Rulemaking: 07-05-025
(U 39 M)
Exhibit No.: ______
Date: April 7, 2011
Witness: Donna L. Barry
Shahrokh Hessami
Marc L. Renson

PACIFIC GAS AND ELECTRIC COMPANY

DIRECT ACCESS REOPENING PHASE III

ERRATA TO PREPARED TESTIMONY

PACIFIC GAS AND ELECTRIC COMPANY
DIRECT ACCESS REOPENING PHASE III
ERRATA TO PREPARED TESTIMONY
APRIL 7, 2011
RULEMAKING 07-05-025

Chapter 1, Introduction and Power Charge Indifference Amount Modification
Witness: Donna L. Barry

Page(s)	Line(s)	Delete	Replace With/Insert/or Explanation
1-16	20	12-05-045	05-12-045

Chapter 4, Security Requirements
Witness: Shahrokh Hessami

Page(s)	Line(s)	Delete	Replace With/Insert/or Explanation
4-5	30	and CCAs	
4-6	7	or CCA	
4-6	26	or CCA	
4-7	3	or CCA	
4-7	33	or CCA	
4-10	26	and CCAs	
4-14	11	equally	
4-14	11	both CCAs and	
4-14	12	either type of	such
4-14	22	or CCA	
4-16	24	and CCAs	
4-16	26	and CCA	
4-16	31-32	, CCA	

ERRATA

APRIL 7, 2011

REPLACEMENT PAGES

REDLINED

not just CDWR stranded costs but also costs related to the Ongoing CTC. Costs recovered through the Ongoing CTC are governed by statute, are calculated independently from the PCIA, and are intended to be the same for bundled and departing customers in the same class.

PG&E believes the non-exempt customers' ability to have low cost generation to offset some portion of their Ongoing CTC contribution, directly or indirectly through a negative rate, violates the guiding principles that bundled customers remain indifferent to departures. Exempt customers are clearly not indifferent as they are treated unequally with respect to how much they contribute to the Ongoing CTC recovery versus similarly situated non-exempt customers. Decision 05-12-045 in PG&E's 2006 ERRA Forecast proceeding specifically addressed the issue of a direct offset by prohibiting a total portfolio Ongoing CTC calculation and ordering that only one Ongoing CTC calculation be implemented and that it be based on a statutory calculation. This decision also directed how negative above-market results are to be handled, with respect to the statutorily calculated Ongoing CTC. The decision did not allow negative Ongoing CTC amounts to offset other components of the CRS.

In response to Decision ~~12-05-045~~05-12-045 prohibitions on a direct Ongoing CTC offset, Decision 06-07-030, which modified the Indifference calculation, also modified the constraints on the Indifference Charge (*e.g.*, PCIA) such that it could be negative up to the level of the Ongoing CTC. Thus, rather than a direct offset, the offset was indirect and implemented by providing a credit on non-exempt customers bill through the negative rate.

One consideration that should have been more thoroughly examined is the effect the negative PCIA has on bundled customer indifference. If non-exempt customers were to remain on bundled service, they would pay the Ongoing CTC regardless of whether the costs for CDWR contracts (or new generation resources) were above or below market. The same should be true if they leave bundled service. That is, regardless of whether there are stranded costs associated with CDWR contracts (or new generation resources), the customers should of CE and PFE for 1-year horizon at 95 percent confidence, and based on the probability of default of one year and LGD.

3. Product Risks

The IOUs are exposed to various product risks including the following:

a. Energy

Depending on the hedging strategies and requirements, a certain percent of any portfolio is exposed to hourly, daily, and term transactions of various durations. The price curves and liquidity levels for these products vary substantially.

b. Resource Adequacy

RA prices substantially vary seasonally and annually depending on the availability of resources.

c. Renewable Energy Compliance

Meeting California's Renewable Portfolio Standard (RPS) requirements may be difficult as the parties approach RPS compliance deadlines with remaining uncertainty around successful development of currently planned projects by IOUs or through Power Purchase Agreements with independent power producers. In addition, as the economic recovery in the United States and California continues to improve, there will be potentially additional price pressure on renewable products to meet this requirement with load growth in California and surrounding states.

d. California Air Resources Board GHG Compliance Mandate

California Air Resources Board's (CARB) implementation of the Cap and Trade program to be effective in January 2012 provides additional uncertainty for availability of GHG allowances or offsets. It is still unknown how this market will evolve over time and level of volatility and liquidity this market may have.

