

Decision **ALTERNATE DRAFT DECISION OF COMMISSIONER PEEVEY**
(Mailed 4/7/2003)**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

Order Instituting Rulemaking to Establish Policies and Cost Recovery Mechanisms for Generation Procurement and Renewable Resource Development.

Rulemaking 01-10-024
(Filed October 25, 2001)

**SOUTHERN CALIFORNIA EDISON COMPANY'S FEBRUARY 3, 2003
PETITION FOR MODIFICATION OF DECISION 02-12-074****Summary**

In this decision, we grant in large part Southern California Edison Company's (SCE) February 3, 2002 Petition for Modification of Decision (D.) 02-12-074. The requested relief we grant is to (1) suspend Standards of Conduct 6 and 7 for all transactions under the respondent utilities short-term 2003 procurement plans; (2) specify for SCE a dollar amount for the disallowance cap under Standard of Conduct 4; (3) provide additional descriptive language for SCE on the operation of our adopted Consumer Risk Tolerance (CRT) protocol that clarifies SCE can enter longer term forward energy, gas, and other procurement hedges that are necessary to serve expected load, mitigate anticipated power conditions, and/or take advantage of cost-effective market opportunities; and (4) modify the standard for negotiated bilateral contracts for transactions less than 31 days in advance of need or for products less than one calendar month in duration.

In all other respects, SCE's petition is denied.

I. Background

On February 3, 2003, SCE filed a Petition for Modification of D.02-12-074. In its petition, SCE requests six changes to the rules established by the Commission to govern SCE's, Pacific Gas and Electric Company's (PG&E) and San Diego Gas & Electric Company's (SDG&E), 2003 short-term procurement plans. These requested changes are:

- Specifically establish the disallowance cap provided in Ordering Paragraph 25 at \$35 million for SCE and specify that the cap should be applied to the reasonableness of the Investor Owned Utilities' (IOU) compliance with their filed procurement plans, in addition to reasonableness of contract administration and least-cost dispatch;
- Delete Standard of Conduct 6 (SOC6), which requires that procurement contracts be subject to Commission modification;
- Delete Standard of Conduct 7 (SOC7), which requires that suppliers submit themselves to the Commission's discovery requests;
- Eliminate the Consumer Risk Tolerance protocol in its entirety, or in the alternative, modify it;
- Modify Ordering Paragraph 25, by inserting the clause "Notwithstanding Conclusion of Law 6," at the beginning; and
- Eliminate the unworkable and unattainable "strong showing" standard for rate recovery of bilateral contract transaction costs, and instead adopt the up-front, achievable standards proposed in SCE's November 12, 2002 Procurement Plan for these transactions.

On February 7, 2003, SCE filed a Motion for Expedited Consideration of its February 3, 2003 Petition for Modification. The Office of Ratepayer Advocates (ORA) filed an opposition to SCE's motion on February 10, 2003, requesting that the time for parties responses to the petition for modification be shortened only

to February 21, 2003. ORA's request was granted by electronic ruling on February 13, 2003. ORA did not file a response.

On March 5, 2003, The Utility Reform Network (TURN) and The Natural Resources Defense Council (NRDC) filed a response that generally supports most of SCE's requests. On April 1, 2003, TURN filed a Motion for Acceptance of Late Filing stating the attorney preparing the March 5 response was not aware the time for response was shortened, SCE is not prejudiced by the late filing and no party has complained. For good cause shown, we grant TURN's motion.

II. Discussion

1. Disallowance Cap

SCE asserts that the total level of the disallowance cap and the costs to which it applies must be clarified in order to provide certainty to the investment community and the respondent utilities. By providing SCE's requested clarification, it states the Commission will foster SCE's creditworthiness, thereby reducing the costs borne by its customers.

SCE's request is two-fold. First, it requests that the Commission establish a dollar level for the maximum annual potential disallowance for violation of Standard of Conduct 4 (SOC4). Ordering Paragraph 25 of D.02-12-074 states:

"We set an annual maximum potential disallowance for violation of standard #4 at twice each utility's annual expenditures on all procurement activities. Setting this maximum amount supercedes, to the extent that it is not consistent with, any decision on DWR and utility operation agreement or orders issued in this docket."

