Van Horn Consulting
Energy, Economic, Regulatory
& Environmental Consultants
Orinda, CA 94563

Public Report

Independent Evaluator Report for Southern California Edison's 2010 Spring Gas Request for Offers

Van Horn Consulting
Orinda, CA 94563
consulting@vhcenergy.com

Mike Katz
Ed Remedios
Andy Van Horn

July 22, 2010

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I. INTRODUCTION

Van Horn Consulting (VHC) prepared this public report, as well as a confidential Addendum, in its role as the Independent Evaluator (IE) for Southern California Edison's (SCE's) 2010 Spring Request for Offers (RFO) for Natural Gas financial products, issued on April 29, 2010.[1] SCE issued this RFO, as part of it overall risk management program to hedge natural gas costs and the volatility of electricity prices. SCE solicited offers on two financial products: natural gas call options for up to 600,000 MMBtu/month each:

- A SoCal Border Q3 Call Option with a 27 month delivery period beginning July 2012, and
- A SoCal Border Annual Call Option with a 36 month delivery period beginning November 2011, and ending October 2014.

The confidential Addendum discusses the rationale for selecting the call options for this RFO.

VHC has assessed the fairness of SCE's RFO solicitation, evaluation methods, selection process and the proposed contracts resulting from this RFO, as well as reviewed the processes, solicitation protocols and procedures, evaluation results and communications between SCE and counterparties, including the bidders' conference call on May 5 and documents exchanged between SCE and the counterparties. VHC also participated in mock auctions to test the solicitation design and procedures. Andy Van Horn was on site to monitor the May 25 auctions that selected the low-priced offers for each product.

The IE review process for electric and gas solicitations resulted from a series of California Public Utilities Commission (CPUC or Commission) rulings and decisions affecting California's Investor-owned Utilities (IOUs). The CPUC's December 2004 decision on long-term resource procurement (D.04-12-048) stated that it would "require the use of an IE for resource procurement where there are affiliates, IOU-built or IOU-turnkey bidders" from that point forward (pp. 135f). The CPUC's intent was to ensure that a utility did not favor itself or an affiliate. Decision 07-12-052, Conclusion of Law, item 24, states "IEs are valuable to the procurement process and we direct the IOUs to utilize IEs according to the parameters established in this decision and in D.04-12-048." On page 140, the Decision also states: "Further, given that IOUs may not know with certainty whether or not it or its affiliate will bid on a particular solicitation, the Commission requires that an IE be utilized for all competitive RFOs[2] that seek products of more than three months in duration.[3]" Under

[1] The confidential Addendum includes details of offers received, evaluation results and recommendations on specific areas of the RFO process. This information is confidential, in order to protect current offerors and to avoid offerors in future RFOs from gaining knowledge of SCE's specific methods of evaluation that could lead to manipulating the process. Review and access to the confidential portions are restricted, subject to PUC Sections 454.5(g), 583, D.06-06-066, and General Order (GO) 66-C.

[2] Competitive RFOs include those issued to satisfy service area needs and to provide specific supply-side resources not covered by the Commission's Energy Efficiency (EE) and Demand Response (DR) programs.

[3] This requirement creates uniformity between the contract length for which an IOU must consult its Procurement Review Group (PRG) and the IE process.

the decisions cited above, the role of the IE is to assist the utility in RFO design and to observe the utility's procurement, evaluation and contract negotiation processes, in order to provide an opinion concerning "fairness." Even though the focus of these decisions have been on electric resources procurement, this natural gas RFO, which seeks contracts with durations of 27 and 36 months leads to the need for an IE. In addition to the CPUC's requirements, the Federal Energy Regulatory Commission (FERC) requires an IE to prevent a bias and to avoid preferences favoring the selection of affiliate offers over offers from other participants.[4]

In 2008, the CPUC ruled that: "parties are to use the attached templates for the purposes specified on the templates: The IEs are to use the IE templates, either the short form or the long form, when preparing their reports on the utilities' RFOs, and the utilities are to use the contract approval template when submitting a request to the Commission for approval of a resource contract. These templates are to be used for the purposes specified until further notice."[5]

