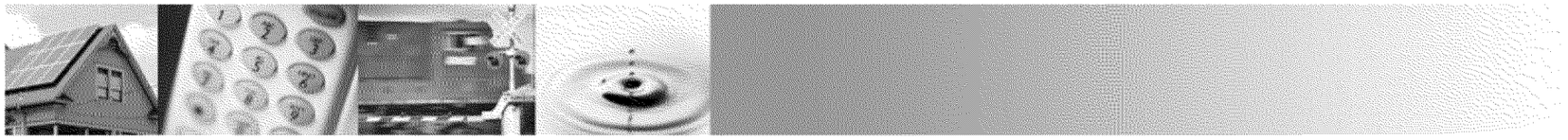
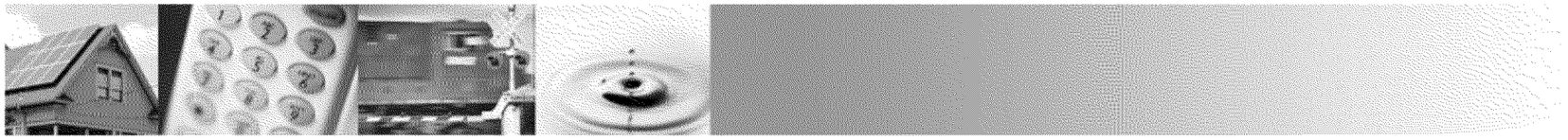


Opening Address Regulatory Review of Utility Hedging Programs

Commissioner Timothy A. Simon

California Public Utilities

American Gas Association Energy Market Regulation Conference
Thursday, September 30, 2010



Overview

I. Background – Natural Gas in California

II. California Consumption and Supply of Natural Gas and the Need for Financial Hedging

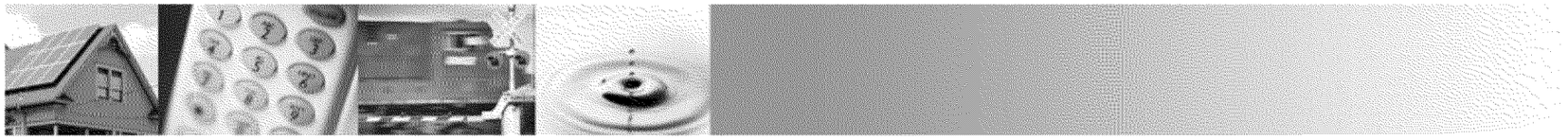
III. Review of Incentive Regulation Mechanism for Gas Utilities

IV. CPUC Policy Gas Cost Incentive Ratemaking and the Costs of Financial Hedging

V. New CPUC Policy to Treat Hedging Costs

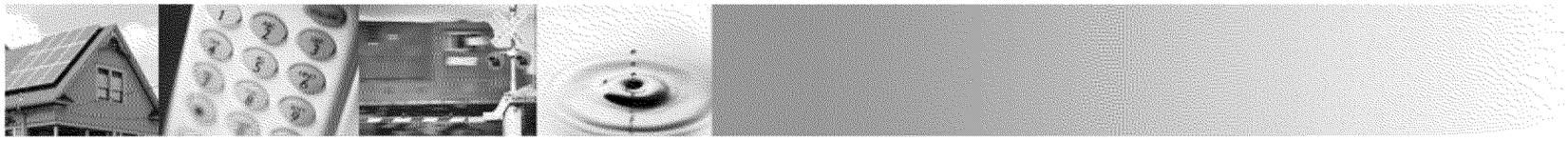
VI. Conclusion

Note: The CPUC does not vouch for the accuracy of the slides in this presentation from non-CPUC sources, and these slides should not be deemed to reflect the policies of the CPUC.



