Decision ____________________

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)

OPINION ALLOCATING THE 2006 REVENUE REQUIREMENT DETERMINATION OF THE CALIFORNIA DEPARTMENT OF WATER RESOURCES AND DENYING PETITION TO MODIFY

I. Summary

This decision allocates the 2006 revenue requirement of the California Department of Water Resources (DWR), using the allocation methodology adopted in Decision (D.) 05-06-060. The results of this allocation are set forth in Appendix A. DWR submitted a revenue requirement determination for 2006 of $4.991 billion on August 3, 2005, revised on October 27, 2005 to $5.366 billion, an increase of $375 million.

At DWR's request, we allocate the benefits and costs of a below-market Williams gas contract that resulted from a negotiated settlement of issues arising from the energy crisis. We adopt the approach recommended by Pacific Gas and Electric (PG&E), which allocates those benefits and costs according to the percentages adopted in D.05-06-060.

Finally, we deny the petition to modify D.05-06-060 filed by Southern California Edison (SCE), The Utility Reform Network (TURN), and the California Large Energy Consumers Association (CLECA), including its request to change the allocation of unavoidable gas hedging costs and benefits.

II. Procedural Background

DWR submitted its Determination of Revenue Requirements for 2006 on August 3, 2005. On October 27, 2005, it submitted a Revised Determination of Revenue Requirement. In a letter memorandum dated August 19, 2005 DWR requested the Commission also address allocation of the benefits of the below-market gas supply contract between Williams and DWR, and the allocation of a reliability-must-run (RMR) portion of a Williams electricity contract. This second issue was also raised by DWR in the Commission's procurement proceeding Rulemaking (R.) 04-04-003, and the Administrative Law Judge in this proceeding ruled that the allocation of the Williams RMR contract would be addressed in R.04-04-003.

In addition, SCE, TURN, and CLECA filed a petition to modify D.05-06-060, the decision establishing the allocation methodology to be used in this proceeding. The petition to modify raised several issues, and was opposed by San Diego Gas & Electric (SDG&E) and opposed in part by PG&E. Based on input from DWR and the active parties to the proceeding, additional briefing was permitted on one of these issues, specifically the allocation of certain gas hedging costs and benefits.[1]

Accordingly, briefs were filed on October 11 and October 17, 2005 by SCE, PG&E, and SDG&E, addressing the two issues of the allocation of the Williams gas supply contract and the allocation of gas hedging costs and benefits.[2] No other issues relating to the allocation of DWR's 2006 revenue requirement were litigated.

III. Williams Gas Contract

The Williams gas contract is a must-take contract, created as a result of the renegotiation of DWR's 2001 power contract with Williams. The most significant aspect of the Williams gas contract is that it provides gas at significantly below market rates. The Commission allocated the gas from the Williams contract for operational purposes in D.03-10-016. In that decision, the Commission determined, based on DWR's recommendations, that for 2004, 84% of the gas would go to SCE and 16% would go to SDG&E, while for 2005-2010, 62% would go to SCE and 38% to SDG&E.

Subsequently, in D.05-03-024 and D.05-04-025, the Commission stated that it intended to address the allocation of the benefits of the below-market Williams gas contract in the process of the rehearing of D.04-12-014. Because the allocation methodology adopted in D.04-12-014 was superseded by the methodology adopted in D.05-06-060, the rehearing of D.04-12-014 became moot, and accordingly the issue was not addressed.

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[1] See transcripts of pre-hearing conferences on August 31, 2005 and September 29, 2005.

[2] DWR also submitted letter memoranda addressing these issues on October 17 and 18.

DWR raised the question of the allocation of the benefits of the contract in its August 19 letter memorandum. The parties in the proceeding disagree as to the proper allocation of the benefits of the contract. (Transcript, August 31, 2005 PHC, vol. PHC-17, pp. 629-633.)

The question we need to resolve is the nature of the benefits of the Williams gas contract. One possible answer is that the gas contract is essentially the same as the electricity contracts whose costs we have been allocating in this proceeding. The other possible answer is that the benefit of the Williams gas contract is unique, and more akin to a cash payment received as part of a negotiated settlement.

