

Memorandum



Date: June 22, 2015
To: Edward Randolph
Director of Energy Division

From: Public Utilities Commission—
San Francisco

Kayode Kajopaiye, Branch Chief
Division of Water and Audits

A handwritten signature in black ink, appearing to be "Kajopaiye", is written over the typed name of the Branch Chief.

Subject: Southern California Edison Advice Letter 3171-E
Quarterly Procurement Plan Compliance Report for the Fourth Quarter of 2014

Based on the results of its audit, except for the findings mentioned below, the Utility Audit, Finance and Compliance Branch (UAFCB) of the Division of Water and Audits did not find any material reasons for Energy Division (ED) to deny the approval of Southern California Edison's (SCE) Advice Letter No. (AL) 3171-E. The procurement transactions that SCE executed during the fourth quarter of 2014 (Q4), that UAFCB examined, except for the findings mentioned below, demonstrated in all material respects, compliance with certain aspects of procurement-related state law and California Public Utilities Commission (Commission or CPUC) directives.

The UAFCB suggests that the Commission provide guidance and establish procedures for SCE to seek and obtain pre-approval from the Commission before it executes substantial amendments to contracts where the original contracts were approved outside of the quarterly compliance report (QCR) process and not vetted through with SCE's procurement review group (PRG).

The UAFCB assesses compliance in accordance with agreed-upon procedures with ED and does not assess compliance with all aspects of the procurement-related state law or those directives. In addition, SCE's transactions conducted in the Integrated Forward Market (IFM) and the Residual Unit Commitment Market (RUC) are outside the scope of UAFCB's audits.

A. Summary of Negative Audit Findings:

- 1. SCE failed to demonstrate that it was in compliance with Decision (D.) 02-10-062, Appendix B and Public Utilities Code (PUC) §581.** In its Q4 Quarterly Compliance Report (QCR) filing, SCE made two types of reporting errors in Attachment D. SCE materially understated its Q4 gas physical traded volume and respective notional value. On March 23, 2015, SCE submitted an amended Attachment D to correct the reporting errors.
- 2. SCE failed to demonstrate that it was in compliance with a) PUC §454.5; b) D.03-12-062, Conclusion of Law (COL) 12; and c) D.04-12-048, Ordering Paragraph (OP) 15.** In Q4, SCE executed two amendments that made material changes to contracts without going through the PRG and QCR review processes. The original contracts were approved through the QCR process. SCE filed the executed amendments for information purposes only in its Q4 QCR and sought recovery for the costs associated with the executed amendments via its 2015 Energy Resource Recovery Account (ERRA) review proceeding. The changes made in these amendments are effective for longer than 90 days or three calendar months. SCE should have sought the Commission's approval for these amendments through the PRG and Q4 QCR filing review processes.

3. UAFCB is unaware of any specific requirements established by the Commission regarding how SCE should seek and obtain pre-approval from the Commission for significant amendments to contracts originally approved outside of the PRG and QCR processes, specifically an enabling agreement amendment and an amendment to a Service and Interchange Agreement. In SCE's Q4 QCR filing, these amendments were reported as filed for information purposes only. SCE sought recovery for the costs associated with the implementation of these amendments via its 2015 ERRRA review proceeding.

B. Recommendations:

- 1. Before submitting its QCR filings, SCE should thoroughly review its QCR and related attachments and ensure that all documents are correct and accurate.**
- 2. SCE needs to seek the Commission's approval through the QCR process for any contract amendments that significantly or materially change the terms of the original contracts which were filed and approved through the QCR process. In addition, SCE must consult with its PRG for any substantial changes made in contract amendments that are effective for longer than 90 days or three calendar months.**
- 3. The Commission should provide guidance and establish procedures regarding how SCE should seek pre-approval from the Commission for amending its enabling contracts and its Service and Interchange Agreements, where the original agreements or contracts were approved outside of the QCR process.**
- 4. The Commission should ensure that such amendments are reviewed in depth for SCE's compliance with the Commission's directives before approving SCE to enter into any material amendments to these contracts and agreements.**

C. Background:

As required by D.02-10-062, OP 8 and clarified in D.03-12-062, Pacific Gas and Electric Company (PG&E), San Diego Gas & Electric Company (SDG&E), and SCE must each submit a Quarterly Compliance Report (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.

UAFCB conducts the quarterly procurement audits based on procedures specified by ED, and as such these examinations are by design agreed-upon procedures. ED specified which aspects of the utilities' Commission-approved procurement plans, AB 57 procurement rules and several procurement-related rulings and decisions to test for compliance. The directives of the decisions and rulings ED chose to test for compliance include, but are 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. UAFCB, however, does not test all of the transactions that the utilities include in their QCR.

