ENERGY/DLW

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Decision 97-08-058 August 1, 1997

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Pacific Gas and Electric Company for An Order under Section 701 of the Public Utilities Code Granting Pacific Gas and Electric Company Permission to Use Energy-Related Derivative Financial Instruments.

Application 96-11-037
(Filed November 25, 1996)

ORIGINAL

OPINION

1. Summary

In this decision, we decline to grant authority to Pacific Gas and Electric Company (PG&E) to use energy-related derivative financial instruments (derivatives), including but not limited to, futures contracts, forward contracts, options, and swaps, to manage gas and electric price risk volatility. We make this determination according to the mandates and guidance provided by our Preferred Policy Decision[1] in the Electric Restructuring Proceeding (Rulemaking (R.)94-04-031/Investigation (I.)94-04-032).

If PG&E would like us to reconsider its proposal, it should file an application which fully addresses market power concerns and the ramifications of its application on electric restructuring. PG&E should file a petition for modification of the Preferred Policy Decision for areas where its application would require a modification of that decision.

2. PG&E's Application

In Application (A.) 96-11-037 (Application), PG&E contends that the purpose of its proposal is to reduce existing or anticipated price risk associated with its

[1] Decision (D.) 95-12-063, as modified by D.96-01-009.

electric portfolio due to volatile gas and electric commodity and related transportation costs. The financial instruments PG&E seeks authority to use include all financial instruments whose values change relative to a change in an underlying commodity or commodity transportation cost, including forward contracts, futures, options, and swaps.

PG&E alleges that controlling costs is especially important to PG&E because of the rate freeze mandated by the new Section 368(a) of the Public Utilities Code.[2] The rate freeze froze PG&E's electric rates; the freeze did not apply to PG&E's gas and electricity costs. PG&E contends that increases in its gas and electricity costs could prevent PG&E from fully collecting its transition costs.

PG&E proposes that shareholders bear the costs and losses, as well as receive any benefits, from the instruments during the electric rate freeze period. PG&E notes that it may later request different treatment after the electric rate freeze period. PG&E contends that since shareholders will bear all costs and losses from the financial instruments, the costs, gains and losses from the financial instruments should not be subject to reasonableness review.

PG&E contends that the financial instruments it seeks to use have already been approved for Southern California Gas Company [3] (SoCal Gas), San Diego Gas & Electric Company[4] (SDG&E), and Southern California Edison Company[5] (Edison).

PG&E seeks authority for use of these instruments under Section 701, claiming that no other section mentions energy-related derivative financial instruments. PG&E admits that there is an argument that the Commission could regulate some of the instruments it seeks authority to use under Section 818, but seeks authority under Section 701. PG&E disputes that Section 818 applies because none of

[2] Section references are to the Public Utilities Code, except as noted.
[3] D. 94-03-076, p. 13 (slip op.).
[4] D. 93-06-092, App. C, p. 3 (slip op.).
[5] Section 368(c).

the financial instruments it seeks to use would grant anyone an ownership interest in PG&E. Further, PG&E contends that the financial instruments in question are not debt securities. Additionally, PG&E alleges that the Commission approved the use of these financial instruments for SoCal Gas, SDG&E and Edison without mentioning Section 818.

PG&E also contends that for the same reasons it believes that Section 818 does not apply, the Commission's Competitive Bidding Rules[6] also do not apply. PG&E requests that if the Commission believes that the Competitive Bidding Rules do apply to PG&E's proposed transactions, PG&E be given an exemption from the rules pursuant to Resolution F-616.[7]

PG&E asserts that to manage its risk effectively, it must be able to respond quickly to changes in the market, often within one to two minutes. The Competitive Bidding Rules require that utilities publish in a newspaper requests for bids and give potential bidders at least a day to respond. PG&E further asserts that publicly requesting bids would put PG&E at a severe disadvantage relative to other market participants because it would be revealing information that would undermine its ability to achieve low prices and reduced volatility.

Finally, PG&E requests ex parte review of the Application.