Background

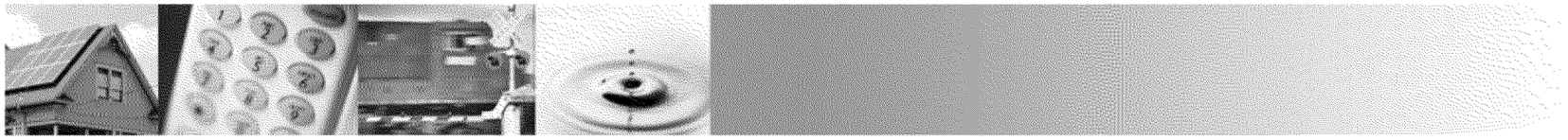
- Discussion on utility hedging reemerged recently with the Financial Reform Act
- Exemption for Utilities under Dodd-Frank
- California history on gas financial hedging suggests that financial hedging within a well designed incentive mechanism benefits ratepayers



CPUC Regulation of Natural Gas Utilities

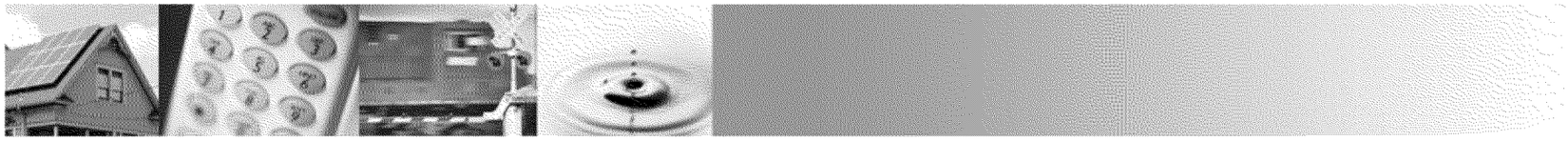
- The three publicly traded Local Distribution Companies (LDCs) providing natural gas in California & regulated by the CPUC are:

Investor Owned Utility	Customers
Southern California Gas Company San Diego Gas & Electric	6.5 million combined gas meters
Pacific Gas & Electric Company	4.5 million
Southwest Gas Corporation	200,000



Background – Natural Gas in California

- 2008 CA Natural Gas usage: 6.2 Bcfd. 87% delivered from out-of-state.
- Incentive mechanisms align shareholder/ratepayer interests, providing market incentives for IOUs to procure gas at least cost possible. Eliminated annual reasonableness reviews. These mechanisms have been in place since the mid 1990's.
- Incentive mechanisms are built around a monthly gas price benchmark of published price indices at the California border and gas production basins. Performance measured against benchmark.
- One size does not fit all. Each California gas utility has a different assets and load profile. Hence, incentive mechanisms and hedging programs are different for each utility.
- Generally, the California utilities rely primarily on physical gas contracts, interstate capacity and storage capacity to provide reliability and most price protection for core customers. Financial hedging supplements these assets.



SoCalGas Gas Cost Incentive Mechanism (GCIM)

50/50 Sharing

(Dead Band)	**+2%**
(Dead Band)	**-1%**

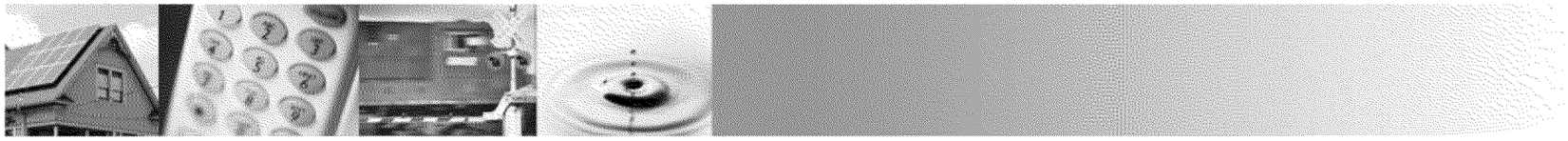
Monthly Index

-1% to -5%

75 / 25 Sharing

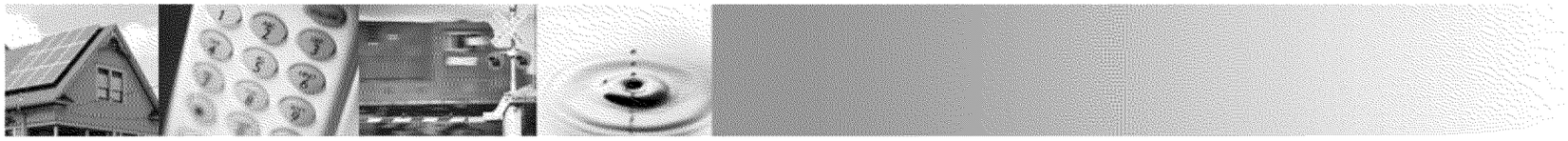
90/10 Sharing

(Capped at 1.5% of Gas Cost)



