PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

ENERGY DIVISION **RESOLUTION E-3506**
NOVEMBER 5, 1997

RESOLUTION

ALTERNATE RESOLUTION E-3506. SOUTHERN CALIFORNIA EDISON COMPANY SEEKS COMMISSION APPROVAL OF RECOVERY OF COSTS OF ACQUIRING RISK MANAGEMENT TOOLS UNDER CALIFORNIA PUBLIC UTILITIES CODE SECTION 368(c) AND DECISION NO. 96-12-77. APPROVED WITH MODIFICATIONS.

BY ADVICE LETTER 1247-E AND 1247-E-A, FILED ON AUGUST 22, 1997 AND OCTOBER 1, 1997, RESPECTIVELY.

SUMMARY

1. By Advice Letter 1247-E, Southern California Edison Company (Edison) seeks Commission approval of recovery of costs of acquiring risk management tools under California Public Utilities Code Section 368(c) and Decision No. (D.) 96-12-77.[1] Edison proposes to use gas hedging instruments to hedge natural gas prices currently used for generation and to hedge the impact of natural gas prices on the cost of electricity. Edison proposes that the costs recoverable from ratepayers per Section 368(c) include the costs of these instruments themselves and brokerage fees.

2. The Office of Ratepayer Advocates (ORA) protests Edison Advice Letter 1247-E on three grounds:

a) Edison's inclusion of system costs;
b) Edison's inclusion of administration and general expenses not included in current rates; and
c) Edison filing the Advice Letter with redacted information concerning the types of transactions Edison seeks to make recoverable from ratepayers and the program limitations. The ORA requests such redacted information not impede future reasonableness reviews of the out-of-pocket costs.

[1] Section references are to Public Utilities Code, except as noted.

3. By Advice Letter 1247-E-A, Edison removed reference to system costs and administration and general expenses from its proposed tariff. Edison also removed the redacted words from its proposed tariff.

4. This Resolution approves with modifications Edison's Advice Letter 1247-E and 1247-E-A.

BACKGROUND

1. Section 368(c) states:[2]

> "In consideration of the risk that the uneconomic costs identified in Section 367 may not be recoverable within the period identified in subdivision (a) of Section 367, ...(Edison) shall have the flexibility to employ risk management tools, such as forward hedges, to manage the market price volatility associated with unexpected fluctuations in natural gas prices and the out-of-pocket costs of acquiring the risk management tools shall be considered reasonable and collectible within the transition freeze period. This subdivision only applies to the transaction costs associated with the risk management tools and shall not include any losses from changes in market prices."

2. D.96-12-077 ordered Edison to modify its Interim Transition Revenue Balancing Account (ITRBA) to include the difference between revenues collected under frozen rates and the adopted consolidated revenue requirement. On December 30, 1996, Edison filed Advice Letter 1212-E revising the ITRBA. On February 7, 1997, Edison filed substitute Preliminary Statement sheets (numbers 21493-E and 21494-E) to Advice 1212-E, which renamed the ITRBA to the Interim Transition Cost Balancing Account (ITCBA) and added a provision for the recording of any interim transition costs to the ITCBA for recovery, effective January 1, 1997.

3. Edison proposes a Transition Cost Balancing Account (TCBA) in Application No. 96-08-071. The TCBA would be used to record certain transition costs and revenues associated with electric industry restructuring. Upon the effective date of the TCBA, Edison proposes to transfer the balance in the ITCBA with accrued interest to the TCBA. Upon the transfer, Edison proposes no further entries to the ITCBA be made and the ITCBA be removed from Edison's Preliminary Statement.

[2] The legislature through Assembly Bill 1890 added Section 368 in 1996.

