

**DOCKET**

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California Energy Commission  
2009 Integrated Energy Policy Report

# Core Natural Gas Procurement

March 10, 2009

# Natural Gas Market Environment

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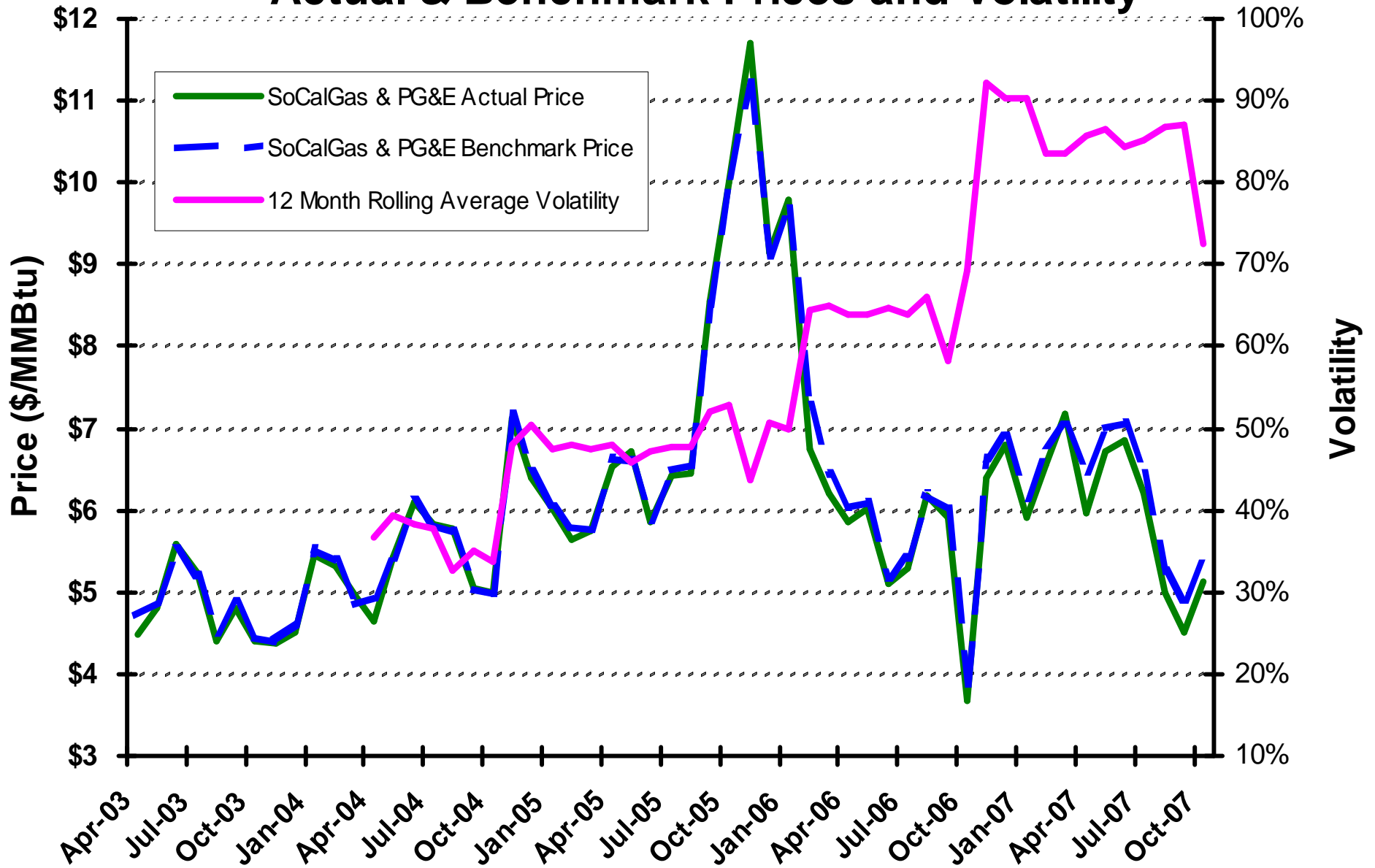
- Prices remain extremely volatile: In 2008 SoCal border prices ranged from \$2.49 per MMBtu (Oct) to \$12.68 per MMBtu (Jun)
- Combined impact of indigenous gas growth and global economic downturn result in current over-supply condition estimated to be 6 Bcfd in a 73 Bcfd market (US + Canada):
  - q Prices collapse
  - q Replacement costs exceed market prices
  - q Exploration activity falls 40% since August 2008
- In recovery, gas demand will outstrip supply driving prices higher
- Dramatic price movements and volatility will characterize this market well into the future

