



# Opening Address Regulatory Review of Utility Hedging Programs



**Commissioner Timothy A. Simon**

California Public Utilities

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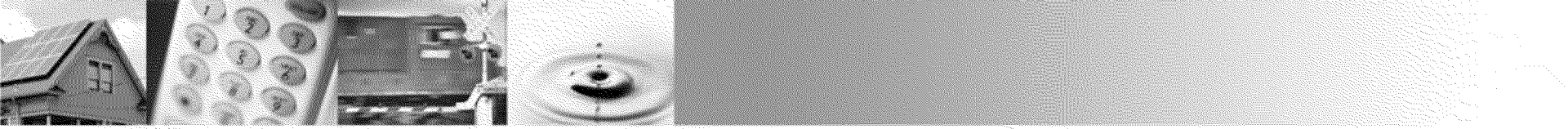


# Overview

- 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 resurfaced 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:

<b>Investor Owned Utility</b>	<b>Customers</b>
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



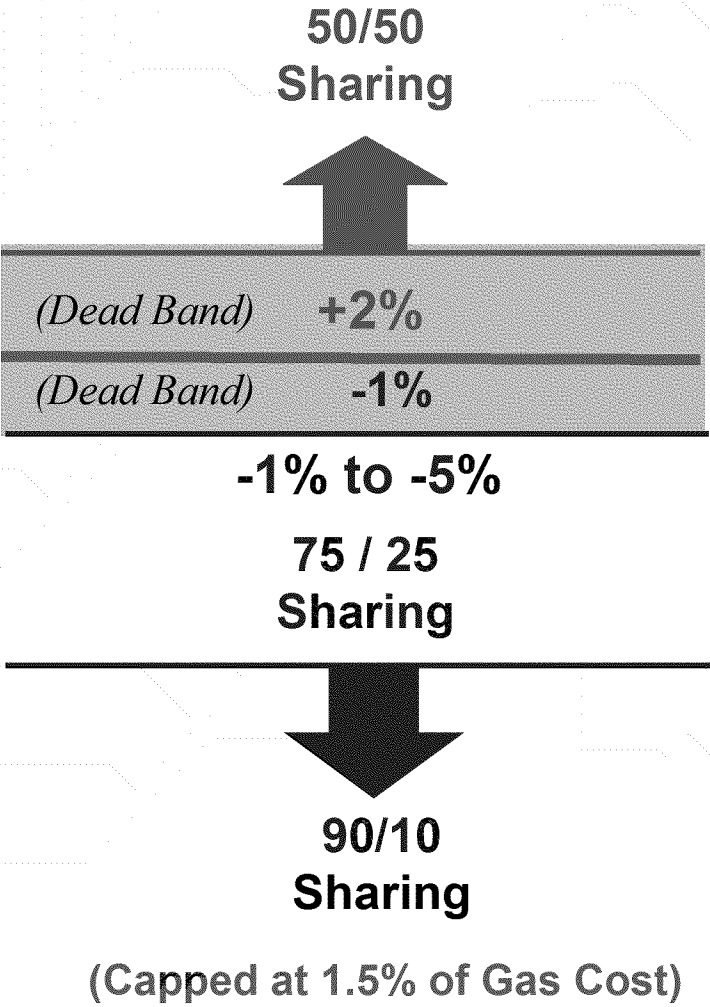


# Background – Natural Gas in California

- 2008 CA Natural Gas usage: 6.2 Bcfd. 87% delivered from out-of-state.
- Incentive mechanisms align shareholder/ratepayer interests.
- Incentive mechanisms are built around a monthly gas price 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 Assets and contracts. Financial hedging supplements these assets.