C. ESP Risk for IOUs and Bundled Customers

Market events causing ESPs ~~and CCAs~~ to default will adversely impact both the IOUs and their bundled customers. The following section describes the risks the IOUs and bundled customers will likely face in the event of defaults resulting in involuntarily returned customers.

1. Increased Capital Costs

IOUs' cash flow, planned working capital, and borrowing facilities are based on many factors ranging from infrastructure investments to hedging activities and requirements, as well as other operational considerations. Managing price volatility is a significant component of a procurement hedging plan and estimation of working capital needs. An unplanned return of Direct Access (DA) ~~or CCA~~ customers will pressure an IOU's working capital primarily because such failures are expected during volatile and high energy prices, when the IOU will likely need to utilize its financial facilities to manage the higher cash flow needs for its bundled customers. The additional daily borrowing needs can shift additional cost to the bundled customers, as the IOU may be forced to pay higher interest rates for its short-term borrowing activities, and be forced to seek additional credit facilities at a higher cost due to perceived risk impact of additional unplanned commitments and recovery risk.

2. GHG Compliance Risk

It is fairly uncertain how the California's GHG market will evolve over time. However, it is clear that non-compliance will likely have significant penalties. The potential secondary market costs are currently unknown should CARB auctions not provide sufficient market liquidity, when customers involuntarily return to the IOUs.

3. RPS Compliance Risk

IOUs must plan and procure for involuntary returning customers RPS requirements. Currently, the IOUs plan to meet the compliance targets using, short- and long-term contracts to ensure compliance. An unplanned ESP ~~or CCA~~ default would cause an IOU to be exposed to the spot market for RPS resources for compliance. The potential costs are unknown, particularly for a large un-hedged renewables position.

4. Unsecured Credit Limit Extended to the IOUs by Suppliers, Merchants and Financial Institutions

As discussed further below, not all unsecured credit limits extended to the IOUs are tied to its external rating. There are bilateral agreements that provide either party the flexibility to use material adverse conditions to eliminate any extended unsecured credit limit and require additional margin, further reducing the credit facilities of IOUs. A substantial default by an ESP ~~or CCA~~ may cause some counterparties to reduce or eliminate unsecured credit limit benefits of the IOUs. Such action requires the IOU to post collateral within three business days for potentially the entire outstanding exposure.

5. Potential Negative Outlook or Lower Financial Rating Increases Cost of Borrowing and Credit Facilities of IOUs

An IOU's credit rating by external agencies significantly affects its ability to borrow and the costs associated with borrowing. The external agencies, other market analysts, and commercial banks closely monitor the IOU's regulatory framework and scrutinize the IOU's ability to recover its costs through rates and the time it may take to recover such costs. The credit agencies will make their evaluation by asking questions such as:

(a) Can involuntary returned customers pay the market rate?

(b) If customers cannot, then what are the chances of the IOU being required to offer bundled rate sooner than the expected period of six months due to the severity of rise in market prices and impact it may have on a community?

(c) Will the size of involuntary returns combined with market prices allow the IOU to raise rates in a timely manner to meet its additional procurement, hedging, and compliance costs?

(d) Does the IOU have sufficient liquidity to manage the market turmoil?

To the extent that the IOU's responses to these types of questions raises concerns for the rating agencies, there is a potential for a negative outlook or potential rating downgrade. Any negative outlook or perceived potential for rating downgrade will challenge the IOU's ability to meet its liquidity needs or will require it to meet its liquidity needs at increasingly higher costs.

