

From: Schultz, Cassandra
Sent: Tuesday, July 31, 2001 7:40 PM
To: Murphy, Ted; Buy, Rick; Port, David
Cc: Hayden, Frank; Gorny, Vladimir
Subject: PGE Market Risk and PGE 3Q IBIT

FYI - per Rod Hayslett and Stan Horton, Ken Lay and Skilling were recently "shocked" to be told that PGE's regulated price risk management activities were going to lose ~\$53MM in the 3rd quarter. Rod said they hadn't realized before this the level of market risk that PGE is exposed to. Evidently PGE is required to have excess supply to meet their projected load requirements, and they're losing \$\$ on price moves. Rod said Stan suggested having a conference call with Rick Buy to discuss, so I told Rod to first let you get familiar with the issue.

You'll probably want to be familiar with it since we're recommending a \$10MM limit on the Regulated Portfolio, and it's losing \$\$\$\$. We're simply imposing a limit on existing risk, but given the significant drop in PGE earnings vs. prior year, Investor Relations is expecting some interest and the BOD might be aware of it and ask for clarification of our risk management practices accordingly.

Regards,
Cassandra.

PGE 3Q IBIT/Sensitivity to power prices

INTERNAL SUMMARY

PGE buys power in advance of its needs to allow for load and reliability balancing beyond their generation capabilities. PG&E is typically long 200-300 average megawatts. These positions are typically entered into 1 to 2 years in advance. The excess positions are sold in the spot (hourly) market. PGE benefited during the 3rd and 4th quarters 2000 by selling into high prices. As a precaution against prices falling, they instituted a cost adjustment mechanism with ranges for cost sharing based on total power costs. In 2001, PGE entered an unfavorable range of the sharing mechanism, where they bear 100% of the upside/downside within a range. As a result of downward trending power pricing and the cost of power outpacing the sharing under the arrangement, PGE IBIT may be flat/slightly negative for 3Q01. On 10/1/01, a new cost mechanism begins. PGE expects to meet internal target of \$110M for 2001, based on YTD performance and additional adjustment mechanisms, which are being executed for 4Q01 and into 2002.

BACKGROUND

The methodology for the current 9-month mechanism is as follows: A band with a ceiling and a floor has been negotiated on a quarterly and a cumulative basis for the nine-month period.

Total Costs	PGE/Customer
\$140M to \$211M	100% PGE (deadband)
\$211M to \$232M	50%/50%
Above \$232M	10%/90%

At 6/30/01, PGE was in the 100% PGE band, (\$105M), but did not significantly impact the financials as this amount was sufficient to cover power generation costs.) It is expected that the 9 mo. total costs will rise to \$325M, which will potentially expose PGE for approx. \$35MM (comprised of 100% of the risk of the deadband to the extent that total costs to be recovered are lower than increases in the costs of power, 50% of the risk between \$211MM to \$232MM and 10% of exposure above \$232MM.) To reduce the exposure for fourth quarter 2001 and 2002, PG&E is in the process of finalizing a similar cost adjustment mechanism for a 15-month period ending December 31, 2002. The structure mechanism will have additional features:

- A tighter band than the 2001 mechanism
- Tiers of sharing, with less sharing as the variance between forecasted power costs and actual power costs is larger, positive or negative.
- Forecasted power costs set using actual reservoir levels, and expected rainfall, significantly reducing forecasted available hydro

13-20010731 PGE Market Risk and PGE 3Q IBIT.txt

PG&E will file the forecasted power costs on or around August 15, reflecting trades and purchases through the end of July

EXHIBIT 1: 9 Month adjustment structure - see attached

-----Original Message-----

From: Hayslett, Rod
Sent: Tuesday, July 31, 2001 1:40 PM
To: Schultz, Cassandra
Subject: FW: PGE 3Q IBIT

This will help enlighten you as to what Portland can look like.

The attached was prepared by Amin Maredia last week, as we were getting up-to-speed on PGE's cost sharing mechanism and a potential drop in 3Q earnings. This document is for your education only - obviously, we will learn more as the 3Q numbers begin shaping up.