PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3298

June 2, 2005

Agenda ID 4662
Ratesetting
Alternate to Agenda ID 4517

TO: PARTIES OF RECORD IN APPLICATION 00-11-038 ET AL.

Enclosed is a Draft Alternate Decision of President Michael R. Peevey to the draft decision of Administrative Law Judge (ALJ) Peter V. Allen previously mailed to you.

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

As set forth in Rule 77.6, parties to the proceeding may file comments on the enclosed alternate no later than June 9, 2005, and reply comments June 13, 2005. An original and four copies of the comments with a certificate of service shall be filed with the Commission's Docket Office and copies shall be served on all parties on the same day of filing. Anyone filing comments shall electronically serve those on the service list who have provided electronic addresses. Parties shall also ensure that they electronically serve their comments on President Peevey's advisor, Julie Fitch, at jf2@cpuc.ca.gov and the assigned ALJ Allen, at pva@cpuc.ca.gov. For those who have not provided electronic addresses, printed copies of the comments shall be served by first class mail or other expeditious mode of delivery.

/s/ Angela K. Minkin (by LTC)
Angela K. Minkin, Chief
Administrative Law Judge

Enclosure

Decision DRAFT ALTERNATE DECISION OF PRES. MICHAEL R. PEEVEY
(Mailed 6/2/05)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Southern California Edison Company (E 338-E) for Authority to Institute a Rate Stabilization Plan with a Rate Increase and End of Rate Freeze Tariffs.	Application 00-11-038 (Filed November 16, 2000)
Emergency Application of Pacific Gas and Electric Company to Adopt a Rate Stabilization Plan. (U 39 E)	Application 00-11-056 (Filed November 22, 2000)
Petition of THE UTILITY REFORM NETWORK for Modification of Resolution E-3527.	Application 00-10-028 (Filed October 17, 2000)

ORDER GRANTING, IN PART, PETITION FOR MODIFICATION OF DECISION 04-12-014, ON THE PERMANENT ALLOCATION OF THE DEPARTMENT OF WATER RESOURCES' ANNUAL REVENUE REQUIREMENT

I. Summary

This decision grants, in part, San Diego Gas and Electric's petition for modification of D.04-12-014, which adopted a permanent allocation of the Department of Water Resources' (DWR) annual revenue requirement.

The primary purpose of this decision is to adopt a cost allocation methodology that will be applied to the revenue requirement of the California Department of Water Resources (DWR) for its power purchases in 2004 and beyond.[1]

The methodology we adopt is effectively a compromise between the proposals originally presented by the parties in this case. In adopting this order, we have reconsidered the policy grounds on which we adopted D.04-12-014. We are modifying that order by this decision, and in the process, we have rendered moot order D.05-01-036, which previously modified D.04-12-014.

The cost allocation methodology we adopt leaves the variable costs of the DWR contracts as previously allocated in D.02-09-053, and separately allocates the fixed costs of the DWR contracts as follows: PG&E 42.2%, SCE 47.5%, and SDG&E 10.3%.[2] This methodology will be applied, consistent with D.04-01-028, beginning January 1, 2004.

II. Background

This Commission has previously established allocations for the DWR revenue requirement for 2001-2002 (see, D.02-02-052), and for 2003 (see, D.02-12-045). For 2004, on an interim basis, we have continued to use the 2003 allocation methodology.

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[1] For more background on DWR's power purchase program and revenue requirement, and on the relevant statutes, see Decision (D.) 02-02-052, pp. 6-12.

[2] D.02-12-045 used the terms "fixed" and "variable" costs. In this proceeding, these terms were largely referred to respectively as "non-avoidable" and "avoidable" costs.

(D.04-01-028, as modified by D.04-02-028, and D.04-08-050.) In this proceeding, we are adopting an allocation methodology applicable to the remaining term of the DWR power purchase contracts.

Based upon DWR's original 2004 revenue requirement determination, the parties litigated the methodology to be used for the permanent allocation. Opening and reply testimony was submitted by PG&E, SCE, SDG&E, ORA, and DWR, evidentiary hearings were held, and opening and reply briefs were filed by the three utilities.[3] Subsequent to the submission of briefs, DWR submitted a supplemental determination, modifying its revenue requirement for 2004.[4] Pursuant to an ALJ Ruling, the parties submitted comments addressing the supplemental determination. D.04-08-050 allocated the 2004 revenue requirement of DWR as modified by the supplemental determination.[5]

On April 22, 2004, PG&E, SCE and TURN (collectively, the "settling parties") submitted a motion for leave to submit their proposed settlement agreement. Parties submitted comments and reply comments on the proposed settlement, along with related procedural motions. SDG&E consistently and vociferously opposed the proposed settlement, while ORA generally supported it. The assigned ALJ allowed for submission of the proposed settlement, granted SDG&E's request for evidentiary hearings, and ordered the settling parties to present witnesses for cross-examination.