The CPUC requires that "This short form template should be used for transactions that do not require submission of an application for CPUC approval, including those transactions that are documented in the IOU's Quarterly Compliance Report (QCR) and/or are submitted to the Commission for approval via advice letter." Consistent with the CPUC ruling, this report answers the CPUC's Short Form template questions. VHC also provides additional comments and observations regarding SCE's solicitation, evaluation and contracting process that may not be required by the IE Template questions, but which VHC believes are relevant to its assessment for this report.

This portion of the report does not contain confidential and/or privileged materials. However, the confidential Addendum provides confidential information, in which review and access are restricted, subject to PUC Sections 454.5(g), 583, D.06-06-066, and General Order (GO) 66-C.

II. BACKGROUND AND PRODUCT OVERVIEW

SCE requested the following two products in this RFO:

- A three-year annual call option product was requested from November 1, 2011 to October 31, 2014. The volume requested for this annual product was up to 600,000 MMBtu/month. On May 21, SCE provided Qualified Respondents (as defined in SCE's RFO Instructions) with a separate strike price for winter and summer strips during the period, six strikes in all. (Winter includes November through March,

[4] 108 FERC ¶61,081 (2004): "Opinion and Order … Announcing New Guidelines for Evaluating Section 203 Affiliate Transactions." VHC is not aware of any additional CPUC requirements for the IE review of Demand-Side Management programs acquired via an RFO process.
[5] "Administrative Law Judge's Ruling Issuing Templates For Independent Evaluator Reports And Contract Approval Requests," Rulemaking 06-02-013, dated May 8, 2008.

and summer includes April through October.) Bidders were asked to bid a single price premium for the 36 month period.

- A 27 month 3rd quarter (Q3) call option product was requested from July 1, 2012 to September 30, 2014. The volume requested for the 3rd quarter product was up to 600,000 MMBtu/month. On May 21, SCE provided Qualified Respondents with a separate strike price for each of the three 3rd quarter periods. Bidders were asked to bid a single price premium encompassing all three Q3 periods.

During the auction process winning offers were selected in ascending order of the lowest-priced offers sufficient to fulfill the full volumes requested, subject to a pre-determined upper price limit or price threshold that SCE applied to all offers.[6] By the day before the auction bidders indicated the maximum amount they were willing to supply in increments of 150,000 MMBtu/month up to 600,000 MMBtu/month.

Only prices were to be offered during the auction for each bidder's single, pre-specified maximum volume. No bids as a function of volumes were allowed in this RFO. In addition, bidders were not allowed to change their volumes, once they indicated the amount that they were bidding into the RFO. If selected, SCE retained the right to select up to the maximum volume offered by a counterparty.

The key differences between the Spring 2010 Gas RFO compared to the Fall 2009 Gas RFO are:

1. The Spring 2010 Gas RFO auction process was run by one of SCE's financial product traders via an instant messaging (IM) platform communicating with all bidders from SCE's trading floor. The SCE trader, accompanied by senior management, decided when to close the auction and "lift," i.e., accept, the lowest-priced offer. In contrast, the World Energy automated electronic platform closed the Fall 2009 auction by lifting the lowest price offer after the auction had been open for 10 minutes. In 2009 all bidders knew the prevailing low bid up until about the last 20 seconds of the auction. In 2010, counterparties were not given a starting price and did not know the lowest bid price.
2. The Fall 2009 Gas RFO allowed price and volume bids. This RFO used price-only bidding for a volume limit pre-specified by each counterparty. Awards could be given up to the volume limit for winning bidders, depending on bid results.

