PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

I. D. #5552

ENERGY DIVISION **RESOLUTION E-3988**

May 11, 2006

R E S O L U T I O N

Resolution E-3988. San Diego Gas & Electric Company (SDG&E) submits an Advice Letter (AL) requesting approval for an updated revenue requirement associated with the purchase and operation of the Palomar Generation Facility, which includes modifications to SDG&E's Non-fuel Generation Balancing Account (NGBA) and Energy Resource Recovery Account (ERRA). SDG&E's request is approved.

By Advice Letter 1778-E Filed on February 28, 2006.

SUMMARY

San Diego Gas and Electric Company's (SDG&E) request to update the monthly revenue requirement (RRQ) associated with the Turnkey Acquisition Agreement (TAA) for the Palomar Generation Facility (Palomar), while modifying their Non-Fuel Generation Balancing Account (NGBA) and Energy Resource Recovery Account (ERRA) is approved:

- SDG&E's request for a fixed monthly RRQ of $7, 482,300 is approved, subject to final adjustment through the advice letter (AL) process within sixty (60) days of assuming commercial operation.
- SDG&E's request for a variable operations and maintenance (O&M) rate of $3.09 per Megawatt Hour (MWh) is approved, subject to final adjustment through the AL process within sixty (60) days of assuming commercial operation.
- SDG&E shall update the Palomar RRQ, variable O&M rate, and any other costs in the next General Rate Case (GRC) Proceeding.
- The Preliminary Statement for the ERRA is modified to reflect rewards or penalties associated with the adopted heat rate incentive authorized for Palomar for recovery in commodity rates, and to record "imputed franchise fees" paid to the city of Escondido on gas delivered to Palomar, for recovery in commodity rates, as authorized in D.04-06-011.

- The Preliminary Statement for the NGBA is modified to reflect recorded over- or undercollections of the authorized fixed RRQ and variable O&M fuel costs, along with any Palomar-related reliability must run (RMR) revenues received from the California Independent System Operator (CAISO), to offset commodity costs.
- Authorizes SDG&E to submit an AL to finalize Palomar's costs consistent with completion provisions of the TAA, subject to Commission review and resolution, upon the date of ownership transfer.

All of the requests in AL 1778-E are in compliance with D.04-06-011, D.05-08-005, or D.05-12-043.

SDG&E Advice Letter 1778-E was not protested.

BACKGROUND

In D.04-06-011, the Commission approved the Palomar TAA as one of five proposals to meet SDG&E's short- and long-term grid reliability needs. This resolution addresses SDG&E's updated RRQ and associated issues in compliance with D.04-06-011, D.05-08-005, and D.05-12-043.

SDG&E executed an agreement with Palomar Energy (a subsidiary of Sempra Energy Resources) on January 29, 2004, to purchase a 500 MW (base load)/550 MW (peaking load) combined cycle natural gas-fired generation plant located in Escondido, CA, with final ownership to take place no later than June 1, 2006. The agreement adopted on June 9, 2004 in D.04-06-011 provides for SDG&E to assume care, custody and control, and risk of loss under the TAA upon closing.

With the exception of authorizing SDG&E cost recovery for Palomar and setting its return on equity (ROE) for generation-owned assets in D.04-06-011 at 10.90% "until modified by further action of the Commission", the process of establishing final cost and resulting RRQ required a separate application and proceeding for the Palomar acquisition, resulting in A.04-11-003.

On November 1, 2004, SDG&E submitted A.04-11-003 to request ratemaking mechanisms necessary to allow it to recover costs of acquiring, owning, and operating Palomar.

In A.04-11-003, SDG&E requested (1) a fixed monthly revenue requirement of $7,600,100, subject to update prior to taking effect on the first month of commercial operation, (2) a variable O&M rate of $3.08 per MWh, subject to update, and (3) a cost recovery plan allowing reset of the RRQ and variable O&M rate in SDG&E's next GRC proceeding.

