STATE OF CALIFORNIA ARNOLD SCHWARZENEGGER, *Governor*

PUBLIC UTILITIES COMMISSION
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TO PARTIES OF RECORD IN RULEMAKING 07-05-025

This is the proposed decision of Administrative Law Judge (ALJ) Pulsifer. It will not appear on the Commission's agenda for at least 30 days after the date it is mailed. The Commission may act then, or it may postpone action until later.

When the Commission acts on the proposed decision, it may adopt all or part of it as written, amend or modify it, or set it aside and prepare its own decision. Only when the Commission acts does the decision become binding on the parties.

Parties to the proceeding may file comments on the proposed decision as provided in Article 14 of the Commission's Rules of Practice and Procedure (Rules), accessible on the Commission's website at www.cpuc.ca.gov. Pursuant to Rule 14.3, opening comments shall not exceed 15 pages.

Comments must be filed either electronically pursuant to Resolution ALJ-188 or with the Commission's Docket Office. Comments should be served on parties to this proceeding in accordance with Rules 1.9 and 1.10. Electronic and hard copies of comments should be sent to ALJ Thomas R. Pulsifer at trp@cpuc.ca.gov and the assigned Commissioner. The current service list for this proceeding is available on the Commission's website at www.cpuc.ca.gov.

/s/ ANGELA K. MINKIN
Angela K. Minkin, Chief
Administrative Law Judge

ANG: lil

Attachment

Decision **PROPOSED DECISION OF ALJ PULSIFER** (Mailed 10/7/2008)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Rulemaking Regarding Whether, or Subject to What Conditions, the Suspension of Direct Access May Be Lifted Consistent with Assembly Bill 1X and Decision 01-09-060.	Rulemaking 07-05-025 (Filed May 24, 2007)

DECISION AUTHORIZING MEASURES TO FACILITATE REMOVAL OF DEPARTMENT OF WATER RESOURCES FROM THE ROLE OF SUPPLYING ELECTRIC POWER

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APPENDIX – CDWR Power Long-Term Power Contract Expiration

DECISION AUTHORIZING MEASURES TO FACILITATE REMOVAL OF DEPARTMENT OF WATER RESOURCES FROM THE ROLE OF SUPPLYING ELECTRIC POWER

1. Introduction

In this decision, we adopt a plan to facilitate the removal of the Department of Water Resources (DWR) from its role of supplying electric power to retail customers. Adoption of this plan completes Phase II(a)(1) of this rulemaking, which we opened to address whether, or under what conditions, "Direct Access" may be reinstituted. Pursuant to the legislative mandate, the Commission suspended the right to enter into new contracts for "Direct Access" after September 20, 2001.[1]

The "Direct Access" suspension was implemented pursuant to Assembly Bill 1 from the First Extraordinary Session (Ch. 4, First Extraordinary Session 2001) (AB1X) signed into law on February 1, 2001, to address the energy crisis of 2000-2001. Extraordinary wholesale power costs increases during that period threatened the solvency of California's major public utilities and their ability to maintain reliable electric service. Among other measures to ensure continued reliability of service, AB1X mandated that DWR become the electric power supplier of last resort for retail customers of the investor-owned utilities

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[1] *See* D.01-09-060 and Pub. Util. Code §§ 366 or 366.5. Direct Access was originally instituted as a retail service option where eligible customers could buy electricity directly from an independent supplier rather then from an investor-owned public utility. The Legislature mandated the suspension of Direct Access to ensure a stable customer base for DWR cost recovery and so that Direct Access customers pay their fair share of DWR costs.

(IOUs).[2] To meet this mandate, DWR entered into a series of contracts for the procurement of electric power to serve customers in the territories of the IOUs: Pacific Gas and Electric Company, Southern California Edison Company and San Diego Gas & Electric Company.[3]

Since that time, the energy markets have stabilized, the IOUs have resumed responsibility for procuring electric power, and DWR no longer is authorized to enter into contracts for power. DWR continues to supply power to retail customers, however, under contracts previously entered into prior to January 1, 2003. As explained below, we find it to be in the public interest to expedite the final phase out of DWR's remaining involvement in supplying electric power to retail utility customers, and to return full responsibility to the IOUs. We accordingly set a target goal for the final removal of DWR from the role of supplying power by January 1, 2010. We shall pursue this goal by supporting a process to implement replacement contracts between the IOUs and the suppliers under the DWR contracts, thereby relieving DWR of further supply obligations under its existing contracts.

As explained below, we recognize that various uncertainties may influence the achievement of this goal by January 1, 2010, and we shall closely monitor the progress of our adopted plan, with provision to make mid-course adjustments, as necessary, to protect ratepayers' interests.

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[2] DWR supplied the "net short," i.e., the shortfall in demand not supplied under existing power contracts of the IOU or generated by an IOU facility.

[3] AB1X authorized DWR to recover its power costs from electric charges established by the Commission (Water Code § 80110). DWR entered into servicing agreements with the IOUs to collect money on its behalf for power that DWR sells to IOU customers.

2. Procedural Background

On May 24, 2007, the Commission initiated this Order Instituting Rulemaking (OIR) to consider whether and if so, how Direct Access could (or should) be restored. The rulemaking was segmented into three phases:

1. Commission Legal Authority to Lift the Direct Access Suspension in accordance with AB1X.

2. Public Policy Merits of Lifting the Direct Access Suspension and Applicable Wholesale Market Structure/Regulatory Prerequisites.

3. Rules Governing a Reinstituted Direct Access Market: e.g., Entry/Exit/Switching; Default Arrangements, and Cost Recovery Issues

On February 28, 2008, Decision (D.) 08-02-033 was issued in Phase I of this proceeding, finding that lifting the suspension on Direct Access was barred as long as DWR supplies power to retail customers as a party to its existing power contracts (Water Code § 80260). The last of the DWR contracts is scheduled to expire in 2015. The Commission also concluded that there was merit in considering ways to relieve DWR of its obligations to supply power on an expedited basis by supporting negotiations with DWR contract counterparties to enter into replacement agreements with the IOUs.

Phase II of this proceeding was thus bifurcated to consider, as Phase II(a), the feasibility and framework for a plan to accelerate the removal of DWR from its role of supplying power through novation and renegotiation of contracts. A prehearing conference (PHC) in Phase II(a) was held on April 11, 2008. An Assigned Commissioner's Ruling (ACR) issued on April 18, 2008, further refined the schedule into Phase II(a)(1) --to explore the feasibility and to consider the design of a plan to support arrangements to implement replacement contracts, as noted above--, and Phase II(a)(2)--to implement any plan that may be adopted in Phase II(a)(1). In defining this procedural scope, the ACR stated:

> "A separate decision will be issued on Phase II(a)(1) issues, addressing the feasibility of going forward with a program to facilitate removing DWR from its role as supplier of power under AB1X, including addressing general timing considerations in conducting any subsequent negotiations. Phase II(a)(1) shall address whether novation/renegotiation efforts should be limited only to contracts that expire after a prescribed date, and the general criteria, constraints, conditions, and guidelines to be applied." (ACR at 9-10).

A technical workshop on Phase II(a)(1) issues was held on June 2, 2008. Parties filed post-workshop comments on June 9, 2008, with reply comments on June 16, 2008. A follow-up workshop was held on July 1 and 2, 2008. Parties presented their positions on Phase II(a)(1) issues in filed comments, as follows: Inter-utility cost allocation comments were filed on July 28, 2008, with replies on August 11, 2008. Comments on net costs-versus-benefits issues were filed on August 4, 2008, with replies on August 18, 2008. Summary closing comments on Phase II(a)(1) issues were filed on August 25, 2008, with replies on September 8, 2008. DWR submitted a final memorandum on September 10, 2008.

The major parties participating in Phase II(a)(1) were the IOUs: Pacific Gas and Electric Company (PG&E), San Diego Gas & Electric Company (SDG&E), and Southern California Edison Company (SCE); various industry and trade groups: Alliance for Retail Energy Markets/California Alliance for Creative Energy Solutions (AReM/CACES), Reliant Energy, Inc. (Reliant), California Large Energy Consumers Association (CLECA) and California Manufacturers and Technology Association (CMTA); various consumer advocate representatives: The Utility Reform Network (TURN), the Division of Ratepayer Advocates (DRA), Consumer Federation of California (CFC), and Californians for Renewable Energy (CARE). The DWR also participated through responding to data requests, attending workshops, and submitting memoranda on its positions.

3. Framework for Considering Plan to Accelerate DWR's Departure

3.1. Scope of the Inquiry

The threshold issue in this phase of the proceeding is whether, and if so, how the Commission should support measures to expedite the removal of DWR from its role of supplying power under AB 1X. Alternatively, we consider whether it is in the public interest simply to refrain from any further efforts in this regard. Our decision has implications for the timing of subsequent phases of this proceeding with respect to the possible reinstitution of Direct Access. The Commission previously recognized in D.02-12-069, however, that there are broader policy reasons for expediting the removal of DWR from its power supplier role. DWR's authority to procure power was not perpetual, but was an emergency measure designed to stabilize a crisis. DWR's authority to contract for power purchases expired on January 1, 2003,[4] and the IOUs concurrently resumed procuring power to meet the load demand for their respective

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[4] Water Code § 80260 provides that:

> On and after January 1, 2003, the department shall not contract under this division for the purchase of electrical power. This section does not affect the authority of the department to administer contracts entered into prior to that date or the department's authority to sell electricity.

customers. In D.02-06-029, we allocated the power supplied under the existing DWR contracts among the three IOUs portfolios. The IOUs now perform all day-to-day scheduling and dispatch functions for the DWR contracts allocated to their portfolios, just as they do for their existing resources and new procurement.

As determined in D.08-02-033, however, DWR continues to supply power under contracts entered into prior to 2003. Legal title to the DWR contracts still resides with DWR. Financial reporting responsibilities, including those associated with the DWR revenue requirements proceeding and Trust indenture reporting requirements, also remain with DWR. Assuming no further changes to existing contracts, the last of the DWR contracts is scheduled to expire in 2015.

As noted in D.02-12-069, relieving DWR from its responsibility to perform energy supply functions is one of this Commission's fundamental short-term goals. Transitioning full responsibility for energy market-related activities back to the IOUs as soon as possible is consistent with the principle that the utility, and not DWR, continues to have a statutory responsibility to serve its customers.

In recognition of such broad policy considerations, the scope of our inquiry here considers the full range of potential effects of expediting the removal of DWR from its power supply role (not just the legal implications relating to Direct Access). Consideration of the impacts of removing DWR from its power supply role therefore include both potential costs as well as any positive benefits. As a framework for this evaluation, we first identify the available options to facilitate the early release from its contracts.

3.2. Options to Facilitate and Expedite DWR Release from Contracts

The number of active DWR contracts has been progressively declining, from an original number of 59 down to 26 contracts today, with 15 counterparties. By 2010, the cost of the remaining contract portfolio is expected to be about $6.1 billion, or about one-seventh of the original liability. In 2001, DWR contracts covered 35% of the IOU's peak demand and energy requirements. The remaining long-term contracts in effect as of 2010 would cover only about 15% of the IOU projected requirements. The vast majority of DWR contracts expire by 2011.[5] Assuming no further action to accelerate the time when DWR no longer supplies power, the DWR contracts will expire under their existing terms, gradually reducing the amount of power that DWR supplies down to zero by 2015. Appendix 1 of this decision summarizes the DWR contracts by expiration date.

Three potential options have been identified whereby DWR could seek release from supply obligations under its existing contracts, namely: (1) novation; (2) renegotiation; or (3) assignment. We describe each of these options below:

3.2.1. Novation Provisions in DWR Contracts

"Novation" refers to the "[substitution] of a new obligation for an existing one" and "may be accomplished either by the substitution of a new debtor or a new creditor."[6] Novation "wholly extinguishes the earlier contract."[7] DWR has already successfully renegotiated 22 of its 26 remaining contracts to include "novation" provisions. These provisions allow DWR, working in conjunction

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[5] *See* the DWR Revenue Requirement Determination for 2007, submitted to the Commission on August 2, 2006, pursuant to Sec. 80110 and 80134 of the Water Code, pp. 22-24, TABLE D-5 LONG-TERM POWER CONTRACT LISTING.

[6] *Fanucchi & Limi Farms v. United Agri Products*, 414 F.3d 1075, 1081 (9th Cir. 2005), as cited in PG&E's comments dated August 25, 2008.

[7] *Id.*

with the Commission, to transfer its contracts to the IOUs. Accordingly, upon execution of a novation of a DWR contract, DWR would be released from all rights, obligations, and ownership interests in the contract and the power supplied under that contract.

Although the specific novation clauses differ somewhat from contract to contract, the clauses generally provide DWR with the option to a request that the counterparty to the contract enter into a "Replacement Agreement" with one or more "Qualified Electric Suppliers."[8] The execution of the "Replacement Agreement" constitutes a "novation," relieving DWR of any liability or obligation arising under the new agreement.

The novation clauses in the DWR contracts are specifically crafted so as to *require* the Seller to enter into a Replacement Agreement with a "Qualified Electric Supplier," once DWR so requests. That requirement is subject only to the fulfillment of certain conditions precedent outside of the control of the Seller. Thus, for contracts with a provision for novation, the Seller is not in a position to refuse to agree to the novation or to insist on unilateral terms which would be detrimental to ratepayers. DWR agrees to work with the Commission and the IOU likely to take on the replacement contract after a novation had been negotiated and executed.

3.2.2. Renegotiation of Contracts that Lack Novation Clauses

Four DWR contracts do not currently have novation provisions, namely: Coral Power LLC, Sempra Energy Resources, City and County of San Francisco,

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[8] In order to be qualified to take over the rights and obligations of a DWR contract, the supplier's long-term unsecured senior debt must meet specified minimum credit rating standards.

and PacifiCorp Power Marketing, Inc. In the case of these contracts, DWR and the IOUs cannot unilaterally require the counterparty to enter into a "Replacement Agreement" as provided for under a novation. Some additional negotiations with the counterparties would be necessary before DWR could end its obligation to supply power under the existing contracts. DWR and the IOUs cannot unilaterally require any of these counterparties to renegotiate their contracts. Except for one counterparty that spoke at the Commission's workshop, none of the four counterparties have given any indication in this proceeding as to whether, or under what conditions, they may be willing to negotiate.

3.2.3. Assignment of DWR Contracts

Another possible option for the transfer of DWR contracts to another entity is through contract assignment. All of the DWR contracts contain some form of assignment provision. Unlike novation provisions, however, the assignment of a contract to another party would not relieve DWR of its liability for performance under the contract without a waiver by the counterparty. Without such a waiver, even if the contract was assigned DWR would not be relieved of its role of supplying power under the contract The CalPeak contract, in particular, permits assignment only if there are no Section 206 complaints the Federal Energy Regulatory Commission (FERC), and requires a release of all Section 206 complaints.

Reliant argues that for those contracts with novation clauses, there is no basis to pursue assignment of the DWR contracts given the superior advantages offered by novation. With respect to the four contracts without novation clauses, Relaint believes that while assignment remains open as a potential option, seeking renegotiation of the contracts may be a more effective solution.

