

Application No.:

Exhibit No.:

Witness:

SCE-1

S. Pickett



SOUTHERN CALIFORNIA
EDISON

An *EDISON INTERNATIONAL* Company

(U 338-E)

Testimony of Stephen E. Pickett

Before the

Public Utilities Commission of the State of California

Rosemead, California
August 28, 2006

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**PREPARED TESTIMONY OF STEPHEN E. PICKETT
ON BEHALF OF SOUTHERN CALIFORNIA EDISON COMPANY**

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**I.
Introduction.**

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Since the changes brought about by electric restructuring in California, the electric system in southern California has grown increasingly dependent on gas-fired generation to reliably serve the demand for electricity. Notwithstanding the “Preferred Loading Order” for new resource additions endorsed by the California Public Utilities Commission (“Commission”), this dependency is expected to exist for the foreseeable future as the demand for electricity continues to grow in California. Over 50% of Southern California Edison Company’s (“SCE”) power is produced by natural gas. Indeed, the ratepayers of SCE incurred over \$5 billion in direct and indirect natural gas costs in 2005. As a result, SCE has again become one of the largest noncore customers of Southern California Gas Company (“SoCalGas”) through its utilization of SoCalGas’ transportation and storage services to serve the gas-tolling arrangements that SCE has entered into under power purchase agreements (“PPAs”) with independent power generators. SCE expects to increase its direct procurement of gas supplies that will be transported on the SoCalGas system due to future local generation requirements, the operation of the Mountainview Power Plant, and the eventual termination of the California Department of Water Resources’ PPAs that will have to be replaced by SCE procurement. SCE and its customers therefore have a significant interest in ensuring that the natural gas market in southern California is efficient and competitive.

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SCE was an active participant in the Commission’s efforts that first commenced in the mid-80s to restructure the natural gas industry in California to create an unbundled market for noncore customers. SCE was also an active participant in the hearings that the Commission

1 commenced in its Gas Industry Restructuring proceeding (OIR 98-01-011). Those hearings led
2 to the Commission’s identification of a series of proposed market reforms as addressed in the
3 Commission’s “Most Promising Options” decision (D. 99-07-015). That decision prompted the
4 parties to that proceeding to engage in a protracted series of settlement discussions. Those
5 discussions resulted in competing settlement proposals, with SCE supporting the settlement
6 approach that became known as the Comprehensive Settlement Agreement (“CSA”).¹ However,
7 the CSA was never implemented as the settling parties had agreed, and the Commission has
8 essentially reconsidered market restructuring through a number of separate proceedings that
9 remain pending before the Commission.²

10 SCE’s belief that the structure of the natural gas market in southern California required
11 reforming was confirmed and strengthened as a result of the dramatic increase in the price of
12 natural gas at the California border during the winter of 2000/ 2001. SCE had become
13 concerned about the potential for manipulation of the price of natural gas at the border as early as
14 1998 when El Paso Natural Gas Company transferred transportation capacity to the southern
15 California border to Dynegy through a significant release of interstate pipeline capacity with
16 anti-competitive release terms. When that was followed in 2000 by El Paso transferring market
17 power to its affiliate, El Paso Merchant Energy (“EPME”), through the release of the interstate
18 pipeline capacity previously released to Dynegy, SCE joined in and supported the Commission’s
19 complaint against El Paso and EPME at the Federal Energy Regulatory Commission. Due to
20 those efforts, El Paso refunded to consumers almost \$1.6 billion in 2004. SCE’s investigations
21 of the circumstances that led to the complaint case against El Paso and EPME also raised
22 questions as to SoCalGas’ ability to affect border prices through its control of its intrastate
23 transportation and storage assets as well as the interstate transportation assets controlled through

¹ The Comprehensive Settlement Agreement was modified and adopted by the Commission in Decision No. 01-12-018, but its implementation was stayed.

² See, e.g., R. 04-01-025 and A. 04-12-004.

1 SoCalGas' core procurement function. Further, SCE was concerned that SoCalGas had both the
2 incentive and ability to conduct operations in ways that could benefit its shareholders at the
3 expense of other market participants and electric consumers. These concerns resulted in SCE
4 expending a considerable amount of time and resources before the Commission advocating
5 market reforms in proceedings such as the Border Price OII³ and SoCalGas' GCIM applications.⁴
6 Ultimately, as a means of addressing these concerns, SCE entered into the settlement with
7 SoCalGas, San Diego Gas & Electric Company ("SDG&E") and Sempra Energy that the three
8 utility parties to the settlement are now jointly presenting in this application for Commission
9 review and approval.