The auction protocols for the Q3 and annual product were straightforward. Bidders submitted prices only on the instant messaging platform. Bidders had the opportunity to decrease, increase or remove their bid at any time during the solicitation as long as such offer had not been lifted by SCE. Once the prices declined and stabilized, SCE decided to lift the lowest-priced offer and notified the winner of the RFO via IM. After messages confirming

[6] The upper price limit or threshold allows SCE to avoid overpaying for the options, if for some reason offers were to come in at prices above the range of acceptable prices anticipated by SCE.

the volumes and prices via IM, all bidders were notified that the auction was closed. A recorded phone call with the successful counterparties confirmed the selection. Within several hours the transactions were cleared through NYMEX ClearPort.

The timing of key events[7] for this RFO was as follows:

Table 1. Key RFO Events

Date	Event
April 28, 2010	SCE notified its Procurement Review Group (PRG) that SCE would seek the gas financial call options to hedge a portion of its open gas position through this RFO.
April 29, 2010	RFO Launched with information posted on the website. **www.sce.com/gasrfo**.
May 5, 2010	Bidders' conference call.
May 6, 2010	Respondents were required to submit to SCE, in electronic format, the following: (1) completed Notice of Intent to Offer, (2) draft Confidentiality Agreement, (3) draft ISDA Schedule, (4) draft Paragraph 13 of the ISDA Credit Support Annex , and (5) completed Call Option Clearing Information
May 13/14, 2010	Qualification Date – All Confidentiality and ISDA forms were required to be delivered at the latest by 12:00 PM (PPT)
May 14, 2010	SCE sent Notices of Qualification to all Qualified Respondents via email.
May 21, 2010	SCE determined the Call Option strike prices and sent them to all Qualified Respondents via email.
May 24, 2010	All Qualified Respondents provided their indicative price and Maximum Volume Limit for each product that they planned to offer in the RFO close. In addition, SCE conducted a connectivity test with all Qualified Respondents to ensure that IM was functioning between the parties.
Tuesday, May 25, 2010	The 3rd quarter product auction and closing process began at 8:00 AM and the annual product auction and closing process began at 9:00 AM. SCE selected the successful Offers, confirmed the selection via recorded phone call and filed the transactions with NYMEX ClearPort.

[7] This link http://www.sce.com/energyprocurement/gasrfo?from=gasrfo on SCE's website provides more details of the timing of key activities for this Gas RFO.

III. SUMMARY OF RESULTS AND CONCLUSIONS

SCE selected the lowest-priced offers for 100 percent of the solicitation amounts requested, in order to help meet a portion of its hedging needs in 2011 through 2014. VHC found no intentional or unintentional biases that might have led SCE to unfairly select specific offers. There were no affiliate offers that were awarded contracts. The RFO outreach was good, and the bidding in each auction was deemed to be competitive. More counterparties submitted bids in this RFO than in the gas RFO last Fall.

VHC believes that SCE used reasonable selection criteria to select the products offered in this RFO, which are intended to minimize portfolio costs and risks to SCE. As a result of our review of RFO processes and evaluations, VHC has suggested some refinements to SCE's risk assessment tools with respect to the selection of hedge products and to auction processes.

VHC also finds that SCE's communications and interactions with all counterparties did not provide preferential treatment that would advantage or disadvantage any particular participant in the RFO.

The confidential Addendum provides more discussion of the offers and successful bids.[8]

IV. RESPONSES TO QUESTIONS IN THE SHORT FORM TEMPLATE

VHC's responses to the Commission's Short Form Template Questions are provided below. Confidential comments, data and responses to some questions are provided in VHC's separate confidential Addendum to this report.

A. Role of the Independent Evaluator (IE)

1. Describe in detail the role of the IE throughout the solicitation.

VHC began its role as an IE for SCE on March 25, 2010. VHC is one of the IEs that SCE has engaged to monitor and assess its various procurement solicitations that require an IE. As the IE for the 2010 Spring Gas RFO, VHC has performed two principal functions:

- Ensure that SCE carries out a fair and unbiased solicitation, offer evaluation, selection and contracting process, and
- Provide advice to improve processes, evaluation techniques and assumptions.