PG&E likewise argues that there is no basis to assume that any of the four counterparties without novation clauses would be willing to grant DWR a release from liability without some additional consideration.

Given the uncertainties as to whether DWR could obtain a release from liability from all counterparties as a result of an assignment, we conclude that pursuing assignment of the DWR contracts does not offer a viable means of removing DWR from supplying power under existing contracts.

3.3. Merits and Feasibility of Pursuing Contract Revisions

3.3.1. Parties' Positions

In order to achieve the goal that DWR no longer supply power, DWR will have to be removed as a party to its existing contracts either through (a) novation or (b) renegotiation of the existing contracts. Parties' disagree considerably on whether (or how soon) this goal could be attained.

DWR expresses confidence that it can have all of its contracts novated by January 2010. DWR believes it can secure an agreement with counterparties to add a novation clause to the four contracts that currently lack such a clause. DWR expresses optimism that the counterparties to those four contracts will accept novation without demanding concessions that would be detrimental to ratepayers. DWR notes that no party has taken issue with the consideration that DWR provided in return for adding a novation provision in any of the 22 contracts that currently have such a provision.

AReM/CACES and Reliant likewise support the goal of 2010 as a target date for completing novation of all DWR contracts. Reliant argues that, as a practical matter, the Commission cannot ascertain with certainty that novation, assignment, or renegotiation can be accomplished, but can only make an informed judgment based on the record. Reliant values DWR's assessment of success, however, since DWR is most familiar with all of the contracts and the counterparties. Reliant argues that the Commission should allow novation of the contracts to proceed as stakeholders work towards assuring that all 26 contracts are timely novated.

The IOUs and consumer groups, however, believe that it will likely not be feasible to effect novation of all of the contracts under terms that are beneficial to ratepayers. Thus, while the IOUs estimate net savings to ratepayers from DWR contract novation, those estimates are based on the underlying assumption that all DWR contracts could be successfully replaced with new agreements by 2010. The IOUs and consumer groups argue that because achievement of full novation of contracts by 2010 is highly unlikely, the ratepayer savings will likely not materialize.

In particular, provisions in the PG&E Bankruptcy Settlement[9] may limit the feasibility of PG&E taking over any DWR contracts. Parties also point to uncertainty as to how the Commission will decide how the costs of any replacement contracts taken over by an IOU would be allocated among the three IOUs and their customers. Since existing DWR contract costs are allocated among all three IOUs, an IOU would not be inclined to take on a "Replacement Contract" if it resulted in an inequitable cost burden as a result of changes in how costs are allocated.

The IOUs and consumer groups also identify the four contracts without novation clauses in their contracts as another significant impediment. Novation

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[9] See D.03-12-035, Appendix C, Section 7 in I.02-04-026 regarding the investigation of ratemaking implications of PG&E's Plan of Reorganization.

of those contracts will not be possible unless the contract counterparties agree to it. The IOUs and consumer groups argue that the four counterparties without novation clauses will likely try to negotiate greater compensation in exchange for accepting a novation clause, based on their perceived bargaining leverage.

Reliant argues that even if contract suppliers expect to benefit from contract renegotiation, there is no reason why ratepayers must necessarily be disadvantaged. Reliant suggests that provisions might be negotiated that benefits both the supplier and ratepayers. For example, a supplier might be willing to accept a price reduction in exchange for negotiating a longer contract duration, granting more favorable payment terms, or more flexible delivery requirements.

PG&E contends that any renegotiation of contracts will be time-intensive and costly based on its experience in negotiating contracts in recent years. PG&E doubts whether DWR and the IOUs will be able to novate, assign, or renegotiate all of the DWR contracts given the hurdles involved. PG&E does not assert categorically that no net benefits are possible or that further efforts to negotiate with suppliers should be abandoned. PG&E believes, however, that such efforts are still at a very preliminary stage. PG&E argues that before the Commission considers supporting any effort to novate, assign or renegotiate the DWR contracts, it should be determined if *all* of the existing contracts as a legal or practical matter *can be* novated, assigned, or renegotiated while producing customer benefits.

Reliant disagrees with PG&E's assertions that the benefits of novation lie, to a large extent, with *all* of the DWR contracts being novated. Reliant argues that there will be a concomitant benefit to ratepayers with the novation of *each* contract.

SCE believes that the probability that DWR will be able to novate or assign all of the DWR contracts is low. SCE identifies (1) the constraints of the PG&E Bankruptcy Settlement and (2) the lack of novation clauses in four of the DWR contracts as particular impediments to successful novation of all contracts. SCE believes, in any event, that a 24-month timeframe would be more realistic for completion, assuming all other potential impediments could be otherwise overcome.

Representatives of consumer groups, DRA, TURN, and CFC likewise believe that successful novation of all of the DWR contracts is unlikely, particularly as early as January 2010. They claim that outcomes are too uncertain to conclude that novation would benefit ratepayers, and argue that the Commission should reevaluate its goal of pursuing novation or assignment of the DWR contracts.

DRA argues that while some impediments to novation may be surmountable, others very likely are not. DRA doubts that all of the impediments can be resolved by January 2010. Given the perceived difficulty of achieving novation of all existing contracts, certain parties suggested limiting the focus only to those contracts that expire after a date certain. DRA suggests it may be more feasible to renegotiate the small number of contracts that expire after June 30, 2012, assuming there were net benefits to ratepayers.

TURN believes that if the Commission moves forward with efforts to expedite the transfer of DWR contracts, the earliest feasible date for completion would be either September 30, 2011, the expiration date of the Sempra contract, or June 30, 2012, the expiration date of the Coral contract. At that point, only about 500 megawatts (MW) would remain under contract with DWR.

3.3.2. Discussion

In deciding whether or how to move forward with a plan to facilitate the expedited removal of DWR from its role as supplier of power, we must determine whether it is in the public interest to implement such a plan. In particular, we must assess whether the potential net benefits for ratepayers of pursuing such a plan outweighs potential downside risks.

Certain parties frame the question before the Commission as a choice between two extremes, either: (1) conclude with 100% assurance that DWR will successfully get out of all its contracts by January 2010 or else (2) immediately close the entire proceeding, and abandon any further exploration of ways to facilitate DWR's early release from its contracts.

Such extremes imply an artificial dichotomy, and do not realistically characterize the broader range of outcomes that are possible. The question is not whether we know with 100% certainty the ultimate success of efforts to remove DWR from its role as power supplier by a certain date. Rather, the question is whether the potential benefits to ratepayers are sufficient to justify moving to next phase of this proceeding, incorporating appropriate safeguards so that such action remains cost-effective.

No party has demonstrated that the likelihood of failure is so compelling that no further efforts should even be attempted to accelerate the removal of DWR as a supplier of power. Likewise, no party has provided a credible argument that this entire proceeding should be closed immediately. While uncertainties must be addressed in order to achieve the ultimate goal, we are not persuaded that such uncertainties are reason to abandon further efforts to secure any ratepayer benefits.

On the other hand, no party has presented a compelling showing that achieving full novation of all contracts by January 1, 2010 will be easy. Challenges do exist that could affect the achievement of the goal, or potentially extend the time line for implementing replacement of all DWR contracts. Our goal instead, is for a balanced approach, providing the opportunity for contract negotiations to provide benefits, but with safeguards to limit or redirect negotiation efforts if, or to the extent that such negotiations do not progress in a positive direction.

On balance, we thus conclude that the potential benefits of going forward with contract negotiations outweigh the potential downside risks, subject to appropriate safeguards. Accordingly, we adopt measures to ensure that any negotiations in contract terms proceed in a cost-effective manner. As discussed in Section 4, while the *specific magnitude* of net savings from this process is uncertain, we conclude that the potential prospects for at least *some* net savings justify going forward with a plan of action. As discussed in Section 5.5, we also provide assurance that retail customers will be protected against any cost shifting attributable to inter-IOU cost allocations associated with taking over a "Replacement Contract."

Pursuing a plan to accelerate DWR's removal from the role of supplying power under AB1X is consistent with the general Commission goals as previously articulated in D.02-12-069, stating:

> Both the Commission and the Legislature have expressed their intent to eliminate the need for DWR to continue procuring power for the utilities after January 1, 2003, consistent with the utilities' statutory obligation to serve their customers.
>
> Consistent with the intent of AB1X, one of this Commission's fundamental short-term goals is to transition full

> responsibility for energy market related activities back to the utilities as soon as possible. We should therefore make every effort to relieve DWR from the responsibility to perform any functions that should be performed in the long term by regular market participants. We note that this direction is consistent with the fact that the utility, and not DWR, continues to have a statutory responsibility to serve its customers. The utilities' obligation to serve their customers is mandated by state law and is part and parcel of the entire regulatory scheme under which the utilities received a franchise and under which the Commission regulates utilities under the Public Utilities Act. (*See, e.g.,* Pub. Util. Code §§ 451, 761, 762, 768, and 770.) [Footnote omitted]
> (D.02-12-069 at 7-8.)

In D.02-12-069, the Commission thus expressed a preference for returning the IOUs to their traditional role of supplying power as a matter of public policy. This proceeding, however, provides a forum to address more analytically whether (or how) such an undertaking can be made cost-effective. Consistent with the goals articulated in D.02-12-069, we hereby adopt specific measures to expedite DWR's departure from the role of supplying power to retail customers.

In Section 4 below, we discuss our specific findings as to the likelihood of costs and benefits associated with various assumptions as to the outcome of contract negotiations. Based on this analysis, we adopt a plan of action, as detailed in Section 6 below, for moving into next phase of the proceeding with a framework as a guiding principle to maximize ratepayer benefits in the most cost-effective manner.

4. Net Costs/Benefits of Expediting DWR's Removal as Supplier of Power

4.1. Framework for Assessing Net Cost/Benefits

As a basis to determine whether a directive for DWR and the IOUs to proceed with contract negotiations to remove DWR from its role as power supplier is in the public interest, we must consider whether, or to what extent, such efforts are justified by resulting in net benefits to ratepayers.

In order to provide a common reference point for evaluation of parties' estimates of the cost or savings impacts of removing DWR from its role of supplying power, parties were directed to assume a range of different target dates for completing all necessary contract negotiations. Because each of the DWR contracts expire at different points in time, and because certain contracts represent a disproportionate share of impacts, the assumed date for completion has a significant bearing on the assumed costs and savings expected to result on a discounted net present value (NPV) basis. These assumed target dates are January 2010, July 2010, July 2011, and October 2012.

The extent of net savings depends in large measure on how rapidly DWR can end its role of supplying power. The longer it takes to finalize and implement DWR's final exit from the power supply function, the more DWR contracts in effect now simply expire automatically due to the passage of time. Any estimate of costs/benefits thus excludes any DWR contracts that simply expire without the need to implement contract novation or renegotiation.

DWR submitted preliminary estimates of the net impacts of contract novation at the June 2, 2008 workshop. These estimates were considered in further written comments and at a followup workshop on July 1, 2008 and July 2, 2008. By comments filed on August 4, and 19, 2008 parties had the opportunity to submit their own estimates of net costs/benefits of undertaking to accelerate the removal of DWR from its role as supplier of power.

The three IOUs each submitted separate estimates applicable to their own customer base, and did not dispute or challenge the corresponding estimates made by other IOUs. Accordingly, we consider the IOUs essentially to be generally in agreement among themselves as to the sum total of net savings estimates based on the assumption that all remaining DWR contracts are novated or renegotiated by the designated target dates. In presenting their estimates, however, the IOUs caution that they are predicated on achieving full novation or other replacement of all DWR contracts by certain dates. The IOUs express doubts, however, as to whether such a goal is likely to be achieved.

SCE estimates net savings for its customers, based on an assumption of novation of all remaining DWR contracts on an "as is" basis, with no change in the permanent cost allocation methodology for DWR costs. SCE believes that the assumption of full novation on an "as is" basis may eventually prove unrealistic due to issues such as the PG&E bankruptcy settlement and counterparties' desire to renegotiate certain terms of DWR's contracts in the novation process. Nonetheless, SCE applies these assumptions in order to calculate the cost effectiveness of full novation. To estimate the costs or benefits of only a partial novation, SCE indicates that further information from DWR would be needed, although SCE believes that the net benefits would be diminished somewhat. Although a partial novation may reduce administrative costs incurred by DWR, such reductions would not likely follow a linear relationship with the reduction in contracts being administered. SCE notes that a partial novation would still likely require DWR to incur a significant share of its existing administrative costs even if a small number of contracts continue to be administered by DWR.

PG&E likewise calculates a net benefit for customers based on the assumption that all contracts could be novated by January 1, 2010. PG&E cautions, however, that the calculation of net benefits "may easily become a cost if certain assumptions change."[10] PG&E indicated that it was unable to quantify certain costs, such as those resulting from contract renegotiation.

While the IOUs express doubts as to the likelihood of achieving full removal of DWR from all obligations under its contracts by the assumed completion dates, each of the IOUs estimate positive net benefits for ratepayers, to the extent they are able to measure the relevant impacts.

The only other parties to present a comprehensive estimate of net benefits were Reliant and AReM/CACES. These two parties each estimated significantly higher net savings to ratepayers than did the IOUs.

A comparison of parties' estimates of costs and savings is summarized below:

[10] PG&E Comments dated August 4, 2008, at 11.

Comparison of Parties' Costs/Benefits Assuming DWR Contract Novation as of January 2010 ($NPV Millions)

	SCE	PG&E	SDG&E	Sum of IOU Estimates	Reliant	AReM/CACES
Novation Costs						
Debt Equivalence	$ 16.1	$ 24.0	$ 9.2	$ 49.3	$ -	$ 12.0
Utility Collateral	$ 1.3	$ 0.7	$ -	$ 2.0	$ -	$ 15.0
Letters of Credit/Stress Case	$ 0.3	$ -	$ -	$ 0.3	$ 5.2	$ 6.0
Working Capital	$ 3.7	$ -	$ 0.8	$ 4.5	$ -	$ -
Administrative Costs	$ 0.7	$ 0.8	$ 1.2	$ 2.7	$ -	$ -
Total Costs	**$ 22.0**	**$ 25.5**	**$ 11.2**	**$ 58.7**	**$ 5.2**	**$ 33.0**
Novation Benefits						
Release of DWR Reserves	$ 76.6	$ 55.0	$ 14.0	$ 145.6	$ 156.3	$ 145.0
Reduced Administrative Costs	$ 11.9	$ 29.0	$ -	$ 40.9	$ 25.9	$ 41.0
Fuel/Power Management	$ -	$ -	$ -	$ -	$ -	$ 169.0
Residential Load Shifting	$ -	$ -	$ -	$ -	$ 8.3	$ -
Contract Renegotiations	$ -	$ -	$ -	$ -	$ 196.1	$ 270.0
Total Benefits	**$ 88.5**	**$ 84.0**	**$ 14.0**	**$ 186.5**	**$ 386.6**	**$ 625.0**
Net Benefits/Costs	**$ 66.5**	**$ 58.5**	**$ 2.8**	**$ 127.8**	**$ 381.4**	**$ 592.0**

source: Reliant Summary Comments (Aug 25, 2008)

The IOUs, DRA, CFC, and TURN argue that the Commission should reject Reliant's and AReM/CACES's estimates of net benefits as exaggerated. DRA claims that the estimates of Reliant and AReM/CACES downplay potential costs and exaggerate potential benefits. As a result, Reliant provides estimates of net benefits that are nearly three times the total IOU estimate, and AReM/CACES provide estimates that are over 4.5 times the total IOU estimates, assuming full novation in 2010. DRA believes that the IOU estimates as more reasonable estimates of benefits assuming 100% novation.