D. Industry Practices for Managing Counterparty Risk

It is a common practice in the energy industry to request security on the basis of current and future exposure. Security requirements are not unique to the DA ~~or CCA~~ programs. The following section discusses some of current

- Level of construction challenges and permitting requirements
- Developer experience and creditworthiness
- Milestone payment structure, which impacts exposure if any advance payments are involved

d. Exchanges and Clearing Entities

Exchanges and clearing entities require both an initial and maintenance security. It is important to understand that individual brokerage firms can, and in many cases do, require margin that is higher than the exchange requirements. Additionally, margin requirements may vary from brokerage firm to brokerage firm. Furthermore, a brokerage firm can increase its "house" margin requirements at any time without providing advance notice, and such increases could result in a margin call.

e. California Independent System Operator

The CAISO has various levels of security requirements from parties depending on level of procurement needs, financial strength and rating, and entity type (governmental or private sector). The maximum amount of unsecured credit limit that the CAISO extends to the highest rated entities based on its assessment is $50.0 million. The CAISO requires 100 percent security for its financial products such as Congestion Revenue Rights. Security requirement is based on the assessed creditworthiness, past procurement volume, and projected Estimated Aggregate Liability as calculated by the CAISO.

E. Commercially Available Security Products

Many entities in the energy industry are required to post security. Entities, including ESPs~~ and CCAs~~, will have access to the following forms of security depending on their level of their creditworthiness or that of their guarantor.

1. Letters of Credit Providers

Most commercial banks can provide a letter of credit. However, the beneficiary may not find all the banks creditworthy to issue the Letters of Credit (LOC). For example, Table 4-1 below shows a list of commercial banks that can provide LOCs acceptable for New York Mercantile Exchange

4. Parental or Third-Party Guarantees

If a counterparty's creditworthiness is not deemed sufficient for issuance of a guarantee, then the party may provide such guarantee through an acceptable parent guaranty or a through the guarantee provided by a third party. The difference between a LOC and a guarantee is that an LOC is an irrevocable and unconditional, where as a guarantee may require litigation in court and poses collection enforcement risk. However, an acceptable guarantee may just be sufficient for the purposes of posting the security requirement or by the surety bond or LOC issuer.

F. Prudency of the Bond Model Proposed in CCA Proceeding

The discussion in this testimony applies ~~equally~~ to ~~both CCAs and~~ ESPs as a default by ~~either type of~~ such entity can have severe impact on IOUs and bundled customers. As discussed above, the levels of unsecured exposure is a major risk factor. Unsecured CCA and ESP programs may be harmful to the financial strength of the IOUs, especially at a time when the IOUs must also comply with renewable energy requirements and other infrastructure developments to support these resources, and to bundled customers. The bond model proposed in the CCA proceeding (R.03-10-003) provides an appropriate, commercially feasible framework for quantifying future exposure risk for these programs. The proposed model provides for an appropriate measure for maintaining prudent level of security to protect the IOUs' bundled customer from involuntary DA ~~or CCA~~ customer returns. PG&E has amended its position on the frequency of recalculating the bond model from one year down to six months. However, for the most part, the CCA proceeding bond model is an appropriate framework for the following reasons:

1. It is PG&E's understanding that the prudency of the methodology is not under question. The model and approach to assessing risk has been proven through various workshops and by experts as an accurate approach to estimate potential risk of a 1-year contract every six months. The details of the bond model and re-entry fee calculations are provided in Attachment 1, which were submitted to the Commission as Settlement Agreement, Attachment A in Rulemaking 03-10-003, on September 8, 2010.
2. The IOUs have provided sufficient description for the sources available to any party to access market prices and volatilities. This information is not

with existing resources if it is recalculated semi annually. However, a more frequent assessment in the form of weekly or monthly will certainly require additional automation and staffing needs to insure appropriate amounts are calculates, disputes are resolved, amendments to the LOCs, bonds or guarantees are appropriately reflected. In addition, because the bond reassessment period is proposed to be every six months, there will be extended periods that market prices may remain below utility bundled rate and therefore, no bond will be required, even if prices were to fluctuate to levels when a security may be needed. In comparison, a daily, weekly or monthly calculation in the form of a MtM approach would have required security to be posted. Therefore, because of the unknown timing of the bond calculation and the price and volatility levels at the time of the quantification, it is difficult to predict whether the bond methodology proposed in the CCA proceeding or a MTM approach would require less security on average over time.