The former approach is taken by SCE and SDG&E, who argue that the Williams gas contract should be treated like the other DWR contracts that the Commission has allocated in the course of this proceeding. Under this approach, the costs are allocated based upon a determination of whether the costs of the contract are considered unavoidable or avoidable, and the gas itself is the benefit.

If the contract costs are unavoidable (SCE's position), the costs are pooled with all other contract costs and allocated according to the percentages adopted in D.05-06-060, and the "benefits," which consist of cheap gas, simply flow where they were allocated in D.03-10-016. On the other hand, if the contract costs are considered avoidable (SDG&E's position), then the costs follow the allocation of the contracts, meaning that SCE pays 84% of the costs for 2004 and 62% of the costs for 2005-2010, with SDG&E paying 16% of the costs for 2004 and 38% of the costs for 2005-2010. Again, the benefits would flow with the gas.

PG&E argues that the Williams gas contract is unique, and is different than DWR's electricity contracts. PG&E points out that the Williams gas contract was part of a negotiated settlement of claims relating to the energy crisis, and that the

Commission allocated it for operational purposes in a different manner than used for electricity contracts. Based on this, PG&E argues that the benefits of the contract (and presumably the costs as well) should not automatically be allocated in the same manner as the costs and benefits of DWR's electricity contracts. PG&E recommends that the benefits of the gas contract, specifically the difference between the market price and the contract price of the gas, be shared among the utilities using the fixed percentages adopted in D.05-06-060. (PG&E Opening Brief, pp. 2-6.)

PG&E's argument is more factually sound, as the Williams gas contract is in fact a unique entity, and is not directly comparable to DWR's electricity contracts. As a part of a negotiated settlement, it was entered into for the purpose of benefiting all California ratepayers, and as a new and separate item, its benefits are in fact more comparable to a cash settlement than to an existing (or renegotiated) electricity contract.[3]

In addition, PG&E's position is more consistent with our previous determinations on this issue. In D.03-10-016, we stated:

> For equity purposes, it would be desirable to allocate some of the Williams volumes to PG&E, however, such an allocation

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[3] This Commission has previously described some of the differences between the gas contract and DWR electricity contracts:

> Unlike the DWR long-term power supply contracts that were allocated in D.02-09-053, the Williams Gas Contract will be administered by DWR. Legal title, financial reporting responsibility and responsibility for contract-related bills will remain with DWR. DWR will perform most contract administration activities and financial settlements. The utilities will only be responsible for scheduling the Williams gas volumes allocated to them. (D.03-10-016, p.8.)

> would be inconsistent with the goal of matching the Williams gas volumes to the physical needs of the DWR long-term contracts to the extent possible. (*Id*., p. 9.)

In D.03-10-016, we were concerned with allocation of the Williams gas contract for operational purposes. That constrained our ability to allocate some of the Williams volumes, and the corresponding benefits, to PG&E. Here, however, we are looking at allocation of the dollar costs and benefits of that contract. Accordingly, we can now do what is equitable, and allocate some of the financial benefits of the contract to PG&E.

We adopt PG&E's recommended method for allocating the benefits of the Williams gas contract. The difference between the market and contract prices of gas are to be computed monthly, with that difference (the financial benefits of the contract) being allocated to the utilities pursuant to allocation percentages adopted in D.05-06-060. As described by PG&E, this calculation can be done without resorting to the use of forecasts. (PG&E Opening Brief, p.3, fn.3.) In essence, this is the existing practice. (See, SCE Opening Brief, pp. 8-9.) We are accordingly leaving this practice in place. DWR will continue to produce a forecast of this benefit in its annual revenue requirement, and this estimate will be subsequently trued-up after the fact using PG&E's proposed method.