DRA presented a modified table comparison assuming adjustments are made to exclude certain claimed savings assumed by AReM/CACES and Reliant. Making these adjustments (shown as shaded areas) brings Reliant's and AReM/CACES numbers much closer to the IOU estimate. DRA cautions that even these estimates may not accurately reflect the true potential net costs/benefits, and argues that the estimates relied on by the Commission should be as accurate as possible assuming a *2010 full novation scenario* is achievable.

Comparison of Parties' Costs/Benefits Assuming DWR Contract Novation Completed as of January 2010, Adjusted for Disputed Costs and Benefits ($NPV Millions)

	SCE	PG&E	SDG&E	Sum of IOU Estimates	Reliant	AReM/CACES
Novation Costs						
Debt Equivalence	$ 16.1	$ 24.0	$ 9.2	$ 49.3	$ 49.3	$ 49.3
Utility Collateral	$ 1.3	$ 0.7	$ -	$ 2.0	$ 2.0	$ 2.0
Letters of Credit/Stress Case	$ 0.3	$ -	$ -	$ 0.3	$ 5.2	$ 6.0
Working Capital	$ 3.7	$ -	$ 0.8	$ 4.5	$ 4.5	$ 4.5
Administrative Costs	$ 0.7	$ 0.8	$ 1.2	$ 2.7	$ 2.7	$ 2.7
Total Costs	**$ 22.0**	**$ 25.5**	**$ 11.2**	**$ 58.7**	**$ 63.7**	**$ 64.5**
Novation Benefits						
Release of DWR Reserves	$ 76.6	$ 55.0	$ 14.0	$ 145.6	$ 156.3	$ 145.0
Reduced Administrative Costs	$ 11.9	$ 29.0	$ -	$ 40.9	$ 25.9	$ 41.0
Fuel/Power Management	$ -	$ -	$ -	$ -	0.0	0.0
Residential Load Shifting	$ -	$ -	$ -	$ -	0.0	0.0
Contract Renegotiations	$ -	$ -	$ -	$ -	0.0	0.0
Total Benefits	**$ 88.5**	**$ 84.0**	**$ 14.0**	**$ 186.5**	**$ 182.2**	**$ 186.0**
Net Benefits/Costs	**$ 66.5**	**$ 58.5**	**$ 2.8**	**$ 127.8**	**$ 118.6**	**$ 121.6**

source: Reliant Summary Comments (Aug 25, 2008), adjusted for removal of benefits of contract renegotiations, fuel/power management, residential load shifting, and addition of missing costs (using total IOU value). Adjusted numbers are shaded.

We recognize that there are various uncertainties associated with the precision and reliability of the estimates, and evaluate them taking into account their inherent limitations. Moreover, we are not relying upon the estimates to set rates or revenue requirements, but are simply considering the estimates as an approximate benchmark to assess the merits of whether continuing support of novation or other negotiations of DWR contracts have a reasonable potential to benefit ratepayers.

As discussed below, we conclude that the combined estimates presented by the IOUs, totaling $127.8 million, represent a reasonable approximation of potential net benefits to be realized assuming the process of removing DWR as a supplier were to be completed by January 1, 2010. We decline to rely upon the higher estimates offered by Reliant and AReM/CACES, in view of the speculative nature of certain assumptions underlying their estimates. We conclude, however, that the net benefits potentially be realized, as estimated by the IOUs, provide a sufficient basis for going forward with further efforts to reach the goal of relieving DWR of its current contract obligations by January 1, 2010.

As explained above, however, we recognize the potential risks that DWR may not be relieved of all of its contract obligations by January 1, 2010. Nonetheless, the potential for benefits justify going forward to attempt to meet this goal, provided that appropriate monitoring is employed, as discussed in Section 6 below, to ensure that provision is available to make adjustments and revise strategies on a timely basis in response to negotiations.

We conclude, however, that a positive net savings to ratepayers is still a reasonable prospect, assuming a date later than January 1, 2010 for completing the process. Positive net benefits are still estimated by the IOUs, albeit at more modest levels, as the assumed target date for completion extends. For example, if we were to extend the target completion date to October 2011, the IOUs estimate that net benefits continue to exist, but are reduced to $56.2 million, calculated as follows:

IOU - Estimated Costs/Savings Assuming DWR Contract Novation Completed as of October 2011 ($NPV Millions)

	PG&E	SCE	SDG&E	Total
Novation Costs				
Debt Equivalency	$ 8.00	$ 0.90	$ 1.30	$ 10.20
Utility Collateral	$ 0.20	$ 0.30		$ 0.50
Letters of Credit		$ 1.30		$ 1.30
Working Capital		$ 0.10		$ 0.10
Administrative Costs	$ 0.80	$ 0.08	$ 0.20	$ 1.08
Total costs	**$ 9.00**	**$ 2.68**	**$ 1.50**	**$ 13.18**
Novation Benefits				
Release of DWR Reserves	$ 24.00	$ 31.50	$ 7.00	$ 62.50
Administrative Cost Savings	$ 5.00	$ 1.90	$	$ 6.90
Total Benefits	**$ 29.00**	**$ 33.40**	**$ 7.00**	**$ 69.40**
Net Benefits/Costs	**$ 20.00**	**$ 30.72**	**$ 5.50**	**$ 56.22**

Source: Opening Comments of PG&E, SDG&E, and SCE (August 4, 2008)

DRA also presented a similar table of IOU estimates assuming that all then-remaining contracts are novated in July 2012, as shown below:

IOUs' Estimated Costs/Benefits Assuming DWR Contract Novation Completed as of July 2012 ($NPV Millions)

	SCE		PG&E		SDG&E		Sum of IOU Estimates	
Novation Costs								
Debt Equivalence	$	-	$	5.0	$	0.4	$	5.4
Utility Collateral*	$	1.3	$	0.1	$	-	$	1.4
Letters of Credit/Stress Case*	$	0.3	$	-	$	-	$	0.3
Working Capital	$	0.1	$	-	$	0.1	$	0.1
Administrative Costs	$	-	$	0.8	$	0.1	$	0.9
Total Costs	**$**	**1.6**	**$**	**5.9**	**$**	**0.6**	**$**	**8.0**
Novation Benefits								
Release of DWR Reserves	$	21.2	$	12.0	$	4.0	$	37.2
Reduced Administrative Costs	$	0.3	$	1.0	$	-	$	1.3
Fuel/Power Management	$	-	$	-	$	-	$	-
Residential Load Shifting	$	-	$	-	$	-	$	-
Contract Renegotiations	$	-	$	-	$	-	$	-
Total Benefits	**$**	**21.5**	**$**	**13.0**	**$**	**4.0**	**$**	**38.5**
Net Benefits/Costs	**$**	**19.9**	**$**	**7.1**	**$**	**3.5**	**$**	**30.5**

* In opening comments, SCE states that these are the collateral costs *per year for every $100 million of Mark-to-Market exposure* (p. 6). SCE additionally states that the total collateral costs are "unknown at this time" (Table 1-6). For illustrative purposes, DRA uses these values because these are how Reliant interpreted the numbers in its Summary Table, and the values appear small enough to not significantly change the results.

source: Opening comments of PG&E, SDG&E, and SCE.

As shown in this table, the total IOU estimated net benefits are still positive, but less than a quarter of the net benefits assumed if all contracts are novated in January 2010. DRA argues that the $30.5 million NPV benefit has a fairly small margin of error considering the magnitude of the potential costs and benefits that turn on the assumptions made (i.e., contracts novated "as is", all contracts are novated, etc.) Additionally, the transaction costs of the novation process – which TURN and CFC previously estimated to be in the millions[11] – are not reflected in these estimates. DRA argues that the Commission must carefully consider potential reductions in net benefits from achieving only partial novation, in addition to potential transaction costs associated with the novation process.

Although the net benefits shown in the Table are significantly lower assuming a 2012 end date, the risks of having to deal with renegotiation of the Sempra and Coral contracts would also be avoided by extending the time horizon to July 2012. By that date, the Sempra and Coral contracts would expire and would no longer pose an impediment to removing DWR from its role of supplying power. We thus conclude that some potential for benefits would exist assuming complete removal of DWR from its role as power supplier for all remaining contracts, even limiting novation or renegotiation only to DWR contracts expiring after July 2012.

We next consider the categories of potential costs and savings that have been identified by parties, as a basis to assess whether the likelihood of overall net benefits are sufficient to justify continuing to the next stage of this proceeding.

[11] TURN, Opening Comments, August 4, 2008, p. 2. Consumer Federation of California, Opening Comments, August 4, 2008, p. 14.

4.2. Potential Categories of Savings

4.2.1. Early Release of Reserves

4.2.1.1. Parties' Positions

DWR maintains a certain level of operating cash reserves associated with its contracts, collected from retail ratepayers to cover any unanticipated costs and to manage cash flow volatility. Once a contract expires, the cash reserves associated with that contract can be released and credited back to ratepayers as a cost reduction. If a contract was novated, thereby removing DWR as a party to the contract, however, the reserves associated with that contract could be released early, rather than waiting for the original contract expiration date. The magnitude of the resulting savings is a function of the time value of money associated with accelerating the releasing of the reserves due to novation of the contracts as compared with the existing contract expiration dates.

DWR calculated the expected net present value savings from the early release of reserves at $145 million, assuming a release date of January 1, 2010. CACES accepted DWR's estimate. The IOUs similarly computed a savings of $145.6 million under the same assumption. Reliant calculated an estimated benefit of $156.3 million.

The IOUs also provided estimates of the savings from early release of reserves assuming later dates for releasing remaining contract reserves. The estimated savings from early release of reserves declines as the release of reserves is projected to occur later in time. The declining savings is attributable to the fact that fewer DWR contracts continue in effect as time passes. Consequently, the savings decline in relation to the reduced amount of reserves remaining to be released early.

4.2.1.2. Discussion

The principal point of controversy over savings from the early release of reserves has to do with the underlying timing of when the existing contracts could be novated or otherwise terminated through renegotiation. Accordingly, we accept the IOUs' estimates of savings of $145.6 million as reasonable, but recognize that the likelihood of achieving the estimated level of savings will depend upon the progress toward meeting the January 2010 target goal. Yet, even if the target goal is extended to 2012, there are still estimated savings from early release of reserves in the amount of $37.2 million.

4.2.2. Potential Cost Savings from Renegotiated Contracts

4.2.2.1. Parties' Positions

Parties are in dispute as to whether any potential savings could be expected by renegotiating contracts, and the amount of such benefit, if any. Two parties, AReM/CACES and Reliant, assert a potential benefit from renegotiating the DWR contracts on more favorable terms. As a potential indication of potential benefits from such renegotiation, AReM/CACES point to the benefits that DWR previously obtained through the renegotiation of contracts. Through the end of 2003, DWR renegotiated 35 contracts for an estimated savings of $7.5 billion, representing a 17.5% savings over the life of those contracts. AReM/CACES estimate that if the same percentage of savings were to be achieved for the remaining contracts, the resulting savings would be $1.6 billion. Even if only a fraction of the savings from previous contract negotiations could be achieved, AReM/CACES argue that the savings could still be substantial, and that a savings percentage as low as 0.3% could offset the net costs that DWR initially calculated to result from contract novation.

Reliant estimates that $182 million in net savings could be realized through renegotiation, based upon the lowest savings achieved in DWR's previous negotiations.

Other parties disagree, characterizing the Reliant and AReM/CACES claims of savings from renegotiation of DWR contracts as "unrealistic and highly speculative". DRA argues that the negotiation of improved terms of contracts that have already been achieved are not indicative of the prospects for similar success with the remaining contracts. Those earlier contracts were renegotiated as part of a settlement agreement that was reached in the context of pending litigation. DRA notes that there has been no settlement of the litigation over DWR's contracts with Sempra, Coral, or PacificCorp, and that there is no basis for assuming that comparable savings could be achieved by another round of negotiations.

4.2.2.2. Discussion

We recognize that a possibility may exist that customer benefits may be realized through the negotiation of replacement agreements to include more favorable prices or other terms, at least in some instances. The amount of—and prospects for—such savings, however are too speculative to rely upon as a basis for estimating a net benefit for purposes of our evaluation here. We agree that the market environment in which past DWR contracts were amended is not necessarily indicative of the environment in which prospective contract amendments may be negotiated. Accordingly, while we expect DWR, in conjunction with the IOUs, to seek negotiate in a manner that is in the ratepayers' best interests, we find insufficient basis at this point, to speculate as to what the substance of the negotiations will be, and as a result, to quantify an estimate for savings from contract negotiations. Accordingly, we will assume no savings associated with this factor for purposes of our analysis here.

4.2.3. Potential Benefits from Price-Responsive Load

Reliant argues that benefits will result from novation because as a result thereof, the statutory prerequisite for lifting the AB 1X rate cap will have been met. Reliant estimates that with the rate cap lifted, the IOUs will be able to offer residential customers with the ability to respond to price signals by way of time-varying rate structures, such as time-of-use pricing, which would otherwise be precluded by the AB1X rate cap. Reliant estimates $8.32 million in savings (assuming a January 2010 novation date) resulting from the IOUs being able to institute statewide residential time-of-use pricing. DRA disputes the claimed potential benefits from price-responsive load.

DRA challenges Reliant's claim that novation of the DWR contracts would result in the immediate lifting of the residential rate protection required by AB1X. SCE likewise argues that it remains very much in question as to whether the rate cap will be lifted in the near term, or concurrently with the novation of DWR contracts.

The disposition of this issue is currently before the Commission in the SDG&E General Rate Case proceeding (A.07-01-047). SCE further argues that even under the existing rate cap, residential customers can elect to be placed on a time-based rate structure, and thus, novation would offer no incremental benefit associated with customers' ability to respond to price signals.

4.2.3.1. Discussion

We will not recognize any effects from customers ability to switch to a price-responsive rate structure as a source of savings attributable to a DWR contract novation. As noted by SCE, residential customers can elect to be placed on a time-based rate structure already. Moreover, any presumed benefits attributable to the lifting of the AB1X rate cap would depend upon subsequent Commission action in the SDG&E General Rate Case where legal issues are being considered as to when the AB1X rate freeze may lifted. Because disposition of this issue is outside the scope of this proceeding, we cannot attribute any savings based upon speculation as to how the issue will ultimately be decided.

4.2.4. Claimed Portfolio Management Savings

4.2.4.1. Parties' Positions

DWR argues that the IOUs have the information and expertise to manage power contracts more efficiently than DWR, taking into account the efficiencies associated with integrating the contracts into their own IOU portfolios.

AReM/CACES argue that while the specific savings from operational efficiencies and purchasing strategies is difficult to assess, even a small percentage reduction in costs would yield significant savings. Assuming only a 2.5% reduction in the $6.7 billion variable costs of the DWR contracts, AReM/CACES calculate a net present value savings of $169 million through 2015.

