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**PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

**ENERGY DIVISION**

**RESOLUTION E-3511  
DECEMBER 16, 1997**

**RESOLUTION**

**RESOLUTION E-3511. SOUTHERN CALIFORNIA EDISON COMPANY (EDISON) SEEKS COMMISSION EXPEDITED APPROVAL TO MODIFY RESOLUTION E-3506 TO PERMIT EDISON TO ENTER INTO GAS RISK MANAGEMENT INSTRUMENTS WITH EDISON'S CUSTOMERS, TO CLASSIFY THESE GAS RISK MANAGEMENT INSTRUMENTS AS CONTRACTS OTHER THAN CONTRACTS FOR DIFFERENCES, AND TO ALLOW EDISON TO PROVIDE INDEPENDENT CERTIFICATION THAT EDISON HAS NOT DIRECTLY OR INDIRECTLY ENTERED INTO A GAS RISK MANAGEMENT TOOL WITH AN AFFILIATE OR GENERATION FACILITY IN LIEU OF THE LANGUAGE REQUIRED IN ANY SUCH CONTRACT. THE ADVICE LETTER ALSO SUBMITS REVISED TARIFF SCHEDULES PURSUANT TO RESOLUTION E-3506. APPROVED WITH MODIFICATIONS.**

**BY ADVICE LETTER 1259-E, FILED ON NOVEMBER 3, 1997**

**SUMMARY**

1. By Advice Letter 1259-E, Southern California Edison Company (Edison) seeks Commission approval of modifications to Resolution E-3506, dated November 5, 1997: to enter into gas risk management instruments with Edison's customers; to classify all of the gas risk management instruments authorized by E-3506 as contracts other than contracts for differences; to allow Edison to provide independent certification that Edison has not directly or indirectly entered into a gas risk management tool with an affiliate or its generation facilities in lieu of the language required in any such contract; and to make minor clarifications to ordering paragraphs 1.d) and 1.k). Edison also submits revised tariff sheets, pursuant to Resolution E-3506, to implement a Risk Management Tools Memorandum Account.
  
2. The Office of Ratepayer Advocates (ORA) protests Edison Advice Letter 1259-E, and proposes modifications: to minimize linkage of the contracts with Edison's customers; to acknowledge any beneficial impacts of the hedging activities on Edison's cost of capital; to credit customers with any potential net gains from the hedging activities; postpone interest eligibility; and to clarify areas of Edison's proposed tariffs.

3. This Resolution approves with modifications Edison's Advice Letter 1259-E.

### BACKGROUND

1. Edison requests expedited consideration of Advice Letter 1259-E, in accordance with Section XV of General Order 96-A. Edison claims consideration on an expedited basis is warranted because of the directives given by the Commission at the November 5, 1997 meeting.
2. By letter, on November 17, 1997, Paul Clanon, Director of the Energy Division, granted Edison's request for expedited consideration of Advice Letter 1259-E, shortening the usual protest period to 10 days and the utility response period to one day. The Energy Division ordered that protests were to be received by the Energy Division and Edison before 5 p.m. on November 24, 1997, and Edison's response was to be received by the Energy Division before 5 p.m. on November 25, 1997.
3. Our Preferred Policy Decision<sup>1</sup> mandates that all jurisdictional sales and purchases of electricity be accomplished through a Power Exchange, to enable the market to send clear pricing signals and prevent utilities from manipulating energy prices. The Preferred Policy Decision also affirms the Commission will continue to regulate the rates, terms, and conditions of the services of customers who choose to remain utility service customers.
4. In the Preferred Policy Decision, we discussed our concerns regarding the abuse of market power. We explained how market power abuse is mitigated in a competitive market by means of contestibility. We went on to show how contestibility is ensured by eliminating any undue competitive advantages to existing competitors and eliminating barriers to entry.
5. Competitive advantages, cited by the Preferred Policy Decision, that could be exercised by the utilities in the absence of proper mitigations include, but are not limited to, exercising market power to raise Power Exchange prices.
6. In the Preferred Policy Decision, we also discussed our concern regarding the impacts of predatory pricing as a potential barrier to entry. We cautioned we would monitor the market structure we establish for market power abuse through predatory pricing.

