

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



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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	

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2 CTC. Costs recovered through the Ongoing CTC are governed by
3 statute, are calculated independently from the PCIA, and are intended to
4 be the same for bundled and departing customers in the same class.

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6 generation to offset some portion of their Ongoing CTC contribution,
7 directly or indirectly through a negative rate, violates the guiding
8 principles that bundled customers remain indifferent to departures.
9 Exempt customers are clearly not indifferent as they are treated
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11 recovery versus similarly situated non-exempt customers.

12 Decision 05-12-045 in PG&E's 2006 ERRA Forecast proceeding
13 specifically addressed the issue of a direct offset by prohibiting a total
14 portfolio Ongoing CTC calculation and ordering that only one Ongoing
15 CTC calculation be implemented and that it be based on a statutory
16 calculation. This decision also directed how negative above-market
17 results are to be handled, with respect to the statutorily calculated
18 Ongoing CTC. The decision did not allow negative Ongoing CTC
19 amounts to offset other components of the CRS.

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

27 One consideration that should have been more thoroughly
28 examined is the effect the negative PCIA has on bundled customer
29 indifference. If non-exempt customers were to remain on bundled
30 service, they would pay the Ongoing CTC regardless of whether the
31 costs for CDWR contracts (or new generation resources) were above or
32 below market. The same should be true if they leave bundled service.
33 That is, regardless of whether there are stranded costs associated with
34 CDWR contracts (or new generation resources), the customers should

1 of CE and PFE for 1-year horizon at 95 percent confidence, and
 2 based on the probability of default of one year and LGD.

3 **3. Product Risks**

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

5 **a. Energy**

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

10 **b. Resource Adequacy**

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

13 **c. Renewable Energy Compliance**

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

23 **d. California Air Resources Board GHG Compliance Mandate**

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

29 **C. ESP Risk for IOUs and Bundled Customers**

30 Market events causing ESPs and CCAs to default will adversely impact both
 31 the IOUs and their bundled customers. The following section describes the risks
 32 the IOUs and bundled customers will likely face in the event of defaults resulting
 33 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

1 eliminate any extended unsecured credit limit and require additional margin,
 2 further reducing the credit facilities of IOUs. A substantial default by an ESP
 3 ~~or CCA~~ may cause some counterparties to reduce or eliminate unsecured
 4 credit limit benefits of the IOUs. Such action requires the IOU to post
 5 collateral within three business days for potentially the entire outstanding
 6 exposure.

7 **5. Potential Negative Outlook or Lower Financial Rating Increases** 8 **Cost of Borrowing and Credit Facilities of IOUs**

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

- 15 (a) Can involuntary returned customers pay the market rate?
- 16 (b) If customers cannot, then what are the chances of the IOU being
 17 required to offer bundled rate sooner than the expected period of
 18 six months due to the severity of rise in market prices and impact it may
 19 have on a community?
- 20 (c) Will the size of involuntary returns combined with market prices allow
 21 the IOU to raise rates in a timely manner to meet its additional
 22 procurement, hedging, and compliance costs?
- 23 (d) Does the IOU have sufficient liquidity to manage the market turmoil?

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

30 **D. Industry Practices for Managing Counterparty Risk**

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

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

5 **d. Exchanges and Clearing Entities**

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

14 **e. California Independent System Operator**

15 The CAISO has various levels of security requirements from parties
 16 depending on level of procurement needs, financial strength and rating,
 17 and entity type (governmental or private sector). The maximum amount
 18 of unsecured credit limit that the CAISO extends to the highest rated
 19 entities based on its assessment is \$50.0 million. The CAISO requires
 20 100 percent security for its financial products such as Congestion
 21 Revenue Rights. Security requirement is based on the assessed
 22 creditworthiness, past procurement volume, and projected Estimated
 23 Aggregate Liability as calculated by the CAISO.

24 **E. Commercially Available Security Products**

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

28 **1. Letters of Credit Providers**

29 Most commercial banks can provide a letter of credit. However, the
 30 beneficiary may not find all the banks creditworthy to issue the Letters of
 31 Credit (LOC). For example, Table 4-1 below shows a list of commercial
 32 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

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

- 16 5. Establishing additional criteria such as posting of bond only within a
 17 20 percent band is not consistent with industry practice and should not apply
 18 to parties that do not have access to appropriate credit support.
 19 Establishing the band will not prevent problems associated with fundamental
 20 issue of credit worthiness and whether or not a party can manage its credit
 21 liquidity in adverse market conditions. It will only delay the inevitable failure
 22 to post the required security in adverse conditions.

23 **G. Conclusions and Recommendations**

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

- 26 | (a) This risk needs to be mitigated by ESP ~~and CCA~~ entities and not by IOUs
 27 | and the bundled customers. The issue remaining is not whether or not
 28 | counterparty risk exists but rather the potential size of this risk and prudent
 29 | amount of security requirement.
- 30 | (b) The accurate measure for this risk is a PFE model as proposed in the CCA
 31 | proceeding (R.03-10-003). The Commission needs to ensure that ESP_T
 32 | ~~CCA~~_T and bundled customers are protected under adverse market
 33 | conditions.

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 33 practices that are common contractual terms for credit risk and security

1 ffi Milestone payment structure, which impacts exposure if any
2 advance payments are involved

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22 **G. Conclusions and Recommendations**

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

- 25 (a) This risk needs to be mitigated by ESP entities and not by IOUs and the
26 bundled customers. The issue remaining is not whether or not counterparty
27 risk exists but rather the potential size of this risk and prudent amount of
28 security requirement.
- 29 (b) The accurate measure for this risk is a PFE model as proposed in the CCA
30 proceeding (R.03-10-003). The Commission needs to ensure that ESP and
31 bundled customers are protected under adverse market conditions.
- 32 (c) A proper security requirement is a sufficient and feasible instrument to
33 ensure appropriate protections for all customers.