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[3] ORA submitted only an opening brief, and DWR submitted a memo concurrently with the parties' reply briefs.

[4] The effective submission date of the supplemental determination was April 22, 2004. (See, DWR Letter Memorandum dated May 17, 2004.)

[5] One difference between the two is that they are based on different modeling runs. The original revenue requirement determination was based on Prosym Run 43, while the supplemental determination is based on Prosym Run 45. The allocation adopted today is based on Prosym Run 45, as reflected in Appendix A.

Evidentiary hearings on the proposed settlement were held on June 14 and 15, 2004, with parties submitting opening briefs on the proposed settlement on June 25, 2004, and reply briefs on July 2, 2004.

In December, 2004, the Commission adopted D.04-12-014 which purported to adopt a permanent allocation methodology. However, SDG&E filed for rehearing of that decision, and by D.05-01-036, partial rehearing was granted on a limited set of issues. In addition to its application for rehearing, SDG&E also filed a petition for modification of D.04-12-014.

III. SDG&E's Petition for Modification of D.04-12-014

In its petition for modification of D.04-12-014, filed on January 11, 2005, SDG&E makes several arguments to support modification of that decision. They are, generally, as follows:

- The decision represents an unwarranted shift of the cost burden onto SDG&E customers, since because of SDG&E's relatively small size, any reassignment of costs creates a disproportionate burden on its ratepayers.
- The decision's reliance on a locked-in ten-year forecast of above-market costs is misplaced, since the forecast is flawed and unreliable.
- The decision adopted a methodology that was not subject to adequate evidentiary review.

In general, we agree with SDG&E that any shift in cost burden towards their customers has a disproportionate rate effect because of the size of SDG&E's territory relative to the other two utilities. However, we do not agree with SDG&E's claim that $800 million is shifted to their customers. The $800 million figure represents a calculation based on the amount shifted from the prior methodology adopted in D.04-01-028. However, that methodology did not impose any burden on SDG&E

ratepayers for the above-market costs of DWR contracts, and thus also represented an inequitable cost shift onto the ratepayers of PG&E and SCE. Thus, although we agree with the overall thrust of the SDG&E argument, we do not agree with their calculation of the dollar impact to their customers.

Second, we agree with SDG&E's argument that basing our allocation methodology on a ten-year forecast of above-market costs, as in D.04-12-014, was misplaced. As SDG&E argues, it is impossible to determine in advance the equity of this approach, because changing market conditions will cause variations in the calculation over time in a manner that we cannot now predict.

SDG&E's third argument, that the D.04-12-014 methodology was not adequately subjected to evidentiary hearings, is rendered moot with the adoption of this decision. The methodology adopted in this decision is a different methodology, and is fully supported by the record in this proceeding.

Based on the strength of SDG&E's first two arguments, we will modify D.04-12-014 as set forth in this decision. The methodology outlined in this decision replaces the methodology of D.04-12-014 in its entirety. The rehearing of D.04-12-014 ordered in D.05-01-036 is no longer needed. This decision reiterates the various proposals made by parties in this proceeding, and articulates reasoning for taking a different approach to a permanent allocation methodology than the one originally adopted in D.04-12-014.

IV. Permanence of the Allocation

All parties agree that the allocation methodology that is adopted here should be permanent. (See, e.g., SCE Opening Brief, p. 43, PG&E Opening Brief, p. 4, SDG&E Opening Brief, pp. 2-3.) We concur. Annual litigation of the allocation methodology is not an efficient use of the parties' or the Commission's time and resources. Prior to today, the relatively uncertain and unstable nature of the electricity market, and the newness of the DWR contracts themselves, made us reluctant to adopt a permanent allocation methodology. The Commission and the parties have now gained enough experience, particularly with the DWR contracts, that it is appropriate to make our allocation methodology for the DWR revenue requirement permanent, and eliminate the annual litigation process we have used to date.

V. Proposed Settlement Agreement

Given the broad-based support among the parties for the proposed settlement agreement, we must give it serious consideration. At the same time, we acknowledge SDG&E's questioning the legitimacy of a settlement entered into by two parties (who already largely agreed with each other) in which those two parties agree to shift costs to a third, non-settling party. (SDG&E Comments re Proposed Settlement, p. 27.)

The proposed settlement divides DWR's revenue requirement into three categories, referred to as: (1) as DWR's contract costs; (2) DWR's other power costs; and (3) planned changes in power charge accounts. (Motion of Settling Parties, p. 4.) Each category receives its own allocation approach.

The proposed settlement would start by allocating DWR's contract costs on the same basis that the contracts were allocated for operational purposes in D.02-09-053. This method is generally referred to as the "cost-follows-contracts" or "CFC" methodology, and was generally advocated in the litigation positions of PG&E and SCE.

