 1997. Based on the foregoing, we believe that the mechanism should be continued on an interim basis. We will approve the petition by ordering SDG&E to file an application for a permanent gas PBR mechanism by July 31, 1997 and by extending the existing Gas Procurement mechanism, as modified by Resolution No. 3187 and by this order, until the Commission enters an appropriate order in that application docket.[3] SDG&E should continue submitting reports and filing annual reports using the schedules approved by this decision.

The Commission is developing a business plan for 1997 as a planning and management tool. One of its purposes is to clearly establish project or program priorities. We recognize that SDG&E's pending application for a permanent gas PBR mechanism creates the potential for significant workload impact on the Commission and that its timing could possibly be inconsistent with the business plan. Therefore, notwithstanding our directive that SDG&E file its application on or before July 31, 1997, we will authorize the Executive Director to approve or direct an extension of the filing date as may be necessary for consistency with the business plan.

We note that on October 30, 1996 the parent companies of SDG&E and Southern California Gas Company (SoCalGas) and related entities filed a joint application (Application (A.) 96-10-038) for approval of a plan for merger of the respective companies. We also note that SoCalGas was authorized to implement an experimental Gas Cost Incentive Mechanism by D.94-03-076 and that its application for authority to implement a base rate PBR mechanism (A.95-06-002) is pending. Notwithstanding any future need to coordinate ratemaking mechanisms if the proposed merger is authorized, we need not address such coordination issues for the purpose of considering the proposed limited extension of SDG&E's experimental Gas Procurement mechanism.

---

3 Prior to filing its application, SDG&E will convene workshops to further an ongoing collaborative process. We expect all parties having an interest in SDG&E's future gas PBR mechanism to fully participate in the collaborative process, including the workshops to be convened by SDG&E. Parties should not await the filing of SDG&E's formal application to register their interests and concerns.

5.2 Weighted Average Proposal

As already noted, SDG&E's proposal to incorporate gas storage in the Part B benchmark will be addressed by SDG&E filing an advice letter.[4] The remaining issue is whether to approve the proposed modification to the Part B benchmark. Part B of the Gas Procurement mechanism is designed to encourage the utility to lower the total delivered cost of gas by including transportation in the comparison of actual purchased gas costs against an average basin index and firm transportation rate. The Part B benchmark uses a DPI calculated with a simple average of the San Juan and Permian basin index prices. SDG&E proposes to change from the simple average to a weighted average based on gas volumes that SDG&E actually purchases in each basin. SDG&E states that the purpose of using a volume-weighted average is to more accurately reflect its actual purchasing patterns in the various gas basins as market dynamics and pricing shift from time to time.

DRA supports the use of a volume-weighted average. DRA points out that SDG&E has minimized purchases in the Permian basin because of its significantly higher prices. For example, the gas price in the Permian basin averaged approximately 50 cents per MMBtu higher than the San Juan basin price during the third year of the Gas Procurement mechanism. Such basin price differentials were not anticipated when the mechanism was adopted in 1993. DRA believes that the use of a simple average which does not account for actual volumes purchased was adequate when it was adopted, but that it now results in the Part B benchmark being overstated to the detriment of ratepayers. The Part B shareholder reward for the third year of the experiment is more than $1 million higher when

4 By Advice Letter 1029-G dated September 26, 1996, SDG&E proposes to include gas storage operations and expenses in the Gas Procurement mechanism.

the DPI is calculated based on the simple average of the basin indices versus using the volume-weighted average.

Enron asserts that a volume-weighted approach simply mirrors SDG&E's actual purchases and provides no meaningful incentives for the company to lower its gas purchase costs. Enron is concerned that with a volume-weighted average, the Part B benchmark is effectively reduced to a transportation-only incentive, and a poor one at that. According to Enron, this is because SDG&E can take advantage of discounted brokered capacity yet the Part B benchmark is tied to as-billed tariff rates.

