Decision 04-07-037 July 8, 2004

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Establish Policies and Cost Recovery Mechanisms for Generation Procurement and Renewable Resource Development	Rulemaking 01-10-024 (Filed October 25, 2001)

ORDER MODIFYING DECISION (D.) 03-12-062 AND D.04-01-050, AND DENYING REHEARING OF D.03-12-062 AND D.04-01-050 AS MODIFIED

Decision (D.) 04-01-050 addressed long-term procurement planning issues as part of our rulemaking to establish the necessary operating procedures and ratemaking mechanisms for the utilities to resume full procurement responsibilities in the aftermath of the energy crisis. On February 25, 2004, timely applications for rehearing of D.04-01-050 were filed by the Cogeneration Association of California ("CAC") and the Energy Producers and Users Coalition ("EPUC") (joint rehearing application), Southern California Edison ("SCE"), San Diego Gas & Electric Company ("SDG&E"), the Alliance for Retail Energy Markets ("AREM"), Constellation NewEnergy, Inc. ("Constellation"), and the California Wind Energy Association ("CWEA") on a number of separate issues. SCE had earlier applied for rehearing of D.03-12-062, an interim opinion in this proceeding, and incorporates the arguments from its earlier application in its application for rehearing of D.04-01-050 ("Decision").[1] All of the listed applications for rehearing are resolved in today's order.

[1] Responses were filed by SCE, PG&E, the California Cogeneration Council ("CCC"), CAC and EPUC (joint response), and The Utility Reform Network ("TURN") and Utility Consumers' Action Network ("UCAN") (joint response).

We have considered all the arguments presented by all the rehearing applicants, and are of the opinion that good cause for granting rehearing has not been demonstrated. However, certain applications have identified areas where D.03-12-062, and D.04-01-050 should be modified, as is fully discussed below. Accordingly, we will order modifications of D.03-12-062 and D.04-01-050, and deny rehearing of the decisions as modified.

I. SCE'S APPLICATIONS FOR REHEARING OF D.03-12-062 AND D.04-01-050

SCE's applications concern Commission-ordered extensions of certain Qualifying Facility ("QF") contracts that are expired or will soon be expired. These contracts were extended under terms of a Standard Offer 1 ("SO1") contract regardless of the original contract type. In D.03-12-062, we ordered a one-year extension of these contracts, and in D.04-01-050 we ordered a five-year extension. We granted these extensions to ensure that QF power would continue to be available to the utilities, and the longer extension was intended to encourage QFs to continue to provide power over the longer term and to "encourage efficiency upgrades to existing facilities." (D.04-01-050, at p. 157.)

SCE takes issue with our continuance of the previously adopted short run avoided cost ("SRAC") formula in ordering the extension of utility QF contracts. SCE's applications contend that the Commission's SRAC formula results in the utilities paying prices that are too high, and, therefore, not in compliance with the Public Utility Regulatory Practices Act of 1978 ("PURPA"). SCE argues: 1) the decisions violate PURPA since they require SCE to purchase power at a rate greater than SCE's avoided cost; 2) the decisions fail to make separate stated findings of fact and conclusions of law on the adequacy of SRAC pricing, as required by Public Utilities Code section 1705; 3) the decisions are not supported by substantial evidence that the extension of certain QF contracts at current SRAC prices complies with PURPA's avoided cost standard; and 4) the decisions err in not providing for adjustments to SRAC on a retroactive basis.

The California Cogeneration Council ("CCC"), comprised of cogeneration QFs, filed timely responses to both of SCE's applications for rehearing. CCC's response to SCE's application for rehearing of D.03-12-062 was joined by The California Wind Energy Association ("CWEA"), and California Biomass Energy Alliance. CCC et al. counters that: 1) the decisions do not violate section 1705 concerning findings because the validity of the SRAC formula was not properly at issue in this proceeding; 2) SCE misrepresents the record in the proceeding, which does not show that the SRAC methodology results in excessively high prices; 3) SCE misrepresents the findings in the decision; and 4) the decisions are supported by substantial evidence. CCC also emphasizes that the decision should clarify that SRAC prices have not been shown to exceed avoided costs.

CAC and EPUC also filed a timely response to SCE's application for rehearing of D.04-01-050. CAC/EPUC responds: 1) there is no evidence to support SCE's allegation that the SRAC prices "systematically and materially" exceed SCE's avoided costs; 2) SRAC prices are not at issue in this proceeding; and 3) the Commission's contract extension is supported by substantial evidence. PG&E also filed a response that generally supports SCE's contentions.