Other parties, including DRA and the IOUs, dispute the alleged savings of $169 million from greater operational efficiencies if the DWR contracts are integrated into the IOU portfolios, arguing that such an estimate is speculative. SCE argues that no quantified amount should be attributed as portfolio management savings beyond a general characterization as a potential benefit.

4.2.4.2. Discussion

We recognize that a possibility may exist of customer benefits as a result of efficiencies from the IOUs taking over full responsibility for managing power resources that are currently under contract with DWR. We agree that the amount of savings of $169 million suggested by AReM/CACES is too speculative to be relied upon for purposes of our analysis here. Accordingly, while we recognize the possibility of such savings in theory, we will not assume any specific figure for purposes of assessing whether the potential net benefits are sufficient to justify going forward with a program for contract novation.

4.3. Potential Categories of Cost

4.3.1. Debt Equivalence Costs

4.3.1.1. Parties' Postions

Another potential cost associated with the IOUs taking over financial responsibility for the DWR contracts involves "debt equivalence" impacts. Various parties contend that in order to avoid a downgrading of the IOUs' credit rating resulting from taking over the DWR contracts, the IOUs will require additional funds to offset these additional debt obligations, referred to as "debt equivalence."[12] In this context, "debt equivalence" (or "imputed debt") is a tool used by credit rating agencies to assess potential financial risks associated with a utility's power purchase agreement (PPA) obligations. The above-market costs of any resulting PPA obligations would be treated as imputed debt by the credit-rating agencies and would impact the IOUs cost of capital.

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[12] In certain circumstances, a rating agency may treat some portion of purchase power agreement costs as payments on debt obligations rather than as operating costs (treating them as "debt equivalent"), and in turn make corresponding adjustments to the utility's credit metrics and financial ratios used as part of the rating agency's overall assessment of credit quality.

DWR initially calculated that based on an assumed novation of its entire portfolio (with other contract terms unchanged) as of January 1, 2009, would add $532 million in debt equivalence for all three IOUs.

The extent of costs attributable to satisfying debt equivalence requirements is a function of the number of DWR contracts that would be novated. PG&E estimates debt equivalence based upon a risk factor of 25% and discounted at PG&E's authorized cost of debt (6.05%). The debt equivalence represents imputed debt needed to maintain PG&E's equity ratio of 52% less the savings on interest associated with capitalization debt replaced by the additional equity. PG&E derived the present value of the additional debt equivalence costs, by applying a 7.66% discount rate (representing PG&E's after-tax weighted cost of capital).

SCE and SDG&E also presented estimates of the funds required to satisfy debt equivalence based on its incremental cost of capital, and the forecast of fixed payments as provided in the DWR workshop materials.

Reliant argues that as a result of DWR contract novation, it is unlikely that any significant debt would be imputed to the IOUs by the credit rating agencies. Reliant also claims that any impact on the key credit ratios of the IOUs would be minimal. For purposes of its analysis, Reliant assumes a 25% risk factor, which is the factor currently used by Standard & Poor's (S&P). The IOUs likewise applied a 25% risk factor in their calculations.

AReM/CACES argue that it is inappropriate to consider debt equivalence as a cost associated with the power purchase agreements that would be taken over by the IOUs through novation. AReM/CACES point to D.07-12-052 in which the Commission found that "[debt equivalence] in and of itself, is not a cost that the utilities incur by entering into a [power purchase agreement

(PPA)]."[13] Therefore, the Commission ruled that "IOUs may no longer apply a [debt equivalence] 'bid adder' as a bid evaluation tool when evaluating PPAs."[14]

SCE disputes the claims of Reliant and AReM/CACES, arguing that D.07-12-052 merely disallowed the use of the debt equivalence "bid adder" in the evaluation and comparison of bids in a competitive solicitation. SCE argues, however, that the novation of DWR contracts does not fall under the same competitive bid evaluation framework. SCE further argues that D.07-12-052 did not restrict the IOUs from requesting mitigation of debt equivalence in cost of capital proceedings.

AReM/CACES further argue that the DWR calculation of debt equivalence is overstated because it includes the effects of contracts with terms shorter than three years. AReM/CACES claim that S&P only considers contracts with terms exceeding three years for purposes of imputing debt equivalency. By excluding contracts with terms shorter than three years, AReM/CACES calculates that the debt equivalency costs decline from $159 million to just $12 million. SCE notes, however, that S&P no longer excludes contracts under three years in duration for debt equivalency imputation, and that it is therefore appropriate to include such contracts in the calculation of debt equivalency costs.

4.3.1.2. Discussion

We agree that the costs of debt equivalence constitute a relevant cost to be considered in assessing the extent of any net benefits to ratepayers from novation of the DWR contracts. The Commission noted in D.07-12-052 that:

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[13] D.07-12-052, Finding of Fact 75.

[14] *Id*, Ordering Paragraph 36.

> "debt equivalence is one of several considerations that rating agencies factor into their assessment of a utility's overall risk profile. The Commission considers the rating agencies' credit ratings in the cost of capital proceeding and thus considers debt equivalence when it determines the IOUs' cost of capital."[15]

Although the Commission excluded debt equivalence for purposes of evaluating PPA bids received in utility request for offers, the Commission explained that such exclusion

> "in no way presupposes any related cost recovery, or adjustments to capital structures in future cost of capital proceedings. We continue to direct the IOUs, especially SDG&E, to raise any individual concerns it has with the impact of a particular PPA on its debt to equity ratio in its Cost of Capital proceeding."[16]

Accordingly, debt equivalency is a relevant cost in assessing the potential for any net benefits associated with IOUs taking over additional power contract obligations as a result of novation. We accept the estimates of the debt equivalence as calculated by each of the IOUs as reasonable, and incorporate them into our analysis as an offset to potential net benefits.

We reject the lower estimates of debt equivalency by AReM/CACES which are based on exclusion of DWR contracts shorter than three years. We agree with SCE that inclusion of such contracts is appropriate based upon current rating agency guidelines for computing debt equivalency.

We also recognize, however, that the cost impacts of debt equivalence would only be incurred if a contract was successfully novated and a replacement contract was taken over by one of the IOUs. Conversely, if negotiations for a

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15 D.07-12-052 at 162.

16 *Id.* at 165.

given replacement contract do not result in a successful outcome, there will be no replacement contract and, consequently, no additional costs attributable to debt equivalence. As a result, because debt equivalence costs would be incurred only if, or to the extent that, replacement contracts were successfully executed, any debt equivalence costs would be offset by a proportionately greater benefit as a result of the release of DWR operating reserves, as discussed previously.

4.3.2. Collateral Requirements

DWR is not currently required to post collateral and does not incur costs of posting collateral or for maintaining a credit facility for potential collateral. DWR estimates, however, that if a replacement contract were assigned to an IOU pursuant to a DWR contract novation, and the replacement contract reflected an above-market price, the IOU would likely be required by the contracting counterparty to secure a letter of credit or collateral as protection against the risk of default. DWR provided an estimate of credit collateral costs of $15 million on a net present value basis over the remaining contract portfolio life. DWR also estimated an additional $6 million would be required to secure a line of credit to cover liquidity in a potential "stress case" scenario, assuming an annual liquidity facility cost of 125 basis points. The "stress case" collateral would cover increased costs until rate relief became available as provided for under the Energy Resource Recovery Adjustment (ERRA) trigger mechanism. SCE estimates, however, that if contract terms changed as part of novation, and SCE was required to post collateral, SCE would incur costs for both current collateral and stress case collateral to cover the risk of default on the contract.

1. Current Collateral — SCE estimates that it would incur an annual cost of $1.25 million based on an assumed cost of 125 basis points for a Letter of Credit for every $100 million of Mark-to-Market (MTM) exposure.

2. Stress Case Collateral — SCE estimates that it would incur an annual cost of $250,000, assuming 25 basis points for credit capacity for every $100 million of potential MTM exposure.

AReM/CACES question the need for an IOU to post collateral since the recovery of contract costs from ratepayers is assured through the Commission's approval of the contract. Reliant argues similarly that it may be possible to avoid collateral costs, and that Commission action to guarantee a stream of payments from the IOUs to the counterparties may alleviate any need for additional credit posting. Reliant agrees that each IOU may need to secure a letter of credit to cover its costs in the event that it under collects revenues relative to costs by less than the 5% trigger afforded under its Energy Resource Recovery Account. Reliant estimates a stress-case collateral for all three IOUs of $5.17 million, assuming a January 2010 novation date.

4.3.2.1. Discussion

We conclude that there are various uncertainties that preclude the identification of precise estimate for the potential cost associated with collateral requirements. SCE has estimated a collateral liability based upon certain assumptions regarding changes in the terms of renegotiated contracts relative to market exposure, as noted above. SCE estimates a provision that is lower than what DWR estimates.

SDG&E omits any estimate of a cost for collateral in their estimates of net costs from novation. We view SCE's estimate as an upper bound for collateral requirements in that it presumes an exposure of $100 million in mark-to-market exposure. Since SCE estimates a debt equivalence requirement of $16.1 million, the equivalent collateral cost would only be about $200,000, assuming a 125 basis point adjustment. We recognize, in any case, any actual amounts required for collateral will vary as a function of the market exposure reflected in specific prices that may apply in any replacement contracts, and the related perception of default risk ascribed to the IOU taking over the contract.

4.3.3. Incremental Administrative and General Costs

4.3.3.1. Parties' Position

Each of the IOUs' estimates that it would incur costs for administration of the DWR contracts if the IOU assumes the replacement contracts through novation or assignment, as follows.

Assumed Date for Taking over Contracts
($ in millions)

	January 2010	July 2010	October 2011	July 2012
PG&E	$0.8	$0.8	$0.80	0
SCE	$0.7	$0.5	$0.08	0
SDG&E	$1.2	$1.2	$0.7	$0.1

4.3.3.2. Discussion

The IOUs' estimates of incremental costs for administrative and general expenses of $2.7 million are uncontested by any other party. We therefore will rely upon the IOU estimates of administrative and general costs for purposes of assessing the impacts of this cost, assuming the IOUs take over replacement contracts through DWR novation.

4.4. Cash Working Capital

SCE and SDG&E included a cost estimate for additional cash working capital that would be required if they become financially responsible for the contracts for power that is currently paid for by DWR. PG&E included no estimate for this item. Working cash costs are incurred to provide liquidity during the time lag between the payment of an expense and the revenue collection to cover that payment. The SCE and SDG&E estimates of additional working cash requirements associated with taking over the DWR contracts is set forth below:

Assumed Date for Taking Over Contracts
($ in millions)

	January 2010	**July 2010**	**October 2011**	**July 2012**
SCE	$3.7	$2.4	$0.4	$0.09
SDG&E	$0.8	$0.6	$0.2	$0.05

4.4.1. Decision

The estimates of SCE and SDG&E for working capital requirements are uncontested by any of the other parties. We therefore will rely upon the SCE and SDG&E estimates of working capital requirements for purposes of assessing the impacts of this cost, assuming the IOUs take over replacement contracts through DWR novation.

4.5. Regulatory Transactional Costs

4.5.1. Parties' Positions

TURN argues that any assessment of net benefits should be offset by the administrative costs of regulatory process to implement novation. TURN estimates costs incurred to date at about $1 million. TURN estimates subsequent contract negotiations with cost "at least a few million dollars" in administrative costs. CFC likewise indentifies regulatory transactions costs as an offset to potential ratepayer benefits.

CLECA argues that any transactions costs associated with pursuing DWR contract novation are likely to be nominal, and in any event, transactions costs would have to be incurred anyway to enter into new contracts as the DWR contracts expire. CLECA also notes that any transactions costs may be mitigated by potential improvements that may be negotiated in the replacement contracts, such as by providing for longer terms, or tailoring the terms more closely to an IOU's specific circumstances.

4.5.2. Discussion

The dispute over regulatory transactional costs is essentially a difference over policy and philosophy as to how such costs should be viewed and attributed, rather than factual disagreements over specific dollars that have been or may be spent on transactional costs. Parties have had the opportunity to argue in workshops and in filed comments as to the conceptual merits of including or excluding this category of costs from the assessment.

While we recognize that some transactions costs will be incurred and constitute an offset to any net benefits that may be realized, no party has shown that such costs will be significant enough to justify overwhelming any potential savings that may otherwise be realized. We agree with CLECA that even without contract novation, negotiations will be required to replace the DWR contracts as they expire. Transactions costs would have to be incurred at the time of such contract negotiations, in any event. We have also adopted safeguards as discussed in Section 6, to limit unproductive negotiations. In short, we find no basis to conclude that the potential for transactions costs is sufficient enough to offset the total savings, as to warrant abandoning further efforts to achieve DWR contract novation.

5. Addressing Other Potential Impediments to Contract Novation/Renegotiation

5.1. Legal Authority for DWR to Enter Into a Novation Agreement

5.1.1. Parties' Position

CFC claims that DWR does not have the legal authority to enter into a novation agreement. CFC interprets contract novation as being in violation of Water Code Section 80260 which specifically prohibits DWR from entering into any new contracts for the purchase of power after January 1, 2003. CFC interprets this prohibition as applying to contractual terms that would allow for the novation of a power contract to a third party.

AReM/CACES and Reliant disagree with such an interpretation, arguing that the sole restriction in Section 80260 is that DWR cannot enter into a contract in which it will be purchasing electric power. Reliant argues that by entering into a novation provision or executing a replacement agreement as the novating party, DWR would not be "contracting to purchase electric power," just the opposite.

DWR likewise disagrees with CFC's interpretation as erroneous. DWR cites Civil Code Sections 1530-1533, indicating that the Legislature recognized that both assignment and novation are permissible means for transferring contractual obligations. DWR argues that the Legislature's reference to "assignment" in Water Code Section 80102 is most reasonably construed, consistent with the normative baseline rules applicable to all contracts, to allow DWR to transfer the contracts by assignment or novation.

DWR also disagree's with CFC's claim that Section 80260 bars novation. DWR explains that in novating a contract, it is not *entering into* a new "contract for the purchase of electrical power." Instead, through novation, DWR is *terminating* such a contract. DWR views novation as a contract administration function, and notes that Section 80260 permits DWR to administer contracts entered into prior to January 1, 2003.

5.1.2. Discussion

We conclude that the novation of DWR's contracts does not violate any provision of Water Code Section 80260. We agree with DWR that a contract novation does not mean that DWR is entering into a new "contract for the purchase of electrical power." Instead, through novation, DWR is *terminating* such a contract. Accordingly, we find no legal basis to preclude DWR from executing a novation of any of its existing contracts. Such action is properly within the scope of DWR's authority under AB1X.

5.2. Satisfying Minimum Credit Rating Conditions

5.2.1. Parties' Positions

Counterparties are legally obligated to accept novation of certain contracts only if certain conditions stated in those contracts are satisfied. For example, certain contracts impose the requirement for minimum credit ratings for any new party assuming obligations under a novated contract. Minimum credit rating requirements apply specifically to the following contracts as a condition of their being transferred: (1) High Desert: (2) CalPine; (3) PacifiCorp; and (4) Sempra.