4. By Advice Letter 1247-E, Edison is proposing to record in the ITCBA, and later in the TCBA when effective, the costs of instruments used to manage the risk of fluctuating prices of natural gas used for generation and the risk of fluctuating natural gas prices' impact on electricity prices. Edison asserts its program will not be using physical transactions which would result in Edison's receiving or delivering gas. Physical contracts, such as forward hedging contracts for the future purchase or sale of gas are not elements of its program and the costs of such transactions would not be recorded in the ITCBA. Edison proposed its risk management program include : (1) a portfolio of "out-of the money" gas options which function as catastrophe insurance against sustained high gas prices; and/or (2) insurance policies which perform the same function.

5. Edison asserts ratepayers would pay for risk management costs only to the extent there is sufficient difference between rate levels needed to recover all costs, including transition costs, and the frozen rate levels. Edison claims hedging costs would only be recovered in situations where the rate freeze period otherwise would have ended earlier than March 31, 2002.

6. Edison proposes to record in the ITCBA, and later in the TCBA when effective, the out-of-pocket costs of acquiring the gas risk management tools: the costs of the financial instruments or an insurance policy with equivalent benefits; brokerage fees; and system costs. Edison claims most of the costs will be the costs of the financial instruments or insurance policies themselves. Edison asserts related administrative and general costs, such as the costs of employees managing the program would not be recorded in the accounts. Edison assures losses from the changes in market prices would not be recorded in these accounts.

7. Edison alleges it would not have the incentive to manipulate power exchange (PX) prices or electric derivative prices. Edison claims attempts to increase the price of energy to enhance the value of a gas financial instrument could potentially cause Edison shareholders to incur large losses. Edison contends any use of market power to affect PX prices is unlikely to affect the value of gas financial instruments. Edison alleges the price of electricity follows gas because substantial generating capacity uses gas, but the reverse is not true, except to the limited extent customers can substitute the two sources of energy. Edison points out that in its March 31, 1997 filing to the Federal Energy Regulatory Commission (FERC), Edison claims there will only be a few hours when it is a net seller. Edison claims it is proposing effective market power mitigations to FERC.

8. Edison contends the Energy Division's assessment in an Examiner's Ruling dated May 12, 1997 in PG&E's Application 96-11-037 that gains from the use of Edison's gas hedging would benefit ratepayers is incorrect. Edison claims gains would be realized only by shareholders in consideration of the risk that the uneconomic costs will not be

recovered and per Section 368(c) losses from changes in market prices shall not be recovered from ratepayers.

9. Finally, Edison proposes a dollar limit on its hedging program costs and describes that types of hedging instruments it would use. Both Edison's proposed program limit and the types of instruments are redacted from parties' copy of Advice Letter 1247-E.

10. Commission staff met with Edison staff to gather further information regarding the Advice Letter and clarify issues. During these meetings, staff expressed concerns regarding the lack of need to hedge gas price volatility after divestiture of Edison's gas-fired generation facilities; anticompetitve transactions involving Edison's customers, generation facilities or generator affiliates; the significantly increase in risks to ratepayers as a result of substantially unlimited hedging; and the inability of ratepayers to share in any gains from these transactions. At these meetings, Edison alleged electricity prices are highly correlated with fluctuations in the price of natural gas, and Section 368(c) provides for Edison to use gas instruments to hedge PX prices. Edison pledges not to enter into any gas hedging instruments with customers, generation facilities, or generator affiliates; contends the risk of nonrecovery of all of its transition costs in conjunction with its proposed program limits will minimize program costs; and is willing to flow back to ratepayers gains, net of any losses, from the use of these transactions, if all of Edison's transition costs are recovered.

NOTICE

1. Edison Advice Letter 1247-E was served on other utilities, government agencies, and to all interested parties who requested such notification, in accordance with the requirements of General Order 96-A. Public notice of this filing has been made by publication in the Commission's calendar.

PROTESTS

1. On September 11, 1997, ORA filed a Protest to Edison Advice Letter 1247-E. The ORA is particularly concerned that Edison redacted certain language regarding the definition of allowable costs and the description of the types of transactions Edison seeks to make recoverable from ratepayers. The ORA is concerned that such redacted information is not in conformance with Section 491. The ORA requests that such redacted information not impede future reasonableness reviews of the expenditures.

