BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Integrate and Refine Procurement Policies and Consider Long-Term Procurement Plans.	Rulemaking 10-05-006 (Filed May 6, 2010)

COMMENTS OF L. JAN REID ON PROPOSED DECISION OF ALJ ALLEN

November 30, 2011

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SUBJECT INDEX

Page

I. Overview 1
II. Recommendations 2
III. Legal Requirements.. 3
A. Just and Reasonable Rates 5
B. Moderation of Price Risk.. 5
C. Balancing of Price and Stability 5
IV. Planning Assumptions 6
V. The Rate Cap 9
VI. Hedging 10
A. The Commission's Traditional View of Hedging 10
B. The DRA's Hedging Analysis 11
C. Hedging Costs 13
D. Hedging Complexity 13
VII. Conclusion 14

SB_GT&S_0612373

TABLE OF AUTHORITIES

California State Law — Page

Public Utilities Code § 454 3-5

CPUC Decisions

Decision 02-08-071 7
Decision 02-10-062 7
Decision 02-12-074 7
Decision 03-12-062 7-8
Decision 04-01-050 8
Decision 04-12-048 8
Decision 07-12-052 8
Decision 09-05-025 6

SB_GT&S_0612374

I. Overview

Pursuant to Rule 14.3 of the Commission's Rules of Practice and Procedure, L. Jan Reid (Reid) submits these opening comments on the proposed decision (PD) of Administrative Law Judge (ALJ) Peter Allen in Track II of Rulemaking (R.) 10-05-006 concerning the bundled procurement plans of the Investor Owned Utilities (IOUs)[1] in Rulemaking (R.) 10-05-006. (Agenda ID #10827.) Chief ALJ Karen Clopton mailed the PD on November 10, 2011. Opening comments are due Wednesday, November 30, 2011. I will file this pleading electronically on the due date, intending that it be timely filed.

The PD introduces and adopts a rate cap of 10% over a rolling 18-month period. That rate cap was not recommended by any party in this proceeding, and this is the first opportunity that parties have had to comment on the proposed rate cap. I discuss the rate cap in Section V of this pleading.

I urge the Commission to modify the PD by eliminating the rate cap; by not changing the Consumer Risk Tolerance (CRT) level; and by correcting the errors identified below.

[1] The IOUs in this proceeding are Pacific Gas and Electric Company (PG&E), Southern California Edison Company (SCE), and San Diego Gas & Electric Company (SDG&E).

SB_GT&S_0612375

II. Recommendations

I have relied on state law and past Commission decisions in developing recommendations concerning the bundled procurement plans of the IOUs.

I recommend the following:[2]

1. The Commission should not approve an IOU's procurement plan if the Commission did not consider the balance between price stability and the price level. (pp. 5-6)
2. The Commission should find that PG&E's and SDG&E's procurement plans, as submitted, comply with the requirements of PUC § 454.5. (pp. 6-8)
3. The Commission should order the IOUs to procure based on the latest available information, and not on planning assumptions that may be up to two years old. (p. 7)
4. The Commission should use the results of the standardized planning assumptions to inform its decision-making process. (p. 7)
5. The Commission should not approve the rate cap suggested by the PD. (pp. 9-10)
6. The Commission has traditionally given the IOUs the authority to conduct hedging in order to reduce risk. (p. 10)
7. The Commission should not change the Consumer Risk Tolerance (CRT) level at this time. (pp. 12-13)
8. If the Commission believes that hedging costs are too high, they should modify the IOUs' plans and reduce the hedge percentage; place a restriction on the amount of money spent; change the mix of swaps and options; and change or establish the hedging targets and limits in the IOUs' plans. (p. 13)

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[2] Citations for these recommendations and proposed findings are given in parentheses at the end of each recommendation and finding.

