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PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

COMMISSION ADVISORY
AND COMPLIANCE DIVISION
Energy Branch

RESOLUTION G-2770
January 28, 1988.

R E S O L U T I O N

RESOLUTION G-2770, SOUTHERN CALIFORNIA GAS COMPANY REQUESTING APPROVAL OF A GAS TRANSMISSION SERVICE CONTRACT WITH HARBOR COGENERATION COMPANY FOR ENHANCED OIL RECOVERY USE; BY ADVICE LETTER 1746, FILED NOVEMBER 5, 1987.

SUMMARY

By Advice Letter No. 1746, filed November 5, 1987 Southern California Gas Company (SoCal) submitted for approval a 15 year Gas Transmission Service Contract with Harbor Cogeneration Company (Harbor) in accordance with Decision (D.) 86-12-009 and Rate Schedule GLT, Long Term Transportation of Customer-Owned Gas.

BACKGROUND

1. SoCal Rate Schedule GLT is applicable to long-term transportation of customer-owned natural gas for use in Enhanced Oil Recovery (EOR) facilities as provided by Decision 86-12-009, including gas used for combined EOR/cogeneration facilities and under the terms of a negotiated Gas Transmission Service Contract. Transportation service under this schedule is limited to volumes equal to or in excess of 250,000 therms per year to each customer's premises as defined in SoCal's Rule No. 1, Definitions.

2. The rate schedule provides that the Utility and customer shall negotiate a transmission rate, a Customer Charge and an appropriate escalation factor to be stated in the Gas Transmission Service Contract. A separate priority charge may be negotiated, a Demand Charge component also may be included. The negotiated transmission rate shall be set neither below the floor rate (short-term marginal cost) nor above the ceiling, default rate (long-term marginal cost).

3. The rate also will include any applicable taxes, fees, regulatory surcharges, intra-or-interstate pipeline charges imposed as a result of transporting gas under the schedule. In the event customer delivers more or less gas into the Utility system than it accepts on redelivery, such imbalances shall be specifically provided for in the contract.

4. To renew the terms of service under the Service Contract, notice from the customer is required at least fifteen days prior to the expiration of the existing contract, and renewal is subject to available capacity on the Utility system as determined by the Utility. At the end of the initial term, the original rate will be revised to an appropriate negotiated rate at the time of renewal.

5. Customers may receive service under the GLT schedule (a) separately or (b) in combination with an applicable sales rate schedule. Where service is rendered under (b), a separate monthly customer charge shall be applicable for service under each schedule. If service is rendered under (a), the customer must still meet the terms and conditions of the customer's otherwise applicable sales rate schedule.

6. Harbor Cogeneration Company, an affiliate of Union Pacific Resources Company of Colorado, is engaged in Enhanced Oil Recovery (EOR) in the Los Angeles Basin. The initial volumes to be transported will be 240,000 therms per day for combined EOR cogeneration steamflood use at a single location. The contract term is for 15 years; the negotiated rate is 3.675¢ per therm with an escalation factor of 3% to 5%.

PROTEST BY DRA

1. The California Public Utilities Commission (CPUC) Division of Ratepayer Advocates (DRA) filed a protest November 25, 1987 to SoCal'- Advice Letter No. 1746, declaring that the contract terms put both SoCal and its ratepayers at significant risk. DRA objects to the Harbor contract's lack of a transmission fuel use clause, and the contract term of 15 years in conjunction with a 3% to 5% rate escalation factor, without a contract negotiation reopener clause.

2. DRA contrasts the Harbor contract with Pacific Gas & Electric Company's (PG&E) recently filed EOR contracts under Advice Letter 1435-G (see Resolution G-2765, approved December 17, 1987.) stating that PG&E, on the other hand, appears to have "negotiated a fair contract that protects itself, the customer and ratepayers."

3. DRA states that the lack of a fuel use factor causes SoCal to be responsible for providing the necessary incremental fuel used to deliver the transported gas to the customer. "By not charging the customer for fuel in kind or as a function of the system average cost of gas, SoCal puts all other ratepayers at risk for its gas buying ability, and disadvantages ratepayers who cannot get similar terms in their transportation agreements. The risk comes from the variable percentage of the transportation rate fuel costs comprise."

4. DRA states that if fuel prices remain at the current level, the incremental fuel use costs will decline over time. But, they argue that, "if gas prices rise the fuel component will increase dramatically and will likely vary significantly from month to month over the life of the contract." If this situation occurs, the fuel use for transporting the gas could erode the transportation rate to a level approaching, or going below the floor rate of 1¢ per therm (short-run marginal cost). DRA attaches a table to demonstrate the effects of escalating fuel use costs under the negotiated terms of the Harbor contract (see Attachment A).

5. Additionally, DRA contends that the contract 3% to 5% escalation rate tied to SoCal's margin and not to inflation, could result in a transportation rate much lower than the cost of serving this customer. They state that if SoCal's margin is affected by greater than 5% inflation, despite efforts to control margin growth, the risk of serving Harbor causes considerable concern. They state that this effect is even greater in consideration of fuel costs, which tend to rise faster than inflation.