This initial CFC-based allocation would then be adjusted by "Fixed Annual Adjustment Amounts." (Brief of Settling Parties, pp. 8, 14.) According to the Settling Parties, using these fixed annual adjustment amounts results in the projected "above market costs" of DWR's long-term contracts being allocated to the customers of PG&E, SCE and SDG&E based on utility allocation percentages of 43.6%, 42.6%, and 13.8%, respectively.[6] These percentages "[A]re designed primarily to constitute a reasonable reflection of the relative net-short positions of the three utilities that DWR initially sought to serve when it entered into its contracts, and the other equity "yardsticks" advanced by the parties to this proceeding." (*Id.*, p. 8.)

The same utility allocation percentages would be applied to DWR's other power costs, which includes all of DWR's administrative, general, and extraordinary item expenses, and any new cost categories specified by DWR not directly related to a specific contract. (*Id.*, p. 7.)

For the third category, planned changes in power charge accounts, which reflects the planned annual changes in the operating reserves maintained by DWR, different percentages would be applied, of 44.4% for PG&E, 45% for SCE, and 10.6% for SDG&E.

The proposed settlement agreement is in fact an odd hybrid. It starts from a CFC approach, which in its pure form has the advantages of simplicity, ease of administration, and not requiring the use of confidential information. A pure CFC approach does, however, have one serious problem – it is simply not equitable, as even its advocates will admit. (SCE Opening Brief, p. 29.)

The benefits and flaws of a CFC approach are well summarized by SCE's witness:

> As Edison's testimony states, CFC allocation methodology provides certain operational and administrative benefits that none of the other allocation methodologies provide, but we were also very clear in our testimony that it is not cost-based, but neither are the other allocation proposals; it is not equitable, and neither are most of the

[6] These annual adjustments are reduced to zero for the years 2012 and 2013.

> other allocation proposals; but that in -- in large, when you look at all the factors considered, it's a reasonable way to allocate these costs for what is a very difficult decision the Commission has to make. (SCE witness Cushnie, Transcript p. 7237.)

The allocation of fixed costs resulting from a CFC approach is somewhat arbitrary, as we noted in D.02-12-045:

> Since DWR signed contracts for a statewide need, allocating the fixed costs of contracts to utility service territories based upon geographic location does not match how or why those contracts were obtained. It would be arbitrary and unfair for one or more service territories to end up with a disproportionate number of high-priced contracts when DWR was not trying to balance costs among service territories. (*Id.*, p. 11.)

In order to remedy this problem with the CFC approach, the proposed settlement adjusts the CFC allocation through the fixed annual adjustment amounts. The logic behind this approach is explained:

> The customers of the utilities must take power from DWR, and must bear the costs of that power. To the extent that the costs are equal to the market costs for the power, there is no burden associated with the requirement that customers take DWR's power. It is only to the extent that the costs of the power exceed its market value that a burden is imposed on customers. Therefore, in allocating the DWR Annual PCRR, the Settlement Agreement focuses on achieving a result that fairly allocates the above-market component of the DWR contract costs to the customers of the three utilities. Under the Settlement Agreement, a CFC allocation is adjusted, through the use of Fixed Annual Adjustment Amounts, so that each utility's customers are expected to bear a market price for the power they receive from DWR, plus a fair share of the above-market component of DWR's costs. (Brief of Settling Parties, p. 15.)

While the underlying logic - attempting to fairly allocate the above-market costs of the DWR contracts – is sound, the actual method the proposed settlement uses to calculate above-market costs is flawed.

As SDG&E points out, “The calculation of the above-market costs of a contract requires forecasts of a variety of assumptions, including gas and electric market prices and conditions.” (SDG&E Comments, p. 15, citing Exhibit 04-21.) SDG&E goes on to list some of the other factors for which assumptions would need to be made, particularly those relating to the market value of the DWR contracts. (*Id.*, pp. 15-16.)

In D.02-09-053, this Commission raised similar criticisms of the above-market cost metric proposed by SCE as a basis for determining the ultimate reasonableness of the various contract allocation proposals in that proceeding:

> SCE’s methodology relies on several calculations and projections that are based on subjective assumptions, including a forecast of future market prices (forward price curve) based on broker quotes and (after 2007) growth rate assumptions, and calculations of future hourly market prices that are derived from a regression analysis of the forward price curves and historical market prices. (D.02-09-053, p. 31.)

Hence, SCE had originally proposed (as one alternative) that there should be an annual determination of above-market costs. (See e.g., SCE Opening Brief, p. 16.) The proposed settlement, however, is based upon a one-time forecast of above-market costs, applicable for the duration of the DWR contracts. SDG&E vigorously attacks this aspect of the proposed settlement, arguing that use of a locked-in ten-year forecast of above-market costs is unreasonable. (SDG&E Brief re Proposed Settlement, pp. 24-32.) There is validity to SDG&E’s criticisms. As SCE originally stated in support of its litigation position: “An annual determination of the AMC costs on a forecast basis is necessary as a ten-year projection of such costs will be unreliable in the later years." (SCE Opening Brief, p. 7, fn. 6.)