3. Background and Procedural History

In April 1994, we initiated R.94-04-031/I.94-04-032, a comprehensive rulemaking and investigation into restructuring California's electric services industry and reforming regulation. After months of extensive public comments and participation, we issued our Preferred Policy Decision, which mandates that during the transition period, all jurisdictional utility sales and purchases of electricity be

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[6] The Commission's Competitive Bidding Rules require utilities to request bids for the purchase of bonds, notes and other evidences of indebtedness and are set forth in D.38614, D.49941, D. 75556, D. 81908, Resolution F-591 (August 4, 1981), and Resolution F-616 (October 1, 1986).

[7] Resolution F-616 provides that "[d]ebt issues for which competitive bidding is not viable or available are exempt," p. 2 (slip op.).

accomplished through a Power Exchange (PX), to enable the market to send clear pricing signals and prevent utilities from manipulating energy prices. Additionally, the Preferred Policy Decision affirmed our desire to encourage contracts for differences (CFDs) but prohibits utilities from arranging CFDs with their own generation facilities and affiliated generation facilities. The Preferred Policy Decision also mandates that CFDs arranged by the utilities are subject to Commission review.

PG&E filed the Application on November 25, 1996, serving it on all parties of record in PG&E's 1997 Energy Cost Adjustment Clause (ECAC) proceeding, A.96-04-001. Thereafter, Commission staff from the Energy Division met with PG&E to gather further information regarding the Application and clarify issues. During these meetings, PG&E alleged that although there may be incentives for it to manipulate PX prices, it would not have the ability to exercise market power and affect PX prices. Further, PG&E alleged that the Commodity Futures Trading Commission ensures the competitiveness of commodity options and futures trading in the United States. PG&E also proposed program limits,[8] and agreed to expanded reporting requirements.

Subsequent to those meetings, on February 10, 1997, Commission staff from the Energy Division and Legal Division met with PG&E to discuss its remaining concerns regarding PG&E's Application and PG&E's proposed mitigations. Those concerns include, but are not limited to: market power; possible violation of the intent of the mandatory buy-sell requirement; potential physical violations of the mandatory buy-sell requirement; incentives and opportunities to manipulate PX prices; anticompetitive derivative transactions involving PG&E's generation facilities or generation affiliates (through third-party intermediaries) or PG&E customers; impacts on transition costs; and the inability of ratepayers to share in gains from these transactions. Commission staff also discussed the concern that granting the Application would result in a modification of the Preferred Policy Decision and not all

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[8] For 1997, at any given point in time, a limit of $500 million or approximately 25% of its adopted energy expense per D.96-12-080 and for 1998 - March 2002 a program limit of $1 billion or approximately 50% of its adopted energy expense per D. 96-12-080.

parties in that docket were served with the Application and properly notified of the ramifications of the Application and its potential impacts on the Preferred Policy Decision.

At that meeting, PG&E was requested, to minimize delay in evaluating PG&E's request, to file an amended application and serve it on all the parties in R.94-04-031/I.94-04-032. This amended application was to clarify issues related to the Preferred Policy Decision. Additionally, PG&E was requested to file a petition for modification of the Preferred Policy Decision with respect to those requests in its application that are inconsistent with that decision.

PG&E did not file an amended application nor a petition for modification. Instead PG&E served its original application on all the parties in R.94-04-031/I.94-04-032, without any clarification of issues related to the Preferred Policy Decision or petition to modify the same decision with respect to the areas of the Application that were inconsistent with the Preferred Policy Decision (see Discussion 2.2, infra.). An Examiner's Ruling was issued to help focus on the issues related to the Preferred Policy Decision (see Discussion 3.4, infra.).

3.1. The Utility Reform Network (TURN)

On January 7, 1997, TURN filed a response to the Application. Although TURN did not take a position on the issue of whether the Commission should grant the authority sought by PG&E, TURN urges the Commission to clarify two points in regard to the Application in any decision that grants PG&E the authority it requests:

1) Under no circumstances will any cost or loss associated with the financial instruments be recovered from PG&E's ratepayers, and
2) Any attempt to change the ratemaking treatment will require a subsequent application rather than an advice letter or petition for modification.