5. Establishing additional criteria such as posting of bond only within a 20 percent band is not consistent with industry practice and should not apply to parties that do not have access to appropriate credit support. Establishing the band will not prevent problems associated with fundamental issue of credit worthiness and whether or not a party can manage its credit liquidity in adverse market conditions. It will only delay the inevitable failure to post the required security in adverse conditions.

G. Conclusions and Recommendations

There is significant risk associated with default by ESPs ~~and CCAs~~ that is quantifiable and real.

(a) This risk needs to be mitigated by ESP ~~and CCA~~ entities and not by IOUs and the bundled customers. The issue remaining is not whether or not counterparty risk exists but rather the potential size of this risk and prudent amount of security requirement.

(b) The accurate measure for this risk is a PFE model as proposed in the CCA proceeding (R.03-10-003). The Commission needs to ensure that ESP~~,~~ ~~CCA,~~ and bundled customers are protected under adverse market conditions.

ERRATA

APRIL 7, 2011

REPLACEMENT PAGES

CLEAN

not just CDWR stranded costs but also costs related to the Ongoing CTC. Costs recovered through the Ongoing CTC are governed by statute, are calculated independently from the PCIA, and are intended to be the same for bundled and departing customers in the same class.

PG&E believes the non-exempt customers' ability to have low cost generation to offset some portion of their Ongoing CTC contribution, directly or indirectly through a negative rate, violates the guiding principles that bundled customers remain indifferent to departures. Exempt customers are clearly not indifferent as they are treated unequally with respect to how much they contribute to the Ongoing CTC recovery versus similarly situated non-exempt customers. Decision 05-12-045 in PG&E's 2006 ERRA Forecast proceeding specifically addressed the issue of a direct offset by prohibiting a total portfolio Ongoing CTC calculation and ordering that only one Ongoing CTC calculation be implemented and that it be based on a statutory calculation. This decision also directed how negative above-market results are to be handled, with respect to the statutorily calculated Ongoing CTC. The decision did not allow negative Ongoing CTC amounts to offset other components of the CRS.

In response to Decision 05-12-045 prohibitions on a direct Ongoing CTC offset, Decision 06-07-030, which modified the Indifference calculation, also modified the constraints on the Indifference Charge (*e.g.*, PCIA) such that it could be negative up to the level of the Ongoing CTC. Thus, rather than a direct offset, the offset was indirect and implemented by providing a credit on non-exempt customers bill through the negative rate.

One consideration that should have been more thoroughly examined is the effect the negative PCIA has on bundled customer indifference. If non-exempt customers were to remain on bundled service, they would pay the Ongoing CTC regardless of whether the costs for CDWR contracts (or new generation resources) were above or below market. The same should be true if they leave bundled service. That is, regardless of whether there are stranded costs associated with CDWR contracts (or new generation resources), the customers should of CE and PFE for 1-year horizon at 95 percent confidence, and based on the probability of default of one year and LGD.

3. Product Risks

The IOUs are exposed to various product risks including the following:

a. Energy

Depending on the hedging strategies and requirements, a certain percent of any portfolio is exposed to hourly, daily, and term transactions of various durations. The price curves and liquidity levels for these products vary substantially.

b. Resource Adequacy

RA prices substantially vary seasonally and annually depending on the availability of resources.

c. Renewable Energy Compliance

Meeting California's Renewable Portfolio Standard (RPS) requirements may be difficult as the parties approach RPS compliance deadlines with remaining uncertainty around successful development of currently planned projects by IOUs or through Power Purchase Agreements with independent power producers. In addition, as the economic recovery in the United States and California continues to improve, there will be potentially additional price pressure on renewable products to meet this requirement with load growth in California and surrounding states.

d. California Air Resources Board GHG Compliance Mandate

California Air Resources Board's (CARB) implementation of the Cap and Trade program to be effective in January 2012 provides additional uncertainty for availability of GHG allowances or offsets. It is still unknown how this market will evolve over time and level of volatility and liquidity this market may have.

C. ESP Risk for IOUs and Bundled Customers

Market events causing ESPs to default will adversely impact both the IOUs and their bundled customers. The following section describes the risks the IOUs and bundled customers will likely face in the event of defaults resulting in involuntarily returned customers.

