PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

COMMISSION ADVISORY
AND COMPLIANCE DIVISION
Energy Branch

RESOLUTION G-3187**
June 6, 1996

R E S O L U T I O N

RESOLUTION G-3187. SAN DIEGO GAS & ELECTRIC COMPANY REQUEST TO REVISE ITS GAS PROCUREMENT PERFORMANCE BASED RATEMAKING MECHANISM PROCEDURE.

BY ADVICE LETTER 1010-G, FILED ON APRIL 8, 1996.

SUMMARY

1. This Resolution approves San Diego Gas & Electric Company's (SDG&E's) request to revise indices used in the calculation of benchmarks for the Gas Procurement Performance Based Ratemaking (PBR) mechanism.

2. There were no protests to Advice Letter (AL) 1010-G.

BACKGROUND

1. The SDG&E Gas PBR was authorized in D.93-06-092 as a two year experiment beginning August 1, 1993. By D.95-04-051, this authority was continued for a third year to run August 1995 through July 1996.

2. The Gas PBR is used to approve SDG&E's natural gas purchasing activities. The purpose of the Gas PBR is to provide an incentive to SDG&E to minimize the costs of its gas supplies and transportation, consistent with providing efficient operations and reliable service to its customers. The Gas PBR incentive is two-fold. First, it utilizes a market-based gas price benchmark to approve gas procurement transactions. Under the Gas PBR, SDG&E is given the ability to procure gas under any contract terms that it deems appropriate, with only the resulting annual total cost of gas being judged by the Commission against an industry benchmark. Second, the Gas PBR provides a financial incentive through the provision of shared savings and costs between SDG&E's shareholders and ratepayers. The reward/penalty is based on SDG&E's ability to beat spot market indices in its purchases of natural gas.

3. The Gas PBR consists of Part A, which measures SDG&E's actual purchased gas costs from the gas basins against a volume-weighted market index, or "benchmark", of applicable basin/pipeline receipt points, and Part B, which is designed to encourage the utility to lower the total delivered cost of gas to its customers by including transportation in the comparison of actual purchased gas costs against an average basin index and firm transportation rate.

4. Savings or costs resulting from differences between the utility's actual gas cost and the market benchmark are shared between the utility's customers and shareholders. Fifty percent of the savings under Part A and five percent of the savings under Part B accrue to shareholders.

5. By AL 1010-G, SDG&E requests to make two modifications to benchmarks for its Year 3 PBR operations. The first would change the calculation of the Average Index used in the Part A benchmark. This change also affects the Delivered Price Index used to calculate the Part B benchmark. The second modification would replace the Proxy Basin Index and Proxy Transportation Index with a single California border index for evaluating gas procurement costs in non-southwest supply basins.

6. The Advice Letter points to the Commission's Division of Ratepayer Advocates' (DRA) February 2, 1996, "Monitoring and Evaluation Report on San Diego Gas and Electric Company's Performance Based Ratemaking Gas Procurement Second Year Results" for additional explanations and reasons for the requested modifications.

7. In its second year report, DRA recommends that the Commission approve these modifications to SDG&E's Gas PBR for the third PBR year (August 1995 through July 1996). SDG&E requests the August 1, 1995 effective date in this Advice Letter.

NOTICE

1. Public notice of this advice letter was made by publication in the Commission calendar and by SDG&E's mailing copies to utilities and other interested parties, including parties to A.92-10-017 (SDG&E's PBR docket) and A.95-10-006 (SDG&E's 1996 ECAC proceeding).

PROTESTS

1. No protests were received to this Advice Letter.

DISCUSSION

1. The requested modifications improve the Gas PBR by reflecting new information about the gas market in which SDG&E participates. They are easy changes and would retain the basic structure of the Gas PBR.

Modification to the Average Index

2. SDG&E proposes to modify the calculation of the Average Index (AI) of southwest basin gas purchases by deleting the Anadarko/El Paso indicated basin pipeline (IBP) receipt point and adding a new IBP for the San Juan/Transwestern.