Ideally, a PBR benchmark will reflect only market conditions that the subject utility cannot influence significantly through its own actions. To the extent that the benchmark is set to measure other than a market result, we lack assurance that ratepayer benefits are being maximized. With this in mind, we are somewhat troubled that with a weighted average, SDG&E's own performance, i.e., its business decisions to purchase in one basin or another, could affect the setting of the Part B benchmark against which that performance will be evaluated.

The natural gas industry is continuing to evolve towards a more competitive market, and as part of our review of SDG&E's application for a permanent mechanism we intend to explore whether market indicators better than those adopted in D.93-06-092 are available. For now, we are interested in determining which basin price averaging method, simple or volume-weighted, is preferable for the remaining duration of the Gas Procurement experiment.

The proposed weighted average reflects actual purchasing decisions and does not provide a fully independent, market-based incentive to drive low-cost gas purchases. Nevertheless, we are persuaded that despite this shortcoming, the weighted average approach is an improvement in the context of the existing mechanism. We find little justification for allowing the enhanced shareholder rewards that can result from what would appear to be a simple managerial decision to avoid purchasing significant volumes of gas from high-cost basin. The volume-weighted method will avoid such a result. We will adopt the proposed modification on an interim basis until we have an opportunity to explore the use of potentially better market indicators. We expect this issue may be taken up as part of the ongoing collaborative process as well as our formal review of SDG&E's application for a permanent mechanism.

5.3 AB 1890

As we have noted, parties were given an opportunity to address any impacts of AB 1890 on the Gas Procurement mechanism. No party has identified any issue requiring resolution at this time. SDG&E points out that the collaborative process provides an appropriate mechanism for parties to consider whether any unanticipated interaction between the Fuel Price Incentive Mechanism and the Gas Procurement mechanism has arisen.

Findings of Fact

1. Evaluation reports by SDG&E, DRA, and Vantage have consistently found that the Gas Procurement mechanism works well; is an improvement over traditional regulation; has met the Commission's objectives for the mechanism; and needs only minor modifications at this time.

2. There is consensus that the Gas Procurement mechanism should be replaced with a better mechanism following a comprehensive review, and that additional time is needed for collaborative efforts to develop such a proposal before it is formally presented to the Commission.

3. There is no opposition to continuing the experimental mechanism with the modifications approved by Resolution No. 3187 dated June 6, 1996 on an interim basis, provided that SDG&E's application for a permanent gas PBR mechanism is filed without undue delay.

4. There is no opposition to SDG&E's proposal to continue monitoring and evaluation requirements similar to those adopted for the existing mechanism.

5. The application for a permanent gas PBR mechanism ordered by this decision creates a potential for significant workload impact which potentially could be inconsistent with the Commission's business plan.

6. The proposed volume-weighted average method reflects actual purchasing decisions and does not provide a fully independent, market-based incentive to drive low-cost gas purchases.

7. The Part B shareholder reward for the third year of the experiment is more than $1 million higher when the DPI is calculated using the simple average of the basin indices instead of the volume-weighted average.

8. No party has identified any unintended or inappropriate interactions between AB 1890 and the Gas Procurement mechanism.

<u>Conclusions of Law</u>

1. D.93-06-092, as modified by D.95-04-051, should be further modified to provide for an interim extension of the Gas Procurement experimental mechanism and to change the Part B benchmark by using a volume-weighted average of gas basin index prices.

2. This order should be made effective on the date signed to provide for implementation of the volume-weighted approach at the earliest opportunity.

O R D E R

IT IS ORDERED that:

1. The May 29, 1996 petition for modification of Decision (D.) 93-06-092 of San Diego Gas & Electric Company (SDG&E) is granted as provided herein.

2. On or before July 31, 1997, SDG&E shall file an application for authority to implement a permanent performance-based ratemaking mechanism for gas procurement to replace the currently-effective experimental Gas Procurement mechanism. We authorize the Executive Director to approve or direct an extension of the July 31, 1997 filing date if necessary for conformance with the Commission's Business Plan for 1997.