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<sup>1</sup> Decision (D.) 95-12-063, as modified by D.96-01-009

7. Additionally, the Preferred Policy Decision affirms our desire to encourage contracts for differences (CFDs) but prohibits utilities from arranging CFDs with their own generation facilities and affiliated generation facilities.
8. The Preferred Policy Decision mandates that all CFDs arranged by utilities are subject to Commission review.
9. California Public Utilities Code Section 367(a) enumerates certain uneconomic costs which can be recovered beyond December 31, 2001.<sup>2</sup> Section 368(c) provides a mechanism to hedge some of these uneconomic costs.
10. In D. 87-05-062, the Commission adopted externally managed trust funds as the vehicle for accruing funds for the ultimate decommissioning of the nuclear power plants owned by California utilities. In that decision, the Commission also established guidelines for these trust agreements (Master Trust Agreements). Some of the Master Trust Agreements, approved by this Commission, mandate guidelines for a Committee to oversee these trusts. These Master Trust Agreements provide that "Ownership of minor amounts of the Company's stock and/or being a customer of the Company and/or having routine business relationships such as providing normal banking services shall not be regarded as creating such a conflict or an agency relationship."
11. In D. 97-08-058, we declined to grant PG&E authority to use energy-related derivative financial instruments. We stated in D.97-08-058, that while we recognize that many customers may desire price stability and predictability over a defined period, we do not intend that such contracts circumvent our prohibition of utility/customer bilateral contracts.
12. In Resolution E-3506, we point out that Edison alleges it would not have the incentive to manipulate Power Exchange (PX) prices or electric derivative prices. Edison claims attempts to increase the price of electricity to enhance the value of a gas financial instrument could potentially cause Edison shareholders to incur large losses. Edison contends any use of market power to affect PX prices is unlikely to affect the value of gas financial instruments. Edison alleges the price of electricity follows gas because substantial generating capacity uses gas, but the reverse is not true, except to the limited extent customers can substitute the two sources of energy. Edison points out that in its March 31, 1997 filing to the Federal Energy Regulatory Commission (FERC), Edison claims there will only be a few hours when it is a net seller. Edison claims it is proposing effective market power mitigations to FERC.

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<sup>2</sup> Section references are to Public Utilities Code, except as noted.

13. On October 30, 1997, in its Phase II Order, the FERC conditionally granted interim authorization for the utilities to sell electric energy at market-based rates through the PX, subject to mitigation measures and monitoring.

14. As reflected in Resolution E-3506, on page 4, item 10.

"Edison alleged electricity prices are highly correlated with fluctuations in the price of natural gas, and Section 368(c) provides for Edison to use gas instruments to hedge PX prices. Edison pledges not to enter into any gas hedging instruments with customers, generation facilities, or generator affiliates; contends the risk of nonrecovery of all of its transition costs in conjunction with its proposed program limits will minimize program costs; and is willing to flow back to ratepayers gains, net of any losses, from the use of these transactions, if all of Edison's transition costs are recovered." [Emphasis is added]

15. Ordering paragraph 1.g) of Resolution E-3506, prohibits Edison from entering into any contracts for differences with its customers, affiliates, or generation facilities. By Advice Letter 1259-E, Edison proposes the gas instruments authorized by Resolution E-3506 not be classified as contracts for differences.

16. Ordering paragraph 1.h) of Resolution E-3506 requires Edison to include language in any risk management contract it enters into under its authorized program to the effect that the other party to the instrument does not have or will not enter into any contracts with any of Edison's customers, affiliates, or generation facilities. By Advice Letter 1259-E, Edison proposes, instead, for Edison to submit to the Commission annually a certificate from Edison's outside auditor that Edison did not contract directly or indirectly with any Edison affiliate or Edison generation facility.

17. Edison's proposal by Advice Letter 1259-E, therefore, would allow contracts for differences and the gas risk management contracts with Edison's customers.

18. Finally, Edison submits revised tariffs pursuant to Resolution E-3506 and proposes two clarifying modifications to Resolution E-3506 to:

- a) clarify that the costs of the hedging program will not exceed \$150 million rather than that its energy needs would not exceed \$150 million;
- b) reflect that the Interim Balancing Account will be replaced by the Transition Cost Balancing Account effective January 1, 1998.

19. Commission staff met with Edison staff to gather further information regarding Advice Letter 1259-E and clarify issues. Edison expressed concern that the prohibition against entering into the gas risk management contracts with customers will prohibit any party who is only coincidentally a customer of Edison merely because it has an office in Edison's service territory from entering into such a contract with Edison, such as any of the large financial institutions. During these meetings, staff expressed concerns regarding the potential for anticompetitive transactions involving Edison's customers if the Commission permitted such transactions with customers. Specifically, staff described the potential for predatory pricing as discussed above and prohibited by the Preferred Policy Decision. Staff requested Edison to address these concerns in its advice letter and to modify its revised tariff sheet, No. 22546-E.