6. DRA recommends that a sound long-term contract should contain a contract repoener clause to provide SoCal an opportunity to adjust the contract rate to reflect the effects of its actions and the results of changes it has no control over.

SOCAL'S RESPONSE TO PROTEST

1. SoCal responds to the DRA protests, charging that in each instance, "the Harbor contract falls well within adopted Commission policies for the EOR market, while DRA recommendations directly conflict with those policies."

2. Regarding the cost of fuel use, SoCal cites Decision (D.) 86-12-009,(pp65-66) stating that the Commission authorized the utilities to negotiate rates with all noncore customers down to a floor of short-run marginal cost, and

that "negotiated EOR rates could conceivably approach the variable cost of transmission currently estimated at 1¢ per therm." They argue that "by definition, the 'variable cost of transmission' includes the cost of fuel (use)." Therefore, if they included a separate charge for fuel use in their contracts, they would be imposing a second charge for incremental fuel use.

3. SoCal continues by stating that "EOR revenues are strictly incremental, and none of the costs of utility service are allocated to the EOR market. Therefore, EOR revenues above variable cost constitute pure benefit to other ratepayers with no risk of imposing additional costs."

4. In response to the DRA argument that the Harbor contract imposes a risk of rising fuel costs on other ratepayers, SoCal states that "as long as the negotiated EOR rate is above the variable cost floor (1¢ per therm), the contract imposes no risk on other ratepayers."

5. Regarding the DRA protest of the Harbor contract escalation rate, SoCal cites D. 85-12-102 (p. 25b) which states "this escalation rate will be limited to a range of three to five percent" and further that it will be "escalated by changes in the utilities' margin in subsequent years."

6. In response to the DRA complaint that the contract should have a clause allowing for periodic reopening of the contract terms, SoCal cites D. 86-12-009 (p. 68) arguing that the Commission authorizes that EOR contracts "having terms of 5, 10, 15 or even 20 years may be necessary to satisfy their service needs" and that "the utilities may need to secure a 'pricing premium' to respond to the 'added risks' of such long-term contracts, but nowhere does it mention a reopener clause."

7. SoCal adds that they have included a 50% take-or-pay requirement rather than a reopener clause to respond to the risk of a 15-year contract, as suggested by the Commission in D. 85-12-102.

DISCUSSION

1. The Commission segregated EOR customers from other ratepayers in Decision 85-12-102, allowing the utilities the negotiating flexibility they required to meet the needs of their EOR customers and to meet the competition of the interstate pipeline proposals. The Commission limited the escalation rate to a range of three to five percent, but added further that the "utilities will be free to negotiate

any type of appropriate escalation factors (such as an escalation index based on changes in field crude oil prices) or other rate provisions as appropriate for EOR customers."

2. D.85-12-102 also stated that "should a negotiated rate ever become less than the floor described above (3¢ per therm at the time), shareholders will be at risk for making up the deficiency." And, Finding 54 (at p.46) states: "A 50% take-or-pay provision is a reasonable condition to all long-term transportation agreements in order to encourage transportation customers to transport their own gas for the entire life of their contract."

3. D.85-12-102 set contract term minimums at 5 years, envisioning contracts up to even 20 years. No conditions were placed on the utilities to establish contract reopeners, but instead, the utilities were urged to negotiate the best terms possible with this new, emerging market.

4. In an continuing effort to support the utilities in negotiating EOR contracts at substantially competitive rates to the extent that the EOR customers would be retained on the utility systems and the utilities would avoid the threat of bypass, the Commission determined that all EOR revenues were to be treated as incremental. D. 86-12-009 established that the floor for this market was 1¢ per therm. D.87-05-046 changed the incentive mechanism established in D.85-12-102[1] to reflect the lower floor rate of 1¢ per therm, allocating revenues above the floor rate 5% to shareholders and 95% to ratepayers.

5. The implementation decision D.87-12-039 resolves the final issue whether or not incremental fuel use is included in the calculation of short-run marginal costs, or, the floor rate. The SoCal Cost Allocation Summary in D.87-12-039 (p.80) identifies Franchise and Uncollectibles, Company Use Gas, and (Lost and Unaccounted For Gas) in the development of the short-run marginal cost methodology. The inclusion of Company Use Gas within this calculation establishes that the incremental gas used for transport has been considered in the floor rate.

6. The staff of the Commission Advisory and Compliance Division (CA&CD) has reviewed the terms of SoCal's Harbor

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1 Based on 3¢ per therm, the incentive mechanism applied to amounts collected above 3¢ per therm, allocating 25% of any overage to shareholders and 75% to ratepayers.

EOR contract and has determined that it is in compliance with Commission Decisions 85-12-102, 86-12-009, 87-05-046 and
87-12-039.

7. Public notification of these filings has been made by mailing copies of the advice letter to other utilities, governmental agencies, and to all interested parties who requested them.