10 Allegations about the actions that SoCalGas took during the energy crisis were also
11 raised by a number of parties, including non-core customer representatives, in what is generally
12 referred to as the Continental Forge class action lawsuit.⁵ On January 4, 2006, various plaintiffs
13 whose claims were being prosecuted in that litigation, along with SoCalGas, SDG&E, Sempra
14 Energy, and other Sempra Energy affiliates, entered into a settlement agreement("Continental
15 Forge Settlement"). In that settlement, the parties agreed, among other things, to certain
16 operational and structural changes to SoCalGas' and SDG&E's gas operations and service and
17 rate structures.⁶ Although SCE is not a party to the Continental Forge Settlement, SCE supports
18 the market reforms in the Continental Forge Settlement and supports SoCalGas' and SDG&E's
19 efforts to obtain Commission approval of the market reforms set forth in that agreement.

20 Separate from the Continental Forge Settlement, representatives of SCE, SoCalGas and
21 SDG&E met for many hours, beginning in August 2005, to attempt to reach a resolution of
22 SCE's concerns about the structure of SoCalGas' system, including the concerns SCE had

³ OII 02-11-040 (Border Price OII).

⁴ See, e.g., Application No. 00-06-023 (GCIM Year 6).

⁵ BC 237336, Superior Court of the State of California, County of San Diego.

⁶ The details of the Continental Forge settlement agreement are set forth in SoCalGas' testimony.

1 expressed in the Border Price OII and other on-going Commission proceedings. These
2 negotiations were discontinued for a period while the Sempra entities focused their efforts on
3 achieving a settlement in the Continental Forge litigation, but resumed in April of this year.
4 Ultimately, the parties' representatives achieved a settlement on May 30, 2006 ("SCE Settlement
5 Agreement").⁷

6 Throughout the negotiation process, SCE vigorously advocated for market reforms that it
7 believed would translate into a more transparent and competitive natural gas market in southern
8 California, which in turn would reduce costs for SCE's ratepayers and ultimately benefit the
9 California natural gas market as a whole. SoCalGas and SDG&E responded to SCE's proposals
10 by vigorously advocating positions that they asserted were necessary to protect the interests of
11 their core and noncore customers and preserve the financial integrity of the gas utilities. Thus, as
12 with any settlement, the SCE Settlement Agreement represents a balancing of interests and a
13 compromise among the parties on various issues. Each of the parties to the SCE Settlement
14 Agreement would likely continue to advocate different positions in the absence of the settlement,
15 but each supports the package of elements reflected in the agreement.

17 II.

18 **The Gas Market Reforms Set Forth In The SCE Settlement Agreement And** 19 **The Continental Forge Settlement Should be Adopted By The Commission In Their Entireties As** 20 **They Represent A Package Of Meaningful Market Improvements That Are Expected to** 21 **Benefit Both Gas And Electric Ratepayers.**

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23 Upon entering into settlement negotiations with SoCalGas and SDG&E, SCE was
24 particularly focused on achieving market reforms that would address the components of the

⁷ The details of the SCE Settlement Agreement are set forth in SoCalGas' testimony.

1 existing southern California gas market that SCE believed had the greatest potential for misuse
2 of market power. For example, one area of specific concern was that SoCalGas has control over
3 all of the gas storage facilities in southern California. SCE was concerned that the lack of third
4 party providers and a secondary market for storage services allowed SoCalGas significant
5 leeway in setting the terms of storage services in southern California, which in turn could
6 potentially impact forward market prices. SCE was also concerned that SoCalGas' control over
7 the use of large quantities of gas in storage provided a mechanism by which the price of gas at
8 the southern California border could be affected.

9 Another area of concern was the existing structure of SoCalGas' procurement incentive
10 mechanism, known as the GCIM, which SCE believed had the potential to provide incentives for
11 SoCalGas to take actions to affect southern California border gas prices in a manner detrimental
12 to the interests of SCE's customers and the market. Specifically, SCE was concerned that the
13 GCIM provided an incentive for SoCalGas to influence southern California border prices to
14 realize shareholder gains at the expense of other market participants and electric ratepayers.