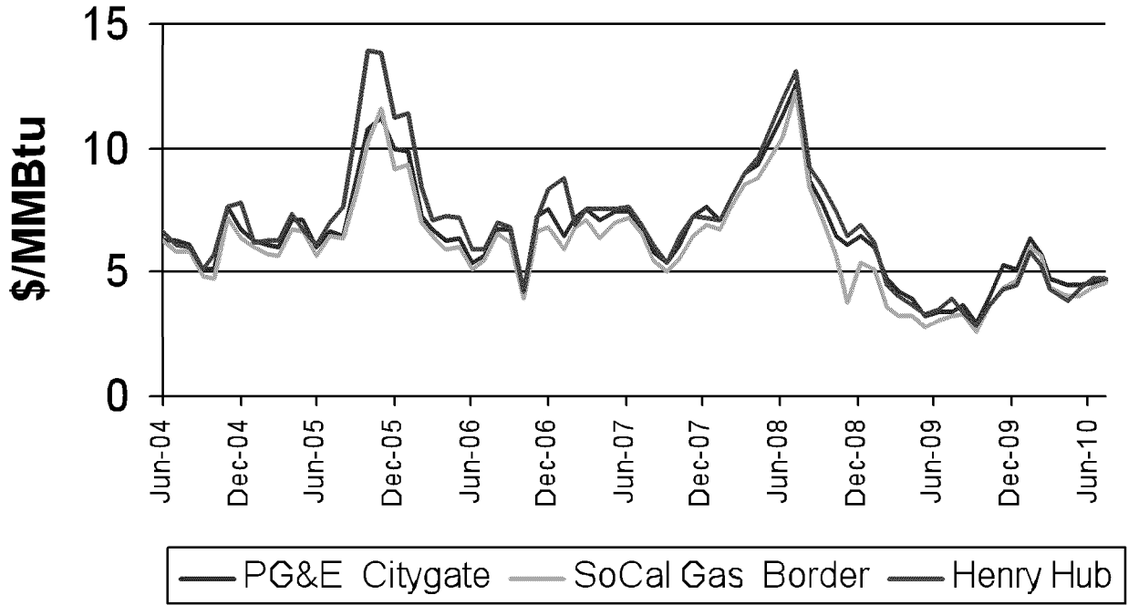
CPUC Regulation: Natural Gas Procurement Incentive Mechanisms

- Gas Procurement Incentive Mechanism or **GCIM** for SoCalGas and Southwest Gas. Since 2008, SoCalGas has also managed SDG&E's core procurement portfolio.
- For PG&E, the Core Procurement Incentive Mechanism or **CPIM**
- The CPUC also authorizes utility natural gas financial hedging programs to hedge against price volatility.
- Until 2005 (Hurricane Katrina), financial hedging costs were included in the incentive mechanisms.

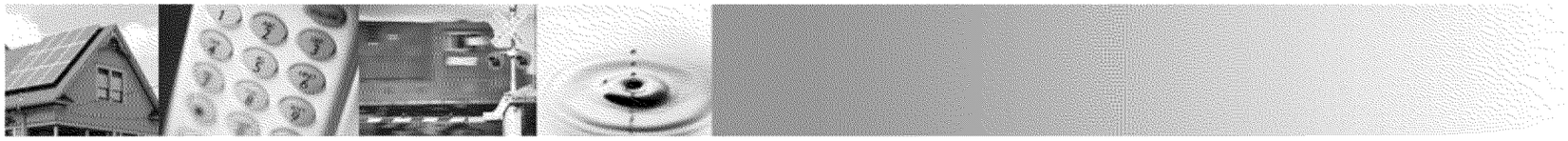


Natural Gas Price Volatility: 2004-2010

Spot Gas Prices



Prepared by CPUC Energy Division

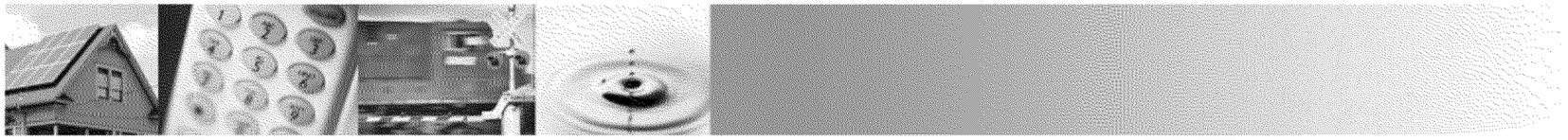


CPUC Response to Hurricane Katrina, 2005

- In response to 2005 price spikes, the utilities requested that winter hedging costs be placed outside the incentive mechanisms.