In Rulemaking (R.) 01-10-024, we have considered certain issues surrounding the utilities' ongoing procurement of QF power. In D.03-12-062, as an interim measure, we ordered the utilities to "renegotiate expiring or expired contracts with existing QFs to cover the calendar year 2004." (D.03-12-062, at p. 81.) We further provided:

> The pricing terms for any such contract should be consistent with existing SRAC policy established in D.01-03-067, as modified by D.02-02-028; provided, however, to the extent that the Commission adopts a revised SRAC policy, the pricing terms of the contract shall be modified to reflect said revised SRAC policy as of the effective date of the Commission decision adopting a revised SRAC policy.

(D.03-12-062, at p. 57.) In D.03-12-062, we also criticized the SRAC methodology and explained that the SRAC pricing formula needs to be revisited. (*Id.* at pp. 56-57.)

In D.04-01-050, we extended the SO1 contracts for a five-year period in order to encourage the QFs to continue providing power over the long term. (D.04-01-050, at p. 157.) D.04-01-050 contained essentially the same provisions as D.03-12-062 regarding modification of the contracts to reflect any Commission changes in SRAC prices, and reiterated that the SRAC pricing methodology needs to be modified. (*Id*. at pp. 156, 158.)

As CCC and CAC/EPUC point out, the adequacy of the SRAC pricing methodology was not directly at issue in this procurement proceeding, and this proceeding was not the appropriate forum to revisit the adequacy of the formula. The purpose of the instant proceeding was not to reexamine avoided costs and the bases for calculating QF pricing. Rather, R.01-10-024 covered a number of issues concerning the utilities' long-term power procurement, as they transitioned out of the energy crisis. Specifically, D.03-12-062 and D.04-01-050 decided whether the QF contracts should be extended, and over what term, and the degree to which PURPA requires that the utilities purchase QF power. Although the utilities raised the issue of the adequacy of the SRAC methodology, the current SRAC formula had been adopted, and contested, in a previous proceeding, R.99-11-022. (See D.01-03-067, D.01-12-025, D.02-02-028.)

In fact, the current SRAC methodology was first developed in D.96-12-028 to comply with the mandates of Public Utilities Code section 390.[2] Originally intended as a short-term formula, we subsequently modified the section 390 SRAC formula in D.01-03-067. Although both SCE and QF parties challenged our revised SRAC formula in D.01-03-067, the California Court of Appeal upheld the Commission's adoption of the modified formula. (*Southern California Edison Co. v. Public Utilities Comm.* (2002) 101 Cal. App. 4th 982.)[3]

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[2] Unless otherwise stated all section references are to the Public Utilities Code.

[3] The Court upheld the Commission's modified SRAC formula, but remanded the case back to the Commission on the limited issue of whether retroactive adjustments were warranted for a specific period before the formula was modified. The Commission is currently considering the remanded issue.

In addition, we recently opened a new proceeding to comprehensively review avoided cost issues, including SRAC pricing. (Order Instituting Rulemaking (R.) 04-04-025.) As we explain in that proceeding, the new rulemaking is an effort to "continue our ongoing efforts to develop avoided costs in a consistent and coordinated manner across Commission proceedings," including QF pricing issues. (R.04-04-025, at p.1.) SCE, and other utilities, will have an opportunity to raise their SRAC concerns in R.04-04-025. Because SRAC pricing is not directly at issue in the current rulemaking, R.01-10-024, SCE's contentions regarding adequate findings and substantial evidence to support the adequacy of the SRAC formula are unavailing.

SCE also cannot maintain that the QF contract extensions necessitated a reexamination of the SRAC formula in this proceeding. When we adopted the modified SRAC formula, in D.01-03-067, its application was prospective for the indefinite future. Although that decision provided that the formula can be updated periodically, it held generally that, "Payments to qualifying facilities paid short run avoided costs or based on the short run avoided cost formula, shall be made consistent with the Transition Formula as modified today." (D.01-03-067, OP 8.) This language is broad enough to include any extension we may order, and SCE has no basis for arguing that the extensions require a new SRAC determination. This is particularly true since D.03-12-062 and D.04-01-050 specifically hold that any new contract must incorporate future SRAC modifications. Since the SRAC pricing was recently considered and upheld, there was no mandate to revisit the pricing here.