1. Increased Capital Costs

IOUs' cash flow, planned working capital, and borrowing facilities are based on many factors ranging from infrastructure investments to hedging activities and requirements, as well as other operational considerations. Managing price volatility is a significant component of a procurement hedging plan and estimation of working capital needs. An unplanned return of Direct Access (DA) customers will pressure an IOU's working capital primarily because such failures are expected during volatile and high energy prices, when the IOU will likely need to utilize its financial facilities to manage the higher cash flow needs for its bundled customers. The additional daily borrowing needs can shift additional cost to the bundled customers, as the IOU may be forced to pay higher interest rates for its short-term borrowing activities, and be forced to seek additional credit facilities at a higher cost due to perceived risk impact of additional unplanned commitments and recovery risk.

2. GHG Compliance Risk

It is fairly uncertain how the California's GHG market will evolve over time. However, it is clear that non-compliance will likely have significant penalties. The potential secondary market costs are currently unknown should CARB auctions not provide sufficient market liquidity, when customers involuntarily return to the IOUs.

3. RPS Compliance Risk

IOUs must plan and procure for involuntary returning customers RPS requirements. Currently, the IOUs plan to meet the compliance targets using, short- and long-term contracts to ensure compliance. An unplanned ESP default would cause an IOU to be exposed to the spot market for RPS resources for compliance. The potential costs are unknown, particularly for a large un-hedged renewables position.

4. Unsecured Credit Limit Extended to the IOUs by Suppliers, Merchants and Financial Institutions

As discussed further below, not all unsecured credit limits extended to the IOUs are tied to its external rating. There are bilateral agreements that provide either party the flexibility to use material adverse conditions to eliminate any extended unsecured credit limit and require additional margin, further reducing the credit facilities of IOUs. A substantial default by an ESP may cause some counterparties to reduce or eliminate unsecured credit limit benefits of the IOUs. Such action requires the IOU to post collateral within three business days for potentially the entire outstanding exposure.

5. Potential Negative Outlook or Lower Financial Rating Increases Cost of Borrowing and Credit Facilities of IOUs

An IOU's credit rating by external agencies significantly affects its ability to borrow and the costs associated with borrowing. The external agencies, other market analysts, and commercial banks closely monitor the IOU's regulatory framework and scrutinize the IOU's ability to recover its costs through rates and the time it may take to recover such costs. The credit agencies will make their evaluation by asking questions such as:

(a) Can involuntary returned customers pay the market rate?

(b) If customers cannot, then what are the chances of the IOU being required to offer bundled rate sooner than the expected period of six months due to the severity of rise in market prices and impact it may have on a community?

(c) Will the size of involuntary returns combined with market prices allow the IOU to raise rates in a timely manner to meet its additional procurement, hedging, and compliance costs?

(d) Does the IOU have sufficient liquidity to manage the market turmoil?

To the extent that the IOU's responses to these types of questions raises concerns for the rating agencies, there is a potential for a negative outlook or potential rating downgrade. Any negative outlook or perceived potential for rating downgrade will challenge the IOU's ability to meet its liquidity needs or will require it to meet its liquidity needs at increasingly higher costs.

D. Industry Practices for Managing Counterparty Risk

It is a common practice in the energy industry to request security on the basis of current and future exposure. Security requirements are not unique to the DA programs. The following section discusses some of current market practices that are common contractual terms for credit risk and security

- Milestone payment structure, which impacts exposure if any advance payments are involved

d. Exchanges and Clearing Entities

Exchanges and clearing entities require both an initial and maintenance security. It is important to understand that individual brokerage firms can, and in many cases do, require margin that is higher than the exchange requirements. Additionally, margin requirements may vary from brokerage firm to brokerage firm. Furthermore, a brokerage firm can increase its "house" margin requirements at any time without providing advance notice, and such increases could result in a margin call.

e. California Independent System Operator

The CAISO has various levels of security requirements from parties depending on level of procurement needs, financial strength and rating, and entity type (governmental or private sector). The maximum amount of unsecured credit limit that the CAISO extends to the highest rated entities based on its assessment is $50.0 million. The CAISO requires 100 percent security for its financial products such as Congestion Revenue Rights. Security requirement is based on the assessed creditworthiness, past procurement volume, and projected Estimated Aggregate Liability as calculated by the CAISO.