SDG&E cost analysis testimony also requested an ROE for investment cost recovery of 10.90%. The testimony also requested a 23.3% "loader" (a fixed overhead cost that cannot be directly assigned to a particular cost area, such as salaries and wages for non-union employees, and a -8% net salvage rate for the Palomar steam generation unit for depreciation costs, as inputs to be used in calculating the RRQ.

On August 25, 2005, the Commission issued D.05-08-005, approving SDG&E's request with modifications.

D.05-08-005 required SDG&E to file an AL no later than 30 days prior to the expected date of operation of the Palomar Energy Center, to implement a RRQ pursuant to D.04-06-011. O.P. 3 of D.05-08-005 specified that this AL shall modify Schedule EECC, Reliability Service rates, the ERRA account, and make changes to any other regulatory accounts that are required, effective on the expected operation date of Palomar Energy Center, subject to Energy Division determining that it is in compliance with this order.

O.P. 2 of D.05-08-005 stated "SDG&E will update in the advice letter (1) the fixed monthly revenue requirement to reflect the return on equity then in effect (2) the fixed monthly revenue requirement to reflect an 18.0% loader for non-union employees, and (3) the fixed monthly revenue requirement to reflect a negative 3.5% net salvage rate for the steam generator."

In approving Palomar's monthly RRQ and variable O&M rate for 2006 and 2007, Finding of Fact (FOF) 6 in D.05-08-005 stated "The fixed monthly revenue requirement and variable O&M rate would be reset in SDG&E's next GRC or COS proceeding, projected to occur in 2008".

On February 28, 2006, SDG&E submitted AL 1778-E, in anticipation of assuming commercial operation of Palomar "on or about" March 30, 2006. SDG&E requested an updated monthly RRQ of $7,482,300, and a variable O&M rate of $3.09 per MWh.

The fixed monthly RRQ (decreasing from $7,600,100 to $7,482,300) reflected adjustments due to the addition of various capital investment and maintenance cost items identified in the TAA, categorized by updated (1) purchase price; (2) fixed and variable O&M and capital escalation; (3) cost of capital; and (4) labor and depreciation cost input factors. The updated RRQ calculation also reflects a commercial operation date of March 30, 2006, in contrast with the previously forecasted June 1, 2006 in service date.

The slight increase in the variable O&M non-fuel rate (increasing from $3.08 to $3.09 per MWh) resulted from an update to variable O&M cost component, forecast generation and escalation factor percentages.

NOTICE

Notice of AL 1778-E was made by publication in the Commission's Daily Calendar. SDG&E states that a copy of the Advice Letter was mailed and distributed in accordance with Section III-G of General Order 96-A.

PROTESTS

No protests were received regarding SDG&E Advice Letter 1778-E.

DISCUSSION

Energy Division has reviewed AL 1778-E. We follow with discussion of the relevant facts that lead to our approval of this advice letter:

The TAA and testimony provided in A.04-11-003 described components of the base purchase price of Palomar, negotiated between SDG&E and Palomar Energy.

The base purchase price in the TAA includes (1) the sale assets; (2) the cost of Palomar's compliance with governmental approvals prior to the closing date; (3) the cost of consumables (lube oil, chemicals, etc.) required through the acceptance date other than (i) the cost of natural gas and (ii) the cost of "backfeed" electrical power for start-up and testing as modified by the TAA; (4) facility operation and maintenance training for personnel; (5) tools and items

normally included with the purchase of equipment from suppliers; and (6) sales taxes associated with work performed by contractors and suppliers.

The TAA provides for the base purchase price of Palomar to be subject to adjustment for certain items as of the commercial operation date.

