

Decision **ALTERNATE DRAFT DECISION OF COMMISSIONER PEEVEY**

(Mailed 9/4/02)

**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

Application of Pacific Gas and Electric Company for an Order Approving an Amendment to the Power Purchase Agreement for Long-Term Energy and Capacity between Pacific Gas and Electric Company and Gaylord Container Corporation, a Delaware Corporation.

Application 02-01-041  
(Filed January 31, 2002)

**O P I N I O N**

**Summary**

This decision approves Pacific Gas and Electric Company's (PG&E) application for approval of an amendment to the Power Purchase Agreement (PPA) between PG&E and Gaylord Container Corporation (Gaylord).

**Background**

In Decision (D.) 01-06-015 the Commission provided an opportunity for utilities to file voluntary qualifying facility (QF) contract amendments using three standard contract modifications<sup>1</sup> that would be deemed reasonable by the Commission if made prior to July 15, 2001. This date was subsequently extended

---

<sup>1</sup> The contract amendments allow (a) supplemental payments for one year to QFs demonstrating immediate need for such funds in order to continue operations, (b) fixed energy prices for five-years at 5.37 cents/kilowatt-hour (kWh), and (c) incentive payments to QFs for energy produced above normal operating levels.

to July 31, 2001 by D.01-10-069. PG&E states that on July 20, 2001, PG&E and Gaylord, a QF, entered into the first amendment to the PPA that modified the energy price in accordance with the one year option in D.01-06-015. On August 22, 2001, PG&E and Gaylord entered into the second amendment to the PPA that changed the energy price to the five-year fixed price option under D.01-06-015. However, when the “safe harbor”<sup>2</sup> date of July 31, 2001 was not extended by the Commission, the second amendment became a nullity.

On January 31, 2002, PG&E filed Application (A.) 02-01-041 for Commission approval of a Third Amendment to its PPA with Gaylord. PG&E and Gaylord entered into the Third Amendment and an Assumption Agreement on January 16, 2002.<sup>3</sup> The Third Amendment, along with the first and second amendments, is included as an attachment to the application, while the Assumption Agreement is referenced in the application. PG&E states that the Assumption Agreement provides for the assumption of the PPA and an intrastate gas transportation service agreement by PG&E. Furthermore, PG&E states the Assumption Agreement, along with the Third Amendment, resolve certain litigation between Gaylord and PG&E. On February 11, 2002, PG&E made a Supplemental Filing in support of its Application.

The Third Amendment modifies the energy price paid by PG&E to Gaylord and fixes it at 5.37 cents/kWh for a term of 3-1/2 years. PG&E states

---

<sup>2</sup> Safe harbor refers to the date by which D.01-06-015 contract amendments are deemed reasonable. (D.01-10-069, Findings of Fact 3, p.14.)

<sup>3</sup> D.01-10-069 provides utilities an opportunity to negotiate amendments after the safe harbor date (July 31, 2001) that could be approved by the Commission through the filing of a new application.

that if the Commission has not approved the Third Amendment by July 31, 2002, the energy price in the PPA will revert to the Commission's generic short-run avoided cost (SRAC) formula.

The California Cogeneration Council (CCC) filed a response in support of PG&E's application on February 20, 2002. The CCC's response elaborates on why the Third Amendment is reasonable and in the public interest, and provides information on how the Assumption Agreement schedule for the payment of debts owed to Gaylord by PG&E. No other parties have filed responses. On April 15, 2002, the CCC and PG&E filed a Motion For Leave to File Supplemental Information regarding the application<sup>4</sup>. The supplemental information is similar to information requested by ruling in A.02-01-042, and consists of an evaluation by MRW & Associates (MRW), a third-party consultant. The MRW evaluation provides information regarding projected natural gas prices, gas price volatility, Gaylord's contribution to the reliability of the electric grid, and a discussion of the litigation between PG&E and Gaylord. MRW's evaluation estimates that as a result of the 3-1/2 year fixed energy price, ratepayers will pay approximately \$3.0 million more under the Third Amendment<sup>5</sup> than they would pay under current SRAC prices. However, the supplemental information filed by CCC and PG&E did not provide detailed information regarding the litigation issues between PG&E and Gaylord. Accordingly, on May 8, 2002, the Administrative Law Judge (ALJ) requested

---

<sup>4</sup> This motion was unopposed and was granted by ALJ ruling on May 8, 2002.

<sup>5</sup> Calculated on a net present value (NPV) basis using a 10% discount rate over the 3-1/2 year term of the Third Amendment.

further information specifically relating to the potential costs of litigation and the assumptions used in litigation cost calculations.