In addition to the difficulty of calculating the above market costs, the methodology does not (and cannot easily) reflect the actual value of a particular contract or contracts. SDG&E argues that the methodology used by the settling parties does not explicitly value capacity or ancillary services, among other things (SDG&E Brief re Proposed Settlement, pp. 26-27), nor does it reflect the value of the contracts in the context of the utility's supply portfolio (SDG&E Comments, p. 16). The settling parties note that their methodology does not value the dispatchability of contracts (see, e.g., Reply Brief of Settling Parties, pp. 13-14), and while this may tend to favor SDG&E, it reflects yet another problem with attempting to calculate the above-market component of the contracts.

Overall, the forecast of above-market costs used in the proposed settlement is simply not good enough to provide a principled basis for allocating the costs of the DWR contracts.

Another problem with the proposed settlement is its fundamental reliance upon forecasts of the relative net-short positions of the three utilities. The "Utility Allocation Percentages" that form the basic yardstick for the proposed settlement "[A]re designed to constitute a reasonable reflection of the relative net-short positions of the IOUs that DWR initially sought to serve when it entered into its contracts." (Motion of Settling Parties, p. 6.)[7]

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[7] The Motion of the Settling Parties states that it used "three principle net short allocation percentages presented in the proceeding." SCE's proposed net short percentages based on D.02-02-052, PG&E's percentages based on DWR's Prosym Run 19g, and percentage shares derived from the Nichol Declaration. (*Id.*, p. 14.) The first source addresses the 2001-2002 net short, while the other two contain forecasts for both 2001-2002 and for future years.

The propriety of allocating future revenue requirements on the basis of forecasts of the utilities' net-short positions was actively litigated. (See, e.g., PG&E Opening Brief, pp. 14-19, re 2001-2002 net short.) The basic idea behind the use of the net-short forecasts is that DWR was procuring power to fill the net-short positions of the utilities, creating a causal link between the net-short positions and the size and cost of the contracts themselves. The net-short forecasts are in essence treated as a proxy for the state of mind of DWR at the time it entered into the contracts that are at issue here.

The main problem with use of the individual net-short forecasts for allocating the costs of the contracts is the fact that DWR's purchases and contracts were made to cover the *aggregate* net short position of all three utilities, not the *individual* net short of each utility. (See, e.g., D.02-12-045, p. 12.) Contracts were signed to meet statewide needs, not the needs of individual utilities. (*Id.*, p. 11.) Second, a forecast of the net-short for only 2001 and 2002 does not actually reflect what DWR may have expected each utility's needs (and other sources of electricity, such as hydro) to be over the life of the contracts. (See, D.02-09-053, p. 30; SDG&E Reply Comments, pp. 5-6.) Third, the longer-term forecasts presented in this proceeding as reflecting the information available to DWR back when it was signing the contracts (the Nichols Declaration and Prosym Run 19g) are of uncertain value. (See, e.g., PG&E Opening Brief, pp. 16-19, SDG&E Reply Brief, pp. 11-12.) Also, as we noted in D.02-12-045, the amount of energy actually delivered to each utility's customers by the remaining DWR contracts does not necessarily match each utility's net short. (D.02-12-045, pp. 11-12.) While superficially appealing, the net short forecasts do not presently provide a principled basis for allocating the costs of the DWR contracts.

Accordingly, we do not approve the proposed settlement agreement.

VI. Litigation Positions, Past Allocations, and Fairness Metrics

Since we have rejected the proposed settlement agreement, we next consider the litigation proposals of the parties. Unfortunately, we also find the litigation proposals to be unsuitable for permanently allocating the costs of the DWR contracts.

The litigation proposals of PG&E and SCE, while not identical, share a number of flaws. Among other things, the PG&E and SCE proposals are based upon the inequitable CFC methodology, rely upon flawed estimates of above-market costs, and invite significant re-litigation. The proposals of ORA and SDG&E are based upon the allocation methodology adopted for 2003 in D.02-12-045. However, the ORA proposal is somewhat incomplete, and SDG&E incorporates additional self-serving resource assumptions in its proposal.

We will, however, take as our starting point the *pro rata* allocation methodology we adopted in D.02-12-045. This allocation methodology is generally advocated in the litigation positions of ORA and SDG&E, and partially supported by the litigation position of PG&E. In D.02-12-045, the adopted methodology pooled the costs of the DWR contracts, reflecting the fact that DWR's contracts were signed with the intent to meet the aggregate need of the utilities. (*Id.*, pp. 11-13.) Aggregating the costs of the contracts accordingly matches the way the costs were actually incurred, and also spreads the pain of those contracts that are particularly expensive. (*Id.*)

After pooling the DWR contract costs, D.02-12-045 then allocated the costs to the customers in proportion to the quantity of energy supplied by DWR to each utility for 2003, as forecast by a modeling run performed by DWR. The use of supplied energy as the basis for the allocation was appropriate, as it allocated the costs of the contracts proportionally to the benefits received from the contracts.

