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STATE OF CALIFORNIA  
BEFORE THE  
ENERGY RESOURCES CONSERVATION  
AND DEVELOPMENT COMMISSION

In the Matter of:

Preparation of the 2009  
Integrated Energy Policy Report

Docket No. 09-IEP-1J

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**COMMENTS OF SHELL ENERGY  
NORTH AMERICA (US), L.P. ON  
GAS UTILITY CORE PROCUREMENT**

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(US), L.P.

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In accordance with the procedural schedule adopted by the California Energy Commission (“Commission”), Shell Energy North America (US), L.P. (“Shell Energy”) presents its written comments on issues related to the California gas utilities’ core procurement practices. Laird Dyer, Shell Energy’s General Manager of Natural Gas Transport and Exchange, provided a presentation at the March 10, 2009, workshop in the above-referenced proceeding.

In its written comments, Shell Energy addresses the following Commission questions related to the California utilities’ gas procurement activities, as well as the utilities’ opportunities to mitigate natural gas price volatility:

1. To what extent are the gas utilities and ratepayers exposed to natural gas market price fluctuations?
2. What options do utilities have for natural gas procurement and cost recovery?
3. What risk mitigation strategies are available to the utilities?

4. How are the risks of hedging balanced against the benefits of hedging?
5. How do regulatory incentive mechanisms function in the overall procurement process?

Shell Energy's responses to these questions are set forth below:

## I.

### **UTILITY AND RATEPAYER EXPOSURE TO GAS PRICE VOLATILITY**

Under the current procurement structure developed by the California Public Utilities Commission ("CPUC"), California's gas utilities have no exposure to market prices or to market price volatility. Ratepayers, however, have unlimited exposure to both.

#### **A. Utility Exposure to Market Prices and Price Volatility**

California's gas utilities operate under CPUC-approved procurement incentive mechanisms that compare the utilities' gas purchase costs against benchmarks comprised of monthly market prices. The current incentive structures ensure that the utilities are indifferent to the price of gas and to price volatility; the incentive structures cause the utilities to focus their procurement strategy on just beating first-of-the-month ("FOM") market prices. Transcript (Tr.) at p. 18 (Emmrich). Under the current mechanisms, if the utilities purchase gas at \$12.95 per MMBtu in a \$13.00 per MMBtu market, these transactions are considered a success and a "savings" for ratepayers.

Utility procurement strategies that deviate from the monthly benchmark price expose the utilities' shareholders to unlimited financial losses. As a result, the utilities do not engage in hedging within the incentive mechanisms. Tr. 88 (Armato).

The utilities support the current incentive structures and argue for their continued use, without modification. At the March 10 workshop, SoCalGas/SDG&E representative Herb Emmrich stated: "If it isn't broken, why fix it?" Tr. 125. Certainly from the utilities' standpoint, the incentive mechanisms are not broken. The mechanisms are zero-risk structures that provide considerable value to utility

shareholders. This is not true for the utilities' core procurement customers, however, for four major reasons:

First, the procurement incentive mechanisms were designed and implemented in the 1990s, in a natural gas market characterized by prolonged gas-on-gas competition and low prices. Today's natural gas market is characterized by high prices and high volatility. The existing mechanism structures, which do not attempt to manage price or price volatility, ensure that customers remain fully exposed to market prices and price volatility. In a market characterized by monthly volatility exceeding 50 percent, the potential range of prices in a \$3 per MMBtu market are \$1.50 to \$4.50 per MMBtu (one standard deviation). In an \$8/MMBtu market, the range of prices can exceed \$4 to \$12 per MMBtu. The potential range of prices, and the corresponding volatility that characterizes the current and forward market, are too high to go unmanaged.

The CPUC has recognized that increased gas price volatility imposes costs and risks on ratepayers. In its ongoing rulemaking ("OIR") proceeding regarding the utilities' procurement and hedging activities (R.08-06-025), the CPUC identified two procurement goals for the utilities: low cost and price volatility mitigation. See OIR at p.5.

Second, the utilities embrace the existing incentive structure because it imposes zero risk on the utilities' shareholders while returning substantial value to shareholders. Under the incentive mechanisms, the utilities are "price takers": that is, the utilities simply buy FOM index gas. Given the substantial assets (i.e. storage, transport capacity and flow gas quantities) and corresponding flexibility available to the utilities (all asset costs are paid for by ratepayers), the only exposure the utilities face is "execution" risk. In the 15-year history of the incentive mechanisms, California's utilities have consistently realized shareholder rewards, illustrating how favorable the current structures are to the utilities.

Third, as a result of the incentives provided in the current mechanisms, the utilities' supply "portfolios" consist of one product: month-to-month index gas. California's gas utilities echo the view expressed by Ray Welch of Navigant (and formerly of PG&E's core procurement group) at the workshop: The utilities cannot beat the market, so why try? Tr. 95. As a result, they do not try. This limited procurement approach is inappropriate in view of current and expected market conditions.

Fourth, when confronted in 2005 by the impact of tight supplies, market upsets (Hurricanes Katrina and Rita) and dramatically increasing prices, the utilities petitioned the CPUC for permission to hedge outside of the incentive mechanisms under a winter-only hedging program. Tr. 16 (Emmrich); Tr. 82 (Armato). The utilities sought and obtained the right to pass through all costs to ratepayers, ensuring that the utilities remained indifferent to the cost of the program. Under the program, the utilities only need execute the pre-approved hedging strategy and ensure they do not incur costs exceeding an annual, per customer limit. Unlike the utilities, however, the utilities' ratepayers are not indifferent to the \$208 million spent by the utilities under the program. Unfortunately, ratepayers have derived no benefit from the utilities' winter hedging costs.