The adjustments to the base purchase price in the TAA include (1) interest costs accrued from beginning of construction through the purchase date; (2) facility site property taxes through the purchase date; (3) sales, transfer or other taxes (e.g. documentary transfer taxes) associated with SDG&E's purchase; (4) delay and/or performance shortfall rebates or performance bonus payments; (5) approved change orders (e.g. purchase of spare parts, facilities, and/or supplies; (6) reimbursement to SDG&E for spare parts drawn from SDG&E's inventory; (7) the cost of natural gas (including transportation and imbalance charges) and backfeed power used during Palomar's start-up and testing that is in excess of revenues generated from the sale of Palomar electricity, less any sales, excise, net proceeds or other taxes (other than income taxes) on such net proceeds, and (8) adjustments resulting from the prorations of expenses affecting sales assets that are customarily prorated, such as utility charges, leases, insurance premiums, and fees related to governmental approvals.

D.04-06-011 approved the contract for SDG&E's purchase of the Palomar facility. The Decision also deferred SDG&E's request to increase its ROE for new generation assets to a cost of capital (COC) proceeding.

O.P. 6 of D.04-06-011 stated "SDG&E may execute the contract with Palomar and is authorized to recover the costs of this generation-owned asset through the established 10.90 ROE." Conclusion of Law (COL) 7 stated "SDG&E's request for a 75-basis point premium for….Palomar to increase the ROE for new generation assets is deferred to a cost of capital proceeding."

The base purchase price and contract was approved for capitalization and inclusion in SDG&E's rate base at $410,149,000, subject to adjustments, as provided for in the TAA and described above. After adjustments in the base purchase price, the purchase was approved for $484,343,000 in rate base, subject to update through the AL process.

D.05-12-043 authorized SDG&E's currently existing capital ratio, and authorized a rate of return (ROR) and weighted average COC of 8.23%.

D.05-12-043 was issued on December 15, 2005, and authorized a weighted average COC of 8.23%. The capital structure consists of common stock (equity), long-term debt, and preferred stock (debt) components, each of which is worth a certain percentage, or capital ratio, of a utility's total capital value. The overall ROR and corresponding COC equals the weighted average percentage return on a utility's capital resulting from the proportionate value (capital ratio) of long-term debt, preferred stock (from which ROE is measured), and common stock components and their respective percentage returns, which results in a weighted average ROR.

In AL 1778-E, SDG&E submitted updated escalation factors used in calculating the Palomar RRQ, to convert estimated 2004 expenses to 2006 and 2007 dollars.

SDG&E updated previously approved escalation factors that were used in calculating the monthly RRQ and variable O&M costs; these were incorporated in AL 1778-E to calculate 2006 and 2007 costs based on 2004 dollars. The original escalation factors were based on second quarter 2004 forecasts, and have been replaced with third quarter 2005 forecasts.

In AL 1778-E, SDG&E submitted an updated total rate base purchase price of $496,122,000, accounting for an $11,799,000 increase in base purchase and other rate base cost adjustments, to be incorporated in the final Palomar purchase price.

SDG&E filed for a total rate base of $484,343,000 in A.04-11-003; the resulting D.04-06-011 approved SDG&E's purchase of Palomar. The approved TAA provides for adjustments to the base purchase price as of the date SDG&E assumes operation of Palomar. SDG&E submitted a list of the requested adjustments in AL 1778-E.

The Commission has reviewed this list, which includes the aforementioned (1) changes in interest cost; (2) property taxes; (3) sales and transfer taxes; (4) delay/performance rebates or bonus payments; (5) approved change orders; (6) spare parts reimbursements to SDG&E; (7) the cost of natural gas and backfeed power used during start-up and testing; and (8) proration adjustments.

SDG&E included a discussion of these items along with an itemized tabulation of the estimated cost increase. Energy Division reviewed and confirmed this data.

The Commission finds that these adjustments in SDG&E's Palomar rate base should be allowed, subject to final adjustment through the advice letter (AL) process within sixty (60) days of assuming commercial operation.

In AL 1778-E, SDG&E requested an updated and reduced monthly fixed RRQ of $7,482,300.