SCE requests that the Commission determine that its annual expenditures on all procurement activities are \$18.4 million, the amount included in its 2003 General Rate Case for the Energy Supply and Management Department (ES&M).

SCE states that this amount is based on recorded data for 1996 through 2000, adjusted for the fact that many of the energy procurement responsibilities currently being performed by the California Department of Water Resources (DWR) will be assumed by ES&M personnel. SCE asserts that with the exception of Demand Side Management (DSM) programs, all procurement related activities are included within this category. Further, it states that while a substantial portion of the \$18.4 million will be dedicated to SCE's resumption of procurement responsibilities, not all of these funds are attributable to those responsibilities. Doubling the ES&M filed amount results in a disallowance cap for 2003 of \$35 million for SCE. SCE requests that Ordering Paragraph 25 be modified to state the maximum disallowance cap for SCE is \$35 million.

TURN states that while it does not support the concept of a disallowance cap in the first place, for the purposes of violations of SOC4 it finds it makes sense that the magnitude of the cap be clear and unambiguous. It does not endorse any specific figure for this purpose.

We find that it is reasonable to adopt a specific dollar figure for the disallowance cap for violations of SOC4 and that SCE's proposal of a \$35 million figure for its cap is reasonable. This approach provides regulatory certainty as to the magnitude of the cap. Therefore, we adopt this modification. If PG&E or SDG&E prefer a specific dollar figure for their disallowance cap, they should file an individual or joint petition.

SCE's second request for modification of the disallowance cap established in D.02-12-074 is to expand the scope of the disallowance cap beyond the prudence of contract administration and least-cost dispatch covered under SOC4 to include all procurement activities undertaken. Thus, all procurement transactions found to be in noncompliance with its adopted procurement plan

would be bound by the \$35 million disallowance cap, unless SCE is found grossly negligent or to have engaged in willful misconduct related to the transactions. SCE states this modification will provide a direct benefit to its customers as it will provide further certainty to the investment community, thereby reducing its cost of debt and overall cost of capital.

TURN does not support the expansion of the cap to apply to an even larger range of utility activities. It states ratepayers should not be forced to bear unreasonably incurred costs simply to improve the utility's credit status and questions whether it would even be lawful for the Commission to allow unreasonable costs to be included in a utility's rates. NRDC does not take a position on this issue.

We find SCE's second request troublesome. The ordering language it proposes is: "To provide certainty to the utilities and the investment community, it is reasonable to adopt a maximum amount of potential disallowance for all procurement-related activities of \$35 million for SCE." We calculate that SCE could spend \$5.6 billion on procurement dollars activities, based on its estimates of its 2002 generation revenues, excluding DWR revenues.¹ Ratepayers would be at risk to potentially pay this amount for procurement transactions not in compliance with the up-front standards or approved products adopted in D.02-12-074.² This would violate the legislative mandate of Assembly Bill

¹ See SCE's 7/29/02 Opening Brief, page 84, footnote 208. Another method of calculating the amount at risk would be to look at SCE's estimated residual net short position for 2003 and its authorization to sign contracts for up to five years in term. The dollar impact of this could be potentially higher.

² SCE proposes that all transactions that are not in compliance with its approved plan and further, are found to be unreasonable, be covered under this disallowance cap.

Footnote continued on next page

(AB) 57 (Stats. 2002, Ch. 835), as codified in Pub. Util. Code § 454.5, to include the requirement in § 454.5(b)(7) for upfront standards and criteria by which the acceptability and eligibility for rate recovery are established. We find it reasonable to apply the disallowance to cap to SCE's total procurement less utility retained generation. We deny SCE's request to expand the scope of the disallowance cap.

2. Standards of Conduct 6 and 7

SCE requests that the Commission delete Standards of Conduct 6 and 7 because it precludes its ability to successfully negotiate and execute power transactions with a significant majority of potential suppliers who refuse to enter agreements that contain the language of SOC6 and/or SOC7; if the Commission does not grant this relief, SCE requests at a minimum we at least carve out an exemption for tariff contracts that are governed by tariffs.

SOC6 requires that utility procurement contracts with terms between 12 and 60 months contain a provision stating "in the event of statutory or federal regulatory changes, this contract shall be subject to such changes or modifications as the Commission may direct."