- Utilities sought to expand financial hedging of their natural gas purchases in order to protect core customers from price spikes during periods of extreme volatility. Keeping hedging costs within the GCIMs and CPIM created a disincentive to hedge at a level needed to protect core customers.

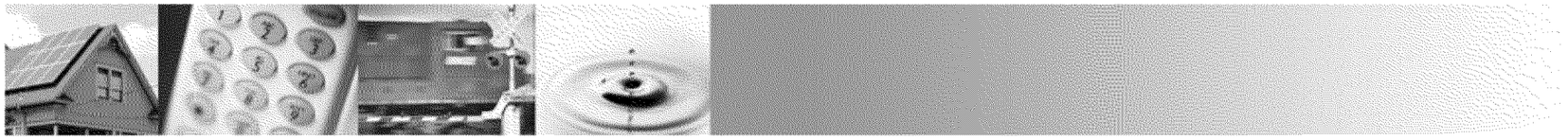
- CPUC granted SoCalGas, SDG&E and PG&E requests.



2005-2008 Results
Utility Hedging Program

- The total winter hedging costs incurred by certain California gas utilities were high.

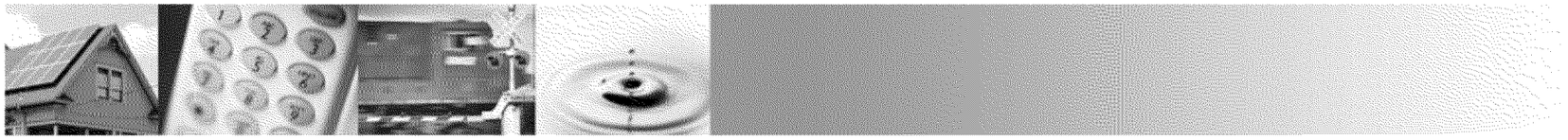
- Because all of these costs were passed on to bundled core gas ratepayers, the Commission ordered a rulemaking to examine the relationship between financial hedging and the incentive mechanisms.



Gas Winter Hedging Rulemaking

R. 08-06-025

- Examination of the role and significance of winter hedging to manage price volatility for bundled core customers.
- Should winter hedging risks and benefits be shared by utility investors?
- If so, how should winter hedging costs be re-integrated into the incentive mechanisms?
- How should the utilities request authority for their winter hedging plans?



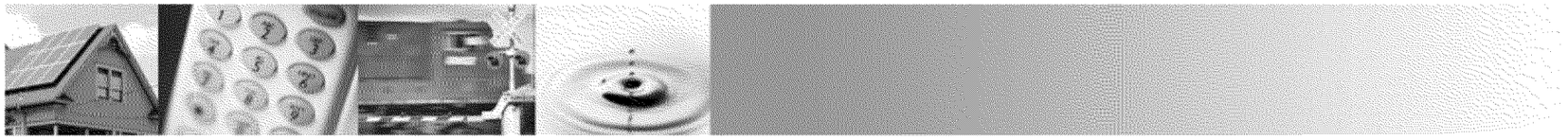
CPUC Decision
Some Hedging Costs in Incentive Mechanisms

- Consumer advocates entered into a Settlement with PG&E to include a portion of gas hedging costs and benefits into PG&E's CPIM.

- The Commission found that SoCalGas should also bear some risk for hedging costs/gains. The Commission placed 25% of winter hedging costs and benefits in SoCalGas' GCIM.

- No change for Southwest Gas because of small size and reliance on fixed-price contracts.

- Eliminated annual utility applications for approval of winter hedging programs.