3.2. PG&E's Motion for Fifteen-Day Comment Period

On April 25, 1997, PG&E served A. 96-11-037 on the electric industry restructuring (R.94-04-031/I.94-04-032) service list. On the same date, PG&E also requested that parties be given fifteen days from the date of its supplemental service in which to file any protests or responses to the Application, rather than the 30 days provided by Rules 8(a)(2) and 44.1 of the Commission's Rules of Practice and Procedure.

3.3. Protest of the Office of Ratepayer Advocates (ORA)

On May 9, 1997, ORA filed a protest to the Application on the ground that it is not clear that ratepayers are indifferent to PG&E's use of derivatives.

ORA offers an example of PG&E taking physical delivery under a futures contract wherein if PG&E had closed out its position, shareholders would absorb a loss. ORA alleges that PG&E has asserted it will "record all costs associated with the physical purchase of [energy] ... to fuel and purchased power accounts,"[9] whereby ratepayers would absorb PG&E losses. Similarly, ORA argues that PG&E may be forced to sell low cost energy to the detriment of ratepayers, in the event PG&E enters into futures contract to sell electricity at a low price when it incorrectly forecasts that energy costs are dropping.

ORA requests that PG&E be ordered to record, to the fuel and purchased power account, the lesser of the spot market price of the cheapest available energy or the actual cost of energy taken pursuant to a derivative transaction and that the Commission ensure that ratepayers are indifferent to sales of energy by PG&E under derivative or similar transactions. Finally, ORA states that it concurs with the comments made by TURN on January 7, 1997.

3.4. Examiner's Ruling

On May 12, 1997, an Examiner's Ruling was issued initiating a fifteen day protest, response and comment period, inviting parties to comment on specific questions developed by the Commission's Energy Division. These questions were intended to help parties contemplate some of the possible impacts of granting PG&E's

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[9] Application, p. 5

application. On May 27, 1997, PG&E, Edison, SDG&E and the New York Mercantile Exchange (NYMEX) submitted comments.

4. May 27, 1997 Comments From Parties

PG&E in its comments asserts that there will be ample safeguards in place to ensure that PG&E cannot manipulate PX or electric derivative prices. These safeguards include regulatory oversight by this Commission, FERC, other bodies in the Independent System Operator (ISO)/PX arena, and the Commodity Futures Trading Commission, as well as proposed program limits and quarterly reporting. PG&E asserts it would not be financially disadvantaged by customers' switching to other suppliers, and therefore PG&E has no incentive to discount the price of power through the use of the derivatives. PG&E believes that with quarterly reporting and shareholders funding the price risk management activities, reasonableness reviews are unnecessary. PG&E assures us that if PG&E took physical delivery under a derivatives transaction, PG&E would either submit that transaction as a bid into the PX or arrange for its sale out of state.

SDG&E in its comments alleges that PG&E will not have market power and will not be able to manipulate electric derivative prices. SDG&E believes reasonableness reviews should be limited to a determination that a CFD was not with PG&E's own generation facility or generation affiliate. SDG&E requests that the Commission clarify that if PG&E has to take delivery, it must bid the power into the PX. SDG&E believes mandatory buy/sell does not apply to make or take off-system sales for resale or wholesale transaction.[10]

Edison in its comments expresses increasing concern about steps that could endanger the efficient, competitive operation of the PX. Edison alleges that PG&E has acknowledged that it will have generation market power even after it

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[10] SDG&E is not a disinterested party. In A.97-04-039, which is pending, SDG&E has requested similar authority. Our decision on PG&E's application does not prejudge SDG&E's application. We will be making a separate determination on the merits of SDG&E's application based on the record for that proceeding.

divests 50% of its gas-fired plants. Edison is further concerned because it alleges that a party to a financial derivative that specifies a price at which it can buy future energy may profit if the market price goes above the level set in the contract, and that party may have an incentive to use its control over physical generating facilities to exercise whatever market power it may have to drive prices up. Edison proposes that the Commission defer ruling on this application pending the Federal Energy Regulatory Commission (FERC) market power evaluation.