8. No other protests were received regarding this advice filing.

9. Based on CACD review of the filing, including the protests and SoCal Gas' response, the Commission concurs with SoCal Gas' advice letter and with the response to the protests.

10. The major concern raised by DRA is that the general body of ratepayers not subsidize service to EOR customers. This concern apparently precipitated from D.87-03-044, which lowered noncore ceiling rates from unscaled replacement cost down to embedded cost. By lowering ceiling rates, the Commission did not intend to suggest that SoCal or PG&E would be expected to recover revenues from EOR customers based on full embedded cost. Such a requirement would be contrary to the Commission's committment to provide reliable and competitive service to the EOR market.

11. The EOR market is attractive because it represents incremental load at a time when SoCal and PG&E have excess capacity to serve this load. As long as the rates negotiated with EOR customers exceed the marginal cost of service, all ratepayers will benefit from the additional contribution to cover the utilities' fixed cost. The adage that "some margin is better than none" explains why the floor was set at a rate equal to short-run marginal cost in D.86-12-009. It also explains the Commission's opposition before FERC regarding the certification of a new interstate pipeline to serve the EOR market. Serving the incremental EOR market with the utilities' existing facilities can be positive for ratepayers because there is no subsidy flowing to the EOR market, as long as rates exceed the marginal cost of service.

12. In D.86-12-009, the Commission required the utilities to file all long-term contracts (contracts with terms of five years or more) with the Commission for approval by advice letter. This procedure was instituted to protect ratepayers from some of the risks inherent in long-term contracts that offer pricing certainty. It also affords the Commission with the opportunity to assure that all long-term contracts

are consistent with the guidelines established in D.86-12-009 and D.86-12-010. The Commission has reviewed the SoCal/Harbor contract to see that it meets the general guidelines established in D.86-12-009. But, this review should not insulate utilities from their responsibility to negotiate reasonable long-term contracts in the interest of all utility ratepayers. The Commission has stated in D.86-12-009 that the utilities bear some of the risks of long-term contracts and are responsible for negotiating contracts that are consistent with market realities (D.86-112-009 at mimeo pp. 41-42).

13. DRA states its concern over the 3% to 5% escalation factor, the 15 year contract term, and the treatment of fuel and line losses. The Commission finds particular merit in DRA's comments regarding fuel and line losses, and reopener provisions due to substantially changed circumstances. However, while DRA's points are well taken, the Commission believes that on balance, the SoCal Harbor contract is reasonable in light of current market conditions and the importance of serving the EOR market.

14. As discussed above, the fact that the negotiated 3.675 cent/therm rate is below embedded cost does not indicate that it is unreasonable. The negotiated rate is clearly above the 1 cent/therm floor established in D.86-12-009. The Commission believes that the negotiated rate bears a reasonable relationship to current market conditions and will provide ratepayers with significant margin contribution over the life of the contract.

FINDINGS

1. The enhanced oil recovery market currently represents the largest new market for natural gas in California.

2. It is reasonable for SoCal Gas to provide service to Harbor under the terms and conditions of this contract to maintain sales at competitive natural gas prices, in accordance with Decision 86-12-009.

3. We find that said agreements comply with our guidelines for long-term gas transportation rates, therefore,

IT IS ORDERED, that:

1. Southern California Gas Company is authorized, under the provisions of Public Utilities Code Sections 491 and 532, to enter into the agreements with Harbor Cogeneration Company for the transportation of natural gas as submitted by Advice Letter 1746-G.

2. Southern California Gas shall be required to furnish data to establish the volumes, price, and priority used for this contract, and the contribution to margin from this contract annually, and at the time of each revision in the transportation rate, beginning sixty (60) days after the first such revision in rates. This information shall be sent to the Chief of the Energy Branch, Commission Advisory and Compliance Division.

3. Advice letter 1746 and the accompaning agreement shall be marked to show that they were approved by Commission Resolution G-2770.

4. This Resolution shall be served on all parties to the Commission's ongoing Rate Design proceedings in OII 86-06-005 and OIR 86-06-006.

5. This Resolution is effective today.

I certify that this Resolution was adopted by the Public Utilities Commission at its regular meeting of January 28, 1988. The following Commissioners approved it:

Executive Director

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

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are consistent with the guidelines established in D.86-12-009 and D.86-12-010. The Commission has reviewed the SoCal/Harbor contract to see that it meets the general guidelines established in D.86-12-009. But, this review should not insulate utilities from their responsibility to negotiate reasonable long-term contracts in the interest of all utility ratepayers. The Commission has stated in D.86-12-009 that the utilities bear some of the risks of long-term contracts and are responsible for negotiating contracts that are consistent with market realities (D.86-112-009 at mimeo pp. 41-42).

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3. Advice letter 1746 and the accompaning agreement shall be marked to show that they were approved by Commission Resolution G-2770.

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5. This Resolution is effective today.

I certify that this Resolution was adopted by the Public Utilities Commission at its regular meeting of January 28, 1988. The following Commissioners approved it:

STANLEY W. HULETT
President
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Executive Director