We concede that some of our holdings critiquing SRAC pricing (see D.03-12-062, at p. 57) can be read to imply that SRAC pricing was at issue in this proceeding. We now clarify that that was not our intent. We note that D.03-12-062 and D.04-01-050 expressly relied on the earlier decisions that adopted the SRAC formula (D.01-03-067, D.02-02-028), and therefore did not independently consider the accuracy of the SRAC pricing. Since we were not revisiting SRAC pricing, many of our statements in D.03-12-062 were not necessary to our decision to extend the utility QF contracts. Rather, the holdings explain the need to open an avoided cost rulemaking, which has now been opened. Because our statements may have been misleading, we will modify certain holdings from D.03-12-062 in today's order.

In any event, SCE overstates the findings in the decisions concerning the SRAC formula. Although we were clear in D.03-12-062 on the need for SRAC prices to be reviewed, we did not state they are inadequate or in violation of PURPA. D.03-12-062 stated the utilities have "paid too much for QF power *in certain time periods relative to market prices*…" (D.03-12-062, at p. 56 (emphasis added).) As CCC notes, spot market prices are not necessarily the same as avoided costs, and therefore this is not a statement that avoided cost has been exceeded. Furthermore, PURPA does not require that QF prices be less than avoided cost at all times. Rather, PURPA requires a reasonable approximation of avoided costs over time. (18 C.F.R. § 292.304 (b)(5).)

SCE's claim that the evidence in this proceeding demonstrates that the SRAC formula violates PURPA is similarly unconvincing. According to SCE, the evidence in this proceeding shows that "the SRAC formula has yielded and will continue to yield prices for QF energy that systematically and materially exceed avoided cost." (SCE App. for Rehg. of D.03-12-062, at p. 4.) In fact, the evidence cited by SCE only demonstrates that during *some periods* SRAC formula costs exceeded spot market costs. This is not the same as systematically exceeding avoided costs in violation of PURPA, and the evidence in the proceeding does not show systematic and continuously excessive prices.

For instance, although SCE cites to evidence indicating that SRAC prices have exceeded avoided costs during specific time periods (see e.g., SCE/Bergman Exs. 16C/17, at 58:4-59:4; CCC/Beach Ex.102, 26:15-16), the evidence does not demonstrate that SRAC prices violate PURPA. There is also a good deal of evidence in the record supporting the view that these snapshots of certain time periods are not necessarily representative of how the power market will function during other periods. (Ex. 104, Resp. to Q 1(a).) Therefore, over time the SRAC prices may reasonably represent avoided costs, as required by PURPA. (See TR, at 4702:14-4703:2 (CCC/Beach).)

CCC's suggestion that the Commission clarify that the evidence in this proceeding does not demonstrate that SRAC prices exceed the utilities' avoided costs is well taken. We agree that the evidence in this proceeding has not demonstrated that SRAC prices are in violation of the PURPA avoided cost standard. However, that evidence has raised issues concerning the accuracy of the SRAC formula, which the Commission will review in its recently opened rulemaking.

SCE's final point, that the SRAC prices must be adjusted retroactively, is premature. As stated, we have not found that the SRAC methodology is inadequate, and unless and until we do it is premature to consider whether retroactive adjustments should be made.

II. SDG&E'S APPLICATION FOR REHEARING

SDG&E challenges D.04-01-050 on the following grounds: 1) the affiliate transactions ban is unlawful;[4] 2) the record does not support a directive requiring changes to SDG&E's procurement risk committee;[5] and 3) the Commission must grant rehearing to clarify that, consistent with the law, a Certificate of Public Convenience and Necessity ("CPCN") is only required when a plant is constructed by a utility.

A. Affiliate Transactions Ban

The Decision adopted a permanent ban on affiliate procurement transactions, with exceptions for anonymous transactions through brokers and exchanges, transactions for natural gas services between SDG&E and SoCalGas, and grandfathering of already existing contracts with affiliates (e.g., QF contracts). (See Conclusion of Law 25, at p. 196; see also Finding of Fact 42, at p. 187 and Conclusions of Law 19-20.) SDG&E contends the affiliate ban is unlawful for several reasons. None of its arguments have merit.

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[4] Sempra Energy Resources makes many of the same arguments in a Petition for Modification and/or Clarification of D.04-01-050 filed on February 10, 2004.

[5] SDG&E makes many of the same arguments in a Petition to Modify D.04-01-050 filed on February 20, 2004.