The costs of the Williams gas contract are allocated using the same fixed percentages, as that aligns the allocation of costs with the allocation of benefits.[4] All parties agree that dispatch decisions are made based on the avoided cost of

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[4] For cost allocation purposes, the must-take nature of the contract also makes it more comparable to a non-avoidable cost, as argued by SCE. (SCE Opening Brief, p. 8, SCE Reply Brief, p. 10.)

the generating facility, rather than upon the actual cost of the gas. (See, e.g. SCE Reply Brief, pp. 8-9.) Accordingly, since the cost allocation does not affect dispatch decisions, a cost-follows-contracts approach is unnecessary.

IV. Gas Hedging

The parties were encouraged to reach a negotiated agreement on the issue of the allocation of gas hedging costs and benefits. (See, Transcript, vol. PHC-17, pp.624-625.) Despite being given significant time in this expedited proceeding to resolve this issue, the parties were unable to reach agreement. Because of the complexity of this issue, a briefing schedule was established to allow further development of the record. (See, Transcript, vol. PHC-18, pp.647, 658-663.)

In their briefs, the parties presented two possible approaches to hedging of unavoidable gas costs and benefits.[5] SDG&E argues that the utility that has operational responsibility for a particular electricity contract should be responsible for hedging 100% of that contract. (SDG&E Opening Brief, p. 7.) The costs and benefits of those hedges are then allocated by the percentages adopted in D.05-06-060. (*Id*.) SDG&E argues that this approach is most consistent with the allocation methodology adopted in D.05-06-060. (See, e.g. SDG&E Opening Brief, pp. 2, 7-10.) We agree that SDG&E's position is essentially the status quo under D.05-06-060.

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[5] There is no disagreement among the parties regarding allocation of gas hedging for avoidable contracts. (See, SDG&E Opening Brief, p. 9.)

PG&E and SCE, with some differences in details, generally argue that, going forward,[6] each utility should hedge only its proportional allocated share of each contract. For example, SCE would hedge 47.5% of a contract, PG&E 42.2%, and SDG&E 10.3%. Each utility would then reap 100% of the cost or benefit of its own hedge. (See, e.g. SCE Opening Brief, p. 7.)

Each of these approaches has certain benefits. SDG&E's approach provides that for each contract, only one utility, the utility responsible for operational decisions for that contract, makes hedging decisions. In other words, decision-making for a particular contract remains unified, rather than shared.

The SCE/PG&E approach allows each utility to make hedging decisions for a particular contract in the larger context of its particular supply portfolio and risk assessment. For example, a utility with a relatively large exposure to spot prices may seek more price stability, while one with more long-term contracts may be willing to accept a greater exposure to market price risk for a particular contract.

In short, the SDG&E approach appears to have operational benefits, while the SCE/PG&E approach has portfolio risk management benefits. It is difficult to compare the relative benefits and potential problems of these dissimilar and complex scenarios, but on balance, we believe that the SDG&E approach is the better choice. We do not wish to have divided operational responsibility, as would be required under the SCE/PG&E approach. The creation of unnecessary operational complexity is simply a bad idea.

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[6] PG&E and SCE also advocate that historical hedges be treated differently than future hedges, but they differ on how historical hedges should be treated. SDG&E argues that historical and future hedges should be treated identically.

In addition, SDG&E's approach is consistent with our approach in D.05-06-060, while SCE and PG&E are essentially trying to save a portion of the superseded cost-follows-contracts methodology used in D.04-12-014. We acknowledge that SCE relied upon D.04-12-014 in its hedging activities, but SDG&E convincingly points out how SCE is overstating its claimed reliance upon that decision:

> One clear fallacy with this argument is that the period of time that a utility management could have relied on D.04-12-014 was short and a clear minority of the "historical" period at issue. D.04-12-014 was issued December 2, 2004. Prior to December 2, 2004, the Commission had employed interim allocation methodologies that did not depend on a particular allocation of "above market" costs. SDG&E submits that the allocation methodologies issued by the Commission before December 2, 2004, were closer to the methodology eventually adopted in D.05-06-060 than the methodology adopted in D.04-12-014 that SCE claims utility management relied on. At most, utility managements could have relied on D.04-12-014 for only the six-plus months from December 2004 to June 2005 when D.05-06-060 was issued, but the "historical" period involved is at least 18 months long – and SCE proposes effectively a two-year "historical" period, including six months <u>after</u> D.05-06-060 was issued. Furthermore, on January 14, 2005, the Commission issued D.05-01-036, granting limited rehearing of D.04-12-014. This action should have told utility managements that they could not rely that D.04-12-014 would not be substantially modified.
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> Another inadequacy in SCE's argument is that it has failed to explain <u>how</u> it allegedly hedged differently between December of 2004 and June of 2005 than it did before or after that period. SCE says that prior to the issuance of D.05-06-060, IOUs made gas hedging decisions on the premise that they were hedging only their own customers' risks and that the economic consequences of their hedging decisions would be borne

> entirely by their customers. But SCE fails to explain what hedging transactions SCE actual engaged in, or refrained from, in response to D.04-12-014 that it would have done differently but for D.04-12-014. Furthermore, there is no reason to assume SCE would have hedged differently if it had known that some of the consequences would be borne by PG&E and SDG&E customers rather than SCE customers. Would SCE act more prudently if it knew only its customers would bear the consequences rather than ratepayers across the state? (SDG&E Reply Brief, pp. 10-11.)

While it is reasonable for utilities and others to act in reliance upon our decisions, we will not artificially preserve a decision beyond its express expiration date. On a going forward basis, consistency with our current methodology is preferable to adherence to a superseded methodology.

PG&E and SCE argue that historical hedges should be treated differently than future hedges, while SDG&E argues that all hedges should be treated identically. Given that D.05-06-060 held that the adopted allocation methodology applies retroactively to January 1, 2004, we hold that there is to be no difference in treatment of historical versus future hedges.

While we are denying the petition to modify on the gas hedging issue, we believe the parties have raised some significant issues in their briefs, and we will provide some additional direction in this area.

SCE points out that under the gas hedging approach adopted in D.05-06-060, and confirmed here, the other two utilities have an interest in the gas hedging strategy of the utility that is doing the hedging for a particular contract. (SCE Opening Brief, p. 7, SCE Reply Brief, pp. 15-16.) SCE predicts that this could result in the non-hedging utilities attempting to discover confidential and market sensitive information about the hedging strategy of the hedging utility. (*Id.*) While SDG&E may be correct that SCE's concerns "are overwrought," we will provide the assurance requested by SCE that the non-hedging utilities be precluded from challenging the hedging decisions of the responsible utility.[7] All utilities should assume that the hedging utility will act equally prudently, regardless of whether the consequences are borne only by its own customers or ratepayers across the state. (See, SDG&E Reply Brief, p. 11.) In short, the utility with operational responsibility also has hedging responsibility, and need not share its hedging strategy with the other utilities.

At the same time, we wish to reiterate that the utility with operational responsibility for a non-avoidable contract is responsible for engaging in an appropriate hedging strategy for the whole contract, not just its proportional share of the costs. In other words, the responsible utility is not necessarily required to hedge 100% of the gas costs of the contract, but must undertake a hedging strategy that is reasonable for 100% of the contract.[8]

V. Petition to Modify

In addition to the gas hedging issue, the petition to modify raised several other issues. We find that the arguments raised by the petition on those issues do not merit modification of our existing decision.

The petition to modify argues that the methodology adopted in D.05-06-060 is unfair, as it results in significant inter-utility cost shifts over time:

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[7] As part of the annual true-up process, each utility is entitled to see the relevant account balance resulting from hedging activities.

[8] This would also be the most prudent approach for the responsible utility to take. For example, if a responsible utility decided only to hedge 38% of a particular contract, because that is the share of costs allocated to its ratepayers, it is ultimately leaving its ratepayers exposed to 38% of the un-hedged 62% of the contract costs, and only getting the benefit of 38% of the portion of the costs that it hedged.