D.02-12-045 used the most current forecast for which there was an adequate record. (*Id.,* pp. 27-28.) Given that the forecast was for one year only, this approach had a reasonable probability of accuracy. However, in this proceeding we need to find a basis for allocating the costs of the DWR contracts through 2013, when the last of the contracts expire. Using a forecast of supplied energy over a relatively long time period, however, raises some of the same concerns we have expressed regarding the accuracy of the above-market cost forecast.

In addition, it is not clear what forecast should be used. One approach would use the most recent DWR forecasts of supplied energy for the relevant time period. (See, e.g., SDG&E Opening Brief, p. 9.) This approach, by using the most recent forecast reflecting the latest data and assumptions, would hopefully be the most accurate. Even so, its accuracy is uncertain at best. In addition, SCE argues that the use of current forecasts requires the use of confidential information, making it difficult for parties to review and confirm the results of the allocation methodology. (SCE Opening Brief, p. 32.)

On the other hand, it is also possible to use a forecast based on a model used by DWR back when it was entering into the contracts. (See, e.g., PG&E Opening Brief, p. 18.) This, as discussed above, is an attempt to mirror the state of mind of DWR at the time it executed the contracts, and tries to reflect DWR's then-current projections over the longer term. As a proxy for DWR's state of mind, this approach may not be bad, but its ultimate accuracy is likely to be worse than the more recent forecasts.[8] Neither the current forecast nor the historical forecast is ideal, and while

[8] As noted above, while the best sources of information appear to be the Nichols Declaration and Prosym Run 19g, there was some controversy about the most appropriate source for the historical data and forecasts available to DWR. Accordingly, it is not clear what relative weight each of these sources should be given, if any.

both have benefits and flaws, it is difficult to determine which would be the lesser of two evils. Ultimately, it is not clear that any forecast in the record of this proceeding is really any good, and we decline to base our allocation on the available forecasts.

We cannot predict the future, and in this case the past is also of little help, as the DWR contracts at issue were signed at a time of crisis, confusion, and uncertainty, rendering our traditional notions of cost causation inappropriate. In large part we are "spreading the pain" of a unique occurrence, for which our standard methods are ill-suited. Accordingly, we must find another way to reach a fair allocation. Fortunately, the parties have provided such a route.

As a guide to evaluating the various allocation methodologies, several parties recommended the use of a "fairness yardstick" or "fairness metric," against which allocation proposals could be measured.[9] Not surprisingly, there was some divergence among the parties among what should be considered fair. Nevertheless, given the problems of the other methods proposed in this proceeding, the fairness metrics appear to provide the best avenue for developing a fair and equitable cost allocation.

In fact, it is quite informative to look at the fairness metrics as well as actual current and recent historical allocations.[10] We note that the percentages recounted below represent total cost allocations, and not percentages of unavoidable costs, which are the only costs at issue in this decision, as described more fully in the next section.

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[9] In essence, the "Utility Allocation Percentages" in the proposed settlement also represent a fairness metric. (Motion of Settling Parties, p. 4.)

[10] For purposes of this table, Prosym Run 43 was used, as that run provided the basis for the parties' litigation proposals, including their fairness metrics.

Source / Method	Allocation to:		
	PG&E	SCE	SDG&E
D.02-12-045[11]	44%	42%	14%
Interim 2004[12]	40%	47.3%	12.7%
PG&E Metric[13]	39%	48.4%	12.5%
SCE Metric[14]	48%	36%	16%
ORA Metric[15]	39.2%	48.3%	12.6%
Settlement Metric	43.6%	42.6%	13.8%

It is particularly interesting to note that two parties other than SDG&E (PG&E and ORA) were willing to argue that an allocation as low as approximately 12.5% would be appropriate for SDG&E. With the exception of SCE's Metric, the range of allocations recommended or previously adopted for SDG&E is also relatively narrow. Since all of the principles upon which we might base an allocation methodology appear to be flawed, we will simply use the concurrence of the parties to establish fixed allocation percentages that will be applied to the cost of DWR's contracts.

SDG&E correctly argues that the percentages in the table above relate to total cost allocation, and not an allocation of fixed or unavoidable costs alone. SDG&E argues that in order to arrive at a result of 12.5% of the total costs to be borne by SDG&E (the lowest of the percentages reflected above), only 9.5% of the fixed costs being allocated in this decision should be attributed to their ratepayers.

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11 Allocation for 2003.