First, SDG&E contends that the ban, which it characterizes as "a drastic step," violates AB 57 (codified at § 454.5) and its "support for open, competitive bidding processes and solicitations." (SDG&E App., at p. 5.) Specifically, SDG&E relies on AB 57's provisions requiring that the electric utilities' procurement plans include "a competitive procurement process" (codified at § 454.5(b)(5)) and that the Commission "specify criteria to ensure that the auction process is open and adequately subscribed." (§ 454.5(c)(1).) SDG&E argues that the affiliate ban is "incongruous," "inconsistent with the law, " and "illogical" because it would reduce the number of potential suppliers in the market. (*Id*.) SDG&E also invokes AB 57's provision that a procurement plan approved by the Commission shall "[e]nable the electrical corporation to fulfill its obligation to serve its customers at just and reasonable rates." (SDG&E App., at p. 6; see §454.5(d)(1).) SDG&E argues that the affiliate ban violates this provision because it hampers a utility's "obligation to enter into the best deals for consumers." (SDG&E App., at p. 6.)

These arguments are unpersuasive. The provisions in section 454.5(b) on which SDG&E relies do reflect a policy favoring competitive bidding, but they do not preclude the Commission from placing restrictions on procurement transactions between affiliates. SDG&E's argument to the contrary is unsupported by the express language of the statute. Its argument is based entirely on inferences, and these inferences are not reasonable. The affiliate ban may well promote a fair and competitive solicitation process, rather than hinder it.

Second, SDG&E contends that although the Decision contains findings and conclusions supporting the affiliate ban, those findings and conclusions "lack a sufficient evidentiary basis." (SDG&E App., at p. 7-8 ("extreme actions such as adopting an outright ban should not be made absent a solid evidentiary demonstration of need").) More specifically, SDG&E argues that the evidentiary record does not establish that the existing affiliate rules are inadequate to protect against affiliate abuses. (*Id*. at pp. 7-8.)

Contrary to SDG&E's argument, the record does in fact support the key findings regarding the affiliate ban. The Decision found, as SDG&E acknowledges, that the Commission does "not have the same level of oversight and authority over affiliate transactions that we do over direct utility operations" (SDG&E App., at pp. 7-8.) The Decision also found that "cross-subsidies and anti-competitive conduct has occurred in the past in affiliate procurement transactions." (Both findings are included in Finding of Fact 19.)

These two findings, taken together, weigh heavily in support of a ban on procurement transactions between affiliates, and each has a sound basis. The first finding is based on the legal parameters of the our authority, which is less direct with respect to unregulated affiliates, and on our experience in overseeing affiliate transactions, and is not reasonably subject to dispute. The second is based on record evidence, including an exhibit listing disallowances for procurement transactions that the three large investor-owned utilities prepared at the request of Administrative Law Judge Walwyn. (Finding of Fact 19; D.04-01-050, at p. 67 [citing record evidence showing that the largest disallowances for procurement expenses in the 17-year period between 1980 and 1996 involved affiliate transactions].)[6]

As we noted in the Decision, the record shows that SDG&E buys "gas and transportation and storage services from SoCalGas, for its own procurement as well as an agent for DWR." SDG&E has also "recommended additional SoCalGas services to DWR." (D.04-01-050, at p. 72, citing Exhibits 110C and 132.) These findings were based on information in the record provided by SDG&E. The Decision also noted that SDG&E's Electric and Gas Procurement Committee ("EGPC" or "procurement risk committee") includes members of management of both the parent company and SoCalGas. Although the multiple responsibilities and functions of each of the EGPC members was unclear at the time the Decision issued, the revised information submitted

[6] This exhibit and other evidence in support of the affiliate moratorium was summarized in the Commission's recent order rejecting challenges to the temporary affiliate moratorium, *Order Modifying Decisions 02-10-062 and 02-12-074 and Denying Rehearing* (D. 03-06-076, pp. 13-15.) The evidence discussed in that order supports the permanent ban as well.

by SDG&E pursuant to the Decision shows that most of the members of SDG&E's EGPC are part of SoCalGas management and two of them are also are in the management team of the parent company. Under these circumstances, the potential for conflicts of interest in procurement decisions is a serious concern. Finally, as the Decision notes, "[t]he most direct and effective means to avoid any potential conflict of interest is to simply prohibit the transactions." (D.04-01-050, at p. 71.)