D. Findings:

- 1. SCE failed to demonstrate that it was in compliance with D.02-10-062, Appendix B and PUC §581.** In its Q4 QCR filing, SCE made two types of reporting errors in Attachment D. First, SCE reported its physical gas traded volume in Trillion British Thermal Unit (Btu) under the label of Billion Btu. Second, SCE erroneously excluded eleven physical gas term transactions from its total physical gas traded volume. SCE claims that it misunderstood these physical gas term transactions to be physical gas option transactions settled in future quarters. As a result, SCE's physical gas

traded volume and respective notional value were materially understated by reporting under the label of Billion Btu and by the total amount of the eleven physical gas term transactions.

Criteria: In Appendix B of D.02-10-062, the Commission requires that each utility file each quarter's energy procurement transactions of less than five years duration with a QCR filing by an advice letter. The QCR filing must contain, among other things, information that is complete and accurate.

In addition, PUC §581 requires that every public utility receiving from the commission any blanks with directions to fill them shall answer fully and correctly each question propounded therein, and if it is unable to answer any question, it shall give a good and sufficient reason for such failure.

SCE's Response: On March 23, 2015, SCE filed a supplemental Q4 QCR filing to correct the two aforementioned reporting errors in Attachment D.

UAFCB's Rebuttal: None.

- 2. SCE failed to demonstrate that it was in compliance with a) PUC §454.5; b) D.03-12-062, Conclusion of Law (COL) 12; and c) D.04-12-048, Ordering Paragraph (OP) 15. Without going through the PRG and QCR approval processes, SCE entered into two contract amendments that substantially changed the terms of contracts originally vetted through the PRG and QCR approval processes.**

During Q4, SCE entered into two contract amendments: a natural gas storage contract amendment and a Greenhouse Gas (GHG) offset credit contract amendment. The Commission reviewed and approved the original contracts associated with these amendments through SCE's first quarter of 2014 QCR filing.

The gas storage amendment significantly increased SCE's firm withdrawal capacity in the original contract and the reservation charge associated with this additional capacity. The increase is effective for five months within the original contract duration of 12 months. The GHG offset credit contract amendment changed the original contract price per each GHG offset credit, vintage periods, and delivery dates. These modifications are effective for nine months within the original contract duration of 17 months.

Instead of following the Commission's directives applicable to the approval of contracts in accordance with PUC §454.5, SCE reported these amendments in its Q4 QCR as filed for information purposes only and is seeking a Commission finding that these amendments were reasonable after the fact via the 2015 ERRRA proceeding. In addition, SCE failed to consult with its PRG for both of the contract amendments that are effective for longer than 90 days or three calendar months as required by D.03-12-062 and D.04-12-048.

Criteria:

1. PUC §454.5 requires each of the investor-owned-utilities (IOU) to file a proposed procurement plan for the Commission's approval. The procurement plan approved by the Commission is to establish upfront achievable standards and criteria by which the acceptability and eligibility for rate recovery of a proposed procurement transaction will be known by the IOU prior to the execution of the bilateral contract for the transaction, and provide for expedited review and either approve or reject the individual contracts submitted by the IOU to ensure compliance with its procurement plan. In addition, per §454.5(d)(2), the Commission is to eliminate the

need for after-the-fact reasonableness reviews of an electrical corporation's actions in compliance with an approved procurement plan.

2. D.03-12-062, COL 12 requires the utilities to consult with their PRG for transactions executed as a result of Request for Offer (RFO) with delivery periods greater than 90 days or one calendar quarter.
3. D.04-12-048, OP15 requires that utilities to consult with their PRG for bilateral transactions with delivery periods greater than three calendar months, or one quarter.

SCE's Response:

SCE indicates:

SCE is in compliance with Commission decisions and correctly categorized the four contract amendments in the "information only" tab of Attachment H of SCE's 2014 Quarter 4 QCR advice letter filing, and correctly indicated that they will be reviewed through the 2015 ERRA Review filing (A.15-04-002). Support for SCE's position includes the following:

1. In Decision D.05-01-054, pages 20-21, the Commission stated that the ERRA Review proceeding is the appropriate venue to review contract amendments.
2. SCE's historic QCR practice has been to report amendments in this manner.
3. The Commission has validated the treatment of contract amendments in the review and approval of prior QCRs (e.g., Q2-14 QCR, AL 3086-E).
4. The utilities' joint report regarding the QCR Reformat provides that SCE's contract amendments will be reported in this manner.
5. The Commission and ORA have reviewed, and the Commission has approved, contract amendments through ERRA Review proceedings in the past.

The approach suggested by the auditors' proposed finding is not substantiated by Commission decisions. It would not be appropriate to have both AB 57 review and ERRA reasonableness review for contract amendments, as those reviews are mutually exclusive. AB 57 is intended to eliminate an "after the fact" reasonableness review, whereas the ERRA Review proceeding is intended to review whether SCE prudently and reasonably administered its contracts (including its amendment of those contracts). To the extent that the auditors seek to alter the long-standing Commission-approved practice of reviewing contract amendments in the ERRA Review proceeding, and instead have amendments reviewed pursuant to the utilities' AB 57 authority, the full Commission should provide that direction in a final decision. Based on the above, SCE is in compliance with the Commission's approval process for these contract amendments, and accordingly, there should be no audit finding regarding this matter.