12 As adopted in D.04-01-028, applying the same method adopted in D.02-12-045.

13 Based on method adopted in D.02-12-045.

14 Based on forecasts of net short (SCE Opening Brief, p. 11).

15 Based on method adopted in D.02-12-045.

We conclude that all of the proposals summarized above represent the range of reasonable possible outcomes. Since the decision we make today is inherently a zero-sum game that involves spreading costs fairly and evenly such that no one set of ratepayers is either harmed or subsidized unnecessarily, we choose to allocate to SDG&E the average of all of the "fairness metric" percentage allocations proposed, which equates to 13.6% of total costs. Using a ratio approach, if 12.5% of total costs equates to 9.5% of unavoidable costs to SDG&E, a 13.6% share of total costs equates to 10.3% of unavoidable costs. Thus, for the fixed costs we are allocating today, SDG&E's percentage will be 10.3%.

There is less concurrence regarding the relative shares to be allocated to PG&E and SCE, but considering the levels of PG&E's Metric, SCE's Metric, and the Settlement Metric, it is appropriate to allocate the remaining 89.7% on the basis that both utilities agreed to amongst themselves in the Settlement Agreement. To derive the appropriate percentages, we use another ratio approach. Under the Proposed Settlement, after subtracting SDG&E's share of the non-variable or unavoidable costs, the remainder is divided between PG&E and SCE 47% to 53%, respectively, over the total period 2004-2013. While we allocate a lower percentage to SDG&E as discussed above, we divide the remainder of the costs between PG&E and SCE in the same manner as results from their Proposed Settlement. Accordingly, after subtracting SDG&E's 10.3% share, we adopt an allocation of the remaining costs in the same relative proportion as results from the Settlement Agreement. Thus, PG&E's share will be 42.2%, while SCE's will be 47.5%.

Use of fixed allocation percentages is consistent with the recommendation of SDG&E. According to SDG&E, fixed percentages eliminate the ability of utilities to shift costs to each other via their dispatch decisions (SDG&E Opening Brief, pp. 17-

19), and also reduce the motivation to relitigate the allocation methodology (SDG&E Reply Brief, pp. 23-24).

VII. Costs to be Allocated

Finally, it is not enough to simply determine allocation percentages. We must also clearly identify the specific costs to which those allocation percentages are applied. The categories of costs that have been discussed in this proceeding include total contract costs, unavoidable costs, avoidable costs, and above-market costs. Total contract costs include the avoidable costs, unavoidable costs, and above-market costs of the DWR contracts. For each individual contract, however, the relative proportions of each of these components can vary.

Avoidable costs were allocated on a CFC basis in D.02-09-053. In general, the parties have not recommended changing that allocation. In D.02-12-045, we allocated total costs and subtracted out the previously allocated avoidable costs to come up with a residual allowance of fixed costs. SDG&E recommends continuing to use that method. The settling parties prefer to base an allocation on above-market costs. While we do not adopt the above-market cost methodology, its proponents raise some valid criticisms of the calculation approach used in D.02-12-045.

SCE argues that the method used in D.02-12-045 (and advocated by SDG&E) treats avoidable contract costs as an economic burden, when in fact such costs should be considered an economic benefit: "Avoidable contract costs should only be incurred when they are projected to be less than the market value of the energy dispatched. As a result, avoidable contract costs will not be incurred when it is uneconomic to dispatch." (SCE Reply Brief, pp. 4-5)

SCE correctly points out that the residual calculation approach results in the customers of SDG&E, which has the largest percentage share of dispatchable contract energy, being allocated the smallest percentage share of the unavoidable contract costs. (*Id.*, p. 5.) While SCE does not support a "prorata" allocation, SCE argues that if a prorata allocation is used, the current residual calculation approach is unfairly biased. (*Id.*)

According to SCE,

> The Commission has already properly determined that avoidable contract costs should follow the physical contract allocation to ensure that least-cost incentives are maintained. As such, it is not necessary or useful to aggregate the DWR revenue requirement to implement a "prorata" allocation, and then residually determine the allocation of unavoidable contract costs by subtracting forecast avoidable contact costs. This proceeding has been established to allocate DWR's unavoidable contract costs. If a prorata methodology is to be implemented, it should be on the unavoidable contract costs only, and not incorporate avoidable contract costs which are actually an economic benefit to customers. (*Id.*, pp. 5-6.)

While we do not necessarily agree with every aspect of SCE's argument, the criticism of the residual calculation approach is generally well founded. In addition to the problems noted by SCE, in the course of this proceeding we have found that the parties are indirectly re-litigating the allocation of the avoidable costs of DWR's contracts, as the total cost approach we adopted in D.02-12-045 creates a direct link between the allocation levels of the unavoidable and avoidable costs.

Accordingly, we adopt SCE's alternate recommendation that the allocation factor be applied only to the unavoidable cost component of the DWR contracts.[16] Ironically, SDG&E made this same proposal during litigation of the 2003 revenue requirement allocation, but the Commission rejected it at that time. (D.02-12-045, pp.