SDG&E argues next that if the Commission maintains the affiliate ban, it should add a fourth exception to the three already adopted. SDG&E urges the Commission to adopt a fourth exception for "affiliate procurement transactions that receive prior Commission approval." SDG&E points out that the Commission recently made such an exception for Mountainview. (SDG&E App., at pp. 9-10.) SDG&E's argument does not constitute a claim of legal error. [7]

SDG&E also makes a half-hearted argument that "there is no rational basis for an outright ban" on procurement transactions with affiliates, and therefore the ban violates its right to "substantive due process" protected by the Fourteenth Amendment to the United States Constitution. (*Id.* at pp. 10-11.) The premise of this argument (no rational basis for the ban) borders on the frivolous, and SDG&E acknowledges that there is no fundamental right implicated here. This argument is without merit and does not warrant further discussion.

SDG&E further argues that the ban violates the Dormant Commerce Clause by impermissibly placing burdens on interstate electricity markets. (*Id.* at pp. 11-12.) We considered and rejected this same argument very recently in D.03-06-076, at pp. 15-16 (rejecting Sempra Energy Resources' argument that the affiliate moratorium violated the Dormant Commerce Clause). We reaffirm these holdings.

Finally, SDG&E argues in a perfunctory manner that the Commission's affiliate ban is preempted by the Federal Power Act, in which Congress "occupied the

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[7] Sempra Energy Resources makes the same argument in a Petition for Modification and/or Clarification of D.04-01-050 filed on February 10, 2004.

field" of regulation of wholesale energy transactions. (*Id.* at pp. 12-13.) The Commission also considered and rejected this argument in Decision 03-06-076 (*Id.* at pp. 17-18), and SDG&E does not advance any additional arguments for the Commission's consideration in its current application for rehearing.

For the foregoing reasons, SDG&E has failed to establish a persuasive argument that the affiliate ban is unlawful.

B. SDG&E's Procurement Risk Committee

In D.04-01-050, we discussed concerns about the potential for conflicts of interest in SDG&E's procurement transactions, in light of its affiliate relationship with SoCalGas and with the parent company of both utilities, Sempra. The Decision expressed concern over the fact that SDG&E's procurement risk committee appeared to be dominated by Sempra, and its affiliate, SoCalGas. An exhibit provided by SDG&E in response to a request from the Administrative Law Judge indicated that a majority of the members of its EGPC were employees of "Sempra Energy Utilities" (abbreviated as "SEU" in Exhibit 70). We directed SDG&E to file a revised Exhibit 70 that shows that this committee is composed entirely of SDG&E management. (D.04-01-050, at p. 74.)

In addition, we ordered an audit of the overlapping procurement-related responsibilities and functions of the management of SDG&E, SoCalGas, and Sempra. The Decision noted that when we approved Sempra's request to further integrate the management of SDG&E and SoCalGas in 2001 (in D.01-09-056), SDG&E was not procuring electricity. Now that SDG&E has resumed procurement:

> A review of whether negotiated transactions with SoCalGas should be subject to special transaction rules should be undertaken, especially since SoCalGas's services are under an incentive mechanism while neither SDG&E's electric procurement operations nor its DWR related gas procurement are under an incentive mechanism.

(D.04-01-050, at p. 74.)

In its application for rehearing, SDG&E contends that the Decision's directive concerning the composition of its EGPC committee is based on the mistaken belief that "SEU" means Sempra management. SDG&E states that in fact, it used the designation "SEU" to refer to a management employee of either SoCalGas or SDG&E. (SDG&E App., at p. 14.) SDG&E asserts that its "EGPC is correctly constituted as is," i.e., entirely SDG&E management, just as the Decision directed. (*Id.* at p. 14.)[8] Therefore, according to SDG&E, there is no need to make any changes to the committee membership or to Exhibit 70, although it has revised Exhibit 70 in accordance with the Decision.

SDG&E has failed to grasp the nature of our concerns about potential conflicts of interest in SDG&E's procurement transactions. SDG&E assures us that its EGPC "is already comprised 'only of SDG&E management.'" (SDG&E App., at p. 14.) This statement may be true, but it is potentially misleading unless one examines the composition of the EGPC more closely. SDG&E's Revised Exhibit 70, which is more informative than the original version, indicates that seven of the nine members of SDG&E's EGPC hold senior management positions in SDG&E *and* SoCalGas. Two of those seven are also in the top management of the parent company. Only two members (out of nine) do *not* hold positions in SoCalGas. (Revised Exhibit 70, p. 4 (copy attached).)[9] For the reasons we set forth in the Decision (at pp. 72-75), we have good reason to be concerned about the potential for conflicts of interest in SDG&E's electric and gas procurement transactions when its procurement decisions are made by individuals who represent SoCalGas and, in some cases, the parent company of both utilities. And as we noted in the Decision, the fact that SoCalGas is subject to incentive-based ratemaking while SDG&E is not creates an incentive to have SDG&E's ratepayers cross-subsidize SoCalGas.