UAFCB's Rebuttal:

1. In D. 05-01-054, pp. 20-21, the Commission stated that the ERRA Review proceeding is the appropriate venue to review the Third and Fourth Amendments to the Metro Water District (MWD) – Edison 1987 Service and Interchange Agreement. The Commission did not state that the ERRA Review proceeding is the appropriate venue to review all contract amendments.
2. In D. 05-01-054, p. 21, the Commission stated that the decision does not preclude the use of the advice letter process, or other processes, for approving future agreements or amendments to agreements.
3. SCE's historic practice of reporting contract amendments in the manner that SCE indicated does not effectively demonstrate SCE's compliance with the Commission's directives.
4. The utilities' joint report regarding the QCR Reformat has not been approved by the Commission.
5. Reviewing the contract amendments through the Q4 QCR Filing review process and vetting the amendments with SCE's PRG is a more effective review process than reviewing these amendments during an ERRA Review proceeding. The ERRA Review proceeding is an after-the-fact review process for transaction reasonableness and does not meet the objective of PUC §454.5 and the Commission decisions, which require SCE to execute contracts in accordance with its procurement plan approved by the Commission and submit them to the Commission for reviewing and approving in accordance with SCE's approved procurement plan. For contract amendments that are effective for longer than 90 days or three calendar months and materially change contracts originally vetted through the PRG process, SCE should bring such amendments before its PRG for their review. The QCR filing review and PRG consultation process for the contract amendments not only ensures that the amendments are executed in accordance with SCE's approved procurement plan but also ensures the significant changes in the amendments were vetted through with and properly advised by the PRG.

SCE's failure to seek the Commission's approval via the Q4 QCR filing and failure to discuss the price and volume changes made in the contract amendments with the PRG has circumvented the Commission's contract approval process and resulted in the significant changes made in the contract amendments not being properly reviewed and approved.

- 3. UAFCB is unaware of any specific guidelines and requirements established by the Commission regarding how SCE should seek pre-approval from the Commission for contract amendments where the original contracts were approved outside of the QCR review process and where the amendments materially change the terms of the original contracts. If the Commission does not have a review and approval process for amendments to contracts established outside of the QCR review process, it should establish guidelines and directives.**

During Q4, SCE entered into the following two amendments that materially changed the terms of the original contracts that were approved outside of the QCR review process: 1) the enabling agreement amendment executed with CP Energy Marketing Inc. and 2) the Fifth Contract Amendment to the Metro Water District – Edison 1987 Service and Interchange Agreement (the Fifth Contract Amendment.) SCE reported the amendments as filed for information purposes only in its Q4 QCR filing and is seeking recovery of costs pursuant to these amendments via SCE's 2015 ERRA Review proceeding. UAFCB is unaware of any requirements for requesting pre-

approval of such contract amendments that materially change the original terms.

The enabling agreement amendment with CP Energy Marketing Inc. significantly changes the original guarantee amount and includes additional miscellaneous provisions. The Fifth Contract Amendment significantly changes several sections contained in the original contract and previous amendments associated with the contract including, but not limited to, changing the power price paid by the Metropolitan Water District of Southern California to SCE from SCE's incremental generating cost to an hourly Edison Purchased Power price and establishing a new financial arrangement for Benefit Energy.

Since the changes made in both of these amendments are material, these amendments should be reviewed in depth through an effective review and pre-approval process. The Commission should establish a specific and effective venue that SCE should use to have the amendments reviewed and vetted before SCE executes them.

SCE's Response: Same as SCE's Response under Finding 2 above.

UAFCB's Rebuttal:

In D.05-01-054, pp. 20-21, the Commission approved the ERRA Review proceeding as the appropriate venue to review only the Third and Fourth Amendments to the MWD – Edison 1987 Service and Interchange Agreement. The decision does not preclude the use of the advice letter process, or other processes, for approving future agreements or amendments to agreements. SCE's 2015 ERRA Review proceeding for seeking the Commission's approval for the enabling agreement amendment with CP Energy Marketing Inc. and the Fifth Contract Amendment is an after-the-fact review and may not be an adequate process. The Commission should ensure that materials amendments to these contacts are reviewed in depth before SCE executes the amendments.

E. Conclusion:

Except for the items noted in Section D above, SCE's Q4 procurement transactions for electricity and natural gas that the UAFCB examined were, in material respects, in compliance with the aspects of SCE's Commission-approved procurement plan and relevant Commission decisions that the UAFCB tested compliance with. SCE's Q4 transactions that the UAFCB examined, in material respects, appear to be complete, accurate and properly authorized by its management.

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

cc: Rami Kahlon, Director, Division of Water and Audits
Judith Ikle, Energy Division
Michele Kito, Energy Division
Lily Chow, Energy Division
Yuliya Shmidt, Office of Ratepayer advocates
Donna Wagoner, Division of Water and Audits
Tracy Fok, Division of Water and Audits