[8] The counterparties' offers and the winning bids are subject to confidentiality agreements and cannot be disclosed in the public portion of this IE report.

VHC's primary focus has been to ensure the fair and non-discriminatory treatment of all offers and to avoid economic evaluation techniques and assumptions that could lead to unintended or unfair biases in the selection of contracts (e.g., unintended preferences due to collateral adders and/or contract types). Once the call option product type had been selected, the IE focused on the uniform treatment of counterparties and on refining and testing auction procedures, since the basic economic criteria for selection in the auction is simply providing the lowest-priced offer.

VHC team members performed the following functions over the course of the solicitation and contract selection process:

- Met with key RFO team members and SCE executives to get a broad overview of the SCE RFO process,
- Reviewed various internal documents and spreadsheets of the evaluation and product selection methodology,
- Reviewed an "After the Fact Analysis" presentation for the Fall 2009 Natural Gas RFO,
- Reviewed past IE reports for the Spring and Fall 2009 Natural Gas RFOs,
- Sent various memos to SCE highlighting areas for clarification and discussion,
- Participated in multiple Mock auctions to validate new bidding protocols and to test that SCE will receive and process bids accurately and uniformly among participants,
- Reviewed and discussed portfolio risk reduction, cost of hedges and hedge ratio calculations that influence the selection of the hedge type products (e.g., call options and fixed-for-floating swaps),
- Provided comments and suggestions regarding auction procedures and broadcasts and about the risk calculation methodology,
- Participated in planning meetings,
- Participated in the bidders' conference call,
- Monitored communications with counterparties, including mark-ups of required documents exchanged between SCE and certain counterparties,[9]
- Participated in SCE's Risk Management Committee (RMC) meetings that discussed and authorized the Gas RFO process and results,
- Participated in the CPUC's Procurement Review Group (PRG) meetings that discussed the Gas RFO process and results,

[9] One of the IE's key roles is to monitor all interactions and communications with any SCE affiliates that intend to provide offers in an RFO. No SCE affiliates participated in this RFO.

- Participated in weekly process meetings,
- Monitored both the Q3 and Annual auctions on-site on May 25, including all broadcasts to counterparties, the bids received, offer selection, notification and confirmation of the successful bidders and transaction documentation sent to NYMEX ClearPort.

B. Fairness of SCE's Bidding and Selection Process

2. Please evaluate the fairness of the IOU's bidding and selection process. (i.e., quantitative and qualitative methodology used to evaluate bids, consistency of evaluation methods with criteria specified in bid documents, etc.)

1. Fairness Assessment

VHC examined SCE's RFO process from the design of the RFO to the final selection of contracts to ensure that SCE created and implemented a fair and unbiased process for all offerors. VHC also monitored SCE's offer evaluation and selection to determine that it was performed according to the criteria specified in the offer documents and internal guidelines. VHC looked for instances where the offer evaluation or selection deviated from the criteria specified in the offer documents or from SCE's internal guidelines. In this RFO, the use of an auction provided a straightforward determination of the lowest-priced bids.

The full amount of the Annual and 3rd quarter contracts requested from the RFO was selected. No SCE affiliate offers were received in this RFO.

2. Conclusions Regarding Fairness

VHC concludes that SCE ran a fair and unbiased RFO process.

VHC finds that the updated auction protocols and procedures and the IM platform applied in this RFO treated all parties in an equivalent manner, enabling the bidding to be competitive and the selection of the winning offers to be unbiased.

VHC also finds that the offers selected by SCE are reasonable and consistent with the evaluation criteria applied by SCE. Simply put, in each auction the lowest-priced offers were selected.

3. Additional Conclusions

Additional VHC conclusions are:

- SCE maintains excellent documentation of its processes and follows them.

- The updated bidding protocols enabled an improved bidding process when compared to the last second "EBay" bidding behavior that occurred in the Fall 2009 Gas RFO, which used an electronic bidding platform to close the bidding after 10 minutes.
- The personnel involved with transferring bids into the bid ranking spreadsheet ensured that all bids were properly ranked and visible to those monitoring the process.
- SCE's senior management and its Risk Control Department provided appropriate oversight during the RFO process and were present on the trading floor during the auctions,
- There are no subjective or qualitative adders that were used to select offers.