## **B. Customer Exposure to Market Prices and Price Volatility**

Unlike the utilities, ratepayers are fully exposed to market prices and market price volatility, both in the month-to-month procurement strategies and in the winter hedge programs employed by California's gas utilities. As discussed at the workshop, the utilities provide customers the option to reduce the variability in their monthly utility bills through level pay plans ("LPP"). Tr. 11 (Emmrich). The LPPs are not a substitute for an effective hedge program that mitigates price volatility, however.

Under the LPPs, prices and consumption are levelized, providing monthly bills that are relatively flat year-round. Tr. 84-85 (Armato). While the LPP is an effective way to reduce month-to-month customer bill variability, the LPP mutes both the price signal and consumption signal, thus eliminating the transparency necessary for effective demand-side management initiatives.

Furthermore, the LPPs do not address the CPUC's underlying procurement goal of mitigating price volatility within the utilities' supply portfolios. Finally, unless all customers are required to participate in the LPP programs, the utilities will still need to manage price and price volatility for non-participating customers in order to achieve the CPUC's dual procurement goals.

## **II.**

### **UTILITY PROCUREMENT OPTIONS AND COST RECOVERY**

The CPUC's ongoing OIR is currently exploring alternative approaches with respect to utility procurement and procurement cost recovery. Shell Energy has submitted a proposal in that proceeding to incorporate the winter hedges in the mechanism, while adjusting it to reflect a risk/reward ratio that encourages the utilities to hedge to mitigate price volatility. Shell Energy's proposal, which was highlighted at a November 2008 CPUC workshop in R.08-06-025, is attached.

## **III.**

### **RISK MITIGATION STRATEGIES AVAILABLE TO THE UTILITIES**

#### **A. Hedging**

Although the current incentive structures discourage hedging, the utilities have the discretion to engage in hedging within the incentive mechanisms. Notwithstanding that hedging can allow the utilities to lock-in favorable prices and manage market price volatility, the utilities have chosen not to hedge given shareholder exposures.

Although hedging involves the transfer of risk which may involve a cost, that cost can be dramatically reduced, eliminated or overcome under a well-designed and well-executed hedging strategy. At the March 10 workshop, CPUC Energy Division representative Richard Myers stated that the overall cost of a hedged portfolio will always exceed the cost of an un-hedged portfolio. Tr. 137. He stated further that hedging is an insurance program against extreme prices. Tr. 138. These statements are incorrect.

First, Mr. Myers ignores the considerable price volatility mitigation benefit that customers derive from hedging. In this connection, there is no evidence to support Mr. Myer's assertion that the incentive mechanisms have delivered lower costs to customers (exclusively through short-term purchases) than would have been realized under a professionally risk-managed supply portfolio. Second, hedging can be more than just expensive insurance against extreme prices. In his statement, Mr. Myers ignores the excessive amount of money the utilities have spent outside of the procurement mechanisms, but within the CPUC-approved winter hedge programs, evidencing the poor design and implementation of the those programs.

In the CPUC's OIR, Shell Energy has proposed that the incentive mechanisms should be modified to promote low cost procurement and price volatility mitigation in order to align the interests of ratepayers and shareholders. Hedging can do much more than just protect the utilities' supply portfolio from price spikes. Utility hedging can and should be more robust, aimed at achieving the CPUC's procurement goals.

## **B. Storage**

California's gas utilities rely upon storage to mitigate price risk. See Tr. 23 (Emmrich). The utilities operate storage, however, in a manner that presumes summer prices will always be lower than winter prices. While this is generally true, over the past eleven years, there were three years in which summer prices exceeded winter prices. In those years, at the southern California border, summer prices exceeded winter prices on average by \$2.70 per MMBtu.

In addition to using storage to address seasonal price patterns, the utilities should also hedge the price of gas injected into storage. In the current environment, locking-in prices for the next few summers and selling put options at attractive strike prices provides value and will reduce costs for customers. The utilities should be more proactive in managing the price of gas in storage.

### **C. Reserve Purchases**

A number of California's municipal utilities have purchased natural gas reserves in the Rocky Mountains and in Texas. Under this approach, the municipal utilities have opted for a very different set of risks. The municipal utilities gain price certainty, provided that the gas flows. The municipal utilities now are exposed to reserve and production risks, however, which require dramatically different core competencies.

### **D. Supply Diversity**

The utilities claim that supply diversity is a "hedge" for customers. Tr. 17-18 (Emmrich). This is misleading. Supply diversity is necessary because it provides flexibility to buyers, increases reliability, and enhances negotiating leverage. However, prices at the locations where California's utilities buy gas are highly correlated, closely tracking the prices at the southern California border and at the PG&E "citygate." With such high price correlation, supply diversity is not a hedge against movements in price.

## **IV.**

### **BALANCING HEDGING RISKS AND BENEFITS**

Hedging involves the transfer of risk. California's utilities claim that hedging is risky for their customers given the potential that market prices will fall below the hedge price. In that circumstance, customers are deemed to be incurring "losses." This view is illogical and shortsighted.

During the workshop, PG&E, in responding to the statement that NYMEX prices could fall to \$2.50 per MMBtu, asked why PG&E should fix the price of gas today (at \$4 per MMBtu) when prices could fall further. Tr. 118 (Fox). PG&E's mindset prevents the utilities from taking advantage of opportunities to develop a portfolio of long-term fixed priced products.