# SoCalGas Gas Cost Incentive Mechanism (GCIM)



**Monthly Index**





## CPUC Regulation: Natural Gas Procurement Incentive Mechanisms

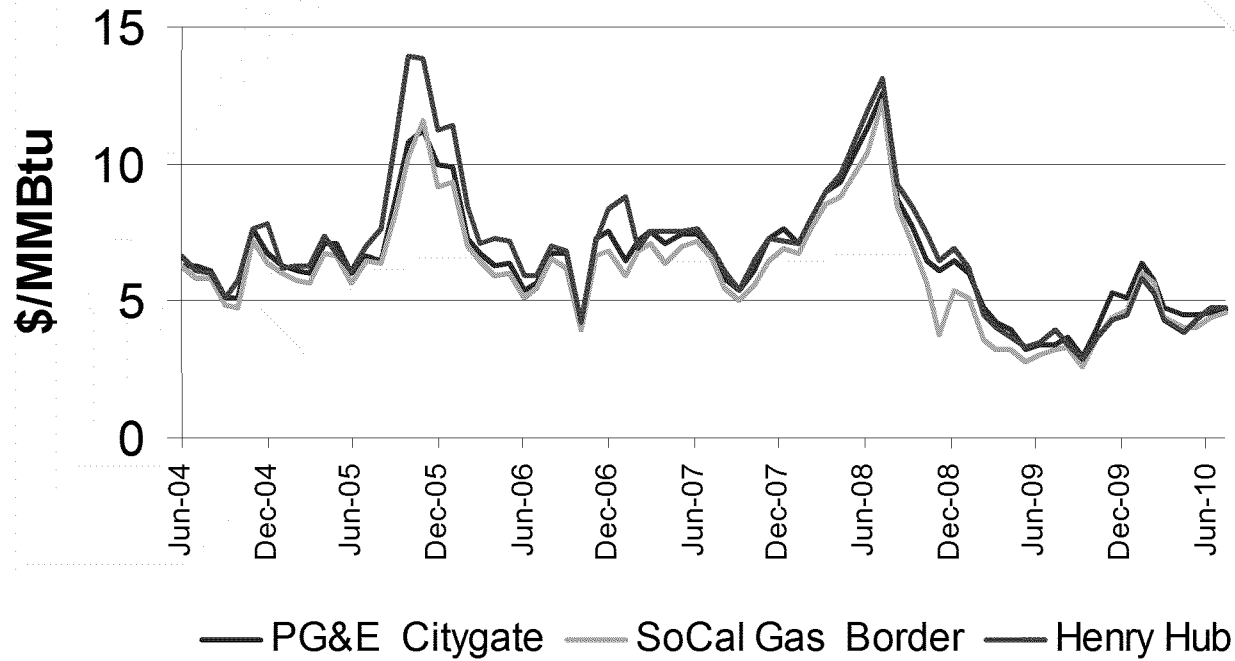
- Gas Procurement Incentive Mechanism or **GCIM** for SoCalGas and Southwest Gas.
- For PG&E, the Core Procurement Incentive Mechanism or **CPIM**
- The CPUC also authorizes utility natural gas financial hedging programs to hedge against price volatility.
- Until 2005 (Hurricane Katrina), financial hedging 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.
- 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.