2. The ORA asserts Edison is including costs which are ineligible for recovery under Section 368(c), specifically system costs, such as the software necessary to monitor the

positions taken in the financial market, and any administrative and general expenses associated with the transactions.

3. On September 19, 1997, Edison responded to the ORA's protest. Edison claims Section 368(c) did not limit the cost recovery only to a specific list of tools, and that systems, such as software to monitor the positions taken, are risk management tools. Edison asserts such costs would be relatively minor and it is willing to remove reference to such costs from its proposed tariff. Edison claims it only included the phrase "included in current Commission rates" as a way to explain why it was not including administrative and general expense. Edison asserted it would remove from its proposed tariff the above phrase.

4. Edison asserts if the market were to know in advance the types and amount of instruments Edison will purchase, the cost of those instruments would likely be driven up by other traders making use of this proprietary information. Edison believes the ORA's concerns can be resolved by removing the redacted words from the tariff entirely. Edison claims the names of the instruments do not need to be included in the tariff in order for the Commission to determine whether Edison traded only the instruments it was authorized to trade.

5. Edison submitted a supplemental filing on October 1, 1997 reflecting the changes as described above.

DISCUSSION

1. We do not have facts from parties in this filing on whether or not Edison's proposed program limitations, sharing mechanism, pledge not to enter into any gas hedging instruments with customers, generation facilities or generator affiliates, or proposals to FERC to mitigate market power are adequate. For example, Edison's program limits may be too high, the sharing mechanism may not be in conformance with what was intended in Section 368(c), or other protective mechanisms may be needed.

2. With regards to the substantial risks inherent in using hedging instruments, we can turn to Commission ordered program limitations and other protective measures used for similar hedging instruments used to manage interest rate fluctuations:

a) utilities deal only with institutions with a credit rating equal or better than the utility;[3]

[3] D.95-09-023, 1995 Cal. PUC LEXIS 694 at 44 (PG&E); D.97-02-007, 1997 Cal. PUC LEXIS 69 at 24 (Pacific Bell); D.93-09-069, 51 CPUC 2d 14, 1993 Cal. PUC LEXIS 670 at 26 (SDG&E); D.96-05-025,

b) implement program limitations;[4]
c) require utilities to separately report all income and expenses incurred from derivative transactions in monthly and annual financial reports to the Commission;[5] and
d) request the utility to deliver, within 30 days, copies of all agreements, along with a report analyzing all costs associated with the agreements in comparison to a projection of all costs without the agreements.[6]

3. Such protective measures, as 2.a. above, help to mitigate concerns regarding the impacts of such hedging activities on a utility's costs of capital. Instead of implementing this restriction, which could impede Edison's ability to use these types of hedging instruments, we will not allow Edison to recover any increase or perceived increase in its costs of capital due to its hedging activities.

4. Edison proposed a program limitation-for the four year period to allow Edison to hedge all of its energy needs.[7] However Edison should only need to hedge energy costs that are subject to gas pricing fluctuations. Our understanding is that such gas pricing fluctuations affect 40% to 60% of Edison's energy needs over time. Limiting Edison to hedge three-fourths of its estimated program limitation costs, a maximum of $150 million for out-of pocket costs for the four year period, will adequately allow Edison to hedge its energy needs that are subject to-gas volatility.

5. We are taking steps relative to FERC and other proceedings to ensure that utilities do not have market power or are unable to exercise market power to effect PX prices.