3. The Gas Procurement mechanism adopted by D.93-06-092, as modified by Resolution No. 3187 and by this order, and as it may be modified pursuant to Advice Letter 1029-G, shall remain in effect until the Commission enters an appropriate order in response to the application required by this order.

4. The first sentence of the fifth paragraph on Page 31 of D.93-06-092 is modified to read as follows:

> "The delivered price indices for gas delivered on the El Paso and Transwestern systems are the volume-weighted average of the Average Indices of the identified basins on the El Paso System."

5. The first two sentences of the first full paragraph on Page 48 of D.93-06-092 are modified to read as follows:

> "SDG&E shall file and serve annual gas procurement reports. The timing of the reports is 90 days after the yearly anniversaries of implementation of the gas procurement mechanism."

6. The first sentence of the first full paragraph on Page 50 of D.93-06-092 is modified to read as follows:

> "Although this is a two-year experiment, we expect the PBR mechanisms may be left in place well into the third year or beyond."

7. The first sentence of Finding of Fact 48 on Page 58 of D.93-06-092 is modified to read as follows:

> "SDG&E should file and serve annual gas procurement reports 90 days after the yearly anniversaries of implementation."

8. Appendix C of D.93-06-092 is modified as set forth in Appendix A to this decision.

This order is effective today.

Dated February 5, 1997, at San Francisco, California.

P. GREGORY CONLON
President
JESSIE J. KNIGHT, JR.
HENRY M. DUQUE
JOSIAH L. NEEPER
RICHARD A. BILAS
Commissioners

APPENDIX A

REVISIONS TO APPENDIX C OF DECISION 93-06-092

APPENDIX C

where, BP_{IBP}: Basin Price, in dollars per MMBtu, of the gas supplies from each of the IBPs incurred by SDG&E.

DP_{OSG}: Delivered Price, in dollars per MMBtu, of the gas supplies from each of those sources other than IBPs incurred by SDG&E.

MC: Miscellaneous Costs, in dollars, for additional fees, surcharges and offsetting revenues as described above.

Shared Savings/Costs. Part A Shared savings/costs are determined at the end of each 12-month period after implementation by comparing SDG&E's total PGC against Part A Benchmark and Deadband for the year.

$$PGC \leq BM(A)_{total} \Rightarrow \text{Shared Savings} = PGC - BM(A)_{total}$$

$$PGC \geq DB(A)_{total} \Rightarrow \text{Shared Costs} = DB(A)_{total} - PGC$$

Shareholders' Reward/Penalty. Shareholders' Reward and Penalty equals to 50% of the Shared Savings and Costs, respectively.

GAS PROCUREMENT CALCULATIONS -- PART B

Basin price data used in calculating the Part B Benchmark is the same as that used in Part A. As with Part A, the development of the Part B benchmark is a multi-step process. The benchmark is the product of the weighted average delivered price indices and actual volumes delivered to SDG&E. First, separate Delivered Price Indices are developed for gas delivered on the El Paso and Transwestern systems. XX

~~**Delivered Price Index on El Paso, DPI(EP).** This index is the simple average of the Average Indices of the three identified basins on the El Paso system.~~

$$\cancel{DPI(EP) = \Sigma\{ AI(EP) + TR_{max}(EP) \} \div 3}$$

~~where, AI(EP): Average Index, in dollars per MMBtu, of each IBP on El Paso.~~

~~$TR_{max}(EP)$: Transportation Rate, in dollars per MMBtu, for firm delivery at the maximum posted rate from each IBP on El Paso's pipeline system, including the applicable reservation and commodity charges and fuel charges.~~

REPLACE WITH INSERT "A"

INSERT "A" (Appendix C, page 4)

Delivered Price Index on El Paso, DPI(EP). This index is the volume-weighted average of the Average Indices and the maximum transportation rate of the identified basins on the El Paso system.

$$DPI(EP) = \Sigma\{[AI(EP) + TR_{max}(EP)] \times DV_{IBP}(EP)\} \div \Sigma DV_{IBP}(EP)$$

where, AI(EP): Average Index, in dollars per MMBtu, of each IBP on El Paso.