Palomar's updated fixed monthly RRQ (excluding fuel and variable O&M costs) declined by approximately 1.5%, resulting from a combination of (1) lower fixed cost components, and (2) a reduced ROR of 8.23%.

In AL 1778-E SDG&E incorporated, as ordered in O.P. 3 of D.05-12-043 and O.P. 2 of D.05-08-005 (1) the respectively reduced ROE and ROR of 10.70% and 8.23%; (2) updated escalation factors; (3) updated labor and depreciation costs; and (4) an updated rate base purchase price in its 2006-2007 Palomar RRQ calculation.

In Advice Letter 1778-E, SDG&E updated and requested approval of O&M costs at $3.09 per MWh, a slight increase compared to the testimony provided in A.04-11-03, which showed variable O&M costs at $3.08 per MWh.

Variable O&M costs consist of the following materials and services: recycled water, contract service agreement, contingency for unplanned maintenance, consumables, and catalyst replacement. The updated total forecasted cost of these components (including escalation factors) was divided by the updated forecasted generated MWh output to arrive at an average variable O&M cost of $3.09 per MWh. Energy Division has reviewed the justifications for these costs, and the methodologies used in calculating, assigning and characterizing these costs as variable O&M, and confirms that these are normal materials and services costs incurred in building an electric generating plant. SDG&E is allowed to recover these costs.

SDG&E's original filing assumed a Palomar in-service date of June 1, 2006; the fixed monthly revenue requirement submitted in testimony reflected that date.

In AL 1778-E, SDG&E submitted that Palomar's expected commercial operation date is on or shortly after March 30, 2006. The fixed monthly revenue requirement has been updated to reflect this new in-service date. Additional data submitted by SDG&E in AL 1778-E demonstrates that utilizing this generation resource approximately two months earlier than anticipated—in place

of currently utilized resources—generates a benefit of over $6,000,000 monthly in fuel, capacity, and interest savings. Energy Division has reviewed and confirmed this data.

In AL 1778-E, SDG&E submitted modifications to the NGBA Preliminary Statement.

The NGBA provides for recovery of approved electric generation non-fuel costs (fixed and variable O&M expenses) that are not recovered by any other component of SDG&E's rates. In compliance with O.P. 3 of D. 05-08-005, SDG&E submitted text updates to the NGBA Preliminary Statement to account for monthly debit entries made (1) equal to 1/12th of the authorized fixed annual generation non-fuel revenue requirement for Palomar, and (2) variable O&M non-fuel costs, calculated by multiplying the variable O&M cost by monthly MWh generation. These commodity costs are offset against the receipt of Palomar-related RMR revenues received from the CAISO.

In AL 1778-E, SDG&E also submitted modifications to the ERRA Preliminary Statement.

The ERRA provides for full recovery of SDG&E's energy procurement costs associated with fuel and purchased power, utility-retained generation (URG), ISO-related costs, and costs associated with its residual net short procurement requirements to serve bundled service customers. The ERRA includes revenues received from SDG&E's Electric Energy Commodity Charge (EECC) adjusted to exclude revenues associated with purchase of California Department of Water Resources (DWR) power.

In compliance with O.P. 3 of D. 05-08-005, SDG&E submitted text updates to the ERRA Preliminary Statement that address changes made to the accounting procedure in the recording of fuel and fuel-related expenses of electric generation: (1) An entry for "in lieu" payments payable to communities where SDG&E-owned power plants are located, (e.g. imputed franchise fees paid to the city of Escondido for gas delivered to Palomar), and (2) an entry to reflect rewards or penalties associated with the adopted heat rate incentive authorized for Palomar by the Commission.

AL 1778-E did not submit modifications to commodity rates in SDG&E's schedule EECC or Reliability Services (RS) rates as ordered in D.05-08-005.