Another restriction applies under the terms of the PG&E Bankruptcy Settlement whereby the Commission may not require PG&E "to assume or accept an assignment of legal or financial responsibility for the DWR contracts unless. PG&E's Company Credit Rating, after giving effect to such assignment or assumption, shall be no less than "A" from S&P and "A2" from Moody's. PG&E's credit rating currently is A3 (Moody's) and BBB+ (S&P).

The Commission is barred from requiring PG&E to assume any of the DWR contracts as long as PG&E's credit ratings remain below this prescribed level. PG&E, however, could voluntarily waive that requirement, however, if there were significant demonstrated benefits to its customers from taking on certain contracts through novation. PG&E states that it is not willing to waive these provisions at this time, but would reconsider its position in light of the overall benefits to its customers and itself, if any, that may subsequently become available based on the circumstances at that time. Therefore, the restriction in the Bankruptcy Settlement currently poses a potential challenge to implementing a replacement agreement between PG&E and one of the current DWR suppliers.

We do not consider the restrictions on PG&E's credit ratings to be an absolute barrier precluding the possibility that PG&E may take over replacement agreements entered into as a result of a DWR contract novation or renegotiation. Instead, the prospects for PG&E to agree to voluntarily take on such a contract will depend upon the specific terms, prices, and conditions involved. If replacement agreements can be negotiated that are beneficial to PG&E and its ratepayers PG&E remains open to the possibility of voluntarily assuming responsibility for such replacement agreements. The results of such negotiations can only be determined after we move into the next phase of this proceeding.

As a result, we recognize the provisions of the PG&E Bankruptcy Settlement as a relevant factor to be addressed in considering PG&E's role in taking over any replacement contracts. Since PG&E is agreeable to participating in the contract negotiation process and to considering any benefits that may be achieved, however, we do not consider the PG&E Bankruptcy Settlement to constitute a bar to moving forward with further efforts toward novation of DWR contracts.

5.3. DWR Contract Novation and Long Term Procurement Planning

5.3.1. Parties' Positions

DRA argues that renegotiation of the DWR contracts would conflict with the statutorily required competitive procurement planning process as prescribed by Public Utilities Code Section 454.5. Pursuant to Section 454.5, the Commission is required to evaluate and approve jurisdictional load-serving entities plans for procurement of resources to meet their customers' long-term energy supply needs pursuant to specified criteria. DRA believes that it would constitute a violation of this statute if a utility was required to "step into the shoes" of DWR without allowing other suppliers to compete to provide the energy needs currently provided by the DWR contracts at more competitive prices than those renegotiated with a counterparty to an existing DWR contract.

DRA argues that renegotiation of the DWR contracts outside of any competitive Request for Offer (RFO) process would prevent the statutorily required competition between suppliers of the capacity in question. DRA further argues that by [c]hanging the cost versus benefits analysis with respect to the DWR contracts", novation of the DWR contracts "could effectively unwind" the IOU procurement process which calculates the net short generation capacity to meet California load over a 10-year period, and could result in duplicative procurement.

DRA further argues that novation of the DWR contracts could disrupt the Long-Term Procurement Planning (LTPP) process which includes a mechanism to calculate the net short generation capacity required over a 10-year period.

A spokesperson for CalPeak Power L.L.C, one of the DWR counterparties, has said that CalPeak would consider novation of its DWR contract on the condition that its contract is extended for a multi-year term, and would oppose novation of the contracts "as is."[17] DRA believes that other generators may seek a similar benefit in negotiations over replacement contracts. At the July 2, 2008 workshop in this proceeding, CalPeak declined to answer why its generation had not been accepted in the IOUs' all-source RFOs issued as part of the LTPP process.[18] DRA infers, however, that the types of resources committed to the state by the DWR contracts do not necessarily fulfill the state's long-term needs as identified through the Commission's LTPP process. DRA contends that those long-term needs, however, must still be met through other contracts to fulfill long-term operational needs (and at the same time meet the objectives set forth in Section 454.5.) DRA believes that such other contracts would in effect render the extended DWR contract superfluous, and a waste of ratepayer money. DRA thus argues that extension of the DWR contracts could fail the least cost/best fit analysis undertaken by this Commission.

Reliant states, however, that because the DWR contracts are already part of the IOUs' portfolios, the IOUs have been incorporating such contracts into their long-term procurement plans since the LTPP process began pursuant to Section 454.5. For that reason, Reliant argues that there is no basis for DRA's claim that the act of novation will result in any duplicative procurement.

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[17] See R 07-05-025 Workshop Transcript of July 2nd Workshop in this proceeding at p. 336, lines 8 - 24, and p. 359 at lines 17-22.

[18] Transcript of July 2nd Workshop in this proceeding at p. 361 at line 16 through p. 363 at line 13.

AReM/CACES agree with DRA that the novation of DWR contracts must not confer on the IOUs an opportunity to circumvent the procurement requirements embedded in their LTPP authority. AReM/CACES propose a competitive auction bidding process as one way to address this concern. AReM/CACES further argue that even absent auction process, the Commission can still exercise appropriate oversight of any renegotiated contract terms, and limit cost recovery of any excess costs deemed not to be competitive.

5.3.2. Discussion

We conclude that the process of implementing novation does not conflict with the statutorily required procurement planning process as prescribed by Pub. Util. Code Section 454.5. Pursuant to Pub. Util. Code Section 454.5, the Commission must review and approve IOU procurement plans, establish policies and cost-recovery mechanisms for energy procurement, ensure that the utilities maintain an adequate reserve requirement, implement a long-term resource planning process, and implement a Renewables Portfolio Standard (RPS) program. Pub. Util. Code Section 454.5(b) specifically enumerates the required elements of a utility procurement plan, and these elements are required to be in the plans filed by the IOUs at the Commission.

One required element of the procurement plan must include "a competitive procurement process under which the electrical corporation may request bids for procurement-related services, including the format and criteria of that procurement process."[19] Additionally, these plans must include "a definition of each electricity product, including support and justification for the

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[19] *See*, Pub. Util. Code Section 454.5(b).

product type and amount to be procured under the plan ... the duration, timing, and range of quantities of each product to be procured."[20] Therefore, the commission-approved procurement plans under which the IOU will operate do not require procurement to come solely via competitive request for offers.

Further, in D.03-12-062, the Commission authorized IOUs to enter into negotiated bilateral contracts for short term transactions of less than 90 days duration and with delivery beginning less than 90 days forward and negotiated bilateral contracts for longer-term products provided the IOU include justification in quarterly compliance filings. Therefore, as the Commission has implemented Pub. Util. Code Section 454.5, it has given each IOU explicit authority, subject to proper conditions and justifications, to contract on a bilateral basis. As the Commission stated in D.07-12-052, it prefers that long term procurement be conducted via competitive procurement mechanisms, however it by no means removes bilateral contracts from the IOUs' options to meet its residual net short positions. In addition, nothing in this process prohibits an IOU from utilizing market benchmarks – including conducting an RFO – to determine whether the renegotiated contract is, indeed, competitive with other options.

Until a renegotiated contract has been presented to us for approval under the "just and reasonable" standards of Section 454, we cannot speculate as to how such a contract would compare with other IOU contracts, or contracting options. Parties will have the opportunity to raise such issues at the appropriate

[20] *See*, Pub. Util. Code Section 454.5(b).

time in connection with the "just and reasonable" review process. At this early point in the process, however, DRA's objections are premature.

As a priority matter in Phase II(a)(2) of this proceeding, we shall provide guidance on appropriate "just and reasonable" standards to be used in the review and approval of any replacement agreements in order to ensure consistency with the applicable requirements of Section 454.5.

5.4. Effects on Resource Adequacy Requirements

5.4.1. Parties' Positions

DRA argues that under current resource adequacy rules, DWR contracts may count for resource adequacy and are exempted from Commission rules that do not allow for new Liquated Damages (LD) contracts to count for RA capacity. Currently, DWR has several LD contracts in its portfolio and it is unclear as to whether novation or replacement of those contracts entered into as a result of a DWR contract novation would qualify as meeting resource adequacy requirements.

The Commission decided in D.04-10-035 that DWR contracts should fully count for purposes of resource adequacy showings. In D.05-10-042, the Commission determined that the sunset date as well as the adopted portfolio limitations adopted related to LD contracts shall not apply to DWR contracts. Consequently, the IOUs currently are able to count the DWR contracts towards their resource adequacy requirements, regardless of whether the DWR contract is generator-specific or market-sourced. SCE argues that unless the Commission allows the novated DWR contracts, as well as any replacement contracts to count towards the IOUs' resource adequacy requirements, the IOUs stand to lose a sizeable amount of eligible capacity from the novation process.

5.4.2. Discussion

We shall adopt the proposal of SCE to allow novated DWR contracts, as well as any replacement contracts to count towards the IOUs' resource adequacy requirements including those contracts currently exempt from the Commission's LD rules.. We agree that imposing this requirement is necessary so that the IOUs do not lose a sizeable amount of eligible capacity for resource adequacy from the novation process. We believe that adopting this condition adequately addresses the concern raised by DRA.

5.5. Effects of Novation on Cost Allocation Among IOUs

5.5.1. Parties' Positions

Parties generally agree that an impediment to the IOUs entering into negotiations to execute a new contract to replace a novated DWR contract up until now has been how the resulting contract costs could be allocated among the IOUs and their customers in an equitable manner. Accordingly, as a prerequisite to the IOUs moving forward with contract negotiations, the manner in which the associated contract costs are to be allocated among IOU customers must first be addressed.

Parties submitted proposals as to the principles, protocols, and processes that the Commission should adopt as necessary for the IOUs to enter into negotiations with power suppliers to arrange to take over DWR contracts pursuant to novation or through renegotiation.

PG&E submitted two alternative proposals addressing the inter-utility allocation issues. Under its first alternative, PG&E proposes that DWR contract benefits and costs be borne fully by the customers of the utility that either receives the contract through novation or assignment, or that continues to administer the contract after a designated date. There would be no allocation of contract costs among the utilities after the designated date. There would be no taking into account the proportion of DWR contract costs paid by the customers of each IOU prior to the designated date, and no attempt to preserve (by inter-utility payments or other means) the "equitable" formula for the life of the contracts adopted in D.05-06-060. Thus, this proposal would entail a revision to the Commission's "permanent" cost allocation decision.

The majority of parties oppose PG&E's first proposal, arguing that it would be inconsistent with the intent of D.05-06-060. DRA argues that the proposed allocation could also result in a substantial and potentially inequitable shifting of costs from one group of IOU customers to another. They argue that relitigating the "permanent" cost allocation adopted in D.05-06-060 is unnecessary and would be a poor use of the Commission's and the parties' resources.

PG&E's second alternative proposal would require recalculation of the inter-utility allocation of all the DWR contract costs over the life of the contracts from 2001 through the current termination date for the last remaining contract (in 2015). A revised cost allocation among the IOUs would thereby be determined based upon a statewide average DWR contract cost on a per-megawatt-hour (MWh) basis over the life of the DWR contracts. Transfer payments would be authorized among the IOUs as necessary to reconcile any differences between the resulting average cost allocation and total costs of each contract novated to a particular IOU. Under this approach, all utility customers would pay the same average DWR contract unit cost for deliveries of power. To the extent that an IOU were to negotiate additional terms after a DWR contract had been novated, the effects of the renegotiated terms would be borne fully by that that IOU's customers.

PG&E argues that its second proposal "ensures that DWR contract costs are equitably allocated for the <u>entire</u> contract period."[21] However, the methodology proposed for determining each utility's "equitable" share is different from the methodology adopted in D.05-06-060. As with PG&E's first proposal, this approach would require modifying that decision and relitigating the cost allocation methodology. Parties generally oppose the proposal as being too complicated to implement.

Most parties oppose PG&E's proposals and argue instead that the "permanent" inter-utility cost allocation methodology adopted in D.05-06-060 should be maintained.[22] Under that adopted methodology, the "unavoidable" costs of the entire portfolio of DWR contracts among the three IOUs are allocated on a fixed percentage basis, while the "avoidable" costs of the contracts are allocated to the IOUs on a "costs follow contracts" basis. The IOU that administers a given contract thereby receives whatever benefits that contract offers and is responsible for the avoidable costs associated with it. Most parties argue that it is unnecessary to revisit these percentages for purposes of allocating costs among the IOUs as a result of taking over the DWR contracts through novation or renegotiation. These parties generally agree that SCE's proposal for inter-utility transfer payments appears to be a reasonable way to meet this objective.

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[21] *Id.*, p. 12.

[22] See comments of SCE, SDG&E, DRA, TURN, CLECA, and Reliant.

SCE argues that the inter-utility allocation of costs associated with contracts entered into as a result of DWR contract novation must preserve the existing inter-utility allocation equities reflected in the permanent cost allocation methodology adopted in D.05-06-060. That methodology was made effective for the allocation of DWR contract costs since 2004, with assurance that the methodology would remain in place over the life of the DWR contracts. Consistent with that assurance, SCE argues that any revised inter-utility allocation methodology must ensure no IOU customers are allocated either a greater or a lesser share of contract costs merely as a result of the novation, assignment, or renegotiation of DWR contract costs.

As a means of accommodating the IOUs' entering into replacement contracts under a DWR novation, SCE proposes a transition to a "cost-follows-contracts" allocation methodology which preserves the principles adopted in D.05-06-060. Under the current allocation methodology, DWR contract costs which are classified as "unavoidable" are allocated among the three IOUs based on fixed percentages. Under SCE's proposal, all unavoidable DWR contract costs would be allocated to the customers of the IOU that administers the subject contract. As a result of this allocation, there would be a disparity as compared with the allocation that would result under D.05-06-060. To ensure that customers are left indifferent to the cost impact of the "costs-follow-contracts" allocation, SCE proposes that the Commission authorize a schedule of indifference payments.

Except for the Coral and Sempra contracts, all DWR unavoidable contract costs are fixed. Thus, except for these two contracts, the total unavoidable contract costs can be readily calculated. For Coral and Sempra, a portion of the unavoidable contract costs are tied to the delivery of natural gas or an index of natural gas prices. Thus, to calculate the costs for Sempra and Coral, SCE recommends that an assessment of forward natural gas prices be used to determine the total unavoidable contract costs at the time that the indifference payments are calculated.

SCE proposes a two-step contract allocation process to facilitate a transition to a "cost-follows-contracts" methodology. Step 1 would establish a transfer payment schedule between the IOUs to keep their respective customers indifferent to a new "costs-follow-contracts" methodology. The transfer payments would be based on the difference between the existing cost allocation methodology adopted in D.05-06-060 and the new allocation methodology. Step 2 would be the implementation of the new "costs-follow-contracts" methodology, which SCE proposes should take effect beginning January 1, 2009. SCE proposes that a 30-day compliance period be employed for the IOUs to coordinate and calculate the transfer payment amounts. The IOUs would also use the 30-day compliance period to explore a mutually acceptable "shaping of the transfer payments, such as levelized fixed payments over a period of time to facilitate rate stabilization."