3. The AI is the market price index for the cost of mainline gas in the Part A benchmark. It is presently calculated by using published indices for the four IBPs in the Southwest. The AI is calculated using a weighted average of the published indices for the IBPs, based on the volumes of gas that SDG&E actually purchases at the IBPs. SDG&E states that, due to the higher prices and distance from California, it will no longer purchase gas supplies from the Anadarko/El Paso basin. The Anadarko/El Paso IBP component of the AI has become superfluous to the Gas PBR and should be eliminated.

4. The addition of a San Juan/Transwestern index is requested because SDG&E procures a significant percentage of its supplies from the San Juan basin and expects that, in the future, it will increase its purchases from there. When the Gas PBR was developed there was no San Juan/Transwestern basin index available but there was always an expectation that such an index would ultimately be utilized. Because the AI does not have a component for San Juan/Transwestern Gas purchases, SDG&E's Transwestern purchases are being evaluated against the Permian basin index. It has been a satisfactory arrangement because, historically, the San Juan basin gas price has been similar to the Permian basin gas price.

5. However, since January 1995, gas prices in the San Juan basin have become considerably less than in the Permian basin, creating an incentive for San Juan purchases over Permian basins purchases, although SDG&E's gas PBR evaluation remains against Permian basin prices. In addition, the access SDG&E has had on the Transwestern pipeline via its SoCalGas capacity contract did not provide direct access to the San Juan basin. With the expiration of SDG&E's contract with SoCalGas, SDG&E has opportunity to make direct San Juan basin purchases on Transwestern. A reliable price index for gas purchases from San Juan on the Transwestern pipeline is now available and would provide a more accurate representation of SDG&E's San Juan gas purchases.

6. DRA states in its second year report on SDG&E's Gas PBR that if the above change, in particular, is not made, the Gas PBR will provide SDG&E windfall profits. Supplemental information provided to the Commission Advisory and Compliance Division (CACD) by DRA indicates that SDG&E's performance reward for the third year Gas PBR, under current benchmark indices would be an estimated $9 million and its reward, under the proposed benchmark indices, would be an estimated $2 million. The estimated $7 million savings to ratepayers is based on existing market conditions, forecasted to July 31, 1996, the end of the year 3 Gas PBR.

Modification to the Delivered Price Index

7. SDG&E points out that the Delivered Price Index (DPI) used in Part B benchmark is derived from the AI used in the Part A benchmark. SDG&E requests authority to change the DPI in the Part B benchmark to reflect the requested changes to basin indices in the AI for Part A.

Adoption of a California Border Index

8. SDG&E proposes to replace the Proxy Basin Index (PBI) and Proxy Transportation Index (PTI), which together comprise the Proxy Index (PI) for the Part A benchmark comparison of Other Source Gas supplies, with a single California Border Index (CBI). ("Other Source of Gas" consists of non-southwest basin supplies: e.g., Canadian Gas, gas produced in California, and gas purchased at the California border.) The CBI would measure the price of delivered gas supplies to the California border into the Southern California pipeline system. SDG&E points out that, using the CBI instead of the PI, also eliminates the previous volume-weighted average calculation.

9. Until recently, there was no index or reliable data available for use as a benchmark to measure SDG&E's performance against gas delivered to the California border. Published index data is now available and SDG&E requests to replace the PBI and the PTI with the new CBI. The CBI will be calculated by averaging the prices of gas delivered to the Southern California border, as reported in specific publications.

10. As currently configured, the PBI may artificially inflate the Gas PBR shared savings and reward calculations. For example in today's market, Permian gas is significantly more expensive than San Juan gas. So with the PBI being dependent on the mix of purchases made in the Southwest supply basins, SDG&E's purchases from Permian are reflected in the PBI. However, to the extent SDG&E buys Permian basin gas instead of San Juan basin gas the benchmark increases. SDG&E's border purchases may contain relatively low volumes of Permian gas, but its purchase of any Permian gas, nonetheless, will exaggerate the differential between actual costs and the benchmark. A change to the CBI would provide a more efficient and a more accurate assessment of SDG&E's purchasing performance.