SB_GT&S_0612376

My recommendations are based on the following proposed findings:

1. Actual procurement costs may be higher than forecasts because of factors that may arise in the future. These may include an increase in natural gas prices, an increase in electricity prices, new regulatory requirements (e.g., carbon reduction), an increase in the IOUs' authorized rate of return, interest rate increases, and other factors. (p. 4)

2. Even if procurement costs increase, the Commission will still be in compliance with the "just and reasonable" requirements of PUC § 454(d), as long as the Commission ensures that the approved procurement plans accomplish the objectives of PUC § 454(d). (p. 4)

3. In the past, the Commission has used planning results both to determine whether or not additional procurement is needed, and to establish certain policy goals. (pp. 7-8)

4. The DRA's hedging analysis was limited to financially settled futures contracts, which are a subset of hedging. (pp. 11-12)

5. The Commission has no basis to conclude that ratepayers have hedged to prevent relatively minor rate increases or that ratepayers have spent too much for hedging. (pp. 11-12)

III. Legal Requirements

The PD is inconsistent with state law. Public Utilities Code Section (PUC §) 454.5(d) requires that:

> A procurement plan approved by the commission shall accomplish each of the following objectives:
>
> (1) Enable the electrical corporation to fulfill its obligation to serve its customers at just and reasonable rates.
>
> . . .
>
> (4) Moderate the price risk associated with serving its retail customers, including the price risk embedded in its long-term supply contracts, by authorizing an electrical corporation to enter into financial and other electricity-related product contracts.

SB_GT&S_0612377

> (5) Provide for just and reasonable rates, with an appropriate balancing of price stability and price level in the electrical corporation's procurement plan.

The PD states that "To the extent that the cost of procurement is higher than forecast, however, there is a potentially significant problem, as the Commission cannot be said to have found the correspondingly higher rates to be just and reasonable, as required under section 454.5(d)." (PD, p. 7)

Procurement costs may be higher than forecasts due to an increase in natural gas prices, an increase in electricity prices, new regulatory requirements (e.g., carbon reduction), an increase in the IOUs' authorized rate of return, an increase in interest rates, and other factors. I note that all of these factors are beyond the control of the utilities.

In its bundled plan, PG&E assumed a low gas price of $2/million British Thermal Units (mmBtu) and a high gas price of $10/mmBtu. PG&E estimated that its 2012 bundled revenue requirement will be $11.695 billion under the low gas price scenario and $13.633 billion under a high gas price scenario, a difference of $1.938 billion. (Exhibit 100, Table V-2, p. 80) Thus, rates will increase by approximately $2.4 million if gas prices increase by only one penny per mmBtu.[3]

Even if rates increase due to the factors listed above, the Commission will still be in compliance with the "just and reasonable" requirements of PUC § 454(d), as long as the Commission ensures that the approved procurement plans accomplish the objectives (see above) of PUC § 454(d).

Therefore, the above-quoted text that appears on page 7 of the PD should be deleted.

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[3] $1,938 million/800 = $2.423 million.

SB_GT&S_0612378

The PD does not allow the IOUs to serve their customers at just and reasonable rates. The PD does not moderate price risk, and it does not balance price stability and price level as required by state law. I briefly discuss each of these issues below.

A. Just and Reasonable Rates

Black's Law defines just as "Legally right; lawful; equitable"[4] and reasonable as "Fair, proper, or moderate under the circumstances."[5] Therefore, I define just and reasonable costs as costs which are lawful and consistent with local market prices, including hedging costs. Since the PD would restrict the IOUs' ability to hedge electricity price risk (and thereby rates), the resulting rates might not be just and reasonable. This is especially true if natural gas or electricity prices increase significantly during a given period. In such cases, the existence of unreasonable hedging limitations would result in rates that would not be just and reasonable.

B. Moderation of Price Risk

Hedging is the primary tool by which utilities moderate price risk. If hedging is unreasonably restricted, price risk will not be moderated or effectively mitigated.

C. Balancing of Price and Stability

State law requires that a procurement plan approved by the Commission must "Provide for just and reasonable rates, with an appropriate balancing of price stability and price level in the electrical corporation's procurement plan."

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[4] Black's Law Dictionary, 9th edition, Thomson Reuters, 2009, p. 942.

[5] *Ibid*., p. 1379.