# California Utility and Ratepayer Market Price Exposure

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- Since the 1990's, California's gas utilities have procured core supplies under CPUC-approved incentive mechanisms
- The incentive mechanisms were designed and implemented in a period of prolonged gas-on-gas competition and low prices
- Performance under the mechanisms is measured against benchmark prices based upon monthly reported market prices
  - ◻ Promotes a short term (month-to-month) procurement focus
  - ◻ Discourages supply portfolio development
  - ◻ Discourages price hedging given shareholder exposures to losses if hedge prices exceed the benchmark price
- Utilities engage in very little hedging within the incentive mechanisms
- California ratepayers are fully exposed to market prices and market price volatility

# Actual & Benchmark Prices and Volatility



# Utility Winter Hedging Programs

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- Reacting to Hurricane Katrina, California's gas utilities petitioned the CPUC in 2005 for authority to hedge outside the incentive mechanisms
- Under the proposed hedging programs, the utilities sought and obtained approval to:
  - q Hedge to defend against price spikes
  - q Limit hedging to winter periods
  - q Pass through all program costs to customers
  - q Impose strict confidentiality on hedging strategies and transactions
- In the first 2 years, the utilities spent in excess of \$208 million
- The winter hedging programs are ineffective and expensive, providing no tangible benefits to customers

# Utility Procurement Options

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- Under the current incentive structures, the utilities limit their procurement options due to concern over shareholder exposure
- Focus is on month-to-month, market-priced gas
- Under the incentive structures, the utilities are financially indifferent to:
  - q The market price of gas
  - q Natural gas price volatility
- All hedging activities are currently conducted outside of the existing incentive mechanisms, under the CPUC's pre-approved winter hedge programs

# Hedging: Benefits and Risks

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- Hedging is not normally considered to be associated with gains or losses; hedging involves the transfer of risk
- The current incentive mechanisms discourage hedging - utility shareholders are exposed to financial losses if market prices fall below hedge prices
- Is hedging an acceptable risk for ratepayers? Yes!
- For ratepayers, hedging:
  - q Reduces price volatility, providing an element of rate stabilization
  - q Reduces exposure to price spikes
  - q May produce lower overall prices

# Utility Risk Mitigation Strategies

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- Hedging
  - q Mix of short-term (seasonal) and long-term (multi-year) products
  - q Fixed Price
  - q Options (Calls, Puts, Collars....)
- Storage (combined with hedging)
- Peak load shaving
- Natural gas reserve purchases
  - q California municipals have pursued this strategy
- Supply diversity
  - q Connect to 3 or more supply basins



# Incentive Structures Require Modification

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- In today's natural gas market, a new core procurement approach is required
- The CPUC instituted an OIR to address the utilities' incentive structures and identified two procurement goals:
  - q Low cost
  - q Price volatility mitigation
- In order to align the interests of ratepayers and shareholders, and to promote the CPUC's goals, the incentive mechanisms should be modified to:
  - q Cap shareholder exposure to hedging
  - q Motivate the utilities to develop and manage diverse supply portfolios
  - q Assess all utility procurement against objective measures
  - q Introduce accountability and consequences
  - q Increase the transparency of utility procurement activities
  - q Reduce the time and resources dedicated to oversight

# Shell Energy's Proposal to Promote Core Supply Portfolio Diversity

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- Leverage and expand the use of the existing incentive mechanism structure and benchmarks
- Introduce a price volatility reduction target and a volatility reduction benchmark
- Eliminate the tolerance bands
- Introduce a favorable risk / reward profile
- Cap utility rewards and penalties
- Require open and competitive hedge product solicitations



Shell Energy North America

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