Statutory Authority for Modifications

11. SDG&E states that in its PBR Decision, D.93-06-092, at Conclusion of Law 6, page 59, the Commission provided authority for adjustments to be made to the Gas PBR mechanism to reflect new or different Gas basin price indices:

> "During the Gas PBR experiment, we may need to modify the gas indices to deal, for example with new supply basins. Such modification would require our prior approval. SDG&E should file an advice letter to request a change already contemplated in the record herein."

12. Accordingly, CACD recommends the Commission approve SDG&E's request to remove the Anadarko/El Paso basin index from the AI calculation and to add the San Juan/Transwestern basin index.

13. CACD recommends the Commission approve SDG&E's request to change the calculation of the DPI used to compute the Part B benchmark, consistent with the revised AI in Part A.

14. CACD recommends the Commission approve SDG&E's request to replace the PBI and the PTI with the CBI.

15. The effective date of the authority to modify the Gas PBR is more problematic. SDG&E states that it agrees with DRA that the changes to its Gas PBR should be made effective August 1, 1995. We are troubled that SDG&E and DRA are proposing the changes for a performance period that has in part passed, as it contravenes the spirit of PBR which was adopted to eliminate or minimize disputes by setting rules, benchmarks and such in advance of the performance to be evaluated.

16 It is a well established tenet of the Commission that ratemaking is generally done on a prospective basis. (See, e.g., Southern California Water Co., D.92-03-094, 43 Cal.P.U.C.2d 596, 600. The Commission's practice is not to authorize changes in utility rates based on formulas adopted after the fact. Rather it is the Commission's normal practice to first authorize a formula for adjusting rates, and thereafter adjust rates on that basis. This practice is consistent with the rule against retroactive ratemaking.

17. This practice is particularly appropriate in the case of PBR. Under PBR a utility's revenue requirement is adjusted to include rewards or penalties for exceeding or failing to meet pre-established benchmarks. This incentive-based system generally would be undermined if a benchmark were changed after a performance period has begun. Accordingly, our normal practice is, and will be, to change a benchmark only for a performance period that has not yet commenced as of the date of the Commission's order.

18. Despite these general practices, we believe that an exception is justified under the peculiar circumstances presented here. As a preliminary matter, we note that the proposed new benchmark more closely meets the goals for this benchmark set forth in our earlier decision. Indeed, the SDG&E Gas PBR was begun as an experiment and then renewed for one additional year. (See D.93-06-032 and D.95-04-051.) Thus, we clearly contemplated making changes as necessary to make the basic program work.

19. More importantly, the change requested here will result in a revenue requirement reduction for the current period. This fact is important for several reasons. First, to the extent that questions about retroactive ratemaking might be raised, it is clear that the only party that might be harmed by any retroactive change is the utility. By requesting the change, the utility has waived any objection it might otherwise be able to raise. The second reason is more practical, but very important. If utilities believed that they could request retroactive changes in benchmarks that would result in increased revenue requirements relating to past periods, the Commission could easily be inundated with such requests. This would waste the Commission's time and be unfair to opposing parties that lack the resources to vigorously oppose such requests.

20. Based on the information provided to CACD at its request, the change in revenue requirement for the current performance period will be negative. Accordingly, we believe that it would be appropriate to authorize the change in benchmark back to the date requested by SDG&E. To the extent this might raise any retroactive ratemaking concerns, the only party harmed is SDG&E, and it has waived its right to complain by asking for the change. We stress that in granting this request (which includes the portion of the performance period prior to the date of today's Resolution) we do so based on the negative change in revenue requirement.