15 SCE was also concerned that SoCalGas' procurement and operations functions were
16 overly integrated, effectively providing the core procurement function with a competitive
17 information advantage over other market participants, particularly with respect to the
18 management of the utility Hub Services program. SCE also sought to increase the transparency
19 of SoCalGas' operations through increased information disclosure to improve market efficiency
20 and to separate further the core procurement and gas operations functions so that the core would
21 operate in the market in a fashion more similar to how noncore customers are required to
22 operate.

23 Additionally, SCE was interested in improving the transportation services available to
24 customers. For example, SCE was interested in introducing an enhanced imbalance trading
25 system, in requiring SoCalGas to make available all unutilized access and storage capacity on an

1 interruptible basis, and in implementing protocols that would facilitate system expansions,
2 including third party interconnections.

3 SCE believes that the market restructuring terms of the SCE Settlement Agreement, when
4 considered in combination with the market reforms specified in the Continental Forge
5 Settlement, provide for meaningful relief in each of the areas of principal concern identified by
6 SCE at the outset of settlement negotiations. For example, with respect to concerns related to
7 SoCalGas' control over storage capacity in southern California, the SCE Settlement Agreement
8 establishes maximum prices SoCalGas can assess for the sale of storage services, and the
9 Continental Forge Settlement establishes a secondary market for storage services. Additionally,
10 the Continental Forge Settlement also establishes physical monthly storage inventory targets for
11 the core reservation that will provide limits on fluctuations in injections by SoCalGas, thereby
12 limiting the potential for such fluctuations to impact forward gas prices.

13 With respect to the GCIM, the SCE Settlement Agreement removes the impact of
14 SoCalGas' financial hedging activities for the winter months from the calculation of the
15 benchmark. This modification to the GCIM largely addresses SCE's concerns regarding the
16 potential that the incentives that currently exist in SoCalGas' procurement incentive mechanism
17 may lead to adverse market consequences. For example, under the current GCIM, SoCalGas'
18 shareholders are potentially exposed to a penalty if the utility's financial hedges expire "out of
19 the money," and conversely, the shareholders may earn a reward if the financial hedges turn out
20 to be "in the money."⁸ This occurs because the impact of the hedges are a component of the
21 GCIM, presumably to provide incentives for the utility to procure cost-effective hedges. The
22 problem with this mechanism, however, is that the hedges should be considered as insurance
23 policies against bad outcomes, and not a speculative instrument. Customers are actually better
24 served if the utility's financial hedges expire "out of the money," because that means market

⁸ The actual reward or penalty is based on the aggregate monthly costs compared to the applicable benchmark, and the performance of financial hedges are one component of the mechanism.

1 prices for natural gas were lower than the strike prices of the hedges the utility entered into.
2 However, if the utility's shareholders are potentially exposed to GCIM penalties for hedges that
3 expire "out of the money," the utility may be reluctant to enter into hedges, or worse, may have a
4 perverse incentive to influence market prices to achieve a positive shareholder value (i.e., an
5 incentive to take actions that raise market prices to increase the likelihood that its financial
6 hedges are "in the money"). By removing the impact of financial hedges that are associated with
7 the winter months from the GCIM, this incentive is eliminated and SoCalGas can engage in cost
8 effective hedging for its core customers without concern that subsequent market movements may
9 adversely impact its shareholders. Moreover, pursuant to the Continental Forge settlement,
10 oversight of SoCalGas' financial hedging activity will take place through a procurement review
11 group and gas supply plan construct, similar to the AB-57 procurement plan processes used for
12 electric power procurement by the electric utilities.

13 The SCE Settlement Agreement also expands upon the public reporting requirements that
14 are contained within the Continental Forge Settlement. The enhanced posting requirements from
15 both settlements will significantly improve the transparency of the operations and market
16 functions related to the SoCalGas system. Additionally, the provisions within the SCE
17 Settlement Agreement that require SoCalGas to transfer the operation of the utility Hub Services
18 and system reliability procurement from the core procurement function to the system operations
19 function provide a clearer line of responsibility between these distinct utility functions and treat
20 the core procurement function on a basis that is more similar to other customers.