#### NOTICE

1. Edison Advice Letter 1259-E was served on other utilities, government agencies, and to all interested parties who requested such notification, in accordance with the requirements of General Order 96-A. Public notice of this filing has been made by publication in the Commission's calendar.

#### PROTESTS

1. On November 24, 1997, the ORA filed a Protest to Edison Advice Letter 1259-E.

2. The ORA asserts there is a potential for linkage between Edison contracting for a gas risk management contract and the terms under which a customer would obtain electric services from Edison. The ORA believes a total prohibition on Edison entering into a gas risk management contract with customers may increase contract costs or limit protection. The ORA proposes Edison be prohibited from directly contracting with its customers but Edison be permitted to contract with customers through an agent or broker, with certain restrictions.

3. The ORA asserts this expedited advice letter is not the appropriate procedural forum to clarify policy issues regarding contracts for differences.

4. The ORA recommends Edison be prohibited from entering into contracts for differences with those customers with whom Edison has contracted for a gas risk management instrument.

5. The ORA requests the Commission acknowledge the prohibition on Edison's recovery of any increased risk due to this hedging program does not preclude consideration of any reductions in risk.

6. The ORA requests modifications to Edison's proposed tariff language:
- a) That in the event the net out-of-pocket costs are less than zero, Edison should refund that net balance to ratepayers;
  - b) Interest eligibility should be determined with the compliance review;
  - c) Edison should reflect its opportunity rather than an absolute right to recover the out-of-pocket costs;
  - d) Edison should explicitly state that the out-of-pocket costs shall not exceed \$150 million and the program limit shall not be modified by any changes in estimated market value;
  - e) Edison should clarify accounting terminology and substitute the term "unamortized out-of-pocket costs" for "net book value."

7. On November 25, 1997, Edison responded to the ORA's protest. Edison asserts most of the ORA's suggested modifications are reasonable. Edison provided revised tariff sheets that it would be willing to file as substitute sheets. Edison proposes modifications to the ORA's proposed modification to ordering paragraph 1.h) of Resolution E-3506. Edison alleges it discussed its proposed modification with ORA and asserts the ORA is in agreement with the modifications. Edison also proposed minor modifications to the ORA's proposed modification to ordering paragraph 1.g) of Resolution E-3506. Finally, Edison states it does not object to the language proposed by ORA regarding the Commission acknowledging the prohibition on Edison's recovery of any increased risk due to this hedging program does not preclude consideration of any reductions in risk.

#### DISCUSSION

1. We do not intend that Edison's use of these gas risk management tools circumvent our prohibitions and restrictions contained in our Preferred Policy Decision, specifically:

- a) our prohibitions on utility-customer bilateral contracts and predatory pricing;
- b) that the Commission will continue to regulate the rates, terms, and conditions of the services of customers who choose to remain utility service customers; and
- c) that the market be able to send clear pricing signals.

2. ORA stated it finds the preferred policy decision, on page 81, is ambiguous about the ability of utilities to enter into CFDs with customers. ORA emphasized that it does not believe this "expedited advice letter is the procedural forum to clarify a policy

issue that is broadly applicable not only to all customers, but also to PG&E and SDG&E." We are therefore surprised that ORA went on to propose language to modify our Resolution E-3506 Ordering Paragraph 1.g. that would permit Edison to enter into CFDs with its customers.

3. We need to insure that, directly or through a third party, such contracts do not circumvent our regulation of the rates, terms, and conditions of the services of customers who choose to remain utility service customers.

4. This expedited advice letter is not the procedural forum to modify the Preferred Policy Decision and its prohibitions on customer/utility contracts. Therefore, we will not modify ordering paragraph 1.g) of Resolution E-3506, other than to clarify that contracts for differences should not be *directly or indirectly* entered into with customers, affiliates, or the utility's generation facilities.

5. On the other hand, we did not intend to limit Edison's use of these instruments by prohibiting Edison from entering into these gas risk management contracts with entities which may only have offices in Edison's service territory and whose energy use, as an Edison customer, is not the basis for the contract. Similarly, we do not limit nuclear decommissioning trust committee members from ownership of minor amounts of the utility's stock and/or being a customer of the utility and/or having routine business relationships such as providing normal banking services.

