

Memorandum



Date: December 20, 2013

To: Edward Randolph
Director of Energy Division

From: **Public Utilities Commission—** Kayode Kajopaiye, Branch Chief
San Francisco Division of Water and Audits

Subject: Pacific Gas and Electric Company Advice Letter 4266-E
Quarterly Procurement Plan Compliance Report for the Second Quarter of 2013

Based on the results of its audit, the Division of Water and Audits' Utility Audit, Finance and Compliance Branch (UAFCB) recommends that Energy Division (ED) not approve Pacific Gas and Electric Company's (PG&E) Advice Letter No. (AL) 4266-E until twelve non-compliant transactions that PG&E executed in the second quarter of 2013 (Q2) are addressed by the Commission. The PG&E procurement transactions during Q2 that UAFCB examined were, in all material respects, in compliance with PG&E's procurement plan, as approved in Decision (D.) 12-01-033, Assembly Bill (AB) 57 procurement rules and several procurement-related Commission directives. PG&E's transactions conducted in the Integrated Forward Market (IFM) and the Residual Unit Commitment Market (RUC) are outside the scope of UAFCB's audits. This audit was limited in scope and does not provide full assurance to the reasonableness of PG&E's Q2 Quarterly Compliance Report (QCR) filing or its Q2 transactions.

A. Summary of Negative Audit Findings:

1. **PG&E failed to demonstrate compliance with D. 03-12-062, Conclusion of Law (COL) 12.** PG&E did not consult with its Procurement Review Group (PRG) regarding the four physical call option transactions executed with four counterparties in a timely fashion. The terms of these transactions are greater than 90 days or three calendar months.
2. **PG&E disclosed that twelve transactions that it executed in Q2 were not in compliance with its approved hedging plan.** PG&E explained that these transactions exceeded one of the hedging limits in its approved hedging plan. Evaluation of the utilities' compliance with the hedging limits in approved hedging plan is outside of the scope of UAFCB's audits.

B. Recommendations:

1. **PG&E should consult with its PRG before it executes any contracts with terms greater than 90 days or three calendar months.**
2. **ED should not approve AL 4266-E until the non-compliant transactions are addressed by the Commission and the Commission determines an appropriate action for the noncompliance.**

C. Background:

As required by D.02-10-062, OP 8 and clarified in D.03-12-062, PG&E, San Diego Gas and Electric, and Southern California Edison must each submit a QCR for all transactions of less than five years duration executed in the quarter. ED requested that the UAFCB conduct compliance audits of these

utilities' QCR filings.

The objective of these quarterly audits is to determine if the utilities were in compliance with their California Public Utilities Commission's (Commission) approved procurement plans, while complying with all AB 57 procurement rules and several procurement-related regulatory rulings and decisions, including, but not limited to, D.02-10-062, D.03-06-076, D.03-12-062, D.04-12-048, D.07-12-052, D.08-11-008, and D.12-01-033.

D. Negative Findings:

Finding 1: PG&E failed to demonstrate that it was in compliance with D.03-12-062, COL 12. In Q2, PG&E executed four physical call option transactions with the following counterparties following its issuance of Request for Offers (RFO):

1. Concord Energy LLC;
2. EDF Trading North America LLC;
3. ConocoPhillips Company; and
4. Cargill Inc.

The terms of the above-mentioned transactions are 153 days or five calendar months, which were greater than 90 days or three calendar months. Prior to execution of the four physical call options, PG&E neither presented to its PRG regarding the bid ranking of these transactions nor consulted with the PRG specifically on the prices and terms of these transactions. PG&E only provided notification to the PRG members with a summary of specific offers from the RFO on June 28, 2013, two months after the physical call options were executed.

Criteria: D.03-12-062, COL 12 requires the utilities to consult with their PRG for transactions of greater than 90 days.

PG&E's Response: PG&E did not consult with the PRG regarding the four physical call options prior to their execution, but communicated with its PRG regarding PG&E's 2013-2014 Physical Gas Supply Plan prior to execution of the transactions. The plan indicated that PG&E would issue a solicitation and also describe the need and the evaluation criteria that it would use to select offers. In addition, during the March 27, 2013 PRG meeting, PG&E provided an opportunity for its PRG members to ask questions, provide comments, or request any information regarding this solicitation. PG&E provided its response that it hedged according to its plan and received no other comments from the PRG. PG&E fulfilled its obligation to communicate with the PRG and solicit comments before negotiating with the counterparties. On June 27, 2013 PG&E provided notification to its PRG members concerning the transactions resulting from the solicitation that had been previously reviewed by and discussed with the PRG.

UAFCB Rebuttal: PG&E's communication with the PRG regarding its 2013-2014 Physical Gas Supply Plan, its intention of issuing a solicitation and the related evaluation criteria is insufficient. PG&E failed to discuss the specific transactions before it executed the four physical call option transactions. PG&E did not fulfill its obligation to consult with its PRG on the physical call options prior to execution of these transactions.

Before executing transactions of over 90 days or three calendar months, PG&E should, at a minimum, present prices, terms, and bid ranks of the contracts to the PRG during the RFO negotiation process. If holding a PRG meeting to discuss the contracts in a short timeframe is not feasible, PG&E could

always, by e-mail, communicate such information to its PRG and request feedback from the members.

Finding 2: PG&E disclosed that it was not in compliance with the hedging limits in its approved hedging plan. PG&E indicated that it executed twelve transactions during Q2 that exceeded one of the operating targets in its approved hedging plan. On October 21, 2013, PG&E filed amended AL 4266-E-A and disclosed the non-compliant transactions that it executed in Q2. PG&E asserts that the non-compliant transactions occurred because a control for one of the operating targets in its approved hedging plan was not included in its electronic hedging implementation model. PG&E indicated that it subsequently implemented additional procedural controls that would prevent the reoccurrence of non-compliant transactions and executed offsetting transactions to close out any non-compliant transactions that could still be exposed to market price risk. PG&E states that when it presents testimony in its 2013 ERRR Compliance Proceeding to be filed on February 28, 2014, it will request the Commission's approval of the non-compliant transactions and associated activity.

UAFCB's Rebuttal: Evaluating whether the non-compliant transactions were under the limits of PG&E's hedging operating targets was not part of UAFCB's audit scope for PG&E's Q2 QCR filing. The transactions should be addressed by the Commission before ED takes action on AL 4266-E and PG&E's Q2 QCR filing.

E. Conclusion:

Except for the items noted in Section D above, PG&E's AL 4266-E and its Q2 procurement transactions for electricity and natural gas that UAFCB reviewed were, in material respects, in compliance with PG&E's Commission-approved procurement plan and all relevant Commission decisions. The Q2 transactions that UAFCB reviewed, in material respects, were complete, accurate and properly authorized by its management.

If you have any questions on UAFCB's audit, please contact Tracy Fok at (415) 703-3122.

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