Edison's comments are further supported by its comments filed with FERC on June 6, 1997, entitled Southern California Edison Company's Comments on Market Power Mitigation Strategies of Pacific Gas and Electric Company and San Diego Gas & Electric Company.[11] In these comments at FERC, Edison explains how a utility may offset lost transition costs with earnings on energy-related financial derivative transactions. Edison claims that shareholders could be better off through profits on energy-related financial derivatives if a utility's market power were used to raise prices in the PX, even if a utility is not a net buyer of energy and whether or not there is a headroom constraint on total cost recovery. Edison expresses concerns that PG&E's proposal of the rate freeze as a market power mitigation strategy does not adequately assure effective mitigation of PG&E's market power in the event that PG&E is given authority to use energy-related financial derivatives.

NYMEX in its comments strongly endorses the use of energy-related derivative instruments by commercial entities to manage commodity price risk. NYMEX points out there may be other factors relevant to the Commission in considering PG&E's request. NYMEX states it is confident that there are reasonable policy formulas to resolve any concerns the Commission may have. NYMEX encourages the Commission to resolve any concerns and allow PG&E to use derivatives.

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[11] In FERC Docket No. ER 96-1663-003.

5. Discussion

PG&E's service of the Application on the R.94-04-031/I.94-04-032 service list was insufficient. PG&E should have included a discussion of the implications of the Application with regard to electric restructuring and impacts of the Preferred Policy Decision, as recommended to PG&E by Commission staff. The subsequent Examiner's Ruling helped to raise some of the issues for the parties regarding the Application's ramifications, which we attempt to explore below.

The Preferred Policy Decision affirms our "encouragement of any contractual arrangements which may prove congenial to consenting traders who wish to manage risks associated with the revelation and realization of the market-clearing prices published by the Power Exchange. Such contracts are called contracts for differences (CFDs) and have been referred to by a variety of parties... to describe the potential for private agreements that hedge the cost of electricity over time." CFDs are contracts to manage the change in prices of electricity without a commitment to buy the underlying commodity. CFDs do not include futures or forward contracts. We recognize that many customers may desire price stability and predictability over a defined period, but we did not intend that such contracts circumvent our prohibition of utility/customer bilateral contracts.

During the transition period, all utility purchases and sales of electricity are to be accomplished through the PX, to enable the market to send clear pricing signals and prevent utilities from manipulating electricity prices. If the Application is granted, PG&E might have incentives and the opportunity to manipulate PX prices or electric derivative prices. Such incentives include, but are not limited to, increasing the amount of transition costs to be recovered and ensuring that its derivatives are profitable.

Additionally, the electric derivatives market is still very immature. With authority to use these instruments, PG&E could be put in the position of having to take or make delivery of electricity outside of the PX if it is unable to find a buyer for such an instrument before the maturity of the contract. Although PG&E asserts that if

PG&E took physical delivery under a derivatives transaction, PG&E would either submit that transaction as a bid into the PX or arrange for its sale out of state, we find that taking physical delivery under a derivatives transaction would be in violation of the mandatory buy-sell requirement as set forth in our Preferred Policy Decision.

If the Application is granted, third party intermediaries could facilitate energy derivatives, including contracts for differences, between PG&E and its own generation facilities or generator affiliates. Such contracts would violate the mandates of the Preferred Policy Decision (p. 81), and raise concerns about market power abuse and price manipulations.

PG&E alleges that Edison, SDG&E and SoCal Gas have already been granted authority to use energy-related derivative financial instruments. That authority governs the use of gas derivatives, not electric derivatives. SoCal Gas and SDG&E appear to be limited to the use of gas futures. The ratemaking treatment between these utilities varies, but in all cases the gains from these transactions are passed through to ratepayers. PG&E requests that all transaction costs, and losses and gains, from the use of these instruments, go to shareholders. Under this scenario, during the transition period, for example, any gains realized from these transactions could not be used to offset transition costs.