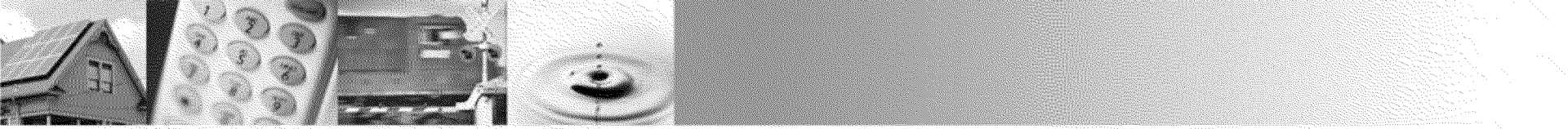


# Gas Winter Hedging Rulemaking

## 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?



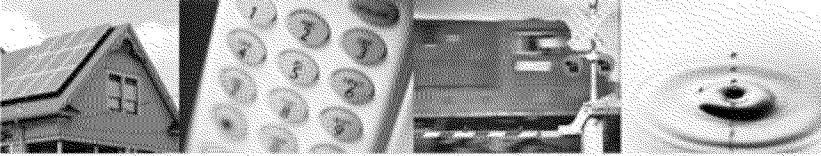


## CPUC Decision

### 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

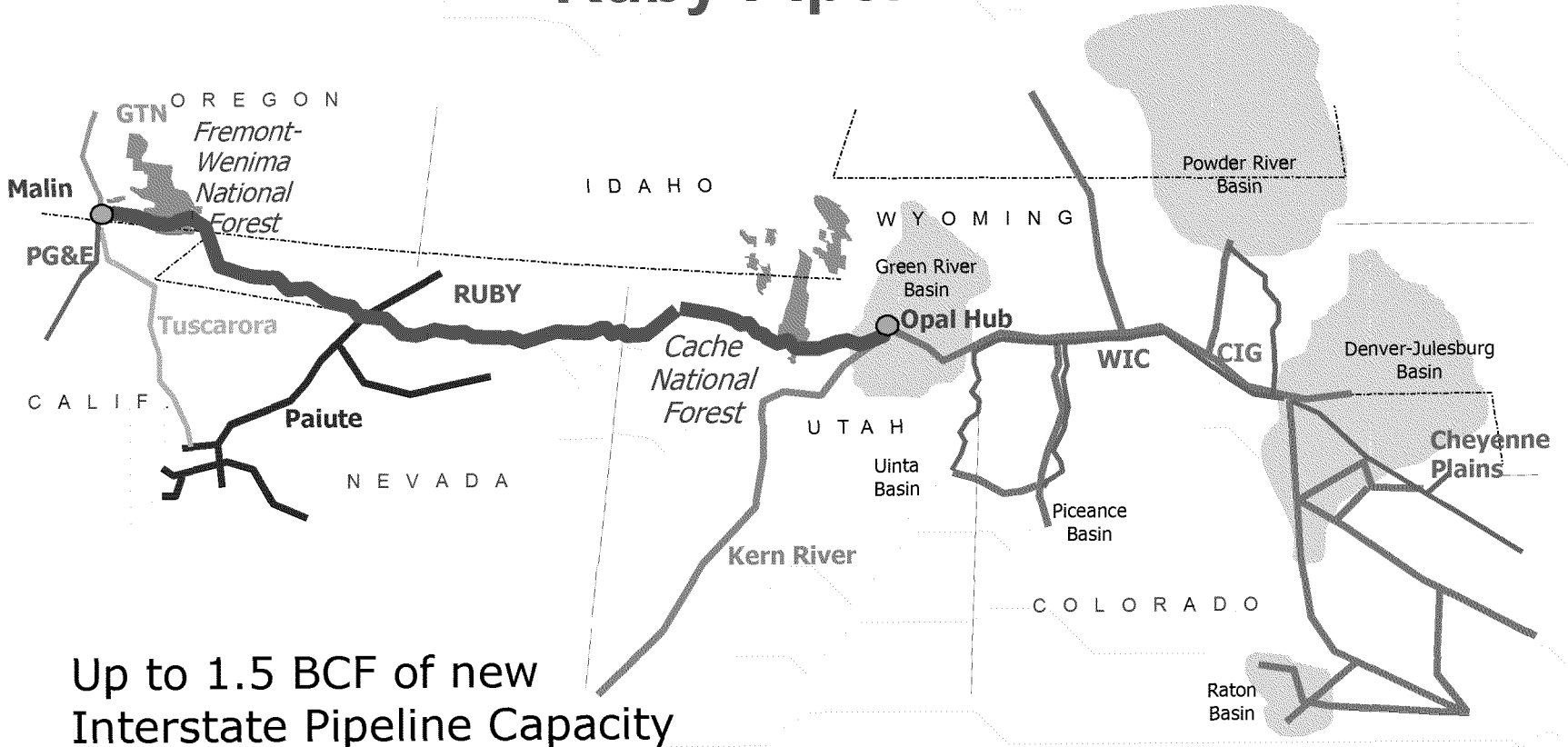
### Commitment to Infrastructure Development

- 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 “incented” utilities.
- Winter hedging is just one tool used in California --Even more important are the benefits provided by new pipeline and storage projects supported by our Commission.







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