6. The language proposed by Edison, modified by ORA and then once again modified by Edison to replace our Ordering Paragraph 1.h. out of Resolution E-3506 is reasonable and will enable Edison to contract with parties who are only incidentally an Edison customer as we described above. Therefore it is reasonable to modify Ordering Paragraph 1.h) of Resolution E-3506 to state:

"Edison may not directly contract with any Edison customers for the gas instruments requested in Advice Letters 1247-E and 1247-E-A, provided, however, that Edison may enter into and administer contracts for gas instruments with an Edison customer, when those contracts have been negotiated by an agent or broker consistent with the following conditions:

- i. Edison may not direct any agent or broker to any particular party. Edison may direct an agent or broker to negotiate price, terms and conditions of the gas instruments and to select among the contracts and transactions identified by the broker or agent; and
- ii. Edison shall direct its agent or broker not to discuss any element of a customer's electricity usage, nor may any term or condition of the financial

instrument contract reference, mention or otherwise be tied to any aspect of a customer's electricity usage."

7. Edison's proposal to modify ordering paragraphs l.d) and l.k) clarifies our intent and these modifications should be granted.

8. The purpose of the gas risk management instruments is to allow Edison to hedge against higher PX prices for the energy it purchases for its customers when it cannot pass on those higher costs because of the rate freeze. This risk is potentially there so long as the rate freeze is in effect.

9. It is reasonable to adopt Edison's proposed modifications to its revised tariff sheets included in its response to the ORA's protest, as modified as follows:

Edison should clarify that cost recovery of the out of pocket costs shall not extend beyond the earlier of March 31, 2002 or the date on which the Commission - authorized costs for utility generation - related assets and obligations have been fully recovered.

10. In consideration that we did not adopt traditional protective mechanisms at this time and per Section 368(c) Edison may not recover any losses from changes in market prices, we stated in Resolution E-3506 that Edison shall not be compensated for any increases or perceived increases in its costs of capital that result from the use of these hedging activities. We did not intend to preclude consideration of any reductions to compensation for reduced risk. It is reasonable to clarify our intent, as raised by the ORA and acquiesced to by Edison.

11. The ORA's protest is moot because Edison agreed to the ORA's proposed changes.

12. Parties have received notice of the proposed changes and have had an opportunity to comment on or protest the proposed changes. Policy and legal issues have been addressed thoroughly in the protest and response. No material factual issues were raised. Therefore, evidentiary hearings are not required.

### FINDINGS

1. On November 14, 1997, Edison filed Advice Letter 1259-E requesting modifications to Resolution E-3506 to classify the approved gas risk management instruments not as contracts for differences, to permit Edison to enter into these instruments with customers, and in lieu of the language to be required in any of Edison's



risk management contracts that Edison be required to provide independent certification that Edison has not directly or indirectly entered into a risk management contract with any of its affiliates or Edison's generation facilities. Additionally, Edison submitted revised tariff sheets, pursuant to Resolution E-3506, to implement a Risk Management Tools Memorandum Account.

2. The ORA protests Advice Letter 1259-E. The ORA's protest is moot because Edison agreed to the ORA's proposed changes.

3. Edison's and ORA's proposed modifications to Ordering Paragraphs 1.g) would circumvent prohibitions and restrictions contained in our Preferred Policy Decision.

4. This expedited advice letter process is not the proper forum to modify the preferred policy decision.

5. We did not intend to limit Edison's use of these instruments by prohibiting Edison from entering into these gas risk management contracts with entities which may only have offices in Edison's service territory and whose energy use, as an Edison customer, is not the basis for the contract

6. Edison's and ORA's proposed modifications to ordering paragraph 1.h are reasonable and should be adopted.

7. Edison Advice Letter 1259-E should be approved with the following modifications:

- a) Ordering paragraph 1.d) of Resolution E-3506 should be replaced with the following:

Edison's use of gas hedging instruments is limited to hedging energy costs that are subject to gas price fluctuations. Our understanding is that such energy is approximately 40-60% of Edison's energy needs over time, and that the costs of hedging such risks will not exceed \$150 million;

- b) Ordering paragraph 1.g) of Resolution E-3506 should be replaced with the following:

Edison shall not directly or indirectly enter into any contract for differences with its customers, affiliates or Edison's generation facilities, except as permitted in 1.h. below;

- c) Ordering paragraph 1.h) of Resolution E-3506 should be replaced with the following:

Edison may not directly contract with any Edison customers for the gas instruments requested in Advice Letters 1247-B and 1247-E-A, provided, however, that Edison may enter into and administer contracts for gas instruments with an Edison customer, when those contracts have been negotiated by an agent or broker consistent with the following conditions:

- i. Edison may not direct any agent or broker to any particular party. Edison may direct an agent to broker to negotiate price, terms and conditions of the gas instruments and to select among the contracts and transactions identified by the broker or agent; and
- ii. Edison shall direct its agent or broker not to discuss any element of a customer's electricity usage, nor may any term or condition of the financial instrument contract reference, mention or otherwise be tied to any aspect of a customer's electricity usage.