O.P. 3 of D.05-08-005 ordered SDG&E to modify schedule EECC and FERC-jurisdictional RS rates in its compliance advice letter. O.P. 2 in D.06-02-018 recently adopted SDG&E's 2006 ERRA RRQ, and authorized SDG&E to combine into one advice letter filing its (1) 2006 ERRA RRQ with (2) other authorized revenue requirements currently being addressed in other proceedings. The ERRA includes revenues received from SDG&E's EECC; in compliance with D.06-02-018, SDG&E plans to update 2006 EECC commodity rates when the advice letter which also updates 2006 ERRA rates is filed.

RS rates are FERC-jurisdictional, and the cost of RMR-related energy should be recovered through the RS rate component. SDG&E stated in AL 1778-E that RS rates have already been updated to reflect the 2006 RS RRQ, effective January 1, 2006 through SDG&E AL 1740-E.

The Commission will allow SDG&E to file updated schedule EECC rates in compliance with D.06-02-018; the Commission also observes that RS rates were already updated to reflect the 2006 RS RRQ on January 1, 2006.

SDG&E identified several cost items that cannot be finalized until the date they assume commercial operation of Palomar. SDG&E requests authorization to file a future AL to finalize these costs.

D.05-08-005 orders SDG&E to update Palomar's fixed monthly RRQ to reflect (1) the ROE (and resulting ROR) then in effect, (2) an 18% loader for non-union employees, and (3) a negative 3.5% net salvage rate for the steam generator by advice letter "no later than 30 days prior to the expected date of operation". Embedded within the monthly revenue requirement is the ROR component (calculated by multiplying the ROR percentage by the total dollar value of the rate base). Palomar's final rate base (capitalized) costs may have an incremental effect on the initial total rate base value, resulting in an incremental change in the RRQ.

SDG&E has identified several cost items (e.g. change orders to facilities, interest and property tax during construction, transfer taxes, delay and/or performance rebates, start-up and testing, etc.) that cannot be finalized until the date it assumes operation of Palomar; final costs may not be available for up to two months after completion. An estimate of final costs at $496,122,000 was provided in AL 1778-E. Accordingly, SDG&E requested authorization to submit an AL

with final costs "consistent with final completion provisions of the TAA for the Palomar facility".

SDG&E should be allowed to submit an AL, providing an update of base purchase price adjustments resulting in the final cost of Palomar's rate base, and the updated RRQ and/or the variable O&M rate, subject to Energy Division review.

Based on Energy Division's review of SDG&E's AL 1778-E and supporting documentation, we expect the changes that SDG&E submits in its future update will be minor. If these changes are minor as we expect, and if SDG&E develops the updated RRQ and the variable O&M rate in a manner consistent with how it developed the Palomar RRQ and variable O&M rate presented in AL 1778-E that we adopt today, then the future update advice letter may be subject to staff disposition pursuant to Rule 4.7 appended to D.05-01-032.

COMMENTS

Public Utilities Code section 311(g)(1) provides that this resolution must be served on all parties and subject to at least 30 days public review and comment prior to a vote of the Commission. Section 311(g)(2) provides that this 30-day period may be reduced or waived upon the stipulation of all parties in the proceeding.

The 30-day comment period for the draft of this resolution was neither waived or reduced. Accordingly, this draft resolution was mailed for comments.

FINDINGS

1. O.P. 6 of D.04-06-011 authorized SDG&E to execute a contract to purchase Palomar and recover costs based on an established ROE of 10.90%, subject to future COC proceeding adjustments.
2. O.P. 7 of D.04-06-011 deferred SDG&E's request to increase the ROE for new generation facilities by a 75-basis point premium to a future COC proceeding.
3. A separate proceeding was required to address the revenue requirement and associated cost recovery issues and proposals for Palomar.
4. SDG&E filed A.04-11-003 to present cost recovery proposals effective the first month SDG&E commercially operates Palomar, regarding (1) revenue

requirement, (2) a per-MWh variable O&M maintenance charge, and (3) an overall cost recovery regulatory plan addressing the length of time these costs would be in effect, the balancing accounts in which revenues and expenses will be accumulated, and the manner in which additional items such as fuel costs, heat rate incentives, RMR revenues, and imputed franchise fee payments to the City of Escondido will be tracked.