PG&E responded to the May 8 ruling on May 24, 2002, stating that the settlement of litigation between Gaylord and PG&E is not contingent on the Commission's approval of the Third Amendment to the PPA.

On July 30, 2002, the California Cogeneration Council (CCC) filed a motion for leave to supplement the record. The motion contains a declaration of Glenn Sheeren, Corporate Manager of Energy and Government Relations for Inland Paperboard and Packaging, Inc. (Inland) a wholly owned subsidiary of Temple-Inland, Inc. In the declaration, Mr. Sheeren states that Temple-Inland acquired effective control of Gaylord on April 5, 2002 and assigned operational and management control for Gaylord to Inland. Mr. Sheeren goes on to declare that Inland will shut down the Gaylord paper mill by the end of September. The paper mill serves as the thermal host for the Gaylord cogeneration facility. Gaylord is seeking another thermal host for the facility. If Inland cannot find a feasible alternative, then Inland is expected to shut down the cogeneration facility. CCC's motion to supplement the record is granted.

### **Discussion**

We begin our review by stating that PG&E's application is not a request to permit Gaylord's operation as a QF. Gaylord currently operates as a QF and under the amended contract receives supplemental payments above SRAC prices. Instead, this is an application that requests approval of an amendment to a Power Purchase Agreement for Long-Term Energy and Capacity between a utility (PG&E) and a QF (Gaylord).

PG&E asserts that the Third Amendment and the Assumption Agreement constitute a settlement agreement that provides a fixed energy price, above

projected SRAC energy prices, and other benefits to Gaylord, while providing benefits to PG&E by resolving Gaylord's claims against PG&E. Therefore, we review the application using the Commission's settlement rules as a standard of review. These rules are found in Rules 51 to 51.10 of the Commission's Rules of Practice and Procedure.<sup>6</sup> The settlement rules provide in pertinent part that "the Commission will not approve a stipulation or settlement, whether contested or uncontested, unless the stipulation or settlement is reasonable in light of the whole record, consistent with law and in the public interest."

### **In the Public Interest**

PG&E and Gaylord estimate that the additional \$3.0 million in energy payments under the Third Amendment represents a 10% premium over maintaining current pricing in the PPA. The additional payments result from the differential between the higher energy costs at 5.37 cents/kWh and lower SRAC energy costs forecasts, estimated at 4 to 4.9 cents/kWh. PG&E and CCC argue that in return for these greater energy prices, ratepayers receive an "insurance policy" through market stability by avoiding potentially higher SRAC energy prices as a result of potentially higher gas prices.<sup>7</sup> PG&E and CCC also argue that approval of the application will improve the reliability of the local Bay Area electric grid and decrease the likelihood that Gaylord would cease operations as a QF.

---

<sup>6</sup> All references are to the Commission's Rules of Practice and Procedure unless otherwise noted.

<sup>7</sup> SRAC payments to QFs are based on a formula that includes a gas price index. If the gas price increases, the SRAC payment increases; while lower gas prices reduce SRAC payments.

In assessing these arguments, we believe that market stability is valuable; and, under D.01-06-015, we have previously approved amended contracts using fixed prices for PG&E's QFs. Furthermore, while gas prices might rise in the future, gas prices might also decline; it is not in the best interest of ratepayers to face such uncertainty. Reversion of the contract to SRAC prices places this risk with ratepayers. This uncertainty is removed with the approval of fixed prices in the Amendment to the Purchased Power Agreement before us.

With regard to the continued operation of Gaylord, we are concerned about the continued viability of QFs generally, and the economic and energy system effects when QFs cease operation. Our concern has been expressed in numerous decisions including D.01-03-067 (p. 34) where we ordered utilities to pay QFs on a going forward basis; D.01-06-015 (pp. 4-5) where we provided non-standard amendment opportunities to QFs that were automatically deemed reasonable and in D.01-10-069 (p. 11) where we provided an opportunity for utilities and QFs to continue to negotiate contract amendments after the safe harbor date and apply for our approval through the filing of an application. As noted by PG&E, Gaylord chose one of the options under D.01-06-015 and amended its contract that provides supplemental payments to Gaylord. Although we have taken these actions to help bring stability to the electricity market, utility energy and capacity payments to QFs are defined by the Public Utility Regulatory Policies Act of 1978 (PURPA) and Pub. Util. Code § 390, and using these definitions each QF must determine whether it will operate based on its unique economic circumstances.

PG&E and Gaylord assert that the Third Amendment, along with the Assumption Agreement, will resolve certain litigation between Gaylord and PG&E.