SOC7 states that "all parties to a procurement contract must agree to give the Commission and its staff reasonable access to information within seven working days, unless otherwise practical, regarding compliance with (the Commission's) standards." In D.02-12-080, the Commission suspended the

(2/3/03 petition, page 7.) The only transactions this would not apply to are those where the Commission finds SCE acted "grossly negligent and engaged in willful misconduct." This language conflicts with SOC5: The utilities shall not engage in fraud, abuse, negligence, or gross incompetence in negotiating procurement transactions or administering contracts and generation resources.

requirement to include SOC7 in contracts for first quarter 2003 transactions and then, in response to an emergency petition from PG&E, we suspended SOC7 through the first quarter of 2004 in D.03-02-034. SCE states that while the Commission has narrowed and clarified both standards, they remain vague. However, even with further revision, SCE asserts that counterparties will continue to find the standards of conduct unacceptable.

TURN and NRDC state they understand and appreciate the concerns that prompted the Commission to establish these two standards. Unfortunately, in today's environment, where many of these suppliers are currently involved in litigation with the Commission or other agencies, these provisions are commercially unacceptable to market participants. Further, while TURN and NRDC would like to be able to suggest alternative language that would stand the test of commercial practicality, they have not been able to come up with any. Therefore, until commercially acceptable alternative language can be developed, TURN and NRDC support removal of the standards.

When the Commission first adopted SOC6 and SOC7 in October 2002, we stated:

“The abuses of energy companies during California's energy crisis are still being uncovered and investigated. The magnitude of these abuses clearly affirms the need for strong standards and vigilant oversight of energy procurement practices and the need for the Commission to investigate and act at any time if standards are violated.” (D.02-10-062, p. 50.)³

³ On March 26, 2003, the Federal Energy Regulatory Commission announced that its two-year investigation had established that there was widespread market manipulation by energy traders during the California energy crisis.

Since D.02-10-062, we have tried in three decisions to narrow the standards in a manner that would be commercially acceptable to suppliers. Neither SCE, TURN or NRDC can suggest alternative language that would be commercially acceptable. We have an opportunity to re-examine this issue in the upcoming procurement hearings. Therefore, it is reasonable to suspend SOC6 and SOC7 for remaining transactions under the respondent utilities short-term 2003 procurement plans and look to the long-term procurement plans, where purchase power agreements for terms up to 20 years will be at issue, to further explore alternatives. Since SOC6 and SOC7 are commercially unacceptable to the majority of energy suppliers, we encourage them to propose alternative language and/or mechanisms to fully address our concerns.

3. Consumer Risk Tolerance Mechanism

SCE states that the practical effect of the Consumer Risk Tolerance (CRT) protocol is to eliminate its ability to execute forward transactions and the CRT protocol is in direct conflict with D.02-12-069 because it prevents SCE from entering into the necessary forward hedges to manage the gas price risk of the DWR contracts it administers. It requests that the Commission modify D.02-12-074 to either eliminate the CRT protocol or, in the alternative, to have it only apply to contracts for delivery of power in excess of one year. SCE provides illustrative examples of its assertions in the confidential version of its petition.

TURN and NRDC state that the concept of customer risk tolerance is an important factor in a rational risk management strategy. The specific CRT level adopted by the Commission in D.02-12-074 was proposed by TURN. However, there has been considerable confusion surrounding the implementation of this mechanism and TURN notes that each of the three utilities has interpreted the provision very differently. TURN supports SCE's alternative recommendation to

modify the CRT to state that it should not be interpreted in such a way as to bar the utilities from entering into forward transactions that are necessary to serve expected load or mitigate anticipated surplus power conditions up to one year from the date of the transaction. TURN states this proposal is entirely consistent with what it had originally intended by the CRT proposal adopted in D.02-12-074.

The Commission's Energy Division staff have reviewed the manner in which each utility applies the CRT protocol and found that SCE is misinterpreting how the CRT protocol should be applied. The misinterpretation appears to arise from SCE not having access to the confidential evidence the Commission relied on in adopting this mechanism. Staff has explained their findings to the utility and we here provide a detailed explanation of how to apply the mechanism in a revised confidential Appendix B to D.02-12-074 (this appendix modifies SCE's short-term procurement plan for 2003).