SB_GT&S_0612379

(PUC § 454(d)(5)) The PD's hedging restrictions do not appropriately balance price stability and the price level. I note that the PD does not even discuss the balance between price stability and price level. The Commission is expressly prohibited from approving procurement plans if the Commission did not consider the balance between price stability and the price level.

IV. Planning Assumptions

The PD incorrectly states that "In essence, SDG&E and PG&E are saying that it does not matter what comes out of this proceeding – they will procure whatever they want, in whatever quantity they think best." (PD, p. 10)

SDG&E and PG&E are saying that they will procure based on the latest available information, and not on planning assumptions that may be up to two years old. SDG&E witness Anderson has explained that "[a]ctual procurement will vary over time, based on the best available data at that time." (PD, p. 9) Anderson's statement is consistent with the prudent manager standard that has guided Commission decision-making for decades.

Most recently, in a decision that approved a contract between Bear Valley Electric Service and Shell Energy North America, the Commission found that:

> The Shell contract terms executed by Bear Valley may or may not prove to be the best possible price in hindsight. But our standard of review is that of a prudent manager. Thus, the reasonableness of a particular management action depends on what the utility knew or should have known at the time that the managerial decision was made, not how the decision holds up in light of future developments. (D.09-05-025, slip op. at 7-8)

IOUs cannot acquire new capacity if the Commission does not authorize it, and they cannot procure power that their customers do not need. The Commission must approve or modify the procurement targets and limits contained in the

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IOUs' plans. If the IOUs ignore the targets and limits contained in their approved plans, the IOUs will be subject to disallowances and will not be allowed to recover their costs in rates.

The PD states that: (PD, p. 6)

> The utilities need to procure the amount of electricity that is actually needed for the reliable operation of the grid, regardless of the level of need that was forecast in this proceeding. Accordingly, the utilities' actual procurement is likely to vary from that assumed in the standardized planning assumptions.
>
> While we should not force utility procurement to precisely conform to the standardized planning assumptions, the utilities cannot just disregard the standardized planning assumptions and procure whatever they want.

The standardized planning assumptions are primarily for the benefit of the Commission's decision makers, not for the benefit of the IOUs. The IOUs should procure based on the latest available information, and not on planning assumptions that may be up to two years old.

The Commission should use the results of the standardized planning assumptions to inform its decision making process. In the past, the Commission has used planning results to determine whether or not additional procurement is needed and to establish certain policy goals.

For example:

- In D.02-08-071, the Commission authorized the utilities to procure up to 100% of their low-case forecast scenario RNS needs. (D.02-10-062, slip op. at 10)
- The Commission ordered SCE to establish its monthly forward energy limit based on its Reference Case RNS-Reference Dispatch Scenario. (D.02-12-074, slip op. at 13)

SB_GT&S_0612381

- The Commission found PG&E's energy efficiency proposals to be reasonable after reviewing PG&E's analysis of its needs. PG&E's analysis incorporated forecasts of its net-residual short needs, matching these to programs that deliver energy savings and peak demand reduction measures with load profiles that reduce demand and save energy at times of forecasted need. (D.03-12-062, slip op. at 62-64)
- The Commission found that "Based on their filings, it appears that the utilities' planning reserve margins for 2004 are significantly above 7%." (D.03-12-062, Finding of Fact 3, slip op. at 81)
- The Commission questioned SCE's use of a $100/megawatt hour (MWh) cost for new generic renewables in SCE's resource models. (D.04-01-050, slip op. at 118)
- The Commission authorized PG&E to procure 1,200 megawatts (MW) of reserve and peaking capacity by 2008, and 1,000 MW of new peaking and dispatchable generation by 2010. (D.04-12-048, slip op. at 44)
- The Commission authorized PG&E to procure 800-1200 MW of new resources by 2015. (D.07-12-052, Ordering Paragraph 4, slip op. at 300)
- The Commission authorized SCE to procure 1200-1700 MW of new resources by 2015. (D.07-12-052, Ordering Paragraph 5, slip op. at 300)
- The Commission authorized SDG&E to procure 530 MW of new resources by 2015. (D.07-12-052, Ordering Paragraph 6, slip op. at 300)

Therefore, the Commission should find that PG&E's and SDG&E's procurement plans, as submitted, comply with the requirements of PUC § 454.5. This does not mean that I have no criticisms of PG&E's procurement plan. I have made several recommendations concerning PG&E's hedging plans that were not addressed by the PD. (See Exhibit 1301-C, pp. 3-7)

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V. The Rate Cap

I find the proposed rate cap in the PD confusing. I believe that it is insufficiently detailed, and I am concerned that it may not be implementable.