> [T]he Decision as adopted will cause substantial, and likely unsustainable, shifts in the annual DWR contract costs allocated to SCE's and PG&E's customers. The DWR Allocation Decision heavily front-loads costs only upon SCE's customers and then shifts the increased costs entirely to PG&E's customers in later years. The Decision's allocation methodology will result in SCE's customers bearing approximately $750 million in additional DWR contract costs through 2009, and then PG&E's customers bearing almost the same burden over just two years (i.e., 2010 and 2011). (Petition for Modification, p. 2.)

This argument is without merit, as the numbers it is based on are meaningless. As SCE later admits, these numbers are based on a comparison between the current allocation methodology adopted in D. 05-06-060, and the superseded methodology adopted in D.04-12-014:

> [By 2009], SCE's customers will have borne approximately $750 million more than they would have under D.04-12-014. During this same period, PG&E's customers would have a reduced allocation of contract costs relative to D.04-12014 until 2009. However, in 2010 and 2011, PG&E's customers would face enormous increases ($370 million per year on average) of allocated costs relative to D.04-12-014, while SCE's customers' DWR contract costs would be substantially reduced. (Petition to modify, p. 5.)

D.04-12-014 has been superseded, and the allocation methodology adopted in that decision has been replaced by the allocation methodology adopted in D.05-06-060. In short, SCE's argument compares the current methodology with a nullity. By focusing on the difference between D.04-12-014 and D.05-06-060, SCE is attempting to indirectly relitigate the very issue (on which SCE lost) that was the primary focus of D.05-06-060. This Commission has no interest in relitigating this issue yet again.

The petition to modify has three tables that illustrate this issue. Table IV-1 shows annual allocations based on D.04-12-014. Table IV-2 shows annual allocations based on D.05-06-060, and Table IV-3 shows the difference between the two. SCE's argument is based upon Table IV-3, but Table IV-2 is more relevant, as it shows the actual allocations that will be passed on to customers of the three utilities. In fact, as shown by Table IV-2, the customers will not see any radical spikes in their costs, as implied by SCE's argument. With a few minor exceptions, customers will see steadily declining costs. SCE has failed to show that the allocation methodology adopted in D.05-06-060 is unfair. The mere fact that SCE preferred the superseded allocation adopted in D.04-12-014 does not provide an adequate basis for modifying D.05-06-060.

SCE does have a valid observation that, in the later years, the contract costs allocated to PG&E are relatively high when compared to the volumes of energy it will be receiving under the contracts. (Petition to Modify, p.6.) This will result in a high per-kwh power charge for PG&E's customers in those years. (*Id*., p.8.) SCE expresses concern that the Decision may not be "maintained" in 2010 because of this shift in the cost burden relative to the energy received. (*Id*., pp. 6, 8.) One scenario that could make this concern a reality would be if PG&E came to the commission in 2008 or 2009, requesting relief from these high power charges, likely characterizing them as an unfair burden for its ratepayers.[9]

[9] In other words, after SCE's customers have borne the heaviest power charge load, and it is time for PG&E customers to take their turn, SCE fears that PG&E may come back to the Commission to keep from taking its turn, and ask SCE customers to again share more of the load.

We state now that we will look upon such an argument with disfavor. The allocation adopted in D.05-06-060 is designed to be fair over the life of the contracts. It is a permanent methodology, and as such balances the burdens over the longer term. We do not intend to revisit the adopted methodology, especially for issues that we have already taken into consideration, such as the relative cost burdens and benefits of the contracts over time.

The Petition to Modify also requests that the allocation methodology adopted in D.05-06-060 be made effective prospectively only (on January 1, 2006), rather than retroactively to January 1, 2004. (Petition to Modify, pp. 10-11.) As SDG&E points out, however, the retroactive application of the permanent methodology to January 1, 2004 has been a fundamental and ongoing assumption of both the parties and the Commission, and results from a stipulation of the three utilities in 2003. (Response of SDG&E to Petition to Modify, pp. 3-4.) There is no good basis for changing this assumption, and doing so now would be inequitable.