TURN suggests that the three IOUs attempt to reach a negotiated agreement on a revised cost allocation approach going forward, based on a "cost-follows-contracts" allocation "in which each utility pays the full costs of the contracts it administers . . . and bears full responsibility for the costs and benefits of any future renegotiation of the contractual terms."[23] TURN believes that "equitable adjustment payments" among the IOUs would likely be a necessary

[23] TURN's Opening Comments on Inter-Utility/Cost Allocation Issues, p. 3.

component of such an agreement.[24] If after a prescribed period of time (e.g., 45-60 days) the IOUs could not reach agreement, TURN suggests the unresolved issues be set for hearing, briefing, and Commission decision. [25]

5.5.2. Discussion

We conclude that the SCE proposal for inter-utility allocation offers the best solution to facilitate the transfer of contracts to the IOU, and we hereby adopt it. Adopting a mechanism that preserves the existing allocation methodology, as proposed by SCE, is consistent with past Commission policy not to revisit the fixed percentages and the methodology adopted in D.05-06-060 to allocate the unavoidable costs over the life of the contracts. The previously adopted allocation methodology was "designed to be fair over the life of the contracts." [26] In the early years of the allocation period, however, SCE customers bear a disproportionate share of contract costs. Correspondingly, in the later years, PG&E customers bear a disproportionate share of costs. We expressly stated in D.05-06-060 that the adopted cost allocation approach fairly balanced the relative cost burdens, and that we did not intend to revisit the adopted methodology.

PG&E's first proposal would result in SCE customers absorbing approximately $1.4 billion more of DWR contract costs than they would under the adopted methodology. PG&E's second proposal would increase SCE customers' costs by $140 million and SDG&E customers' costs by $260 million.

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[24] *Id*.

[25] *Id.* at pp. 3-4.

[26] See D.05-06-060, *mimeo.*, pp. 9-10.

Accordingly, we reject PG&E's proposals for a new allocation methodology as they unfairly shift costs to SCE and SDG&E customers and are in conflict with the principles of fairness underlying the methodology adopted in D.05-06-060.

We shall adopt the SCE proposal. The adoption of this approach thus will provide needed certainty so that each IOU will have the incentive to negotiate the best possible terms for its customers and to administer the replacement contract as cost-effectively as possible. This approach will also simplify calculation of inter-utility transfer payments. We shall direct the IOUs to make a compliance filing to be due 30 days from the effective date of this decision, calculating the amount of transfer payments to be adopted beginning effective January 1, 2009.

6. Adopted Plan for Going Forward

6.1. General Framework for Formulating a Plan

We hereby adopt a plan for implementation in Phase II(a)(2) of this proceeding to facilitate the logistics and to provide guidance on the negotiating parameters to effect contract revisions to remove DWR from its obligations as supplier of power. In the assigned Commissioner's and ALJ's Ruling dated April 18, 2008, a preliminary procedural plan was adopted for Phase II(a)(2). We elaborate on that plan in prescribing the next steps in this proceeding. We also consider parties suggestions for how to design and coordinate the process.

DWR has expressed its view that it is up to the Commission and the IOUs to take the lead in transferring the legal and financial responsibility for DWR's contracts to the IOUs.[27] SCE recommends that DWR work with the Energy

[27] DWR Memorandum dated June 9, 2008 at p. 2.

Division, the IOUs and interested non-market participants to develop a comprehensive plan for novation/assignment/renegotiation of contracts with a preliminary effort to determine if all of the sellers are willing to novate their contracts without material modification. SCE recommends provisions be adopted for periodic feedback during negotiations so that the Commission can make ongoing assessments of the advisability of continuing to support further efforts, or of making mid-course corrections if negotiations prove easier or more problematic than expected.

Reliant proposes that in any plan for pursuing negotiations, DWR should set as a priority to focus immediately on negotiations with those four counterparties whose contracts lack novation clauses. TURN points more specifically to the Sempra contract as the logical beginning point for prioritizing contracts to be renegotiated. The Sempra contract represents the single largest capacity resource of any DWR contract. TURN argues that it will be extremely difficult for DWR to transfer the Sempra contract to any of the IOUs, noting that renegotiation of the contract's original terms has not been achieved over the last several years, and that the contract has spawned multiple arbitrations and lawsuits that still continue. DRA likewise argues that given that the Commission has sought relief from this same contract for years in federal litigation, negotiations over contract novation would likely take substantial time, even if the material terms are not modified.

CFC likewise argues that, in view of the considerable funds that Sempra has already spent to avoid a change in its contract with DWR, Sempra is unlikely to agree easily to changes in the DWR contract as a result of further negotiations pursuant to this proceeding.

6.2. Formation of Working Group

We hereby authorize the formation of a Working Group as a vehicle for DWR, the IOUs, and Commission staff to plan and implement detailed protocols and strategies for conducting negotiations with the counterparties to the DWR contracts with the goal of removing DWR as a party to the contracts while ensuring that any resulting contract changes are not detrimental to ratepayers.

The assigned Commissioner will issue a procedural ruling to initiate the formation, organization, and operation of this Working Group. That ruling will address the applicable procedural processes, such as the vehicle(s) for communication among members of the Working Group, confidentiality protocols, and initiating mid-course adjustments as negotiations progress. As part of this process, a team coordinator will be designated to facilitate the formulation and implementation of Working Group goals. We expect all Working Group members to work in a collaborative manner to build consensus on a strategic plan for developing and conducting contract negotiations

As directed by the assigned Commissioner, the Working Group will be required to comply with reporting requirements, providing frequent updates on the progress of contract negotiations. Based on those progress reports, the assigned Commissioner will provide periodic guidance to the Working Group on whether to redirect priorities or to revise strategies for conducting further negotiations.

We shall generally delegate to the Working Group the specific administrative processes to carry out its work. We shall, however, adopt certain general guiding principles to govern the strategic plan for negotiations to be developed and implemented by the Working Group.

6.3. Setting Priorities and Contingencies

As a guiding framework for the Working Group's development of a plan, we shall establish certain priorities and contingencies for the focus of negotiations. We establish initial target priorities both in terms of (1) an end date to complete the removal of DWR from its role as supplier of power, and (2) the sequence in which the contract negotiations should be conducted.

As to the appropriate target for an end date, we recognize that there is a trade-off between the magnitude of expected customer benefits and the risks of achieving those benefits. The range of possible outcomes is a function of several assumptions, including whether novation or renegotiation of *all* outstanding DWR contracts is assumed or only some subset thereof. Another relevant assumption affecting the potential benefits is whether the goal is to target only those outstanding DWR contracts *expiring after a designated date in the future*. The number of contracts requiring novation or renegotiation could be reduced simply by limiting efforts only on contracts that expire after a selected time. In that way, any remaining implementation difficulties involved in negotiation of certain problematic contracts may be reduced or avoided entirely. On the other hand, waiting until certain contracts expire would reduce the expected ratepayer savings from novation, and would also impact the earliest date that Direct Access could possibly be reinstituted.

A threshold question, therefore, is whether to set as a goal the successful novation or renegotiation of *all* remaining DWR contracts in effect as of a certain date, or only of a subset of contracts. The related risks of not succeeding are also greater, resulting in the expenditure of efforts and resources that might ultimately not result in any net benefits to customers.

We shall adopt an approach which is aimed at maximizing the potential for ratepayer benefits while mitigating the potential for downside risk. Thus, we shall adopt as our initial target goal the removal of DWR from all of its outstanding contracts by January 1, 2010. The targeting of this date will maximize the potential benefits that may be realized by customers, as discussed previously in Section 4. The Working Group will be responsible for proceeding with contract negotiations with the goal of removing DWR from all of its remaining contract obligations by January 1, 2010.

The Working Group shall develop more specific priorities for scheduling the contracts to be negotiated in order to meet the January 1, 2010 goal. We do not expect, however, that negotiations of all contracts necessarily must be completed on the same exact date.

We recognize that by setting a goal of January 1, 2010, the risks of delay and of additional costs are also higher than if a later date were set. To mitigate such risks, we shall adopt measures for the Working Group to prioritize its activities, with contingency plans for mid-course adjustments depending on the course of negotiations. As a result, the target date for completion, and the specific contracts to be renegotiated may be subject to revision depending upon the course of negotiations

In Phase II(a)(2), a process will be established for periodic progress reports on negotiation efforts by the Working Group and for assessing the prospects for agreement on acceptable new contracts. We support continued negotiations as long as the prospects for success justify continued efforts. On the other hand, if the contract negotiations prove unfruitful or are not in ratepayers' interests, the Working Group will be instructed to discontinue such attempts, and to redirect priorities. The assigned Commissioner shall provide further guidance on this process in Phase II(a)(2) of this proceeding. In this manner, our goal is to curtail unproductive negotiation efforts before they result in the expenditure of unnecessary costs or time.

Consistent with the recommendation of various parties, we set as an initial priority the goal of negotiating replacement agreements for the existing contracts without novation clauses. For these four DWR contracts, the goal will be to negotiate provisions to remove DWR and substitute one of the IOUs for subsequent power purchased from the respective supplier.

Of the four contracts without novation clauses, the first priority shall be to focus on the Sempra contract. As second in priority, we set the goal of negotiating to replace the existing Coral contract. Prioritizing these two contracts is appropriate, particularly given the uncertainties as to whether a successful revised Sempra or Coral contract can be negotiated, the potential time required for negotiations, and the magnitude of benefits to ratepayers that depend upon the successful negotiation of these contracts.

As discussed in further detail below, the Commission is still involved in litigation as to whether the terms and prices of the existing Sempra and Coral contracts are "just and reasonable." In authorizing a process to facilitate negotiations for replacement contracts with Sempra and Coral in which DWR will not be a party, the pending litigation over the existing contracts may have a bearing on negotiations for a new replacement contract. We do not prejudge at this time how negotiations for a replacement contract should be negotiated, however, or whether the negotiated terms of the new contract would be found "just and reasonable" under Section 451. We observe, however, that the setting in which any replacement contract would be negotiated and reviewed would be in reference to the prospective market conditions in effect during the period that such replacement contract would be in effect. In that regard, the setting for the negotiation and Commission review of any new replacement contract would be separate and distinct from the historic market conditions applicable to any pending litigation over the existing contracts.

The Coral contract currently has provisions stating that it cannot be transferred unless all other contracts have been transferred.[28] The contract permits assignment or transfer only if the transaction is "in connection with "DWR's transfer of title to the bond, the Fund, and all power purchase agreements" into which it entered pursuant to AB 1X. Thus, in order to prioritize transferring the Coral contract as an early priority, the negotiations will need to consider seeking agreement on revisions in this contract limitation.

While our goal is to maximize the potential for successful outcomes, it is prudent to provide contingency plans in the event that Sempra and/or Coral negotiations ultimately prove unproductive. After a reasonable period of time, to be determined in the next phase of this proceeding, if parties do not make reasonable progress toward negotiating new contracts with Sempra and/or Coral, the assigned Commissioner may direct the Working Group to discontinue such negotiations, and redirect priorities to negotiations of other DWR contracts.

If negotiations for new contracts with Sempra and/or Coral were not successful, their existing contracts would continue in effect until they expire. It would then become necessary to revise the target date for completing negotiation of the remaining DWR contracts. We would then consider revising

[28] Similar provisions appear in the Calpine contract.

the target date to October 1, 2011, the expiration date of the Sempra contract, with negotiations focused on DWR contracts that expire after that date.

Based on the net benefits that parties have estimated, we conclude that continued efforts to implement novation or renegotiation of the remaining contracts would still be justified. For example, the IOUs estimate that while net savings would decline if the Sempra contract is not terminated early, net savings of $56 million could still be realized, assuming novation or renegotiation of only those DWR contracts expiring *after* September 30, 2011, the Sempra contract expiration date.

Even if the Sempra contract negotiations were discontinued, renegotiation of the Coral contract should continue to be pursued. Assuming that negotiations with Coral were also subsequently unsuccessful, however, we would further revise the target completion date to June 30, 2012, the expiration date of the Coral contract. At that point, only about 500 MW would remain under contract with DWR. The IOUs' estimate of net benefits under this assumption is still positive, but declines to only $30.5 million. Our goal would then be to complete novation or renegotiation of those few remaining DWR contracts expiring after June 30, 2012. The SFO Peakers contract has the longest term (expiring in 2015), and does not have a novation clause. Accordingly, the SFO Peakers contract should be next in priority for renegotiation after Coral.

Our goal is to ensure that negotiations with a given counterparty continue only so long as reasonable prospects remain of reaching an agreement that is in ratepayers' interests. We shall provide a reasonable period of time to give negotiations with each supplier a chance to succeed. We will not hesitate, however, to redirect contract negotiation efforts if necessary to avoid wasting time or resources on unproductive discussions. Through close monitoring and frequent feedback, we shall keep negotiation efforts focused so as to maximize benefits for ratepayers while avoiding protracted negotiations that are not productive, while pursuing the goal to relieve DWR of its remaining supply obligations at the earliest feasible date.

6.4. Negotiating Replacement Agreements to Retain Existing Terms "As Is" Versus Concurrent Revisions to Existing Terms

6.4.1. Parties' Positions

Parties disagree as to whether novation should be executed merely to continue all existing contract terms and prices "as is", except substituting DWR with one of the IOUs as the contract party. Alternatively, certain parties believe that the contracts should be concurrently negotiated to seek broader amendments in other terms or prices of any replacement agreements.

DWR argues that to facilitate the exercise of novation rights, as a general rule, replacement agreements should be as nearly identical as possible to the existing contracts, with only such changes as are necessitated by the change in parties. The DWR contracts define a "replacement agreement" as "any agreement identical to" the contract being replaced "with such additional changes as the Seller and Qualified Electric Corporation may mutually agree."

DWR advocates proceeding with novation as quickly as reasonably possible while allowing the IOUs to renegotiate the terms and schedules under the contracts with counterparties to provide retail customers with benefits that only the IOUs can obtain.

DWR argues that limiting the terms subject to negotiation in the replacement agreements will eliminate any basis for counterparty objections to the novation provisions. DWR's counterparties to contracts with novation provisions are legally obligated to accept novation if the stated conditions specified in the contract are met. DWR believes that "a single-focus negotiation and just dealing with a novation provision shouldn't be that time consuming, all encompassing."[29] Following the novation, the IOUs as new counterparties could then enter into a subsequent amendment, or other agreement, to restructure the replacement agreement.

Reliant agrees with DWR that the appropriate starting point for a replacement agreement is that it be identical to the original agreement that it is replacing. Reliant proposes that the IOUs be directed to take the contracts "as is" (or subject to a narrow set of predetermined changes as made necessary by the change in parties.) Consequently, Sellers will have notice that negotiating "mutually" agreed-to changes will not be possible. Reliant believes that novating the DWR contracts will not be complex or time consuming. Reliant disputes claims that counterparties will be able to hold out for contract modifications that deprive customers of benefits or increases their costs. AReM/CACES likewise argues that, where possible, the contracts should be novated "as is" with no changes to terms and conditions other than those required to effectuate novation, leaving the new counterparties free to negotiate whatever changes to the contracts they want.[30] AReM/CACES acknowledges, however, that "at least some of the contracts will require some level of

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[29] July 1, 2008 Workshop Tr. at 180.

[30] Comments of the California Alliance for Competitive Energy Solutions and the Alliance for Retail Energy Markets Regarding Inter-Utility Cost Allocation Issues (July 28, 2008), pp. 4-5, 8.

renegotiation.[31] AReM/CACES reasons that this approach would "simplify the novation process."