21 Finally, the SCE Settlement Agreement builds upon the Continental Forge Settlement by
22 requiring SoCalGas to release all unutilized firm access and storage capacity on an interruptible
23 basis and to provide enhanced balancing services. The SCE Settlement Agreement also contains
24 provisions designed to facilitate third party interconnections to the SoCalGas/SDG&E systems
25 and requirements for SoCalGas to perform system expansion studies and to conduct industry
26 meetings if system utilization exceeds a certain threshold. All of these elements of the

1 settlements are designed to increase the efficiency and reliability of the gas infrastructure system
2 that serves southern California.

3 In summary, SCE believes that the combined market reforms in the Continental Forge
4 Settlement and the SCE Settlement Agreement, on balance, will benefit all natural gas customers
5 in California by (1) fostering more efficient and competitive intrastate transmission and storage
6 markets, (2) instituting more equitable and efficient balancing rules, and (3) increasing market
7 transparency. In light of these market reforms, the SCE Settlement Agreement also resolves a
8 number of resource-consuming regulatory proceedings, such as the Border Price OII and the
9 SoCalGas GCIM proceedings, where SCE and SoCalGas were the primary parties advocating
10 opposing positions in the proceedings. Furthermore, particularly given the substantial “gives and
11 takes” that occurred during the negotiation process, SCE strongly urges the Commission to adopt
12 all of the market reforms set forth in the SCE Settlement and the Continental Forge Settlement as
13 a package. Although it is within the Commission’s authority to do otherwise, SCE respectfully
14 urges the Commission to adopt all of the market reforms contained in the SCE Settlement and
15 the Continental Forge Settlement because they represent a balanced outcome from extensive
16 negotiations, and a limited implementation of the proposed market reforms runs the risk that
17 unintended consequences or market reform shortcomings will arise.

18 The market reforms established in the settlements are a significant step in the right
19 direction to help ensure that the market for natural gas in southern California is efficient and
20 transparent, as well as consistent with the Gas Accord market structure in place on the Pacific
21 Gas and Electric Company system. The Settlement also resolves many of the extensive and
22 time-consuming gas market-related proceedings currently pending before the Commission, and
23 in particular the Border Price OII proceeding and the reserved issues in the identified SoCalGas
24 GCIM proceedings. The resolution of these proceedings should benefit the parties and the
25 Commission by permitting them to redirect their resources to other important energy policy
26 issues.

1 **SOUTHERN CALIFORNIA EDISON COMPANY**
2 **QUALIFICATIONS AND PREPARED TESTIMONY**
3 **OF STEPHEN E. PICKETT**

4 **Q.** Please state your name and business address for the record.

5 **A.** My name is Stephen E. Pickett, and my business address at Southern California Edison Company
6 (“SCE”) is 8631 Rush Street, Rosemead, California 91770.

7 **Q.** Briefly describe your present responsibilities at the Southern California Edison Company.

8 **A.** I am Senior Vice President and General Counsel. Among other things, I overall responsibility
9 for the Law, Claims, and Workers’ Compensation Departments. During the negotiation of the
10 May 30, 2006 settlement with certain Sempra Energy parties that is being presented to the
11 Commission for approval in this application, I served as one of the principal negotiators for SCE.

12 **Q.** Briefly describe your educational and professional background.

13 **A.** I received a Bachelor of Science degree in Electrical Engineering from California State
14 University, Los Angeles, in 1974, and a Juris Doctor degree from Southwestern University in
15 1980. I have been an employee of Southern California Edison since 1978. Since 1982, I have
16 been an attorney in the Law Department.

17 **Q.** What is the purpose of your testimony in this proceeding?

18 **A.** The purpose of my testimony in this proceeding is to sponsor SCE-1 in this application.

19 **Q.** Was this material prepared by you or under your supervision?

20 **A.** Yes, it was.

21 **Q.** Insofar as this material is factual in nature, do you believe it to be correct?

22 **A.** Yes, I do.

23 **Q.** Insofar as this material is in the nature of opinion or judgment, does it represent your best
24 judgment?

25 **A.** Yes, it does.

26 **Q.** Does this conclude your qualifications and prepared testimony?

1 A. Yes, it does.