Finally, the Petition to Modify requests that the allocation that flows out of D.05-06-060 be implemented on January 1, 2006. (*Id*., p.18.) All active parties agree with this implementation date, and it is within the authority of the Assigned Commissioner and ALJ to administer housekeeping details of this sort. Modification of D.05-06-060 on this issue is unnecessary.

VI. Bond Charge

DWR's revised determination states that its 2006 revenue requirement for Bond Related Costs is $820 million.[10] DWR's modeling in support of its revised

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10 This is a reduction from DWR's August 3, 2005 request of $863 million.

determination indicates that it will receive the required $820 million if the Commission sets the bond charge at $0.00485. We adopt DWR's requested 2006 bond charge.

VII. 2004 and Partial 2005 True Up

Consistent with our past practice in this proceeding, this decision performs a "true-up" of DWR's 2004 revenue requirement, and adopts adjustments that reflect actual DWR costs and utility remittances through September, 2005. These are reflected in Appendix A.

VIII. 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 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.

IX. Assignment of Proceedings

Geoffrey F. Brown is the Assigned Commissioner and Peter V. Allen is the assigned ALJ in these proceedings.

X. Comments on Draft Decision

The draft decision of the ALJ in this matter was mailed to the parties in accordance with Pub. Util. Code § 311(g)(1) and Rule 77.7 of the Commission's Rules of Practice and Procedure.

Findings of Fact

1. The Commission adopted a permanent allocation methodology for this proceeding in D.05-06-060.

2. DWR's 2006 revenue requirement determination was submitted to the Commission on August 3, 2005, and a revised determination was submitted to the Commission on October 27, 2005.

3. The Williams gas supply contract is unique, and differs from DWR's electricity supply contracts.

4. The Williams gas supply contract was allocated for operational purposes in D.03-10-016.

5. Gas hedging costs and benefits associated with the unavoidable costs of electricity supply contracts are allocated by the methodology adopted in D.05-06-060.

6. Operational responsibility for each unavoidable electricity supply contract rests with one utility, rather than being divided among multiple utilities.

7. In addition to the gas hedging issue, the petition to modify raised other issues relating to the allocation methodology adopted in D.05-06-060.

8. DWR calculates a 2006 Bond Charge of $0.00485 per kWh.

9. The Commission's Energy Division has calculated utility-specific DWR Power Charges for 2006 from the adopted allocation of DWR's 2006 revenue requirement.

Conclusions of Law

1. The allocation methodology adopted in D.05-06-060 should be applied to DWR's 2006 revenue requirement determination.

2. The costs and benefits of the Williams gas supply contract need not be allocated the same way as the costs of electricity supply contracts.

3. Equity supports allocating some of the benefits and costs of the Williams gas supply contract to PG&E.

4. Allocation of gas hedging costs and benefits associated with unavoidable electricity supply contracts should be allocated consistently with the methodology adopted in D.05-06-060.

5. Operational responsibility for each unavoidable electricity supply contract should remain undivided.

6. The petition to modify failed to provide a basis for modification of D.05-06-060.

7. DWR's calculation of the 2006 Bond Charge should be adopted.

8. Energy Division's calculation of the utility-specific 2006 DWR Power Charges should be adopted.

O R D E R

IT IS ORDERED that:

1. The allocation of Department of Water Resources' (DWR) 2006 revenue requirement shown in Appendix A is adopted.
2. The benefits and costs of the Williams gas contract are allocated using the percentages adopted in D.05-06-060, as described above.
3. The costs and benefits of gas hedging for the unavoidable costs of DWR's electricity supply contracts are allocated using the percentages adopted in D.05-06-060, as described above.
4. Operational responsibility for unavoidable electricity supply contracts remains undivided, as described above.
5. The petition to modify is denied.
6. The 2006 Bond Charge is set at $0.00485 per kWh,` as calculated by the Department of Water Resources.
7. The 2006 Power Charges shown in Appendix A shall go into effect on January 1, 2006, and will remain in effect until further order of the Commission.
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.

This order is effective today.

Dated ______________________, at San Francisco, California.

APPENDIX A