C. Description of SCE's Evaluation and Selection Process

3. Describe the IOU's Least Cost Best Fit (LCBF) methodology (or provide the IOU's own description). Evaluate the strengths and weaknesses of the IOU's LCBF methodology. (This should include a thorough analysis of the RFO results.)

SCE's Spring 2010 Gas RFO is part of its overall risk management efforts to reduce gas portfolio costs and risks and electricity price volatility. SCE examines the composition of its electric resources portfolio to determine the portions that contribute price volatility to its customers. Since SCE has a combination of natural gas-fired power plants and tolling agreements without fixed-price gas, future gas price volatility leads to electricity price volatility from the effects of the gas-fired resources in its portfolio.

SCE purchases and sells gas on a daily basis, in order to continuously match natural gas supplies with the demand from its gas-fired electric generators. For longer-term needs, SCE regularly examines its open position, and then determines the amount of natural gas needed to partially fill that open position. For an RFO, such as the 2010 Spring Gas RFO, SCE examines its needs over a multi-year timeframe that begins 18 months after the expected closing date of the RFO.

In order to reduce the volatility associated with its market sensitive procurement costs, SCE examined various financial products including call options (annual and 3rd quarter), swaps, call spreads and collars. SCE compared the portfolio risk reductions provided by various potential financial products, in order to determine the product(s) that could best meet SCE's risk management needs. During conference calls with the PRG on April 28 and May 24, SCE reviewed the product options with the PRG and explained the rationale for selecting call options for this RFO. VHC believes SCE has used a reasonable approach in selecting the products for this RFO. However, for future RFOs VHC recommends some potential refinements in the product selection calculations and selection metrics. Additional comments regarding the selection of the financial products for this RFO is discussed in the confidential Addendum.

D. VHC's Opinion of SCE's Auction Process

VHC participated in four mock trials as part of the validation process to confirm that all parties received communications at the same time, to refine SCE trader responses to non-conforming bids and other situations that might arise, and to ensure that processing of bids was done properly. VHC found the testing process to be very thorough. A host of bidding strategies and submittals of invalid bids were tested to see how the bid selection team would handle these situations.

Andy Van Horn was on site monitoring the auction processes during and after the submittal of bids on May 25, 2010 VHC believes that SCE followed the applicable guidelines for this RFO and, as stated previously, that the process was competitive, fair and unbiased.

1. Key Strengths

The RFO process and the auction procedures were well-documented and tested before the auction date. Using an SCE financial trader communicating with counterparties with Instant Messaging, instead of the previous electronic bidding platform, allowed bids to decline and stabilize before the auction was closed.

2. Weaknesses

VHC did not find any weaknesses in the RFO and bid selection that would have changed the outcome of this RFO. However, VHC did note several potential refinements that may further improve SCE's product selection process in future RFOs. These refinements are discussed in the confidential Addendum. Even though some refinements are recommended, VHC finds that SCE's overall approach to tackling this complex hedging problem is thorough and informative.

3. Least-Cost, Best-Fit Conclusions

VHC believes that SCE's evaluation methodologies comply with the Commission's Least-Cost Best-Fit methodology requirements. SCE performed a host of calculations to find the lowest-cost financial products to provide the most cost-effective hedging value to customers. SCE also considered other factors, such as the diversity of different financial products used by SCE for hedging.

VHC finds SCE's selection of call options as the sole product solicited for this RFO to be reasonable. This selection helps to maintain a mix of different hedge products within the portfolio.

VHC finds SCE's overall approach to be reasonable, methodical and consistent with the goals of Least-Cost, Best-Fit.