The clarification we provide gives SCE the flexibility to enter longer term forward energy, gas, and other procurement hedges that are necessary to serve expected load, mitigate anticipated power conditions, and/or take advantage of cost-effective market opportunities. The Commission will be looking further at risk management tools in the upcoming Energy Division workshop on Measures of Portfolio Risk Exposure to be scheduled for April 2003 and in this summer's procurement hearings.

Our revision to Appendix B of D.02-12-074 is filed under seal and subject to the May 1, 2002 protective order governing access to and the use of all protected materials. Utilities are not authorized access to each others' appendices. SCE should obtain a copy of its appendix from Chief Administrative Law Judge (ALJ) Angela Minkin, or her designee, and is

responsible for providing copies to all individuals authorized to receive this material within two days of the release of the draft decision for comment.

4. Ordering Paragraph 25

SCE asserts that Ordering Paragraph (OP) 25 of D.02-12-074 contradicts Conclusion of Law (COL) 6 of the same decision because OP 25 provides that the disallowance cap adopted supercedes the provisions of the DWR and Utility Operating Agreements, while COL 6 makes it clear that to the extent the procurement plans conflict with the procedures adopted in the DWR/Utility Servicing Agreements and Operating Agreements, the Servicing and Operating Agreements govern. The language at issue is:

“6. Nothing in the approved procurement plans should be contrary to the procedures adopted in the DWR/utility servicing agreements and operating agreements and the underlying decisions adopting those agreements. To the extent any material in the procurement plans filed by the respondent utilities is contrary to the referenced agreements and decisions, those sections are not approved here.”

* * *

“25. We set an annual maximum potential disallowance for violation of standard #4 at twice each utility’s annual expenditures on all procurement activities. Setting this maximum amount supercedes, to the extent that it is not consistent with, any decision on DWR and utility operating agreements or orders issued in this docket.”

TURN and NRDC state that they do not see a conflict between OP 25 and COL 6 because they address different subjects, and do not support SCE’s request on this issue.

We also do not find a conflict between OP 25 and COL 6. COL 6 makes clear that nothing in the adopted procurement plans should be implemented in a

manner that is contrary to the provisions adopted in the DWR/utility servicing agreements and operating agreements and the underlying decisions adopting those agreements. The reason this clarification is given in COL 6 is that the Commission moved in an expedited and simultaneous manner to review and adopt the procurement plans and operating orders. This is different from OP 25, where the Commission makes a policy decision that was not addressed in the procurement plans. Finding no conflict between COL 6 and OP 25, we therefore deny SCE's requested modification.

5. Standard for Bilateral Contracts

SCE requests that the Commission modify D.02-12-074 to remove the upfront standard it adopted for negotiated bilateral contracts because it is unachievable and, instead, adopt SCE's proposed standard for negotiated bilaterals from its November 12, 2003 Modified Short-Term Procurement Plan as an alternative to the current standard.⁴

D.02-12-074 requires that the utilities demonstrate through a "strong showing" that bilateral transactions represent a reasonable approximation of what a transparent competitive market would produce. Further, this "strong showing" can be met by a "comparison to Requests for Offers (RFOs) completed within one month of the transaction." SCE states this standard is impractical given the dozens of system balancing transactions it enters into every day at different times of the day for different (non-standard) blocks of hours for delivery in the near-term. According to SCE, direct bilateral contacting is the only way for an IOU to obtain or sell these types of short-term, non-standard

⁴ The Commission in D.02-12-074 found this proposal insufficient.

products from the marketplace and that a transparent competitive market for such products does not exist.

TURN and NRDC offer a middle ground on this issue. They are sympathetic to SCE's problem with applying the standard to short-term specialized products that it must purchase (or sell) on a daily basis to keep its system in balance. However, they also understand why the Commission found SCE's original "standards and criteria" so vague as to represent no standard at all. TURN proposes the following: to eliminate the "strong showing" standard only for transactions less than 31 days in advance of need or for products less than one calendar month in duration.

Given the difficulties encountered by SCE for the specific transactions discussed, we find that it is reasonable to waive the strong showing standard for negotiated bilaterals for non-standard products procured less than 31 days in advance of need and for non-standard products with terms less than 31 days. For these transactions the utilities should have flexibility to demonstrate that the transactions are priced competitively, including showing competing price offers, results of market surveys, broker and online quotes, and/or other sources of price information such as published indices, historical price information for similar time blocks, and comparison to RFOs completed within one month of the transaction.