In the Preferred Policy Decision, we prohibit utilities from buying or selling power through bilateral contracts, on the basis that we do not want to have the onerous task of conducting reasonableness reviews (pp. 58-60). On page 81, we state that "CFDs arranged by the utilities are subject to Commission review." At the time of that decision, we did not specify the extent of the review nor did we contemplate all of the ramifications of CFDs arranged by utilities. In fact, our discussions in that decision revolved around *customers* using CFDs to hedge the cost of electricity.[12]

PG&E is requesting that its use of energy derivatives not be subject to reasonableness reviews (Application, p.2). If we allow PG&E to request preapproval of

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[12] D.95-12-063, as modified by D.96-01-009, Finding of Fact No. 13, p. 191.

these contracts on a generic basis, such Commission review may be insufficient to deal with market power issues. On the other hand, preapproval review on an individual or case by case basis would, according to PG&E, affect PG&E's use of these electric derivatives.

It may be determined that even if we granted PG&E's current request for shareholders to absorb all costs and losses while reaping all of the gains, reasonableness reviews of the kind we had hoped to avoid by prohibiting bilateral contracts would still be needed to explore the impacts of these instruments on market prices and provide assurance about the absence of self-dealing. In fact, if authority is granted to PG&E to enter into these contracts, reasonableness reviews on the PX prices as well as PG&E's derivative instruments would need to be conducted to evaluate market power concerns.

Again, if PG&E's application is granted as requested, with shareholders absorbing transaction costs, losses and gains, ratepayers will be subject to certain costs and risks. Such costs include the indirect costs associated with these instruments (contract review by the legal department, analysis, overheads, set-up costs, etc.), which was not addressed in the application, and risks include the risk that overall debt costs could increase due to the utility being perceived as riskier by lenders or rating agencies.

Although the Application itself lacks protection mechanisms, during Commission staff meetings with PG&E several such mechanisms were proposed by PG&E, including quarterly reporting and program limits. We do not have any evidence to ascertain if these protective mechanisms are adequate. For example, PG&E's program limitations may be too high or proposed reporting requirements may need to be increased, or other protective mechanisms may be needed.

PG&E requests approval to use its proposed financial instruments under Section 701. We note that this Commission is not basing its review of PG&E's application solely under this section of the Public Utilities Code. Our review is based on our broad powers to regulate utilities, which is set forth in the Public Utilities Code.

(See e.g. §§330(e), 330(l), 451, 454, 491, 728, and 729.) We are also reviewing this Application in light of the mandates of AB 1890 to ensure a competitive market place, and our legal duty to look at all elements of public interest, including competitive issues (see Northern California Power Agency v. Public Util. Com. (1971) 5 Cal.3d 370, 380).

PG&E also argues Section 818 does not apply because the financial instruments proposed in its application are neither bonds or notes. Based on this argument, PG&E asserts that the Competitive Bidding Rules do not apply. Further, PG&E requests that if the Commission concludes that Section 818 applies, then the financial instruments should be exempted pursuant to Resolution F-616 (October 1, 1986) which states that "[d]ebt issues for which competitive bidding is not viable or available are exempt." Because we are not granting PG&E's Application, we need not resolve these issues related to Section 818 and the Competitive Bidding rules at this time.

There is much concern that PG&E, if granted its request, may have the incentive and opportunity to manipulate PX prices, thereby affecting the amount of transition costs. Edison also shares these concerns. It is also uncertain at this time whether or not current filings on market power issues before the FERC take all of these issues into account. Further, it appears that granting PG&E's request in its present form would result in a modification of the Preferred Policy Decision; thus, the proper forum for addressing this portion of PG&E's request should be a petition to modify the Preferred Policy Decision, which would encompass all of these issues.