As Shell Energy representative Dyer indicated in the workshop, the risk-reward profile of locking-in a fixed price in the current environment is extremely favorable. Given the range of prices



over the last year (\$2.49 per MMBtu to \$12.68 per MMBtu), the potential downside of not locking-in long-term prices at \$4.00 per MMBtu is far greater than the impact of a \$1.50 per MMBtu move down. Tr. 118-19 (Dyer). Furthermore, current market prices are extremely attractive relative to prices witnessed since 2002, and very attractive in absolute terms given that prices are trading at or below replacement cost. Finally, it is not a good strategy to limit one's procurement activities to buying absolute bottoms or selling absolute tops. That approach is neither practical nor reasonable.

There is much at stake for the utilities' core procurement customers regarding the cost of gas in the utilities' core supply portfolios. In the workshop, SoCalGas/SDG&E and PG&E indicated that their average core loads are 1.1 Bcfd and 0.8 Bcfd, respectively. Tr. 97 (Emmrich); Tr. 99 (Armato). Over a full year, total gas costs for these utilities can range from \$2.8 billion (at \$4 per MMBtu) to \$8.3 billion (at \$12 per MMBtu). This is a range of \$5.5 billion per year, the costs of which are borne solely by ratepayers. The utilities should be motivated to buy opportunistically and reduce customer exposure to market price volatility.

When combined with fundamental analysis, technical analysis, and a well thought-out risk management strategy, hedging provides substantial benefits for customers in terms of cost and overall bill stability. Although hedging involves a cost (entities need to be paid to assume risk), that cost can be mitigated, eliminated or overcome through a well-designed and executed strategy.

## V.

### **IMPACT OF REGULATORY MECHANISMS ON THE UTILITIES' PROCUREMENT PROCESS**

#### **A. Procurement Incentive Mechanisms**

The utilities' procurement incentive mechanisms, which were adopted in the early 1990s, were implemented to replace the very contentious and time consuming "reasonableness review" process, and to provide clear and objective measures of utility procurement performance. Under the incentive

structures, the utilities have well-defined parameters within which to procure gas, and their shareholders' financial exposure to these activities is contained. Shell Energy agrees with Mr. Myers' assessment that the incentive mechanisms are far superior to the reasonableness review process and can be designed to promote the Commission's procurement goals. Tr. 95-96 (Myers).

There are drawbacks, however, in the current design of the incentive mechanisms as was discussed in detail in Section I above. In general, the incentive structures ensure that the utilities are: (a) indifferent to both price and price volatility; (b) reactive to market conditions and upsets; and (c) price takers. These drawbacks were highlighted in comments made by Mr. Welch and by PG&E at the workshop, discussed in Section IV above.

In view of the utilities' comments at the workshop and in response to the CPUC's incentive mechanism OIR, it is evident that the utilities believe that prices and market movements are beyond their control. However, customers expect their utility to represent their interests and to have the necessary competencies to navigate the market on their behalf.

#### **B. Winter Hedging Programs**

There is limited information available regarding the utilities' actions and performance given the confidentiality surrounding the utilities' winter hedge solicitation activities. There are, however, annual DRA reports and anecdotal evidence that provide clues to the efficacy of the programs. Based upon DRA's reports, for the first two years the utilities spent, in aggregate, in excess of \$208 million. While the utilities like to characterize the cost of these programs in terms of \$2 per customer per month (Tr. 12 (Emmrich)), there are real and significant dollars involved. Furthermore, and based upon reported utility procurement data, customers have realized no tangible customer benefits from these programs.

As review of the winter hedging programs is limited to non-market participants, the program designs are not subject to meaningful review and assessment. The limited evidence suggests, however, that the winter hedging programs have been wholly ineffective.

### **C. Utility Procurement Transparency**

The utilities assert that they need strict confidentiality for their winter hedging programs. The utilities claim that if market participants are aware of their hedging strategies, those participants could purchase products in front of the utilities driving hedge product prices higher and increasing costs to customers. The utilities' claim is erroneous.

Under the current winter hedging program (and under the cloak of confidentiality), the utilities' hedging strategies are executed with a small but sophisticated group of banks and trading houses. These entities are perfectly capable of purchasing products in front of the utilities and driving prices higher. In view of the reality of the current hedging protocol, it is clear that confidentiality has not addressed the utilities' concern. Confidentiality has only limited the opportunity to a select number of counter-parties, and only serves to increase the cost and reduce the efficacy of the winter hedging programs.

By contrast, California's municipal utilities, as well as Southern California Edison and Southwest Gas, conduct very public solicitation processes to procure short- and long-term hedge products. Through their solicitation processes, these entities do not disclose their hedging strategies, but invite transparency, competition and informed assessment and comment. Similarly, SoCalGas/SDG&E and PG&E should be required to conduct open and competitive solicitations for all hedge products.

### **D. Hedging, All Year Round**

During the workshop, Commissioner Byron asked SoCalGas/SDG&E if they could have hedged against the higher gas prices experienced in June 2008. Tr. 17, 28. The utilities could have

chosen to hedge June 2008 gas prices, but doing so would have exposed their shareholders to potential financial losses. The utilities will not hedge under the existing procurement incentive structure. The utilities limit any significant hedging to the winter hedge program. Because the utilities are not obligated to hedge within the existing mechanisms, they choose not to do so.