$TR_{max}(EP)$: Transportation Rate, in dollars per MMBtu, for firm delivery at the maximum posted rate from each IBP on El Paso's pipeline system, including the applicable reservation and commodity charges and fuel charges.

$DV_{IBP}(EP)$: Delivered Volumes, in MMBtu, recorded by SDG&E as transported from each IBP on El Paso, corresponding to the calculated Average Index, to San Diego's metering stations.

APPENDIX C

REPLACE WITH INSERT "B"

~~**Delivered Price Index on Transwestern, DPI(TW).** This index is the sum of the Average Index and the transportation rate for the Permian/Transwestern IBP[3]. The transportation rate is for Transwestern firm delivery at the maximum posted rate, including applicable reservation and commodity charge and fuel usage cost.~~

$$\cancel{DPI(TW) \quad = \quad AI(TW) \quad + \quad TR_{max}(TW)}$$

Weighted Average Delivered Price Index, DPI_{WA}. The weighted average index is calculated by applying weighting factors to El Paso (70%) and Transwestern (30%) delivered price indices. These factors represent a distribution of firm capacity originally available through SoCalGas from El Paso and Transwestern and are referenced in SDG&E's gas service contract with SoCalGas.

$$DPI_{WA} \quad = \quad [\, DPI(EP) \;\times\; 70\% \,] \quad + \quad [\, DPI(TW) \;\times\; 30\% \,]$$

Part B Benchmark, $BM(B)_{total}$. The Part B benchmark developed each month is the product of the weighted average delivered price index and the actual delivered volumes of gas ~~purchased by~~ delivered to SDG&E in that month. XX

$$BM(B)_{total} \quad = \quad DPI_{WA} \quad \times \quad [\ \Sigma\,(DV_{IBP}) \quad + \quad DV_{OSQ}\ ]$$

Purchased Gas Cost, PGC. This amount is same as that already calculated in the Part A of the mechanism.

Part B Shared Savings, SS(B). Shared Savings results if at the end of the 12-month period, SDG&E's recorded PGC is less than the Part B Benchmark. The Shared Savings amount is equal to PGC less the Benchmark.

$$SS(B) \quad = \quad PGC \; - \; BM(B)_{total}, \quad \underline{\text{and}} \quad PGC \quad \leq \quad BM(B)_{total}.$$

Part B Reward, Reward(B). Whenever SDG&E's actual purchased gas cost is less than the Part B benchmark, its shareholders would earn a reward equalling 5% of the savings.

$$Reward(B) \quad = \quad SS(B) \;\times\; 5\%$$

---

[3] An simple average of the delivered cost on the Transwestern system would be calculated if there are additional basins identified on the Transwestern system in the future.

INSERT "B" (Appendix C, page 5)

Delivered Price Index on Transwestern, DPI(TW). This index is the volume-weighted average of the Average Indices and the maximum transportation rate of the identified basins on the Transwestern system.

$$DPI(TW) = \Sigma \{ [AI(TW) + TR_{max}(TW)] \times DV_{IBP}(TW) \} \div \Sigma DV_{IBP}(TW)$$

where, AI(TW): Average Index, in dollars per MMBtu, of each IBP on Transwestern.

$TR_{max}(TW)$: Transportation Rate, in dollars per MMBtu, for firm delivery at the maximum posted rate from each IBP on Transwestern pipeline system, including the applicable reservation and commodity charges and fuel charges.

$DV_{IBP}(TW)$: Delivered Volumes, in MMBtu, recorded by SDG&E as transported from each IBP on Transwestern, corresponding to the calculated Average Index, to San Diego's metering stations.

(END OF APPENDIX A)