6. The Commodity Futures Trading Commission has oversight authority over instruments traded at exchanges under its jurisdiction and maintains a rule enforcement program which monitors market activities for price distortions, and conducts a prior review of exchange contracts to assure that the terms of the contracts closely reflect the underlying cash market. Limiting Edison's use of gas hedging to instruments traded on exchanges regulated by the Commodity Futures Trading Commission could help to

---

1996 Cal. PUC LEXIS 716 at 18 (Southwest Gas Corporation); D.96-05-066, 1996 Cal. PUC LEXIS 680 at 9 (SDG&E).

[4] No more than 20% of the utility's outstanding debt, D.95-09-023 at 44 (PG&E), D.97-02-007 at 24 (Pacific Bell); no more than 20% of total outstanding debt or the total amount of floating interest rate long-term debt, D.96-06-025 at 18 (Southwest Gas); no more than $250,000,000 of its total long-term debt, D. 93-09-069 at 25-26, D.96-05-066 at 9 (SDG&E); with the exception of currency forward contracts, no swaps or over the counter derivatives are allowed, D.95-07-055, 60 CPUC 2d 658, 667, 995 Cal. PUC LEXIS 605 at 44 (PG&E, Edison, and SDG&E Nuclear Decommissioning Trust).

[5] D.95-09-023 at 44 (PG&E); D.97-02-007 at 24 (Pacific Bell); D. 93-09-069 at 26 (SDG&E), D.96-05-066 at 9 (SDG&E).

[6] D.95-09-023 at 46 (PG&E); D.97-02-007 at 24 and 25 (Pacific Bell); D. 93-09-069 at 27-28 (SDG&E, documentation of executed agreements only).

alleviate market power concerns and help to mitigate the substantial increase in risks associated with the use of hedging instruments. However, we will not impose this condition at this time. As we review the reports Edison will submit pursuant to this order, we may further consider the need for this condition.

7. Section 368(c) permits recovery of out-of-pocket costs of acquiring the risk management tools, but those costs are not to include any losses from changes in market prices.

8. Section 368(c) provides for Edison to use "risk management tools, such as forward hedges." The one example of the type of management tool specifically mentioned by Section 368(c), a forward hedge, is a physical transaction which would result in Edison's receiving or delivering gas, if it is unable to close its position before maturation of the instrument. The risk management tools Edison is requesting out-of-pocket costs for will not involve physical transactions which would result in Edison's receiving or delivering gas if it is unable to close its position. Physical contracts, such as forward hedging contracts for the future purchase or sale of gas are not elements of Edison's proposed program. Section 368(c) does not limit Edison to forward hedges, but allows risk management tools in general. There is no specific basis in the code to limit Edison to any particular risk management tool.

9. Edison should not enter into any contracts for differences with its customers, generation facilities or affiliates without first seeking approval from the Commission to do so.

10. It is possible that third party intermediaries could facilitate contracts for differences between Edison and its customers, generation facilities, or affiliates. Edison should include language in any hedging contracts it enters into under this program to the effect that the other party to the instrument does not have any risk management contracts with any of Edison's customers, generation affiliates or generation facilities.

11. Transition cost eligibility issues are being addressed in A.96-08-001. Edison did not include a request for recovery of these out-of-pocket costs in that proceeding. To date, there has been substantial controversy over what should be included as a transition cost. These costs should be reviewed for compliance in the annual transaction costs proceedings.

12. Edison Advice Letter 1247-E is in compliance with Section 368(c). The following modifications will help to alleviate concerns regarding the substantial risks associated with the use of hedging instruments and help to mitigate market power concerns:

a) limiting recovery to out-of-pocket costs such as brokerage fees that do not include losses from changes in market prices;
b) recording the out-of-pocket costs (brokerage fees) in a memorandum account;
c) limiting Edison's program-to energy costs that are subject to fluctuations. Our understanding is that such energy is approximately 40-60% of Edison's energy needs over time;
d) limiting Edison to hedge at three-fourths of its proposed program limits, a maximum of $150 million, for out-of pocket costs for the four year period;
e) not compensating Edison for any increases, or perceived increases, in its costs of capital that result from the use of these hedging activities;
f) requiring Edison to not enter into any hedging contract under this program with any of its customers, generation facilities, or affiliates;
g) requiring Edison to include language in any hedging contracts it enters into under this program to the effect that the other party to the instrument does not have or will not enter into any risk management contracts with any of Edison's customers, affiliates or generation facilities.
h) Edison shall send a copy of each hedging instrument it enters into under this program to the Energy Division within 10 days of executing the contract;
i) requiring Edison to file a monthly report with the Commission indicating its monthly maximum end-of-day hedging position, including but not limited to gross receivable (in-the-money) and gross payable (out-of-the-money), and at-the-money volumes on open financial positions, showing both contract volume (MMBTU) and market value ($M). To qualify for netting, instruments must meet three requirements: 1) the financial product must match, 2) the location must match, and 3) time must match (the product must be bought and sold within the same month). Additionally, the average maturity would be presented as the end of day average maturity for both receivables and payables; and
j) reviewing Edison's out-of-pocket costs will for compliance before being booked into the ITCBA.

13. The out-of-pocket costs are not costs of programs to accommodate the implementation of direct access, the PX and the Independent System Operator and therefore are not Section 376 costs.

14. The ORA's protest is moot because Edison filed Advice Letter 1247-E-A which removed from its proposed tariff the inclusion of system costs, removed the phrase "included in current Commission authorized rates" with respect to administrative and general expenses, and deleted the redacted words from the proposed tariff.

FINDINGS

1. On August 22, 1997, Southern California Edison Company (Edison) filed Advice Letter 1247-E and 1247-E-A requesting approval of recovery of costs of acquiring risk management tools under California Public Utilities Code Section 368(c) and Decision 96-12-77.

2. ORA protests Advice Letter 1247-E. ORA raised the following issues:

a) Edison's inclusion of system costs;
b) Edison's inclusion of administration and general expenses not included in current rates; and
c) Edison filing its proposed tariff with redacted information concerning the types of transactions Edison seeks to make recoverable from ratepayers and the program limitations. The ORA requests such redacted information not impede future reasonableness reviews of the out-of-pocket costs.

3. ORA's protest is moot because:

a) Advice Letter 1247-E-A addressed and implemented the ORA's first three requests; and
b) the redacted information which was removed from the proposed tariff will not impede ORA's review of the out-of-pocket costs for compliance.

4. Section 368(c) permits recovery of out-of-pocket costs of acquiring the risk management tools, but those costs are not to include any losses from changes in market prices.

5. Physical contracts, such as forward hedging contracts for the future purchase or sale of gas, are not elements of Edison's proposed program.

6. Edison Advice Letter 1247-E and 1247-E-A is in compliance with Section 368(c). The following modifications should be approved to help mitigate concerns regarding market power and the substantial risks associated with the use of derivatives:

a) limiting recovery to out of pocket costs such as brokerage fees that do not include losses from changes in market prices;
b) recording the out-of-pocket costs (brokerage fees) in a memorandum account;
c) limiting Edison's program to the gas instruments requested in Advice Letter 1247-E and 1247-E-A;

d) limiting Edison's use of gas hedging instruments, to hedging energy costs that are subject to gas pricing fluctuations. Our understanding is that such energy is approximately 40-60% of Edison's energy needs over time;
e) limiting Edison to hedge at three-fourths of its proposed program limits , a maximum of $150 million, for out-of-pocket costs for the four year period;
f) not compensating Edison for any increases or perceived increases in its costs of capital that result from the use of these hedging activities;
g) requiring Edison to not enter into any hedging contract under this program with any of its customers, generation facilities, or affiliates;
h) requiring Edison to include language in any hedging contracts it enters into under this program to the effect that the other party to the instrument does not have or will not enter into any contracts with any of Edison's customers, affiliates or generation facilities;
i) Edison shall send a copy of each hedging instrument it enters into under this program to the Energy Division within 10 days of executing the contract;
j) requiring Edison to file a monthly report with the Commission indicating its monthly maximum end-of-day hedging position, including but not limited to, gross receivable (in-the-money) and gross payable (out-of-the-money), and at-the-money volumes on open financial positions, showing both contract volume (MMBTU) and market value ($M). To qualify for netting, instruments must meet three requirements: 1) the financial product must match, 2) the location must match, and 3) time must match (the product must be bought and sold within the same month). Additionally, the average maturity would be presented as the end of day average maturity for both receivables and payables;
k) requiring Edison to record the out-of-pocket costs in a memorandum account; and
l) reviewing the out of pocket costs will for compliance in the annual transaction costs proceedings before being booked into the ITCBA.