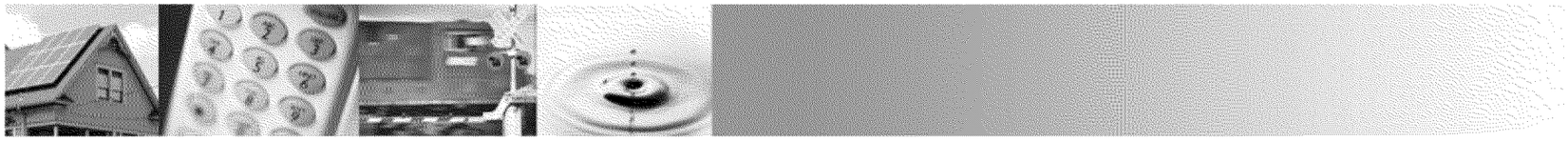


Other Key Policies
Commitment to Infrastructure Development

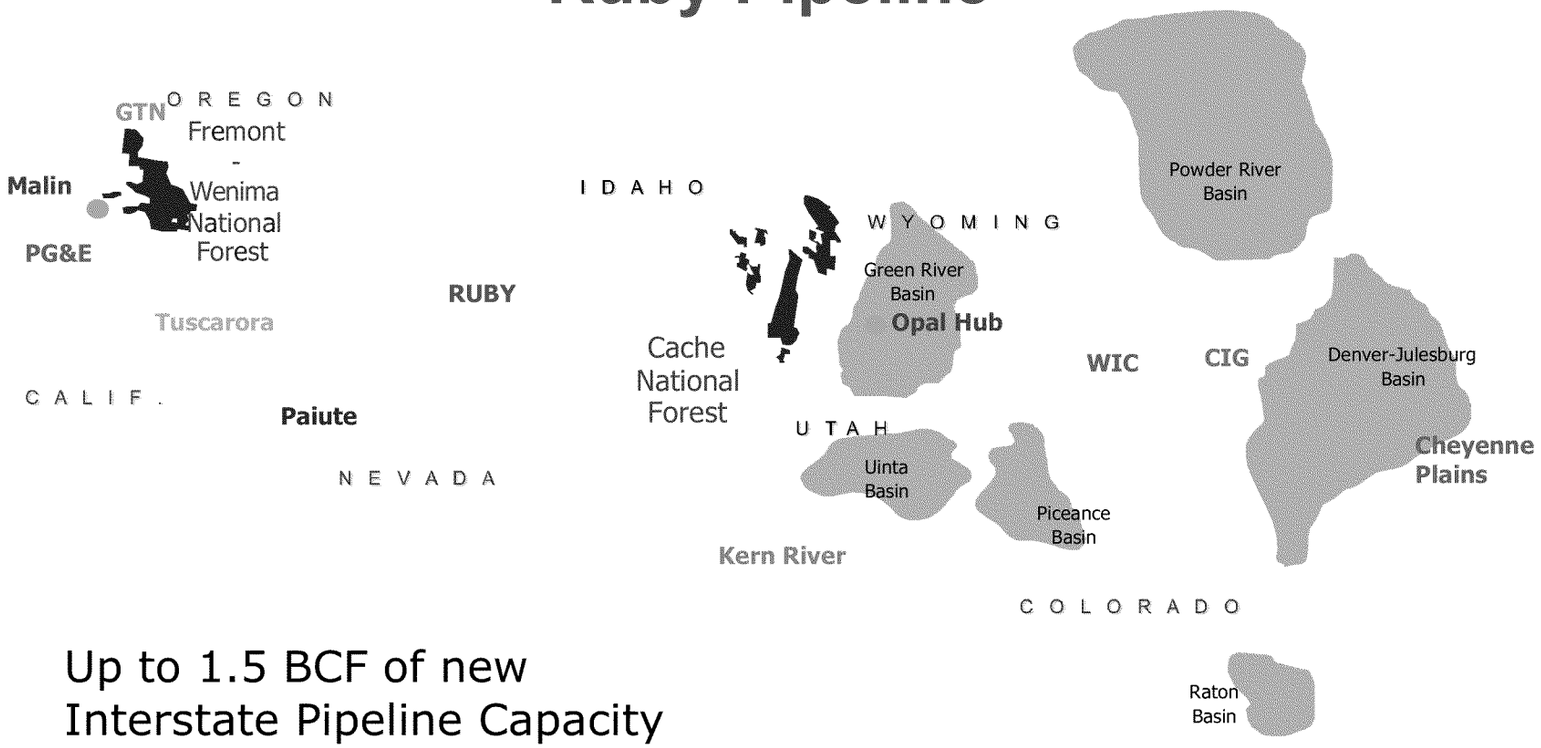
- One of my key priorities has been to ensure that CA continues to develop natural gas infrastructure.