E. Commercially Available Security Products

Many entities in the energy industry are required to post security. Entities, including ESPs, will have access to the following forms of security depending on their level of their creditworthiness or that of their guarantor.

1. Letters of Credit Providers

Most commercial banks can provide a letter of credit. However, the beneficiary may not find all the banks creditworthy to issue the Letters of Credit (LOC). For example, Table 4-1 below shows a list of commercial banks that can provide LOCs acceptable for New York Mercantile Exchange

4. Parental or Third-Party Guarantees

If a counterparty's creditworthiness is not deemed sufficient for issuance of a guarantee, then the party may provide such guarantee through an acceptable parent guaranty or a through the guarantee provided by a third party. The difference between a LOC and a guarantee is that an LOC is an irrevocable and unconditional, where as a guarantee may require litigation in court and poses collection enforcement risk. However, an acceptable guarantee may just be sufficient for the purposes of posting the security requirement or by the surety bond or LOC issuer.

F. Prudency of the Bond Model Proposed in CCA Proceeding

The discussion in this testimony applies to ESPs as a default by such entity can have severe impact on IOUs and bundled customers. As discussed above, the levels of unsecured exposure is a major risk factor. Unsecured CCA and ESP programs may be harmful to the financial strength of the IOUs, especially at a time when the IOUs must also comply with renewable energy requirements and other infrastructure developments to support these resources, and to bundled customers. The bond model proposed in the CCA proceeding (R.03-10-003) provides an appropriate, commercially feasible framework for quantifying future exposure risk for these programs. The proposed model provides for an appropriate measure for maintaining prudent level of security to protect the IOUs' bundled customer from involuntary DA customer returns. PG&E has amended its position on the frequency of recalculating the bond model from one year down to six months. However, for the most part, the CCA proceeding bond model is an appropriate framework for the following reasons:

1. It is PG&E's understanding that the prudency of the methodology is not under question. The model and approach to assessing risk has been proven through various workshops and by experts as an accurate approach to estimate potential risk of a 1-year contract every six months. The details of the bond model and re-entry fee calculations are provided in Attachment 1, which were submitted to the Commission as Settlement Agreement, Attachment A in Rulemaking 03-10-003, on September 8, 2010.
2. The IOUs have provided sufficient description for the sources available to any party to access market prices and volatilities. This information is not free and is subscription based. However, there should be no doubt about its

frequent assessment in the form of weekly or monthly will certainly require additional automation and staffing needs to insure appropriate amounts are calculates, disputes are resolved, amendments to the LOCs, bonds or guarantees are appropriately reflected. In addition, because the bond reassessment period is proposed to be every six months, there will be extended periods that market prices may remain below utility bundled rate and therefore, no bond will be required, even if prices were to fluctuate to levels when a security may be needed. In comparison, a daily, weekly or monthly calculation in the form of a MtM approach would have required security to be posted. Therefore, because of the unknown timing of the bond calculation and the price and volatility levels at the time of the quantification, it is difficult to predict whether the bond methodology proposed in the CCA proceeding or a MTM approach would require less security on average over time.

5. Establishing additional criteria such as posting of bond only within a 20 percent band is not consistent with industry practice and should not apply to parties that do not have access to appropriate credit support. Establishing the band will not prevent problems associated with fundamental issue of credit worthiness and whether or not a party can manage its credit liquidity in adverse market conditions. It will only delay the inevitable failure to post the required security in adverse conditions.

G. Conclusions and Recommendations

There is significant risk associated with default by ESPs that is quantifiable and real.

(a) This risk needs to be mitigated by ESP entities and not by IOUs and the bundled customers. The issue remaining is not whether or not counterparty risk exists but rather the potential size of this risk and prudent amount of security requirement.

(b) The accurate measure for this risk is a PFE model as proposed in the CCA proceeding (R.03-10-003). The Commission needs to ensure that ESP and bundled customers are protected under adverse market conditions.

(c) A proper security requirement is a sufficient and feasible instrument to ensure appropriate protections for all customers.