Beyond this, the utilities believe there is no need to hedge summer prices notwithstanding that: (a) summer prices can be and have been substantially higher than winter prices; and (b) the utilities are actively filling storage and serving load during the summer period. Based upon information provided at the workshop, PG&E's summer load and storage capacity (0.5 Bcfd and 32 Bcf, respectively) conservatively represent 48 percent of its annual core demand. SoCalGas/SDG&E, in turn, indicate that they purchase 1.1 Bcfd ratably over the year, meaning that almost 60 percent of core supplies are acquired during summer periods. Despite these demand and procurement figures, the utilities see no reason to manage prices and volatility during summer periods.

#### **E. Motivating the Utilities to Hedge**

Commissioner Byron also asked how the utilities can be motivated to hedge (Tr. 59), which goes to the heart of the inquiry in the CPUC's OIR. In the OIR, the CPUC identifies price volatility mitigation as one of its key utility procurement objectives.

In its proposal in the CPUC's OIR, Shell Energy recommends the following modifications to the existing incentive mechanism structures in order to promote utility hedging:

1. Introduce a targeted reduction in utility supply portfolio volatility. The targeted reduction should be based upon customer risk tolerances, but lacking that information, Shell Energy recommends an initial reduction target of 30 percent. Supply portfolio volatility, and the reduction in volatility achieved by the utilities, would be measured using a standard volatility calculation applied to benchmark and actual prices. The utilities would be subject to a fixed reward or penalty (\$8 million) should they achieve (or miss) the portfolio volatility reduction target.

2. Adjust the risk/reward profile for the utilities within the incentive mechanism to motivate proactive hedging strategies. Under Shell Energy's proposal, the utilities would share in 15 percent of gains and 2 percent of losses, subject to caps of \$30 million and \$6 million, respectively. Given the favorable risk/reward profile, the existing tolerance bands would be eliminated. This favorable risk/reward profile would align the utilities' interests with those of ratepayers and would promote the CPUC's procurement objectives.

3. Include all utility procurement activities within the mechanism, assessed against objective measures of performance thereby reducing the CPUC's resources dedicated to oversight of the utilities' procurement activities.

Shell Energy's proposal advances the CPUC's procurement objectives of achieving low cost and price volatility reduction. Shell Energy's proposal also leverages and expands the current mechanism structure, introduces accountability and consequences for all utility procurement activities, aligns shareholder and ratepayer interests, allows objective assessment of utility procurement, and simplifies the regulatory oversight process.

#### **F. CPUC Procurement Policy**

In its ongoing OIR, the CPUC expanded its procurement policy objectives by identifying low cost and price volatility mitigation as its two utility procurement goals. Price volatility is not addressed under the current procurement incentive structure, and the utilities have not advanced any procurement proposal that incorporates both price volatility mitigation and low cost. In fact, in the OIR, the utilities have chosen to ignore the CPUC's price volatility mitigation goal. Because the utilities operate under zero-risk incentive structures that provide substantial value to shareholders and impose no proactive utility portfolio management obligation, the utilities are not motivated to change the status quo.

## VI.

### CONCLUSION

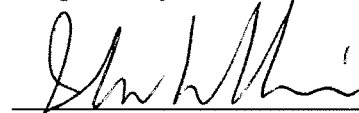
The current and expected future natural gas market environment is characterized by high prices and substantial price volatility. Under California's current regulatory structure the utilities are not actively managing price or volatility and, contrary to the utilities' claim, the current procurement structure fails to align ratepayer and shareholder interests. The utilities and their shareholders remain insulated from market prices and price volatility while customers remain fully exposed.

Given the outlook for prices and price volatility, the CPUC initiated an OIR to find a way to address its stated objectives of achieving low cost utility procurement and price volatility mitigation. The utilities' procurement incentive mechanisms must be modified to promote the CPUC's dual procurement goals and align the interests of ratepayers and shareholders.

Shell Energy has proposed modifications to the existing incentive structures that achieve the CPUC's goals and introduce accountability, impose consequences and transparency for all utility

procurement activities, and reduce the resources required for oversight. Shell Energy urges the Commission to recommend that the CPUC adopt Shell Energy's proposed modifications to the utilities' procurement incentive mechanisms.

Respectfully submitted,



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Date: March 18, 2009

Attorneys for Shell Energy North America  
(US), L.P.

CERTIFICATE OF SERVICE

I hereby certify that I have served, this day, a copy of the foregoing **COMMENTS OF SHELL ENERGY NORTH AMERICA (US), L.P. ON GAS UTILITY CORE PROCUREMENT** on the Commission's Docket Unit and on Commissioners Jeffrey D. Byron and James D. Boyd by overnight delivery and electronic mail.

Executed on March 18, 2008, at San Diego, California.

A handwritten signature in black ink, appearing to read 'Debra A. Casebier', written over a horizontal line.