The IOUs disagree, however, that novation merely involves signing over the existing DWR contracts to the IOUs. They argue that several of the novation clauses include unique requirements and all of the novation clauses provide for a "replacement agreement" that provides Sellers with the opportunity to seek additional modification. SCE argues that Sellers may also dispute that the novation conditions have been satisfied which will require time and potentially litigation to resolve.

DRA argues that it is not in the best interests of ratepayers to have these contracts novated to the utilities without concurrently negotiating the best terms and conditions possible for the replacement contracts. DRA argues that the IOUs should not agree to become counterparties to any contracts containing terms that are unjust and unreasonable. DRA argues that negotiation of improved terms (from a ratepayer standpoint) must be a precondition for assignment or novation of at least some of the DWR contracts. Accordingly, DRA argues that replacement contracts between sellers and the utilities should be negotiated *before* DWR contracts are novated, not *after.*

PG&E supports an initial novation of the agreements, with any subsequent renegotiation to occur between the IOU and counterparty. PG&E observes that concurrent renegotiation would be more complex, as it would involve three parties (DWR, the IOU, and the counterparty) and could result in the

[31] *Id.*, p. 5.

counterparty refusing to agree to novation if it could not prevail on other concessions.

6.4.2. Discussion

We conclude that the choice of whether to execute novation by replacing the contract "as is", or to seek more extensive revisions at the same time is best evaluated on a contract-by-contract basis, rather than simply requiring a one-size-fits-all approach. The relative trade-off of advantages and disadvantages between these negotiating strategies may be different for each contract depending on a number of variables including the relative bargaining strength of the counterparty, the specific terms of the existing contract, and the potential to arrive at a bargaining result that is mutually beneficial both to the counterparty and to the IOU and its customers. During the workshops, DWR declined to disclose specific details regarding the status of pending negotiations for contract modifications with contract suppliers, citing the commercial sensitivity of such discussions. [32] Moreover, except for one supplier who attended the workshop, none of the counterparties to the DWR contracts have provided any indication as to their willingness to negotiate revisions to existing contracts.

Without further information, it would therefore be premature at this point to prejudge the specific bargaining strategy that may be appropriate for every single contract. Instead, as part of the strategic plan for pursuing negotiations, we shall instruct the Working Group to assess the progress of initial discussions with counterparty to each contract on its own merits, as to whether it is productive to pursue simultaneous renegotiation of substantive terms

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[32] See Workshop Transcript dated July 1, 2008, at pp. 178-179.

concurrently with executing a novation, or instead, to limit the negotiations only to novation of the existing contract, continuing existing terms "as is." This evaluation of alternative negotiating strategies should apply both to contracts that already have novation clauses, as well as to the four contracts that currently lack novation clauses. In the latter case, the choice would be between negotiating simply *to add* a novation clause, thereby retaining all existing terms, versus exploring a broader renegotiation of other terms and prices.

If the results of initial discussions with a counterparty indicates that seeking expanded modifications in contracts terms or prices is likely to result in protracted delays or disputes, then a determination may be made to focus subsequent negotiations only on a novation of the existing contract "as is," without seeking revisions beyond the minimum changes required for novation. On the other hand, if initial discussions indicate that all parties to the negotiations believe that more expansive revisions are feasible which provide mutual benefits, parties should be provided the flexibility to pursue such negotations within a single replacement contract.

We view the provisions of the novation clauses as a potential source of bargaining strength for DWR and the IOUs by giving the DWR the unilateral option to require the counterparty to accept a "Replacement Contract" under essentially the same substantive terms, while preserving the flexibility to consider—but not be required to accept—additional terms that the counterparty may seek to negotiate on a concurrent basis. Accordingly, the resulting "Replacement Agreement" must, at a minimum be at least as beneficial for ratepayers as the existing contract. The potential also exists for parties to mutually negotiate a new agreement that is more beneficial to ratepayers compared to the existing agreement. At the same time, if negotiations with a particular supplier are to include making revisions beyond an "as is" novation, the risk of additional delay and uncertainty must be weighed against any potential ratepayer benefits that may be possible. Under no circumstances, however, is DWR obligated to effect a novation with a "Replacement Agreement" that is less beneficial to customers than the current contract.

6.5. Novation to Third Parties other than IOUs

6.5.1. Parties' Positions

AReM/CACES argues that the Commission should consider the potential for novating or assigning the contracts to third parties other than the utilities, as an option if obstacles arise with respect to transferring the contracts to the utilities. AReM/CACES sees no need to presume that DWR contracts can or should be novated or assigned only to the IOUs.

AReM/CACES makes a proposal that would allow the DWR contracts to be transferred to non-IOUs by means of auctions in which both IOUs and non-IOUs could offer to accept novation of the DWR contracts.[33] AReM/CACES does not address what categories of non-IOUs it has in mind – Electric Service Providers, energy traders, or other categories of market participants.

DRA believes that novating/assigning DWR contracts to Electric Service Providers appears to be barred by the terms of the DWR contracts, most of which require that a replacement agreement be with a "Qualified Electrical Corporation" (in some cases specifying "as defined by AB1X"). Under AB1X, a

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[33] Final Summary Comments of CACES and AReM (August 25, 2008), pp 12-16.

"Qualified Electrical Corporation" does not include Electric Service Providers.[34] Reliant does not believe that novation to parties other than IOUs is expressly barred by the terms of every DWR contract, but argues that even for contracts where it is not expressly barred, there are various reasons why novation to non-IOUs is not practical.

6.5.2. Discussion

We reject the proposal of AReM/CACES to incorporate a provision for a competitive auction whereby non-IOUs could bid to acquire ownership rights for power that is currently supplied by DWR. We agree with the concerns raised by various parties that the practical difficulties and potential delays resulting from such a program would not be in the best interests of ratepayers.

As a practical matter, only a limited number of DWR contracts could be made available to a non-IOU as a "Qualified Electric Company". The remainder of the contracts expressly require that an IOU must take over the "Replacement Contract." Even for this limited number of contracts, however, novation to a non-IOU presents a number of practical difficulties. For example, such a novation could adversely affect the IOUs' ability to serve load. Power supplied under the DWR contracts has been incorporated into the IOUs' respective portfolios for long-term planning purposes. If a non-IOU took over the contract, there is no assurance as to where the power would ultimately be delivered, and

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[34] See Overview of DWR Power Contracts presented at workshop on June 2, 2008, Slides 22, 23, 27; California Water Code Section 80010 (c) (giving "electrical corporation" same definition as that found in Public Utilities Code Section 218); Public Utilities Code Section 218.3 (electric service providers are not "electrical corporations" as defined in Section 218).

the IOU would face the uncertainties associated with replacing the power that may no longer be available to serve retail IOU load.

Novation to a non-IOU would also unnecessarily complicate the inter-IOU allocation process, as adopted in D.05-06-060, which intended that a fixed percentage of DWR contract costs be allocated among IOUs over the life of the contracts. If a non-IOU took over certain contracts, it is uncertain how the applicable allocation of costs under D.05-06-060 would be affected.

Novation to a non-IOU would also unnecessarily complicate the process for conducting a "just and reasonable" review of the "Replacement Contract" as called for under the novation provisions.

As noted by DRA, novation involving Electric Service Providers might also violate AB1X, since the purpose of the DWR contracts is to procure energy for "retail end use customers served by electrical corporations."[35]

As noted by both DRA and Reliant, novation or assignment to non-IOUs would impact long-term procurement planning objectives mandated by Pub. Util. Code § 454.5. Reliant also argues that novation to non-utilities could negatively impact the IOUs ability to serve load and would unnecessarily complicate the process of inter-utility allocation of contract costs.

[35] Water Code Section 80002.5.

6.6. "Just and Reasonable" Review Approval of Replacement Agreements before the California Public Utilities Commission (CPUC)

Phase II(a)(2) also will establish procedures for the review and approval process for any Replacement Agreements consistent with the just-and-reasonable standards of Pub. Util. Code § 451.

Many of the DWR contracts require, as a condition of transfer, that the Commission first conduct a review and issue findings that the terms of the "Replacement Agreement" are "just and reasonable" under Section 451 of the Public Utilities Code. We believe that the more explicit guidance that we can provide to parties early during the negotiation process as to how the "just and reasonable" standard will be applied, the more likely it is that any proposed "Replacement Agreements" will be able to meet this standard once the review process is undertaken.

CFC argues that the transfer of contracts could be delayed while the reasonableness of their terms was being litigated. Reliant argues, however, that assuming that a DWR contract is novated "as is," and solely to the IOUs, the requisite "just and reasonable" review under Section 451 has already been completed through past Commission decisions under which the DWR power charges have been allocated to the IOUs and recovered in retail rates.

PG&E disagrees, however, that the Commission has "already completed" a review as to whether a novated DWR contract is "just and reasonable. PG&E contends that the opposite is true, and that the Commission has asserted before the FERC and in court that many of the DWR contracts are unjust and unreasonable. For example, the Commission is currently challenging the justness and reasonableness of the Sempra contract at the Ninth Circuit Court of

Appeals. PG&E argues that merely because the Commission has allowed DWR costs to be passed through in retail rates, the Commission has not reviewed the DWR contracts to determine that they are "just and reasonable." PG&E argues that if the DWR contracts are novated "as is", the Commission would be required by statute and by DWR contract provisions to conduct a review and determine that the novated contracts are "just and reasonable" in accordance with Pub. Util. Code § 451.

DRA likewise notes that AB1X requires the Commission to pass through to ratepayers the costs of the DWR contracts.[36] AB1X makes an express exception to the Section 451 requirement that the Commission review the reasonableness of all charges included in rates. DWR, rather than the Commission, is responsible for the Section 451 review of the contracts entered into pursuant to the temporary authority bestowed on DWR by AB1X.[37]

Accordingly, DWR, not the Commission, reviews and determines the reasonableness of the revenue requirements established to recover the costs of the existing DWR contracts. The Commission has never made a finding that the DWR contracts are just and reasonable. Even though it was required by AB1X to

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[36] Water Code Section 80110 provides in relevant part: The department [DWR] shall be entitled to recover, as a revenue requirement, amounts and at the times necessary to enable it to comply with Section 80134, and shall advise the commission as the department determines to be appropriate." Section 80134 directs DWR to "establish and revise" revenue requirements sufficient to cover the costs of the contracts, including bond costs, power purchase costs, and operating reserves.

[37] Section 80110 provides in relevant part: "For purposes of this Division and *except as provided in this section*, the Public Utilities Commission's authority as set forth in Section 451 of the Public Utilities Code shall apply, *except any just and reasonable review under Section 451 shall be conducted and determined by the department* [DWR]." (Emphasis added.)

pass through the costs of those contracts to ratepayers in retail rates, the Commission simultaneously challenged the wholesale contracts as unjust and unreasonable under the Federal Power Act. The Commission's legal challenge to DWR's contracts with Sempra, Coral, and PacifiCorp (as well as the contract with Dynegy, which has now expired) is still being litigated. That litigation has gone to the United States Supreme Court, and is currently before the United States Court of Appeals for the Ninth Circuit, which has been directed by the Supreme Court to further consider the case in light of the Supreme Court's recent *Morgan-Stanley* decision.[38] We therefore reject Reliant's argument that the Commission has implicitly determined that the DWR contract costs are just and reasonable because it has allowed those costs to be included in rates.[39]

Reliant asks the Commission to require the utilities to accept novation of the contracts "as is." The replacement contracts would likely include modifications to the existing contracts. The Commission will not have reviewed the replacement contracts and would be required to do so pursuant to Section 451. The replacement agreements would not fall within the AB1X exception for the DWR contracts discussed above, because they are *new* contracts

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[38] Publ*ic Utilities Commission of Cal. v. FERC, 474 F.3d 587* (9th Cir. 2006) ("*CPUC v. FERC"), vacated and remanded on June 27, 2008 by Dynegy Power Marketing v. Public Utils. Comm.,* 2008 Lexis 5272 for consideration in light of the Supreme Court's opinion in *Morgan Stanley Capital Group Inc. v. Public Utility District No. 1 of Snohomish County* and *American Electric Power Service Corp. et al. v. Public Utility District No. 1 of Snohomish County,* 554 U. S.____ (2008); 128 S. Ct. 2733.

[39] The Commission challenged the DWR contracts as unjust and unreasonable under federal law. However, there is no reason to believe that the Commission would find just and reasonable under Section 451 the same contracts it challenged as unjust and unreasonable under the Federal Power Act.

between sellers and utilities. And any replacement agreement that would extend the term of a contract should also be reviewed by the Commission for consistency with long-term procurement planning criteria, pursuant to Section 454.5.

We cannot declare that the replacement contracts will be deemed just and reasonable before they have been negotiated and presented to us for review.

Certain parties argue that there are potential legal impediments relating to the Commission's rendering "just and reasonable" findings of a novation or assignment in view of pending federal actions relevant to the certain DWR contracts. Various parties expressed concerns as to the impact of the recent United States Supreme Court decision in *Morgan Stanley.*

PG&E argues that *Morgan Stanley* directly affects the DWR contracts, and in particular, the DWR/ Sempra contract. The Supreme Court remanded the Sempra contract dispute back to the Ninth Circuit, which in turn, could remand the case back to FERC. If FERC and the courts ultimately determine that the Sempra contract is not entitled to *Mobile-Sierra* protections, and decide to abrogate the agreement, PG&E argues that such an action would have a significant impact on novation or assignment. PG&E argues that the Commission cannot approve the novation or assignment of a DWR contract that may ultimately determined not to be just and reasonable and abrogated by FERC.

DRA also notes that the long-term power contracts that DWR entered into during the energy crisis were challenged by the California Commission in another proceeding, which eventually led to a decision by the United States Court of Appeals for the Ninth Circuit (*Public Utilities Commission of Cal. v. FERC, 474 F.3d 587* (9th Cir. 2006) ("*CPUC v. FERC*"), *vacated and remanded by Dynegy*

Power Marketing v. Public Utils. Comm., 2008 Lexis 5272 (June 27, 2008). The contracts this Commission challenged in that litigation include DWR's long-term contracts with Sempra, Coral, and PacifiCorp.[40]

In *CPUC v FERC,* th*e* Court of Appeals granted the Commission's petition for review of FERC's orders rejecting challenges to the DWR long-term contracts, and remanded the case to FERC to review the challenged contracts under standards outlined in the opinion. The day after it issued its opinion in *Morgan Stanley*, the Supreme Court granted certiorari, vacated the Court of Appeal's opinion in *CPUC v. FERC,* and remanded to the Ninth Circuit for further consideration in light of the *Morgan Stanley* opinion.

DRA believes that it will be some time, however, before the question of whether the DWR contracts are unjust and unreasonable is remanded to FERC. The Commission has requested that the Court of Appeals first address an issue that was reserved and not addressed in the Court's earlier opinion: whether the Commission, as a non-party to the contracts, must meet the "public interest" standard.[41] DRA states that this issue should be decided by the Court of Appeals before it remands the case to FERC. Thus, DRA argues that it could be a long time before the question of whether DWR's contracts with Sempra, Coral, and PacifiCorp are unjust and unreasonable, is sent back to FERC.