- As mentioned before, 87% of California natural gas requirements are delivered from out-of-state.

- Proper infrastructure provides important physical hedging for customers, complemented by financial winter hedging. Physical hedging generally lessens the need for financial hedges.

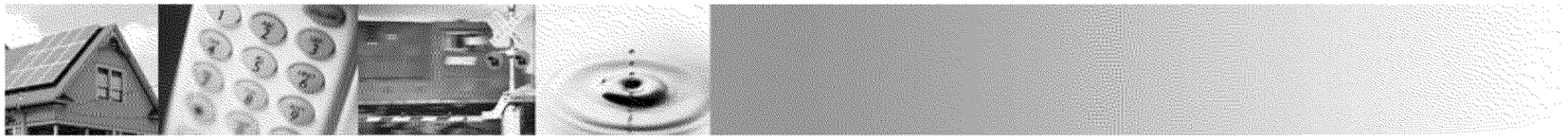


New Pipeline Infrastructure In CA
Ruby Pipeline



Up to 1.5 BCF of new Interstate Pipeline Capacity to the CA-Oregon Border

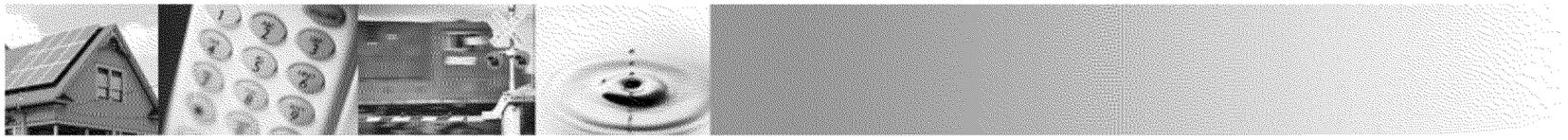
*Source of Map: El Paso



New Storage Projects in CA

Storage Project	Bcf (working gas)
Gill Ranch/PG&E	20
Wild Goose Storage	29 existing; 50 after expansion*
Honor Rancho Expansion, SoCalGas	23 existing; 28 after expansion
Aliso Canyon, SoCalGas	84/300MMcfd existing; compressor expansion to 445 MMcfd*
Lodi Storage	34
Central Valley Storage	Initial 9, up to 11*
Sacramento Natural Gas Storage	7.5*
Tricor Ten Section (FERC)	22.4*

*Proposed, active application

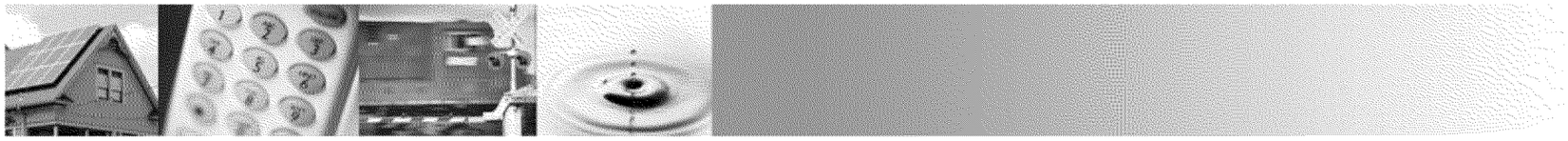


Wrap Up

- Under California regulation, utilities use limited winter hedging as a tool to protect customers from extreme winter price spikes.

- When combined with well-designed incentive mechanisms, ratepayers are provided some protection from winter price spikes, while still receiving the gas price benefits of procurement by properly “incented” utilities.

- Winter hedging is just one tool used by the CPUC and California natural gas utilities to provide price protection for core procurement customers. Even more important are the benefits provided by new pipeline and storage projects supported by our Commission.



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