E. SCE's Outreach

4. How did the IOU conduct outreach to bidders, and was the solicitation robust?

VHC believes that SCE's outreach to publicize and notify prospective offerors for this RFO was reasonable and similar to the outreach efforts of its past bi-annual Gas RFOs. This was SCE's fifth Gas RFO. The first Gas RFO was conducted in 2006. Subsequent bi-annual RFOs were conducted in Fall '08, Spring '09, Fall '09, and Spring '10.

In order to be eligible to participate, potential counterparties had to have a fully executed ISDA Master Agreement (including the Schedule to the ISDA Master Agreement and the Paragraph 13 to the Credit Support Annex) and an appropriate Confidentiality Agreement in place with SCE by the Qualification Date, May 13, 2010.

On April 29, 2010, SCE notified approximately 350 contacts compiled from Gas RFO solicitations, regulatory service lists, members of the media, etc., that the RFO had been released. On the same day, SCE posted the solicitation on its company website, providing a means for interested parties to download the RFO and related materials. The SCE web site provided an effective way for prospective offerors to ask questions and read posted responses. On May 5, 2010, SCE held a bidders' conference call regarding this solicitation. The conference call provided prospective offerors an overview of the solicitation and provided an opportunity to ask questions. VHC participated in this conference call.

VHC believes that the auction response from offerors was robust and notes that there were 15 Qualified Respondents and 13 actual bidders involved with this solicitation, which was one more bidder than participated in SCE's 2009 Fall Gas RFO.

F. Project-specific Negotiations

5. Describe project-specific negotiations. Highlight any areas of concern including unique terms and conditions.

There were no project-specific negotiations. All counterparties were required to sign confidentiality agreements and International Swaps and Derivatives Association, Inc. (ISDA) agreements that were negotiated in advance, in order for each counterparty to become a Qualified Respondent.

VHC monitored the progress of various counterparties in negotiating the agreements but did not review each of the contract documents in detail, since these agreements are not RFO-specific and SCE has been using them for some time in its hedging program.

If there had been contracts for fixed-for-floating swaps in this RFO, then VHC would have examined the collateral posting requirements and the credit standards required for counterparties and considered how these would have been applied in the selection of offers.

G. Affiliate Offers and UOG Ownership Proposals (If Applicable)

> 6. If applicable, describe safeguards and methodologies employed by the IOU to compare affiliate bids or Utility-Owned Generation (UOG) ownership proposals. If a utility selected a bid from an affiliate or a bid that would result in utility asset ownerships, explain and analyze whether the IOU's selection of such bid(s) was appropriate.

There were no affiliate bids.

H. VHC's Recommendations

> 7. Do you agree with the IOU that the contract(s) merit Commission approval? Explain.

Yes, VHC agrees with SCE that the contracts selected in this RFO merit Commission approval. As discussed throughout this report, SCE ran a fair, effective and competitive solicitation to find a set of cost-effective contracts to help meet its gas hedging needs and to diversify the types of financial products it uses for hedging.

VHC makes the following recommendations regarding SCE's future Gas RFO hedging activities:

- Hedging products should be selected in separate, sequential auctions, where each auction selects a single product, as was the case in this RFO. Picking the best offers for more than one type of financial product in a single real-time auction would create unwarranted complexity for both the buyer (SCE) and sellers.
- VHC views SCE's periodic RFOs using this auction format and RFO design to be an efficient means for adding future hedges to SCE's portfolio.
- SCE should continue to:
    - Examine and refine financial hedging product selection calculations and metrics,
    - Use its own financial traders for this type of RFO,
    - Enhance the Instant Messaging platforms by automating the interface with the spreadsheet program that ranks the offers,
    - Integrate software and display graphics to aid in the closing process,

- Plan for similar Gas RFOs in the future.

Based on our interactions with SCE and counterparties and our observation and review of SCE's RFO processes, methods and results, VHC believes these contracts were selected fairly without biases or preferential treatment to the participants. Overall, SCE's process follows Commission guidelines for making a Least-Cost, Best-Fit selection. Therefore, for all the foregoing reasons, these contracts merit Commission approval.