The Commission, meanwhile, continues to challenge those contracts in the *CPUC v. FERC* litigation. DRA questions how the Commission could be

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[40] DWR's contract with Dynegy is also at issue in this litigation, but it is not relevant to the Direct Access proceeding because it has already expired.

[41] See Letter from CPUC General Counsel Frank Lindh to the Ninth Circuit Court of Appeals re *CPUC v. FERC*, dated July 29, 2008 (copy attached as Attachment 1).

expected to find the contracts that are the subject of this litigation "just and reasonable" under Section 451.

Contrary to DRA's premise, the Commission will not be making any findings as to the "just and reasonableness" of any existing DWR contracts as a result of the novation process. Instead, the contracts that will be subject to Commission review and approval under the "just and reasonable" standards of Section 451 will be new replacement contracts entered into between an IOU and each of the counterparties to the existing DWR contracts. The extent to which the replacement contracts contain prices and other terms that are similar to those under the previously existing DWR contracts will depend upon the manner in which the replacement contracts are negotiated. As stated previously, we will not prejudge how those contract negotiations will proceed. In any event, the replacement contracts will be reviewed in the context of market conditions at the time of negotiation, and based on expectations of market conditions for the period that the replacement contract will be in effect. As such, the review of those contracts will be separate and distinct from the setting in which the previously executed DWR contracts were negotiated and subsequently litigated.

7. Comments on the Proposed Decision

The proposed decision of the assigned ALJ in this matter was mailed to the parties in accordance with § 311 of the Pub. Util. Code and Rule 14.3 of the Commission's Rules of Practice and Procedure. Comments were filed on _____________, and reply comments were filed on ___________, by ___________.

8. Assignment of Proceeding

Michael R. Peevey is the assigned Commissioner and Thomas R. Pulsifer is the assigned Administrative Law Judge in this proceeding.

Findings of Fact

1. Although DWR's authority to enter into new power contracts terminated as of January 1, 2003, and the IOUs took over responsibility for the scheduling and dispatch of DWR contract power thereafter, DWR still supplies power to retail customers pursuant to previously executed contracts which continue in effect.

2. In D.02-12-069, the Commission identified the fundamental short-term goal to transition full responsibility for energy market related activities back to the IOUs as soon as possible, and to make every effort to relieve DWR from the responsibility to perform any functions that should be performed in the long term by regular market participants.

3. The removal of DWR from the role of supplying power is consistent with the fact that the IOUs--and not DWR--are regular market participants that continue to have a statutory responsibility to serve electric customers.

4. The IOUs' obligation to serve their customers is mandated by state law and is part and parcel of the entire regulatory scheme under which the IOUs received a franchise and under which the Commission regulates IOUs under the Public Utilities Act

5. The most practical means by which DWR can be removed from its role of supplying power is through the novation of DWR contracts.

6. Given the uncertainties as to whether DWR could obtain a release from liability from all contract counterparties, assignment of the DWR contracts does not offer a viable means of removing DWR from supplying power.

7. A number of DWR contracts contain novation clauses whereby, upon request by DWR and satisfaction of specified conditions in the contract, the

counterparty must enter into a replacement agreement with a "qualified electric supplier."

8. The number of active DWR contracts has been gradually, declining from 59 originally down to 26 contracts today, with 15 separate counterparties.

9. Assuming no further action to accelerate DWR's removal as a power supplier, the DWR will supply declining amounts of power as contracts expire, gradually reducing to zero by about 2015.

10. Novation clauses have been negotiated in 22 out of the 26 remaining DWR contracts as a vehicle to allow for removal of DWR from its contract obligations by substituting a new contract with a different entity which wholly extinguishes the earlier contract.

11. In order for a novation to be executed, a series of conditions must be satisfied, culminating in the execution of a replacement agreement which substitutes an IOU for DWR as party under the new agreement.

12. In the case of the four contracts lacking novation clauses, DWR and the IOUs cannot unilaterally require the counterparties to those contracts to allow the substitution of DWR with an IOU. Negotiations with those counterparties would be necessary to elicit their agreement before DWR could be relieved of its obligations to supply power under such contracts.

13. In devising a plan for contract negotiations to remove DWR from its role as supplier of power, the most efficient outcome can be expected if negotiations are conducted in a sequence of priorities, beginning with the Sempra and Coral contracts.

14. Prioritizing the Sempra and Coral contracts as the initial focus of negotiations is appropriate, particularly given uncertainties as to whether revised Sempra or Coral contracts can be successfully negotiated, the potential

time for negotiations, and the magnitude of benefits to ratepayers that depend on the successful negotiation of these contracts.

15. The IOUs estimate quantifiable net savings to ratepayers of approximately $128 million from DWR contract novation, assuming that all DWR contracts were to be successfully replaced with new agreements by 2010 through contract novation.

16. To the extent that the full novation of remaining DWR contracts were to occur later than 2010, the estimated net savings to ratepayers correspondingly decline.

17. If negotiations prove to be unsuccessful for the early removal of DWR as a party to the Sempra contract, DWR would be relieved of its obligations under the Sempra contract as of September 2011, the contract's expiration date.

18. If, as a result of unsuccessful Sempra negotiations, and the target completion date for novation of DWR contracts was extended to October 2011, net savings would continue to be forecast, but would be reduced to $56.2 million.

19. The estimate of quantifiable net ratepayer savings as a result of extending the target novation completion date to October 2011 is reduced principally because DWR reserves associated with the Sempra contract would not be released early.

20. If the Coral contract negotiations also were not successful, the Coral contract would expire in June 2012.

21. If the target date for completing DWR contract novation were to be extended to June 2012, there would only be about 500 MW of DWR contract power remaining. The estimated net benefits of novating the remaining contracts would be reduced to about $30.5 million.

22. Although the estimated benefits of novation decline as the target date for completion is extended, the associated risks and potential impediments to novation also decline correspondingly.

23. Although uncertainties exist as the prospects for achieving successful novation of all DWR contracts by January 2010, the potential benefits of going forward with contract negotiations to achieve such a goal outweigh the potential downside risks, subject to appropriate safeguards.

24. Uncertainties exist as to whether, or to what extent, parties may be able to negotiate a replacement contract that provides benefits relative to the existing DWR contract, or (in the case of contracts without novation clauses) whether the counterparty will agree to novation at all.

25. The trade-off between negotiating an "as is" novation versus more extensive amendments may be different for each contract depending on the relative bargaining strength of the counterparty, the specific terms of the existing contract, and the potential to arrive at a bargaining result that is mutually beneficial both to the counterparty and to the IOU and its customers.

26. If DWR were to terminate its ownership interests in the remaining DWR contracts, through the plan adopted in this decision, then DWR would no longer be supplying power under AB1X.

27. A potential impediment to the IOUs entering into negotiations to execute a new contract to replace a novated DWR contract up until now has been uncertainties as to how the resulting contract costs could be allocated among the IOUs and their customers in an equitable manner.

28. Because PG&E's proposed methodology for allocating each utility's "equitable" share of contract costs is different from the methodology adopted in

D.05-06-060, the proposal would require modifying that decision and relitigating the cost allocation methodology.

29. SCE's proposed methodology for allocating contract costs to each utility would maintain the allocation principles adopted in D.05-06-060, and would be consistent with the Commission's goal not to relitigate the allocations adopted in D.05-06-060.

30. Under SCE's proposal, all unavoidable DWR contract costs would be allocated to the customers of the IOU that administers the subject contract, described as a "costs follows contract" allocation.

31. In order to ensure that ratepayers are left indifferent to the effects of a "costs follow contracts" allocation, SCE's proposal calls for developing a schedule of transfer payments to ensure that the allocation equities adopted in D.05-06-060 are preserved.

Conclusions of Law

1. The basis for deciding whether or how to move forward with a plan to expedite the removal of DWR from its role as supplier of power is whether it is in the public interest to implement such a plan.

2. In D.02-12-069, the Commission expressed a preference for returning the IOUs to their traditional role of supplying power as a matter of public policy. This proceeding provides a forum to address analytically whether (or how) such an undertaking can be cost-effective.

3. Good cause exists to move forward to Phase II (a)(2) of this proceeding for the purpose of implementing negotiations to execute novations of DWR's remaining contracts.

4. The goal of removing DWR from the role of supplying power should be pursued under a balanced approach, providing the opportunity for contract

negotiations to produce ratepayer benefits, but with safeguards to limit or redirect contract negotiation efforts if, or to the extent that negotiations do not progress positively.

5. Many of the DWR contracts require, as a condition of transfer, that the Commission first conduct a review and issue findings that the terms of the "Replacement Agreement" are "just and reasonable" under Public Utilities Code Section 451.

6. We do not prejudge how negotiations for a replacement contract should be negotiated or whether the negotiated terms of the new contract would be found "just and reasonable" under Section 451. The framework for conducting and approving replacement contracts pursuant to Section 451 should be developed in Phase II (a) (2) of this proceeding.

7. The Commission will not make any findings as to the "just and reasonableness" of any existing DWR contracts as a result of the novation process, but instead will make those findings for new replacement contracts. Any replacement contract to be negotiated should be reviewed in reference to the market conditions in effect at the time of negotiation and for the period that such replacement contract would be in effect.

8. Any "just and reasonable" findings that may be made by the Commission in connection with replacement agreements executed pursuant to DWR contract novation or other negotiations should in no way be construed as affecting the disposition of any pending litigation relating to existing DWR contracts.

9. In order to provide the appropriate incentives for the IOUs to enter into negotiations to take over replacement contracts as a result of DWR contract novation, provision should be made to ensure that the cost allocation equities established in D.05-06-060 are preserved.

10. SCE's proposed contract allocation methodology should be adopted since it preserves the allocation equities established in D.05-06-060, and provides a practical approach to protect customers against cost shifting as replacement contracts are taken on by the three respective IOUs.

11. Because the Coral and Sempra unavoidable contract costs are tied to the delivery of natural gas or an index of natural gas prices, to calculate the costs for Sempra and Coral, an assessment of forward natural gas prices should be used to determine the total unavoidable contract costs at the time that the indifference payments are calculated.

12. This decision should be effective immediately so that the contract negotiations discussed in this decision may commence expeditiously.

O R D E R

IT IS ORDERED that

1. A process is hereby authorized to facilitate efforts aimed at the early removal of the Department of Water Resources (DWR) from its role as supplier of power to retail electric customers through negotiations to remove DWR as a party to its existing contracts by executing new replacement agreements.

2. A Working Group shall be organized as a vehicle for DWR, the investor-owned-utilities (IOUs), and Commission staff to plan and implement protocols and strategies for conducting negotiations with the counterparties to the DWR contracts with the goal of removing DWR as a party to the contracts while ensuring that any resulting contract changes are not detrimental to ratepayers.

3. A process will be established for periodic progress reports on negotiation efforts by the Working Group for assessing the prospects for agreement on

acceptable new contracts, with the goal being to curtail unproductive negotiation efforts before they result in the expenditure of unnecessary costs or time.

4. The Assigned Commissioner will issue a procedural ruling in Phase II (a)(2) addressing the formation, organization, and operation of this Working Group, prescribing, among other things, vehicle(s) for communication among the Working Group members, confidentiality protocols, and contingency plans for mid-course adjustments, if necessary, as negotiations progress.

5. The initial target date for the removal of DWR from all of its outstanding contracts shall be set by January 1, 2010.

6. The following priorities shall apply for purposes of scheduling and sequencing negotiations for replacement contracts. The first priority shall be negotiating to replace the Sempra contract. The second priority shall be negotiating to replace the Coral contract. The third priority shall be renegotiation of the SFO Peakers contract, followed by novation of any remaining DWR contracts, sequenced by the latest expiration date.

7. Whether to execute novation by replacing the contract "as is", or to seek more extensive revisions at the same time shall be assessed on a contract-by-contract basis, rather than necessarily requiring the same approach for every contract.

8. Novated DWR contracts, as well as any replacement contracts shall count towards the IOUs' resource adequacy requirements. Imposing this requirement is necessary so that the IOUs do not lose resource-adequacy-eligible capacity from the novation process.

9. The proposal of Southern California Edison Company (SCE) is hereby adopted for a two-step contract allocation process to facilitate a transition to a

"cost-follows-contracts" methodology to facilitate the IOUs' taking over replacement contracts pursuant to DWR novation.

10. The adoption of the SCE proposal shall constitute a modification of the cost allocation methodology adopted in Decision (D.) 05-06-060, with the purpose of ensuring that IOU customers remain indifferent as a result of an IOU taking over a replacement contract pursuant to a DWR contract novation.

11. The adopted modification to D.05-06-060 shall extend the allocation principle of "costs-follow-contracts" to include not just avoidable costs (as currently applicable), but shall also apply the same principle to unavoidable contract costs.

12. Under the revised "cost-follows-contract" allocation process adopted herein, customers of each IOU will be responsible for 100% of the unavoidable power costs for the DWR contracts assigned to each IOU.

13. Any miscellaneous DWR contract costs that are not attributable to energy deliveries shall continue to be allocated in accordance with the fixed percentage allocations adopted in D.05-06-060.

14. As the first step in implementing the revised allocation process, a transfer payment schedule between the IOUs shall be established to keep their respective customers indifferent to a new "costs-follow-contracts" methodology. The transfer payments shall be based on the difference between the fixed-percentage cost allocation methodology adopted in D.05-06-060 and the new "costs-follow-contracts" allocation methodology as proposed by SCE.

15. For purposes of calculating transfer payments to implement the revised cost allocation methodology for unavoidable costs for all DWR contracts (except for the Coral and Sempra contracts), parties shall utilize the DWR 2009 revenue requirement workpapers.

16. In calculating transfer payments applicable to costs of the Coral and Sempra contracts, parties should utilize the most current assessment of forward natural gas prices at the time that the 30-day compliance filing of transfer payments is being prepared. The IOUs shall retain one or more consultants to provide assessment of the forward curve for natural gas, to be coordinated by the Commission's Energy Division.

17. Implementation of the new "costs-follow-contracts" methodology shall take effect beginning January 1, 2009. A 30-day period shall be authorized from the effective date of this decision for the IOUs to meet and confer to coordinate and calculate the transfer payment amounts necessary to implement the SCE allocation proposal. The IOUs shall also use the 30-day compliance period to explore a mutually acceptable shaping of the transfer payments, such as levelized fixed payments over a period of time to facilitate rate stabilization. The IOUs shall jointly file and serve the agreed-upon calculation of transfer payments within 30 days of the effective date of this decision.

18. This proceeding shall remain open for consideration of subsequent Phase II(a)(2) issues. As a priority, Phase II(a)(2) of this proceeding shall address the appropriate "just and reasonable" standards to be used in the review and approval of any replacement agreements, in order to ensure consistency with the applicable requirements of Section 454.5.

This decision is effective today.

Dated ______________________________, at San Francisco, California.

INFORMATION REGARDING SERVICE

I have provided notification of filing to the electronic mail addresses on the attached service list.

Upon confirmation of this document's acceptance for filing, I will cause a Notice of Availability of the filed document to be served upon the service list to this proceeding by U.S. mail. The service list I will use to serve the Notice of Availability of the filed document is current as of today's date.

Dated October 7, 2008, at San Francisco, California.

/s/ LILLIAN LI
Lillian Li