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[16] ORA proposes that gas tolling costs associated with must-take contracts be considered avoidable costs. We rejected this same proposal in D.02-12-045 (p. 17), and we reject it again here.

12-14.) The methodology the Commission adopted for 2003 (and that SDG&E continues to advocate) actually resulted in a more favorable allocation for SDG&E than SDG&E's own. (*Id.*, Table A, p. 18.)[17]

VIII. Surplus Sales

All three utilities propose that the sharing of revenue from surplus sales on a pro-rata basis between DWR and the utilities, as established by D.02-09-053, be eliminated. (See, e.g., SDG&E's Opening Brief, pp. 33-37.) DWR does not oppose the elimination of sharing revenues from surplus sales, but notes that as a result of eliminating the sharing of revenues of surplus sales, all DWR sales would be deemed delivered to retail end use customers. DWR states its willingness to work with the utilities and the Commission to amend the Operating and Servicing Agreements to accommodate a Power Charge calculation that reflects that all DWR power is delivered to retail end use customers.

However, in spite of the agreement between DWR and the utilities on this matter, we cannot change the Operating and Servicing Agreements in this decision, in advance of the necessary filings by DWR and the utilities. The current surplus sales methodology will remain in place for 2004, but we encourage the utilities and DWR to work together to bring the proposed changes before the Commission in the appropriate forum, so that we can implement any agreed-upon changes concurrently with our allocation of DWR's 2005 revenue requirement.

IX. Rehearing and Judicial Review

This decision construes, applies, implements, and interprets the provisions of Assembly Bill (AB) 1X (Chapter 4 of the Statutes of 2001-02 First Extraordinary

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[17] The rate increase that SDG&E will see as a result of the allocation we adopt today is largely a reflection of the favorable allocation that SDG&E received for 2003.

Session). Therefore, Pub. Util. Code § 1731(c) (applications for rehearing are due within 10 days after the date of issuance of the order or decision) and Pub. Util. Code § 1768 (procedures applicable to judicial review) are applicable.

X. Comments on Alternate Decision

The alternate decision of President Michael R. Peevey was mailed to the parties in accordance with Rule 77.6 of the Commission's Rules of Practice and Procedure. Comments were received on June 9, 2005 from __________. Reply comments were received on June 13, 2005 from _________.

XI. Assignment of Proceedings

Geoffrey F. Brown is the assigned Commissioner and Peter V. Allen is the assigned Administrative Law Judge in these proceedings.

Findings of Fact

1. The allocation methodology ordered in D.04-12-014 creates a disproportionate rate effect on SDG&E ratepayers.
2. Annual re-litigation of an allocation methodology to be applied to DWR's revenue requirement is neither efficient nor necessary.
3. DWR's supplemental revenue requirement determination was based on Prosym Run 45.
4. The Proposed Settlement's use of the costs-follows-contracts methodology is not equitable.
5. The Proposed Settlement and D.04-12-014 both relied upon a forecast of future above-market costs.
6. The Proposed Settlement's and D.04-12-014's use of historical forecasts of the net short positions of the three utilities as a basis for future cost allocation is too uncertain to be found equitable.

7. No party's litigation position proposed an equitable allocation methodology.

8. The pro rata allocation methodology adopted in D.02-12-045 was generally equitable, but the residual calculation approach used in that decision was flawed.

9. Several parties proposed fairness metrics for evaluating allocation methodologies.

10. Avoidable DWR contract costs were previously allocated in D.02-09-053.

Conclusions of Law

1. A permanent allocation methodology for DWR's revenue requirement should be adopted.

2. SDG&E's petition to modify D.04-12-014 should be granted, in part, as described in this decision.

3. D.04-12-014 should be vacated and replaced with this decision.

4. D.05-01-036, which granted partial rehearing of D.04-12-014, is now moot.

5. The Proposed Settlement is inconsistent with D.02-12-045.

6. The Proposed Settlement is not equitable, and should not be approved.

7. The parties' fairness metrics provide an equitable basis for determining a permanent allocation of total costs. Those percentages should be adjusted to account for the fact that this decision is allocating unavoidable costs only.

8. The pro rata allocation methodology adopted in D.02-12-045 provides a reasonable starting point for a permanent allocation of total costs.

9. The residual calculation approach used in D.02-12-045 should be replaced with a separate calculation of fixed costs.

10. This decision construes, applies, implements, and interprets the provisions of Assembly Bill (AB) 1X (Chapter 4 of the Statutes of 2001-02 First Extraordinary Session).