Debra A. Casebier



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Gas Procurement Incentive OIR  
R.08-06-025

Re-integration and Management of  
Hedging within the Utilities'  
Procurement Incentive Mechanisms

November 5, 2008

# Underlying Commission Objectives in the OIR

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- **Achieve low cost & mitigate volatility**
- **Align the interests of ratepayers & shareholders**
- **Introduce accountability & consequences for utility procurement activities**
- **Provide objective measures of performance**
- **Reduce Commission resources dedicated to oversight**

# Achieve the Commission's Supply Portfolio Goals

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- In the OIR, the Commission identified two supply portfolio goals:
  - q Low Cost
  - q Price Volatility Mitigation
- Low cost procurement is achieved by comparing utility gas purchase costs to benchmark prices that reflect market prices
- Volatility mitigation can be achieved by comparing utility supply portfolio price volatility to benchmark price volatility
- The benchmark prices from the incentive mechanisms can be used:
  - q As objective measures of “market” price volatility
  - q To assess utility supply portfolio volatility
  - q As a basis against which the Commission can establish price volatility reduction targets

# What is Price Volatility?

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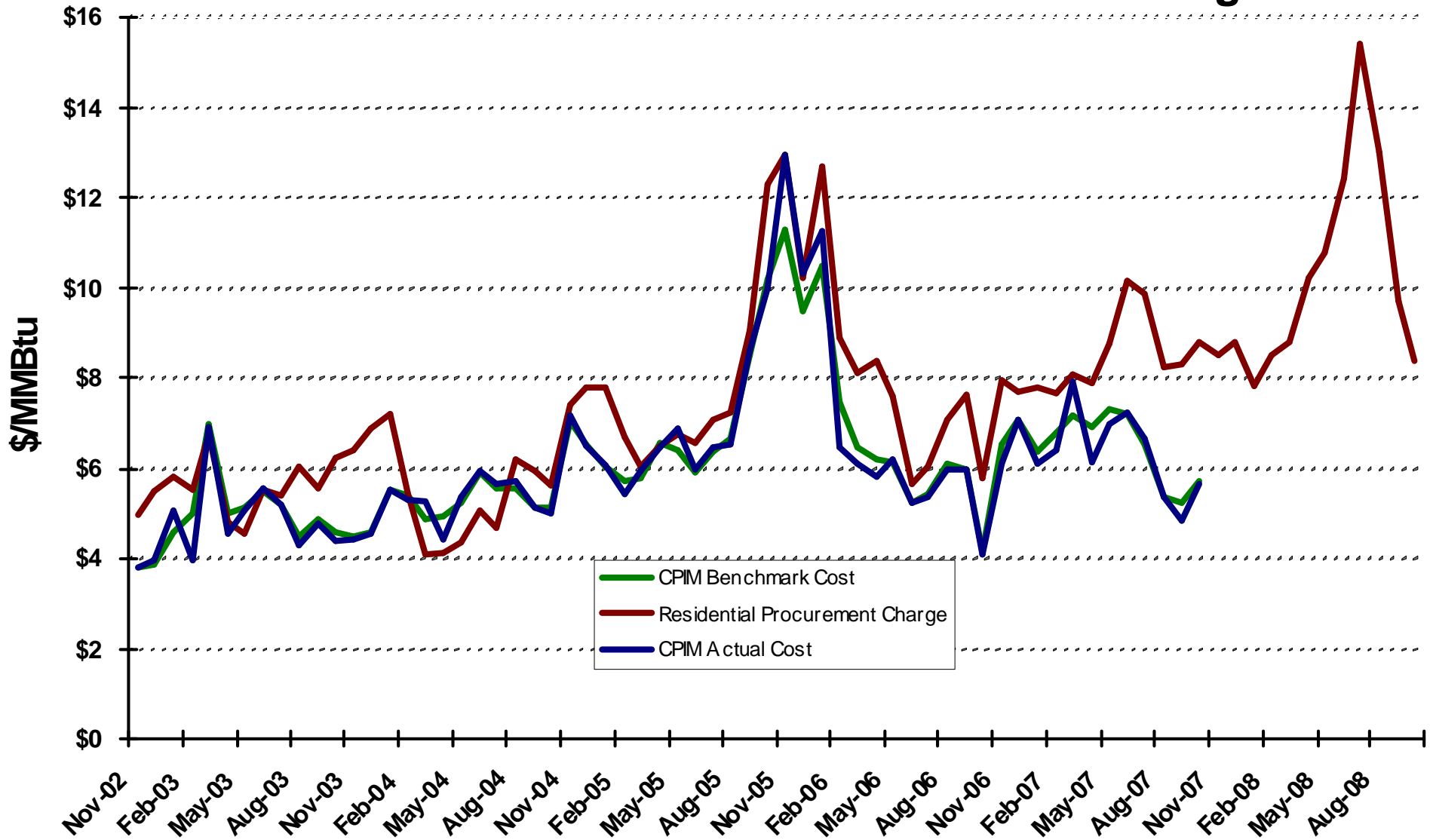
- Price volatility is:
  - the variation in price from the average price over a period of time
  - the annualized standard deviation of monthly price changes
- For example, SoCalGas' Dec '07 to Nov '08 procurement charge averaged \$8.37 per MMBtu with an annualized monthly volatility of 66.5%
- Therefore, over the next year, SoCalGas' procurement charge is expected to range between \$2.80 and \$13.93 per MMBtu with a 68.3% probability (1 standard deviation)