7. These out-of-pocket costs are not costs of programs to accommodate the implementation of direct access, the PX and the Independent System Operator and therefore are not Section 376 costs.

THEREFORE, IT IS ORDERED that:

1. Edison Advice Letter 1247-E and 1247-E-A are approved with the following modifications and clarifications:

a) recovery is limited to out of pocket costs such as brokerage fees that do not include losses from changes in market prices;
b) the out-of-pocket costs-shall be recorded in a memorandum account;
c) Edison's program is limited to use of the gas instruments requested in Advice Letter 1247-E and 1247-E-A;
d) Edison's use of gas hedging instruments is limited to hedging energy costs that are subject to gas price_fluctuations. Our understanding is that such energy is approximately 40-60% of Edison's energy needs over time and will not exceed $150 million.
e) Edison is limited to three-fourths of its proposed program limitation for_-out-of pocket costs for the four year period;
f) Edison shall not be compensated for any increases or perceived in its costs of capital that result from the use of these hedging activities;
g) Edison shall not enter into any contracts for differences with its customers, generation facilities, or affiliates;
h) Edison shall include language in any risk management contract it enters into under this program to the effect that the other party to the instrument does not have or will not enter into any contracts with any of Edison's customers, affiliates or generation facilities.
i) Edison shall send a copy of each hedging instrument it enters into under this program to the Energy Division within 10 days of executing the contract;
j) Edison shall file a confidential monthly report with the Energy Division indicating its monthly maximum end-of-day hedging position, including but not limited to gross receivable (in-the-money) and gross payable (out-of-the-money), and at-the-money volumes on open financial positions, showing both contract volume (MMBTU) and market value ($M). To qualify for netting, instruments must meet three requirements: 1) the financial product must match, 2) the location must match, and 3) time must match (the product must be bought and sold within the same month). Additionally, the average maturity would be presented as the end of day average maturity for both receivables and payables; and
k) Out-of-pocket costs shall be reviewed for compliance in the annual transaction costs proceedings before being booked into the Interim Transition Cost Balancing Account.

2. Within ten days from today's date, Edison shall file revised tariff sheets to reflect the above changes.

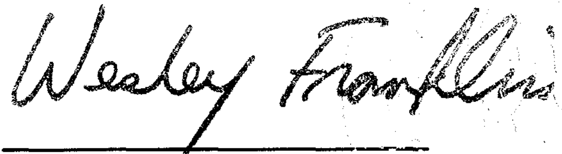
3. The ORA's protest is moot.

4. Edison Advice Letter 1247-E and 1247-E-A shall be marked to show that they were approved with modifications by Commission Resolution E-3506.

5. Edison is hereby put on notice that this Commission may on its own motion, at any time, institute additional modifications to or program limitations on the authority we grant today.

This Resolution is effective today.

I hereby certify that this Resolution was adopted by the Public Utilities Commission at its regular meeting on November 5, 1997. The following Commissioners approved it:



WESLEY M. FRANKLIN
Executive Director

P. Gregory Conlon, President
Jessie J. Knight, Jr.
Josiah L. Neeper
Richard A. Bilas
Commissioners

I dissent.

/s/ Henry M. Duque
Commissioner