- d) Ordering paragraph 1.k) of Resolution E-3506 should be replaced with the following:

Out-of-pocket costs will be reviewed for compliance in the annual transition costs proceeding before being booked into the Transition Cost Balancing Account.

- e) Edison's proposed modifications to its revised tariff sheets included in its response to the Office of Ratepayer Advocates' (ORA) protest are reasonable and should be adopted with the following modification:

Edison shall clarify that cost recovery of the out of pocket costs shall not extend beyond the earlier of March 31, 2002 or the date on which the Commission - authorized costs for utility generation related assets and obligations have been fully recovered.

8. It is reasonable to clarify our intent that we did not intend to preclude consideration of any reductions to compensation for reduced risk

9. Evidentiary hearings are not required

**THEREFORE, IT IS ORDERED that:**

1. Southern California Edison Company (Edison) Advice Letter 1259-E is approved with the following modifications and clarifications:

- a) Ordering paragraph 1.d) of Resolution E-3506 is replaced with the following:

Edison's use of gas hedging instruments is limited to hedging energy costs that are subject to gas price fluctuations. Our understanding is that such energy is approximately 40-60% of Edison's energy needs over time, and that the costs of hedging such risks will not exceed \$150 million;

- b) Ordering paragraph 1.g) of Resolution E-3506 is replaced with the following:

Edison shall not directly or indirectly enter into any contract for differences with its customers, affiliates or Edison's generation facilities, other than is permitted in 1.h below;

- c) Ordering paragraph 1.h) of Resolution E-3506 is replaced with the following:

Edison may not directly contract with any Edison customers for the gas instruments requested in Advice Letters 1247-E and 1247-E-A, provided however, that Edison may enter into and administer contracts for gas instruments with an Edison customer, when those contracts have been negotiated by an agent or broker consistent with the following conditions:

- i. Edison may not direct any agent or broker to any particular party. Edison may direct an agent or broker to negotiate price, terms and conditions of the gas instruments and to select among the contracts and transactions identified by the broker or agent; and
- ii. Edison shall direct its agent or broker not to discuss any element of a customer's electricity usage, nor may any term or condition of the financial instrument contract reference,

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mention or otherwise be tied to any aspect of a customer's electricity usage; and

- d) Ordering paragraph 1.k) of Resolution E-3506 is replaced with the following:

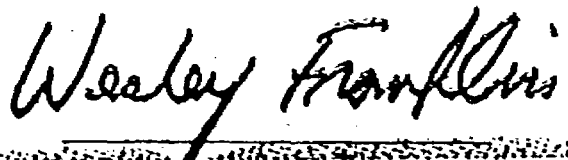
Out-of-pocket costs will be reviewed for compliance in the annual transition costs proceeding before being booked into the Transition Cost Balancing Account.

2. Edison's proposed modifications to its revised tariff sheets included in its response to the Office of Ratepayer Advocates' (ORA) protest are adopted, as modified as follows:
3. The cost recovery of the out of pocket cost shall not extend beyond the earlier of March 31, 2002 or the date on which the Commission - authorized costs for utility generation related assets and obligations have been fully recovered.
4. The ORA's protest is denied as moot.
5. Edison Advice Letter 1259-E shall be marked to show that it was approved with modifications by Commission Resolution E-3511.
6. On or before December 24, 1997, Edison shall file a supplemental Advice Letter with revised tariff sheets to reflect the above changes. The tariff sheets shall be effective on filing.

This Resolution is effective today.

I hereby certify that this Resolution was adopted by the Public Utilities Commission at its regular meeting on December 16, 1997. The following Commissioners approved it:

December 16, 1997



WESLEY FRANKLIN  
Executive Director

P. Gregory Conlon, President  
Jessie J. Knight, Jr.  
Henry M. Duque  
Josiah L. Neeper  
Richard A. Bilas  
Commissioners

I will file a partial dissent  
JOSIAH L. NEEPER  
Commissioner