# Price Volatility within PG&E and SoCalGas' Portfolios

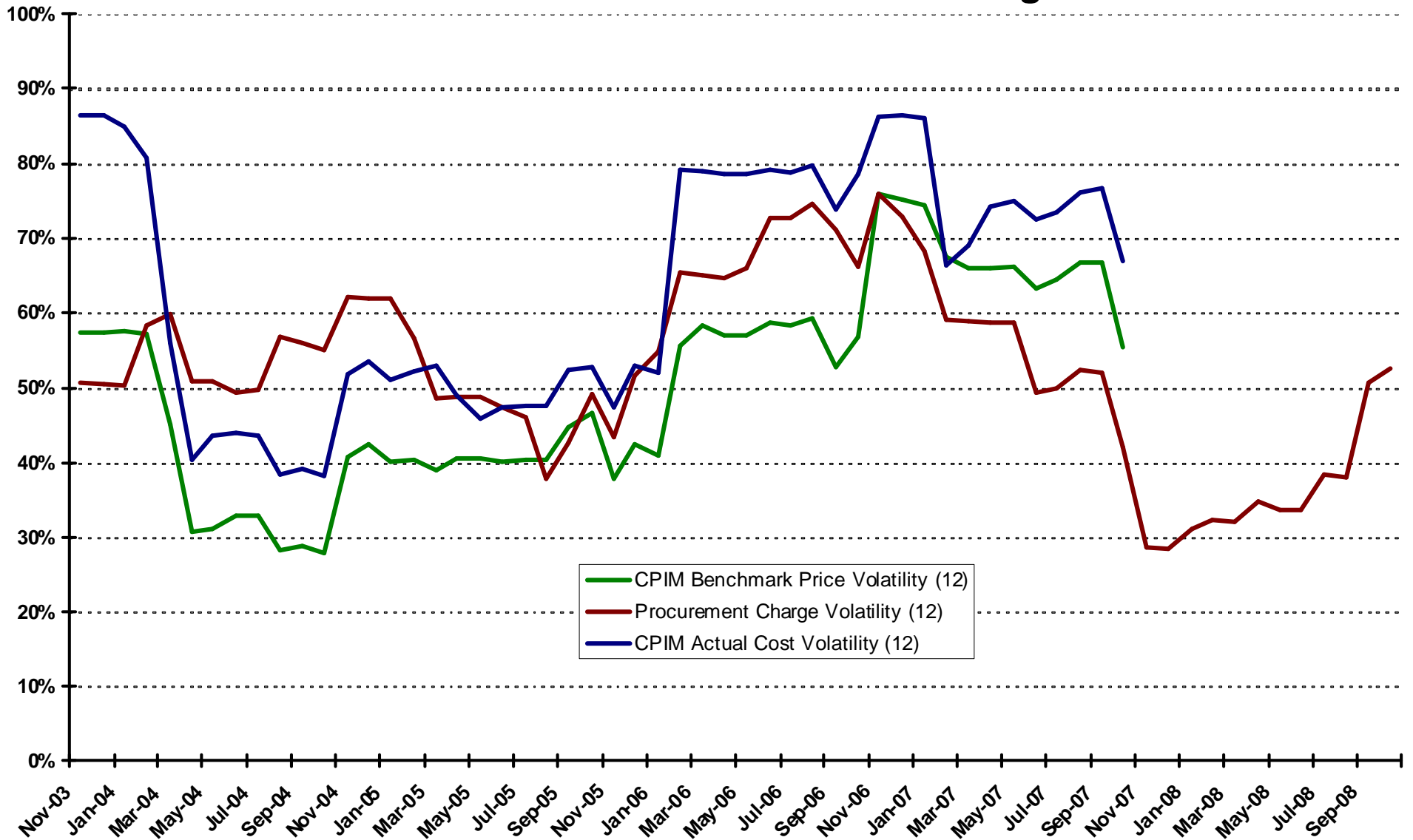
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- PG&E and SoCalGas' existing core portfolios mirror and pass through market prices and market price volatility to core procurement customers
- There is no volatility mitigation resulting from the utilities' winter hedging programs
- Volatility in the market (and within the utilities' portfolios) is high not only during winter months, but all year round