We maintain the strong showing standard for negotiated bilaterals for transactions of products executed more than 31 days in advance of need and longer than 31 days in duration. In instances where it is known that non-standard energy products are needed to serve load on a forward and recurring basis in advance of short-term system balancing, we strongly encourage the utilities to transact for such products using an RFO process.

III. Assignment of Proceeding

Michael R. Peevey is the Assigned Commissioner and Christine M. Walwyn is the assigned ALJ in this proceeding.

IV. Reduction of Time for Comments on the Alternate Draft Decision

Pursuant to the Commission's Rules of Practice and Procedure, we determine that the public necessity requires waiver of the 30-day period for public review and comment because failure to adopt a final decision by the Commission's April 17, 2003 agenda meeting could cause SCE to delay entering into necessary forward energy and gas hedges. Interested parties shall file comments by April 11, 2003, and reply comments by April 14, 2003.

Findings of Fact

1. It is reasonable to adopt a specific dollar figure for the disallowance cap for violations of SOC4 in Ordering Paragraph 25 and Edison's proposal of \$35 million for its cap is reasonable.
2. SCE's request to expand the disallowance cap established in D.02-12-074 to include all procurement activities would put its customers at extreme risk.
3. Standards of Conduct 6 and 7 are commercially unacceptable to a significant majority of energy suppliers and SCE and TURN state they are unable to offer alternative language that would be acceptable.
4. Confidential Appendix B of D.02-12-074 should be modified in order to provide SCE a detailed explanation of how to apply the CRT protocol adopted by the Commission.
5. Given the difficulties encountered by SCE for specific transactions, we should waive the strong showing standard for negotiated bilateral contracts for

non-standard products procured less than 31 days in advance of need and for non-standard products with terms less than 31 days.

Conclusions of Law

1. SCE's request to expand the disallowance cap established in D.02-12-074 to include all procurement activities violates the legislative mandate of Assembly Bill 57, as codified in Pub. Util. Code § 454.5.
2. The Commission should adopt alternative language or proposals to Standards of Conduct 6 and 7 in the utilities' long-term procurement plans. With this matter scheduled for resolution by the end of 2003, it is reasonable to suspend Standards of Conduct 6 and 7 for all transactions under the utilities adopted 2003 short-term procurement plans.
3. There is no conflict between D.02-12-074's Ordering Paragraph 25 and Conclusion of Law 6.
 4. Pursuant to Rule 77.7(f)(9) we reduce the period for public review and comment due to public necessity.

O R D E R

IT IS ORDERED that:

1. The Utility Reform Network's April 1, 2003 Motion for Acceptance of Filing is granted.
2. The February 3, 2003 Petition for Modification of Decision (D.) 02-12-074 filed by Southern California Edison Company (SCE) is granted in part.
3. D.02-12-074 is modified as follows:
 - a. Ordering Paragraph 25 is modified to read: We set an annual maximum potential disallowance for violation of Standard #4 at twice each utility's annual expenditures on all procurement activities. For SCE this amount is \$35

million based on its 2003 General Rate Case request for \$18.4 million in administrative and general expenses for the Energy Supply and Management Department. Setting this maximum amount supercedes, to the extent that it is not consistent with, any decision on Department of Water Resources and utility operating agreements or orders issued in this docket.

- b. Standards of Conduct 6 and 7 are suspended for all transactions under the respondent utilities' 2003 short-term procurement plans.
- c. Appendix B should be modified to provide SCE a detailed explanation of how to apply the Consumer Risk Tolerance protocol adopted for the three utilities. A revised Appendix B is filed under separate seal.
- d. We waive the strong showing standard for negotiated bilateral contracts for non-standard products procured less than 31 days in advance of need and for non-standard products with terms less than 31 days. For these transactions, the utilities should have flexibility to demonstrate that the transactions are priced competitively, including showing competing price offers, results of market surveys, broker and online quotes, and/or other sources of price information such as published indices, historical price information for similar time blocks, and comparison to RFOs completed within one month of the transaction. We retain the strong showing standard for all other bilateral transactions.

4. In all other respects, SCE's February 3, 2003 Petition for Modification of D.02-12-074 is denied.

This order is effective today.

Dated _____, at San Francisco, California.