The PD states that:

> Based on our analysis and conclusions in the hedging section below, we find that procurement activities (consistent with this and other Commission decisions) that result in no more than a 10% system average rate increase over a rolling 18-month period are reasonable. We modify the procurement plans of PG&E and SDG&E to include this 10% cap.
>
> We note that a 10% system average rate increase due to procurement costs is significantly higher than what the utilities are forecasting in their procurement plans. (PD, pp. 13-14)

On the one hand, the PD refers to system average rates, and on the other to procurement costs. Does the PD propose a cap on system average rates, or does the cap apply only to procurement costs? Does the PD intend to somehow separate rates coming from procurement costs from rates coming from other factors? Does this mean that rates could go up 20% as long as only half the increase (10%) were due to procurement costs?

It is the Commission, not the utilities, that controls rates. The Commission determines a revenue requirement for each IOU in the IOU's general rate case. The Commission determines the cost of capital for the IOUs in cost-of-capital proceedings. The Commission also increases rates to accomplish policy goals such as in the case of smart meters, greenhouse gas reduction, resource adequacy, and many other policy goals.

The IOUs should only be responsible for costs which they have the ability to control. Much of their procurement costs are beyond their control. The IOUs do not control the market price of electricity or the market price of natural gas.

SB_GT&S_0612383

The Commission has noted that: (D.04-01-050, slip op. at 98)

> Fuel prices are notoriously volatile, especially on a short-term basis. They vary with changes in the economy, changes in hydro conditions, changes in drilling and pipeline conditions. They vary for other reasons that are sometimes understandable only in retro-spect if at all.

For all of the above reasons, the Commission should not approve the rate cap suggested by the Proposed Decision.

VI. Hedging

A. The Commission's Traditional View of Hedging

The PD departs from the Commission's traditional view of hedging by regulated utilities. Traditionally, the Commission has given the IOUs authority to conduct hedging in order to reduce risk. By definition, a hedge is a trade designed to reduce risk.[6] Hedge effectiveness is the percentage of variance that is eliminated by hedging.[7] The PD implicitly takes a market view, and would require the utilities to target rates instead of risk.

In 2002, the Commission ordered the IOUs to resume full procurement on January 1, 2003. (Decision (D.) 10-02-062, Ordering Paragraph 1, slip op. at 76) In this decision, the Commission recognized the basic risk-management principle that entities should hedge to reduce risk, subject to certain cost constraints.

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[6] John C. Hull, "Options, Futures, and Other Derivatives," 7th edition, Prentice Hall, 2009, p. 782.

[7] *Op. cit.*, Hull, pp. 55-56.

SB_GT&S_0612384

The Commission has stated that:

> It is clear that in order to develop coherent procurement strategies, the utilities must be able to evaluate potential transactions in terms of the costs of the transaction against the elimination of potential price risk. Given the lack of record, we require the utilities to provide a level of consumer risk tolerance, along with a justification for the level they propose in their modified procurement plans on November 12th.
>
> . . .
>
> In D.02-08-071, we granted utilities the authority to enter into additional contracts that will further reduce any reliance on spot purchases and *reduce consumers' risks of price volatility*. (D.02-10-062, slip op. at 44, emphasis added)

The Proposed Decision states that:

> We agree with DRA that our currently authorized hedging appears to have resulted in ratepayers purchasing hedging to protect against relatively minor rate increases. In short, ratepayers have been paying for too much hedging. Raising the CRT to 10% of each utility's system average rate should reduce both the amount and cost of hedging. While this potentially increases the risk to ratepayers of rate increases, that risk remains relatively limited. In addition, with the elimination of the previous 25% gap between CRT and remedial action, the utility and PRG will be more closely monitoring hedging activities at the critical times when markets become more volatile. (PD, pp. 25-26)

B. The DRA's Hedging Analysis

The PD's statements are based on an incomplete hedging analysis conducted by the DRA. The DRA's analysis was limited to a subset of hedges: financially settled futures contracts. Thus, the DRA provided an incomplete picture of the overall costs and benefits of the IOUs' hedging programs. Therefore, the Commission has no basis to conclude that that ratepayers have hedged to prevent relatively minor rate increases or that ratepayers have spent too much for hedging.