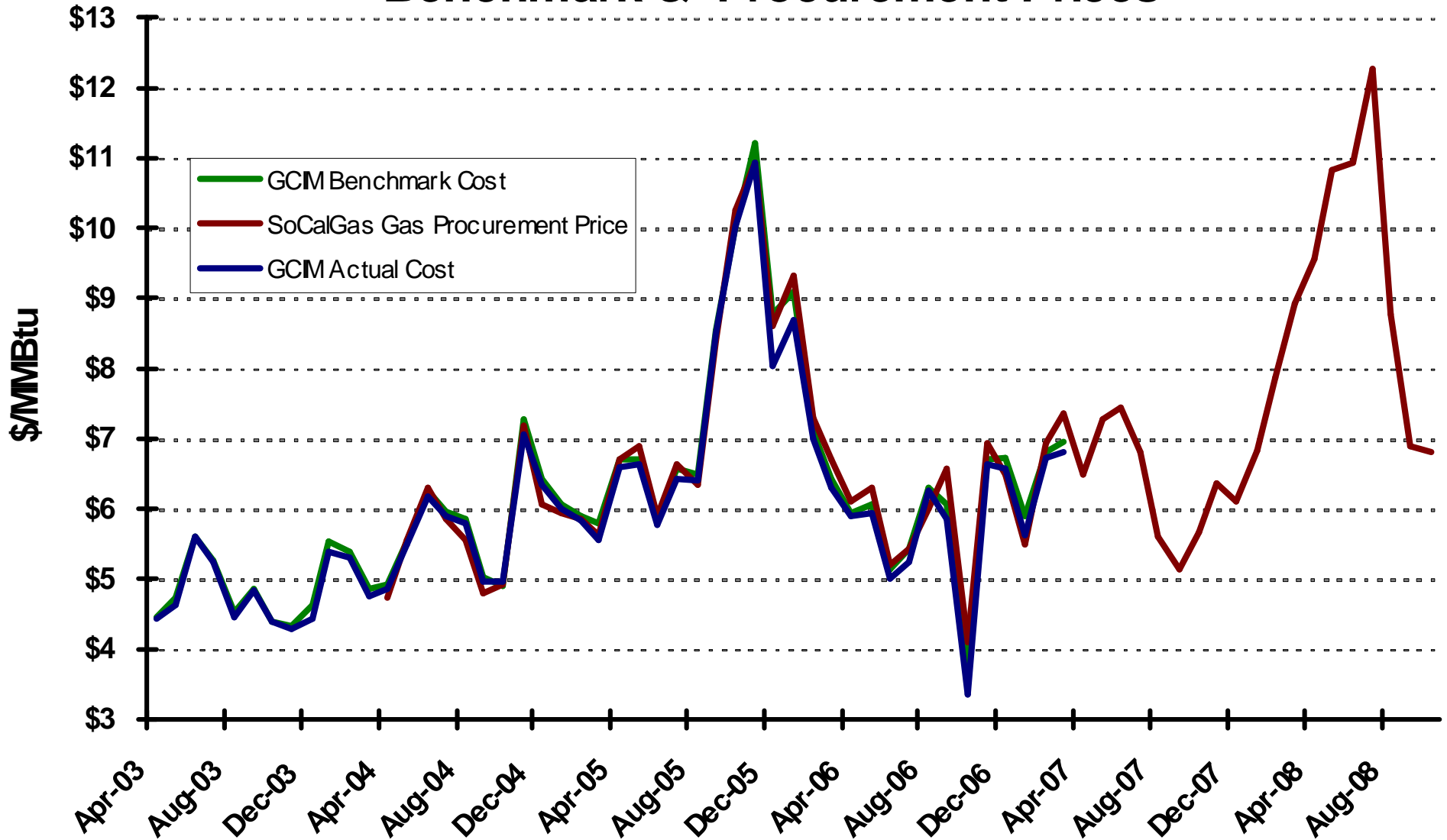
# PG&E Price Summary: CPIM Actual, CPIM Benchmark & Residential Procurement Charge