We are not convinced that PG&E's proposed safeguards and assurances are adequate with regard to the market power issues.[13] Without certainty with regard to the market power issues and all of the other unresolved issues, we are unconvinced

[13] We do not express an opinion on PG&E's parent company or any other affiliates use of energy-related derivative financial instruments. By our decision today, we do not mean to prohibit PG&E's parent company or any other affiliates from using energy-related financial derivatives (not involving PG&E in any transaction), so long as there are no ratepayer impacts, even indirectly, or adverse anticompetitive effects on the electricity market.

that we can grant the authority requested at this time. The enormity of the interrelationships of the issues set forth in the Examiner's Ruling, along with possible impacts on transition costs and the rate reduction bonds, should be given careful consideration. Therefore, if PG&E is interested in continuing to seek authority to use energy-related derivative financial instruments, it may file an application seeking the requested authority that fully addresses these interrelationships and clarifies the possible ramifications on electric restructuring. PG&E should also file a petition to modify the Preferred Policy Decision with respect to aspects of its application that if granted would require changes to the Preferred Policy Decision.

Findings of Fact

1. On April 25, 1997, PG&E served the Application on parties in R.94-04-031/I.94-04-032, without any clarification of issues related to the Preferred Policy Decision or noticing parties wherein the Application results in a modification of the Preferred Policy Decision.

2. PG&E's service of the Application on parties in R.94-04-031/I.94-04-032 is insufficient.

3. Also on April 25, 1997, PG&E requested that parties be given an additional fifteen days from the date of its supplemental service in which to file any protests or responses to the Application.

4. On May 9, 1997, ORA filed a protest to the Application on the ground that it is not clear that ratepayers are indifferent to PG&E's use of derivatives.

5. On May 12, 1997, an Examiner's Ruling was issued initiating a fifteen day protest, response and comment period, inviting parties to comment on specific questions developed by the Commission's Energy Division.

6. The questions in the Examiner's Ruling were intended to help parties contemplate possible impacts of granting PG&E's application.

7. On May 27, 1997, PG&E, Edison, and SDG&E submitted comments.

8. In its comments, Edison expressed concerns about steps that could endanger the efficient, competitive operation of the PX, and proposed that the Commission defer ruling on the Application pending the FERC market power evaluation.

9. The Preferred Policy Decision orders all utility purchases and sales of electricity be accomplished through the PX, during the transition period.

10. Through an electric derivative, PG&E could be put in the position of buying or selling electricity outside of the PX.

11. PG&E's buying or selling electricity outside of the PX would be a violation of the mandatory buy-sell requirement of the Preferred Policy Decision.

12. Energy derivatives between PG&B and its generation facilities or generator affiliates are prohibited.

13. If PG&E's request is granted, third party intermediaries might facilitate energy derivatives between PG&E and its generation facilities or generator affiliates in violation of the prohibition.

14. We do not intend that energy derivatives circumvent our prohibition of utility/customer bilateral contracts.

15. Use of electric derivatives may provide PG&E incentives and opportunities to manipulate PX prices or electric derivative prices.

16. It is uncertain whether or not PG&E's proposed safeguards and assurances are adequate.

17. Granting PG&E's request in its current form would result in a modification of the Preferred Policy Decision.

18. The review of PG&E's application is not based solely on Public Utilities Code Section 701, but on the broad powers of the Commission to regulate utilities.

19. PG&E's parent company or any other affiliates may use energy related derivative financial instruments (not involving PG&E in any transaction), as long as there are no ratepayer impacts, even indirectly, or any adverse anticompetitive effects on the electricity market.

Conclusions of Law

1. The Application should be denied.

2. CFDs should not circumvent our prohibition of utility/customer bilateral contracts.

3. If PG&E desires to have this Commission consider its request, it should file an application and serve it on parties in R. 94-04-031/I.94-04-032, clarifying the implications of its requests with regard to electric restructuring, and it should also file a petition for modification of the Preferred Policy Decision with respect to any impacts its request would have on that decision.