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Reid has pointed out that "Hedges which may purchased by the IOUs include capacity contracts, tolling contracts, financially and physically settled options, financially and physically settled swaps, purchases in the California Independent System Operator's (CAISO's) convergence bidding market, long-term natural gas supply contracts, renewables contracts, demand response products, and many other instruments." (Reply Brief of L. Jan Reid, [Reid Reply Brief] June 30, 2011, p. 5)

There are at least three major problems with DRA's analysis of hedging costs. These problems include: (Reid Reply Brief, pp. 2-5)

1. DRA assumes that there is no interaction between spot and forward or futures markets.

2. DRA assumes that the maximum possible annual rate increase is only 6.5%.

3. DRA defines the "cost" of hedging" as the settled value of financial hedges.

The IOUs are required to provide electricity and natural gas services to their bundled customers, regardless of the cost of energy. As the Commission and ratepayers found out during the energy crisis of 2000-2001, the risk being hedged is virtually infinite.

Reid has pointed out that: (Reid Reply Brief, p. 4, footnote omitted)

> As of late 2010, litigation concerning the energy crisis of 2000-2001 had still not been resolved. In 2010, the CPUC's Legal Division pointed out that California short-term claims are approximately $9 billion. There are also significant long-term costs. In 2010, the CPUC's Legal Division stated that "The CPUC and the Department of Water Resources (DWR) assert that ratepayers are entitled to recover the difference between the price of the contracts for power between long-term sellers and DWR and the much lower fair market price."

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C. Hedging Costs

The PD states that "When the costs of hedging are taken into consideration, this becomes even clearer, as the cost of hedging against a 10% rate increase should be lower than the cost of hedging against a 6.5% increase." (PD, p. 25)

This assumes that the IOUs would do the same type of hedging in both cases. This is not necessarily true. If the IOUs are forced to hedge against a 10% rate increase, the IOUs could simply purchase deep out-of-the money options.[8] These options would almost certainly expire out of the money and ratepayers would lose all of the money paid for option premiums. In fact, ratepayers could be worse off if the IOUs hedge against a 10% rate increase than under the present system. Therefore, the Commission should not change the CRT at this time.

If the Commission believes that hedging costs are too high, they should modify the IOUs' plans and reduce the hedge percentage, place a restriction on the amount of money spent, change the mix of swaps and options, and change or establish the hedging targets and limits in the IOUs' plans.

D. Hedging Complexity

Conclusion of Law 9 states that "Utility hedging should be made simpler and less expensive." The PD does not discuss whether or not utility hedging programs are overly complex. I am unaware of any record evidence related to the complexity of utility hedging programs. Therefore, Conclusion of Law 9 should be deleted.

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[8] A deep out-of-the-money option is an option with a low probability of being exercised. For example, an IOU could purchase a call option on natural gas with an exercise price of $15/mmBtu when the current price of natural gas is $4/mmBtu.

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VII. Conclusion

The Commission should modify the PD as recommended by Reid for the reasons given herein.

* * *

Dated November 30, 2011, at Santa Cruz, California.

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APPENDIX

Proposed Findings of Fact

Delete 4, 6, 8, 9, 10, and 11

Proposed Conclusions of Law

Delete 5, 8, 9, 10, and 11

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VERIFICATION

I, L. Jan Reid, make this verification on my behalf. The statements in the foregoing document are true to the best of my knowledge, except for those matters that are stated on information and belief, and as to those matters I believe them to be true.

I declare under penalty of perjury that the foregoing is true and correct.

Dated November 30, 2011, at Santa Cruz, California.

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