# Volatility of PG&E's CPIM Actual, CPIM Benchmark & Residential Procurement Charges

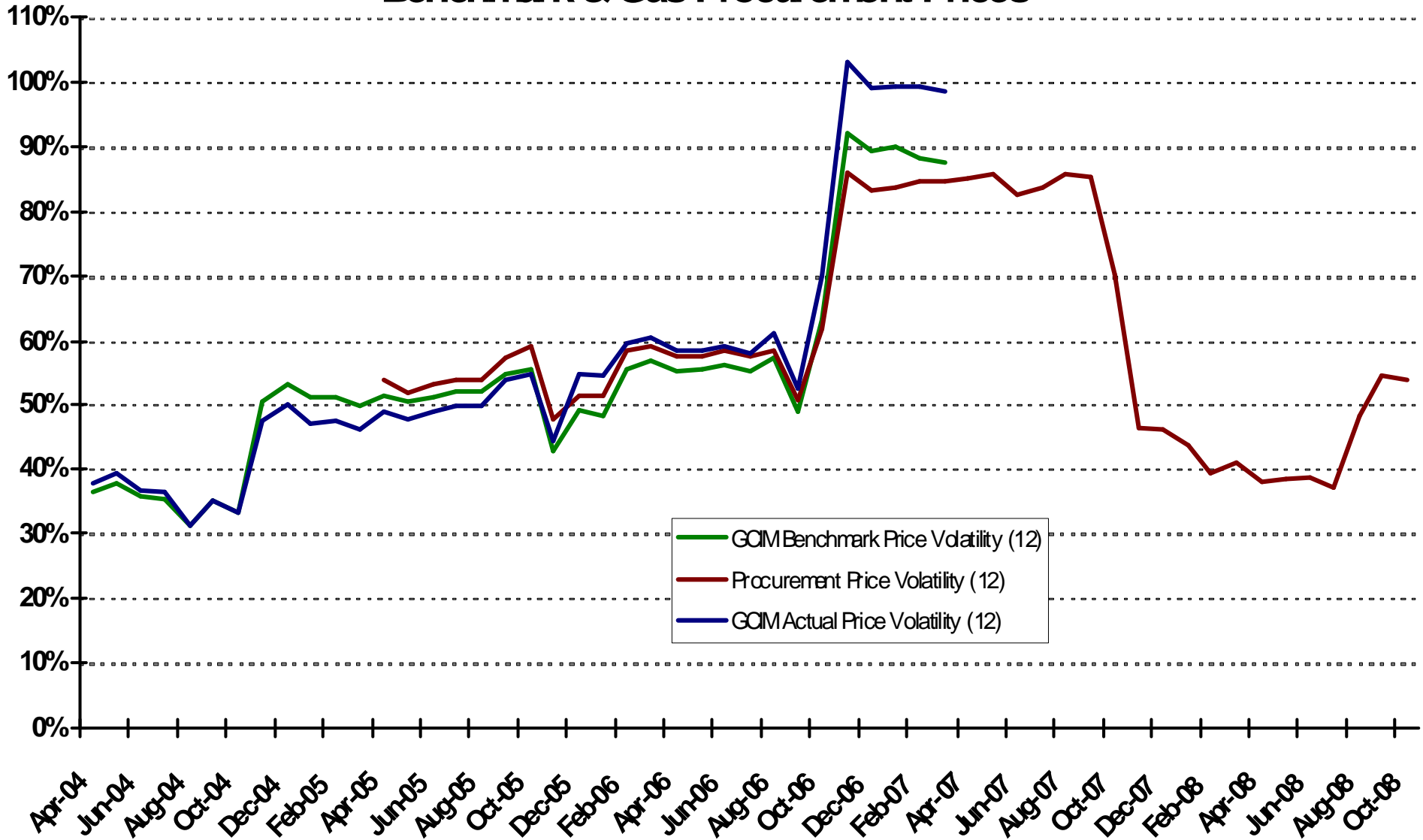


# SoCalGas Price Summary: GCIM Actual, GCIM Benchmark & Procurement Prices





# Volatility of SoCalGas' GCIM Actual, GCIM Benchmark & Gas Procurement Prices



# Supply Portfolio Price Volatility Mitigation

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- Using benchmark price volatility as an objective standard, the Commission can target reductions in utility supply portfolio price volatility
- The Commission should establish a target based on ratepayers' tolerance for risk. For example:
  - Portfolio price volatility = 70% of benchmark price volatility
  - This target would require the utilities to hedge between 25% and 50% of core portfolio demand
- A portfolio price volatility target can be readily incorporated within the existing incentive mechanisms

# Align the Interests of Ratepayers and Shareholders

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- The current incentive structure discourages the utilities from hedging due to potential shareholder risk exposure
- The current winter hedging structures have no risk / reward component and impose no accountability and consequences on the utilities
- The Commission should incorporate risk / reward structures in the incentive mechanisms that:
  - q Encourage low cost procurement strategies
  - q Promote mitigation of price volatility
  - q Impose accountability on the utilities for all of their procurement related activities
  - q Address shareholder risk exposures

## Align the Interests of Ratepayers and Shareholders

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- The risk / reward structure should provide an incentive for the utilities to hedge:
  - q 85% / 15% sharing when procurement costs are below the benchmark, subject to a \$30 MM annual shareholder reward cap
  - q 98% / 2% sharing when procurement costs are above the benchmark, subject to a \$6 MM shareholder penalty cap
  - q A bonus payment (or penalty) of \$4 MM or \$8 MM (utility specific) if the Commission's volatility reduction target IS (or IS NOT) met

# Align the Interests of Ratepayers and Shareholders

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- Under this incentive structure, the Commission would:
  - q Motivate the utilities to achieve low costs
  - q Motivate the utilities to mitigate volatility
  - q Align the interests of ratepayers and shareholders
  - q Introduce accountability and consequences
  - q Provide objective measures of performance

# Impact of Adopting the Proposed Structure

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- All utility commodity procurement activities will be managed within the incentive mechanisms
- A single incentive structure for all core procurement activities will:
  - q Reduce the Commission's resources dedicated to oversight
  - q Simplify the review process
  - q Impose accountability and consequences on the utilities

# Impact of Adopting the Proposed Structure

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- The Utilities will be motivated to:
  - q Achieve the Commission's procurement objectives throughout the year
  - q Focus on procurement over multi-year terms; beyond the current month-to-month (or winter-only) timeframe
  - q Leverage their fundamental, technical and risk management skills
  - q Develop risk management strategies tailored to their specific needs

# Summary of the Proposed Modifications to the Incentive Mechanisms

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- Monthly benchmark prices remain the standard against which utility procurement is measured
- Benchmark price volatility is determined from benchmark prices
- The utilities' actual monthly procurement costs, including the cost of all hedged products, are compared to the monthly benchmark price
- Tolerance bands are eliminated given the proposed risk/reward structure
- Sharing percentages are simplified:
  - q 85 / 15 (when costs are below the benchmark)
  - q 98 / 2 (when costs exceed the benchmark)



# Summary of the Proposed Modifications to the Incentive Mechanisms

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- Annual rewards and penalties associated with commodity procurement are capped at \$30 MM and \$6 MM, respectively
- Each year, the price volatility of the utilities' core supply portfolio is compared to the benchmark price volatility
- If the utility's portfolio volatility is  $< 70\%$  of the benchmark volatility, a reward of \$4 MM or \$8 MM (utility specific) is applied
- If the utility's portfolio volatility is  $> 70\%$  of the benchmark volatility, a penalty of \$4 MM or \$8 MM (utility specific) is applied
- If a utility fails to achieve the Commission's volatility reduction target over consecutive years, the penalty doubles each year (\$4 MM, \$8 MM, \$16 MM... or \$8 MM, \$16 MM, \$32 MM...)

# Procurement Protocols

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- The utilities claim they require confidentiality regarding their hedging activities to protect ratepayers
- The utilities' concern is that disclosure of their hedging activities would allow market participants to take positions for themselves first, driving up the price of hedge products before the utilities transact
- Notwithstanding, the utilities disclose their hedging activities to a select group of very sophisticated trading counterparties (who can take positions in advance of the utility)
- As such, confidentiality does nothing to address the utilities' stated concern

# Procurement Protocols

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- The utilities' winter hedging is expensive and fails to provide ratepayer benefits
- The benefits of informed scrutiny and assessment would more than offset the claimed downside of transparency
- SCE conducts very public and very large solicitations through which they procure long-dated products
- Likewise, California's gas utilities can solicit products from a large group of creditworthy counterparties to meet their procurement needs



Shell Energy North America

*Experience Commitment*<sup>SM</sup>