5. In response to A. 04-11-003, D.05-08-005 found SDG&E's proposed costs reasonable with specific modifications, and ordered SDG&E to submit an advice letter with an updated fixed monthly RRQ to reflect (1) the ROE (and resulting ROR) then in effect, (2) an 18% loader for non-union employees, and (3) a negative 3.5% net salvage rate for the steam generator no later than 30 days prior to the expected final purchase date of Palomar, effective on the date of SDG&E operation, subject to Energy Division approval.
6. D.05-08-005 also ordered SDG&E to modify Schedule EECC, Reliability Rates, the ERRA account, and any other regulatory account required pursuant to that order.
7. D.05-08-005 authorized future changes to Palomar's fixed monthly RRQ and variable O&M rate to be made in future GRC or COS proceedings.
8. D.05-08-005 approved a base purchase price for Palomar at $484,343,000, subject to update.
9. D.05-08-005 approved a fixed monthly revenue requirement of $7,600,100, subject to update.
10. D.05-08-005 approved a variable O&M rate of $3.08 per MWh, subject to update.
11. D.05-12-043 approved SDG&E's capital structure, and set SDG&E's ROE at 10.70%, and the ROR and resulting COC at 8.23%
12. In compliance with D.04-06-011, D.05-08-005, and D.05-12-043, SDG&E submitted AL 1778-E on February 28, 2006, requesting an updated fixed monthly RRQ and variable O&M rate, and text changes to the ERRA and NGBA tariffs.
13. In AL 1778-E, SDG&E provided an estimate of final costs with resulting RRQ and variable O&M rate, but stated that final costs cannot be provided for up to sixty (60) days after SDG&E assumes operation of Palomar.
14. Schedule EECC was not modified as ordered in D.05-08-005; O.P. 2 in D.06-02-018 allows SDG&E to combine its authorized ERRA RRQ to be filed in combination with other RRQs being addressed in other proceedings. Because the ERRA includes revenues received from schedule EECC, SDG&E should be allowed to modify schedule EECC in the compliance AL that updates the ERRA RRQ.

15. The NGBA is the appropriate balancing account in which to record any first-month under- or overcollection resulting from SDG&E's Palomar commercial operation date, and the corresponding fixed monthly revenue requirement.
16. SDG&E should be allowed to update the base purchase price adjustments resulting in the final cost of Palomar's rate base, and fixed monthly RRQ and variable O&M rate that we adopt today, by filing an AL within 60 days of commercial operation of Palomar.

THEREFORE IT IS ORDERED THAT:

1. SDG&E's request in AL 1778-E for a fixed monthly RRQ of $7,482,300 and variable O&M rate of $3.09 per MWh is approved, effective on the date that SDG&E assumes commercial operation of Palomar.
2. Within sixty (60) days of assuming commercial operation of Palomar, SDG&E shall file an AL providing base purchase price adjustments resulting in the final cost of Palomar's rate base, the fixed monthly RRQ, and the variable O&M rate for Palomar. The AL shall be effective on the date filed, subject to Energy Division review.
3. SDG&E shall request a Palomar RRQ and variable O&M rate to be effective after December 31, 2007, in its next GRC.
4. SDG&E shall reflect changes to Schedule EECC resulting from the Palomar RRQ authorized herein in a future AL in compliance with O.P. 2 in D.06-02-018.

This Resolution is effective today.

I certify that the foregoing resolution was duly introduced, passed and adopted at a conference of the Public Utilities Commission of the State of California held on May 11, 2006; the following Commissioners voting favorably thereon:

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STEVE LARSON
Executive Director