ORDER

IT IS ORDERED that:

1. Pacific Gas and Electric Company's (PG&E) Application 96-11-037 is denied.

2. If PG&E desires to have this Commission reconsider its request to use energy-related derivative financial instruments, it shall file an application and serve it on parties in Rulemaking 94-04-031 and Investigation 94-04-032. The application shall fully address the interrelationships between the authority it seeks and the issues set forth in this decision, including but not limited to market power concerns; effects on the mandatory buy-sell requirement; incentives and opportunities to manipulate Power Exchange prices; anticompetitive derivative transactions involving PG&E's generation facilities or generation affiliates (through third-party intermediaries) or PG&E customers; impacts on transition costs; impacts on the rate reduction bonds; and the inability of ratepayers to share in gains from these transactions.

3. If PG&E desires to have this Commission reconsider its request to use energy-related derivative financial instruments, it shall file a petition for modification of Decision (D.) 95-12-063, as modified by D.96-01-009, with respect to those requests in its application that are inconsistent with that decision.

4. Application 96-11-037 is closed.

This order is effective today.

Dated August 1, 1997, at San Francisco, California.

P. GREGORY CONLON
President
DANIEL Wm. FESSLER
JESSIE J. KNIGHT, JR.
HENRY M. DUQUE
Commissioners

I will file a dissent.
/s/ JOSIAH L. NEEPER
Commissioner

Commissioner Josiah L. Neeper Dissenting

I dissent from the majority opinion on Item H-16, which would disapprove PG&E's application for derivatives, without prejudice. I would have preferred item H-16a, which was an alternate I sponsored that would have approved PG&E's application, with various appropriate conditions. My alternate would have allowed PG&E to enter into derivative contracts, with PG&E shareholders taking all the risks and gaining all potential rewards. Some of the conditions included a limit on the amount of derivatives, a requirement that derivatives be traded on exchanges overseen by the Commodity Futures Trading Commission, and a requirement that any physical sale or delivery of energy through derivatives transactions be accomplished through the Power Exchange. Further, safeguards to protect ratepayers include a prohibition on any costs related to derivatives being passed on through a rate case, a cost-of-capital proceeding, or in Section 376 costs. The alternate also requires a case-by-case application for any contracts-for-differences with customers, consistent with the 1995 restructuring Policy Decision.

The fundamental issue here is whether a utility should have the opportunity to control its costs and risks. PG&E is constrained by a rate freeze and cannot increase its rates. PG&E has significant risks, not only from our regulatory schemes, but also due to the limits imposed by AB 1890, including a time limit on transition cost recovery. I am aware of no law or regulation that prevents PG&E or any other utility from attempting to decrease its costs or risks, and would strongly oppose any such limitations.

If PG&E enters into derivatives transactions for its own purposes, I agree with the majority that such activities should not put ratepayers at risk. My alternate shielded ratepayers from such risks. But in return for taking all the risks, shareholders must be given the opportunity to gain the benefits of the company's efforts.

The major concern about this application, aside from risk issues, is that derivatives purportedly may have a deleterious impact on the marketplace, due to the potential of PG&E to exercise market power. Let's take it as a given that the exercise of market power is a bad thing. In that case, what we should be doing is working to prevent the exercise of market power, or perhaps even preventing the achievement of market power in the first place. We should focus on the cause of the problem, not the symptoms.

My understanding is that we are actively participating in a proceeding at FERC, at which market power is an important topic. My understanding is that we expect FERC to take actions to limit or prevent the exercise of market power. My understanding is that this may involve design issues regarding the Power Exchange and the ISO, divestiture issues, and perhaps many other conditions for approval. I am told that FERC is unlikely to approve the utilities' applications without mitigation of market power. We are also undertaking efforts on our own initiative to deal directly with market power issues. The majority opinion agrees that derivatives do not become a problem unless the utility is able to exercise market power.

I am confident we will do our job, and we should let FERC do its job, regarding market power. Given that, I see no reason not to allow PG&E to use financial tools such as derivatives (with proper safeguards to protect ratepayers) to do what any other company can already do to control its costs and risks.

For all the above reasons, I dissent.

/s/ JOSIAH L. NEEPER
Josiah L. Neeper
Commissioner

San Francisco, California
August 1, 1997