21. As this advice letter states, the requested changes will "improve the incentive mechanism and better reflect the gas market in which SDG&E participates". PBR parameters must measure the right thing to give the intended risk/reward balance. We note, however, that market conditions continue to change and that conditions may well develop to justify further modification to the Gas PBR in the future. We stress, therefore, the importance of the ongoing monitoring and evaluation program to flag potential problems and to affect minor remedies. If unforeseen changes have major detrimental consequences to PBR goals and objectives, parties should bring the situation to our attention for timely, appropriate action.

FINDINGS

1. San Diego Gas & Electric Company (SDG&E) filed AL 1010-G on April 8, 1996 requesting revision of indices used in the calculation of benchmarks for the Gas Procurement Performance Based Ratemaking (PBR) mechanism.

2. SDG&E proposes to modify the calculation of the Average Index (AI) of southwest basin gas purchases by deleting the Anadarko/El Paso indicated basin pipeline (IBP) receipt point and adding a new IBP for the San Juan/Transwestern.

3. The Anadarko/El Paso IBP component of the AI has become superfluous to the Gas PBR and should be eliminated.

4. No San Juan/Transwestern basin index was available when the Gas PBR was developed, but there was always an expectation that such an index would ultimately be utilized.

5. A reliable San Juan/Transwestern price index is now available and would provide a more accurate representation of SDG&E's San Juan purchases.

6. The proposed modification to SDG&E's third year Gas PBR is anticipated to result in a $7 million reduction in its performance reward.

7. The Delivered Price Index (DPI) used in the Part B benchmark is derived from the AI used in Part A. Therefore, a change to the AI affects the calculation of the DPI used to compute the Part B benchmark.

8. SDG&E proposes to replace the Proxy Basin Index (PBI) and Proxy Transportation Index (PTI), which together comprise the Proxy Index (PI) for the Part A benchmark comparison of Other Source Gas supplies, with a single California Border Index (CBI).

9. Until recently, there was no index or reliable data available for use as a benchmark to measure SDG&E's performance against gas delivered to the California border. Published index data is now available and SDG&E requests to replace the PBI and the PTI with the new CBI. The CBI will be calculated by averaging the prices of gas delivered to the Southern California border, as reported in specific publications.

10. As currently configured, the PBI may artificially inflate the Gas PBR shared savings and reward calculations. A change to the CBI would provide a more efficient and a more accurate assessment of SDG&E's purchasing performance.

11. SDG&E requests that the effective date of this authority to be retroactive to August 1, 1995. It is a well established tenet of the Commission, however, that ratemaking is generally done on a prospective basis.

12. Incentive based ratemaking generally would be undermined if a benchmark were changed after a performance period has begun.

13. Despite these general practices, an exception is justified under the peculiar circumstances presented here, in that, the change requested here will result in a revenue requirement <u>reduction</u> relating to the current performance period.

14. To the extent the change raises retroactive ratemaking concerns, the only party harmed is SDG&E, and it has waived its right to complain by asking for the change.

15. CACD recommends the Commission authorize the change in benchmark effective August 1, 1995, as requested by SDG&E.

16. Granting this request is based on the negative change in revenue requirements for the current performance period.

THEREFORE, IT IS ORDERED that:

1. San Diego Gas and Electric Company Advice Letter 1010-G and attached tariff sheets are approved.

2. As requested, this Resolution shall be effective retroactively to August 1, 1995 for purposes of calculating the company's third year Gas Purchases Performance Based Ratemaking rewards and penalties.

3. Approval of this Advice Letter is not precedent for considering changes in performance rewards that would result in an increase in revenue requirements relating to performance periods that have passed in whole or part.

I hereby certify that this Resolution was adopted by the Public Utilities Commission at its regular meeting on May 22, 1996. The following Commissioners approved it:

Wesley Franklin

Wesley Franklin
Executive Director

P. GREGORY CONLON
President
JESSIE J. KNIGHT, Jr.
HENRY M. DUQUE
JOSIAH L. NEEPER
Commissioners

Commissioner Daniel Wm. Fessler,
being necessarily absent,
did not participate.