In its response,<sup>8</sup> PG&E states that while the proposed Third Amendment is part of an integrated settlement of litigation between Gaylord and PG&E, “the settlement of the Gaylord litigation is not contingent on the Commission’s approval of the Third Amendment to Gaylord’s PPA.” This statement leads us to conclude that the approval of the Third Amendment is not directly related to litigation costs. Therefore, we must conclude that PG&E’s litigation assumptions and estimate of potential litigation costs are not relevant for purposes of comparison to the premium energy costs in the Third Amendment as provided in PG&E’s April 15, 2002 response.

However, approval of the Third Agreement provides the state of California with the opportunity of maintaining a valuable resource, which will enhance electric grid reliability and mitigate against blackouts. Governor Davis’ proclamation of a State of Emergency due to the energy crisis is still in effect.<sup>9</sup> So far this summer, there has been one Stage 1 Alert and one Stage 2 Alert.<sup>10</sup>

Based on the supplemental information that CCC provided in its motion, it appears that Inland may shut down the Gaylord facility if another thermal host cannot be found. The Gaylord facility will be a more attractive investment for Inland if it finds a new thermal host, and it has a fixed price of 5.37 cents/kWh. It is then much more likely that Inland may keep this valuable

---

<sup>8</sup> Response of PG&E to ALJ’s Ruling Requesting Supplemental Information, filed May 4, 2002.

<sup>9</sup> Proclamation of Governor Gray Davis, January 17, 2001.

<sup>10</sup> A Stage 1 Alert is declared by the Independent System Operator (ISO) when anticipated operating reserves are less than 7%. A Stage 2 Alert is declared by the ISO when anticipated operating reserves are less than 5%.

resource on line. If, however, a thermal host cannot be found, then the Gaylord facility will be shut down, and the issue of the pricing differential is moot. Thus, it is in the ratepayers' interest to take every reasonable effort to provide Inland the opportunity to keep this cogeneration facility operating.

Therefore, approval of this Application is in the public interest.

#### **Consistent with the Law**

Negotiation of QF contract amendments after July 31, 2001 are permitted by D.01-07-031 and reiterated by D.01-10-069 and D.02-01-033.

#### **Reasonable in Light of the Whole Record**

The record shows that Gaylord is a 24 MW gas-fired cogeneration facility that has operated at an average capacity factor of 90%. There were no protests.

#### **Categorization**

In Resolution ALJ 176-3083 dated March 6, 2002, the Commission preliminarily categorized this application as ratesetting, and preliminarily determined that hearings were necessary. No protests have been received. Given this status, public hearing is not necessary and it is necessary to alter the preliminarily determinations made in Resolution ALJ 176-3083 to determine that hearings are not necessary.

#### **Comments on Alternate Decision**

The alternate decision of Commissioner Peevey in this matter was mailed to the parties in accordance with Rule 77.6 of the Commission's Rules of Practice and Procedure. Comments were filed on \_\_\_\_\_.

**Findings of Fact**

1. PG&E filed A.02-01-041, January 31, 2002 requesting Commission approval of a Third Amendment to PG&E's PPA with Gaylord.
2. On July 20, 2001, PG&E and Gaylord entered into a First Amendment to the PPA under the one-year option approved in D.01-06-015.
3. On August 22, 2001, PG&E and Gaylord entered into a Second Amendment to the PPA that changed the energy price to a fixed price of 5.37 cents/kWh. The Second Amendment became a nullity when the safe harbor date for non-standard contract modifications was not extended beyond July 31, 2001.
4. PG&E and Gaylord estimate that under the Third Amendment, PG&E will pay approximately \$3.0 million more for energy than PG&E's energy payments using the current generic SRAC formula on a net present value basis.
5. Without Commission approval of the Third Amendment by July 31, 2002, energy payments by PG&E to Gaylord will revert to the Commission's generic SRAC formula.
6. No party has protested PG&E's Application.

**Conclusions of Law**

1. The motion of PG&E for an expedited order is denied.
2. Energy and capacity payments to QFs are defined by PURPA and Pub. Util. Code § 390.
3. The motion dated July 30, 2002 of the California Cogeneration Council for leave to supplement the record is granted.
4. The Third Amendment to the PPA, or the settlement agreement with Gaylord, is in the public interest, consistent with the law, and reasonable in light of the whole record.

**O R D E R**

**IT IS ORDERED** that:

1. Pacific Gas and Electric Company's application for approval of an amendment to the Power Purchase Agreement between Pacific Gas and Electric Company and Gaylord Container Corporation is approved.
2. This proceeding is closed.

This order is effective today.

Dated \_\_\_\_\_, at San Francisco, California.