O R D E R

IT IS ORDERED that:

1. SDG&E's petition to modify D.04-12-014 is granted, in part, as specified in this decision.

2. D.04-12-014 is vacated and replaced with this decision.

3. D.05-01-036 is vacated.

4. The allocation methodology adopted today for Department of Water Resources' (DWR) revenue requirement is permanent.

5. The Proposed Settlement is not adopted.

6. The allocation of variable costs previously adopted in Decision (D.) 02-09-053 remains unchanged.

7. The allocation of fixed costs of DWR's revenue requirement is: Pacific Gas and Electric Company – 42.2%, Southern California Edison Company – 47.5%, and San Diego Gas & Electric Company - 10.3%.

8. Pub. Util. Code § 1731(c) (applications for rehearing are due within 10 days after the date of issuance of the order or decision) and Pub. Util. Code § 1768 (procedures applicable to judicial review) are applicable to this decision.

9. Consistent with D.04-01-028, the allocation methodology adopted in this decision should be applied as of January 1, 2004 as in Appendix A.

This order is effective today.

Dated ____________________________, at San Francisco, California.

APPENDIX A

IOU Cost Allocation Summary

1	Power Costs				$4,859,626,196
2	Administrative & General Expenses				$59,000,000
3	Extraordinary Costs				$37,054,868
4	Net Operating Revenues				($320,372,326)
5	Interest Earnings on Fund Balance				($32,212,129)
6	Other Revenues (Contract Settlements, Extraordinary Receipts)				($51,896,968)
7	Net Total of Variable Contract Costs, other Fixed Costs, and Net Revenues				$4,551,199,641
8					

		PG&E	SCE	SDG&E	Total
9		PG&E	SCE	SDG&E	Total
10	Direct-assign Variable Contract Costs	$91,240,650	$175,304,580	$204,519,570	$471,064,800
11					
12	Total Fixed Costs = Total Costs less Variable Costs				$4,080,134,841
13	Adopted Allocator of Fixed Costs	42.20%	47.50%	10.30%	100%
14	Fixed Cost Allocation	$1,721,816,903	$1,938,064,049	$420,253,889	$4,080,134,841
15	Less: Off-system Sales	($18,078,332)	($215,013,323)	($39,486,934)	($272,578,590)
16	DWR Reconciliation to State Controller (Table A-1, line 19)	($2,807,666)	($3,160,287)	($685,283)	($6,653,237)
17	Subtotal	$1,792,171,555	$1,895,195,019	$584,601,241	$4,271,967,815
18	2001/2002 True-up Amounts (D.04-01-028)	($100,590,687)	$41,308,258	$59,282,429	$0
19	Sub-Total--IOU DWR Revenue Requirement before DA CRS	$1,691,580,868	$1,936,503,277	$643,883,670	$4,271,967,815
20					
21	Less: Direct Access Power Charge-Related Revenues	($104,312,750)	($104,663,900)	($32,119,330)	($241,095,980)
22	Total Revenue Requirement (Bundled Service)	$1,587,268,118	$1,831,839,377	$611,764,340	$4,030,871,835
23	2004 DWR Delivered Energy (kWh)	21,145,876	21,910,180	7,998,786	51,054,842
24					
25	**IOU Power Charge Calculation**	PG&E	SCE	SDG&E	Total
26	Variable Power Cost Component	$0.00431	$0.00800	$0.02557	$0.00923
27	Fixed Power Cost Component	$0.08143	$0.08845	$0.05254	$0.07992
28	2001/2002 True-up	($0.00476)	$0.00189	$0.00741	$0.00000
29	Less: Off-system Sales	($0.00085)	($0.00981)	($0.00494)	($0.00534)
30	Adjustment to Operating Account (Table A-1, line 19)	($0.00013)	($0.00014)	($0.00009)	($0.00013)
31	Adjustment to match DWR year-end balance	($0.00092)	($0.00092)	($0.00092)	($0.00092)
32	DA CRS Contribution	($0.00493)	($0.00478)	($0.00402)	($0.00472)
33	**Total IOU Power Charge**	**$0.07414**	**$0.08268**	**$0.07556**	**$0.07803**

(END OF APPENDIX A)

CERTIFICATE OF SERVICE

I certify that I have by mail this day served a true copy of the original attached Draft Alternate Decision of President Michael R. Peevey on all parties of record in this proceeding or their attorneys of record.

Dated June 2, 2005, at San Francisco, California.

/s/ Sally Cuaresma
Sally Cuaresma

N O T I C E

Parties should notify the Process Office, Public Utilities Commission, 505 Van Ness Avenue, Room 2000, San Francisco, CA 94102, of any change of address to insure that they continue to receive documents. You must indicate the proceeding number on the service list on which your name appears.

* *

The Commission's policy is to schedule hearings (meetings, workshops, etc.) in locations that are accessible to people with disabilities. To verify that a particular location is accessible, call: Calendar Clerk (415) 703-1203.

If specialized accommodations for the disabled are needed, e.g., sign language interpreters, those making the arrangements must call the Public Advisor at (415) 703-2074, TTY **1-866-836-7825 or (415) 703-5282 at least** three working days in advance of the event.