SDG&E is correct that the Decision incorrectly states that the designation "SEU" on the original Exhibit 70 indicates employees of the parent company. SDG&E has now clarified that "SEU" was used to indicate a committee member in the

[8] SDG&E makes the same argument in a Petition to Modify D.04-01-050 filed on February 20, 2004.

[9] Advice Letter 1569-E (filed Feb. 23, 2004).

management of SoCalGas, SDG&E, or (in most cases) both. (See Revised Exhibit 70.) But for the reasons discussed above, this clarification does not obviate the concerns expressed in the Decision. We will therefore correct the factual error pointed out by SDG&E, but we note that the presence of so many SoCalGas managers on SDG&E's EGPC is still a matter of concern.

On this point, SDG&E argues that that there is nothing improper about members of the EGPC wearing "two hats" because we approved the further integration of the two utilities several years ago (in D.01-09-056). As we pointed out in the Decision, however, when D.01-09-056 was issued SDG&E was not in the business of procurement. This is a fundamental change in circumstances. The audit ordered by the Decision will provide the information necessary to evaluate whether the current structure and conditions are effective in preventing conflicts of interest and cross-subsidization in SDG&E's procurement.

C. CPCN Requirement For New Utility-Owned Generation

SDG&E contends that rehearing must be granted "to clarify that, consistent with the law, a CPCN is only required when a plant is constructed [as opposed to purchased] by a utility." (SDG&E App., at p. 19), but SDG&E fails to specify what statement in the 201-page decision it contends is legally erroneous.

SDG&E states: "D.04-01-050 also contains legal error by including a statement that could be interpreted to require a CPCN whenever a utility acquires ownership of a new plant (D.04-01-050, p. 88.)" (SDG&E App., at p. 19.) SDG&E contends this "conclusion is overbroad and incorrect" as Public Utilities Code section 1001 "only requires a CPCN if a utility constructs a new plant." (*Id*.) But there is no discussion of this topic on page 88 of the Decision,[10] and SDG&E fails to quote the Decision language it is referring to. Thus, it is impossible to determine with certainty what statement in the Decision SDG&E contends is erroneous. SDG&E does not

[10] Page reference is to the mimeo form of the Decision that was mailed to the parties on 1/26/04.

contend that the Decision contains any erroneous findings or conclusions (or directives) concerning CPCN requirements.

In an application for rehearing, parties must "set forth specifically the ground or grounds on which the applicant considers the order or decision to be unlawful." (§ 1732). We decline to address SDG&E's CPCN argument because SDG&E failed to identify the allegedly erroneous statement in the 201-page decision. Moreover, we can find no language that could be interpreted in the manner SDG&E suggests.

D. Conclusion

SDG&E has failed to demonstrate that the Decision is legally erroneous. SDG&E's argument that the affiliate ban is unlawful is unpersuasive, and the Decision's mention of CPCN requirements for utility-owned generation facilities is not legally erroneous. We will correct a factual error in the Decision concerning the composition of SDG&E's risk procurement committee, but the need for more information to enable us to evaluate the potential for conflicts of interest in SDG&E's procurement transactions still remains.

III. AREM'S AND CONSTELLATION'S APPLICATIONS FOR REHEARING

AREM challenges D.04-01-050 on the following grounds: 1) the Commission's stated reasons for imposing resource adequacy requirements on energy service providers ("ESPs") are factually incorrect; 2) the Commission lacks authority to impose resource adequacy requirements on ESPs; and 3) requiring ESPs to satisfy adequacy requirements for loads served under pre-existing contracts is unlawful. AREM also requests oral argument on its rehearing application.

Constellation challenges D.04-01-050 on the following grounds: 1) the Commission lacks jurisdiction to directly impose resource adequacy requirements on ESPs; 2) the Commission lacks jurisdiction to impose forward contracting requirements on ESPs; and 3) D.01-04-050 makes numerous factual errors in attempting to establish a reason for imposing resource adequacy requirements on ESPs.

Because AREM and Constellation assert largely similar allegations of error, their claims are considered together.

A. The Commission Did Not Exceed Its Jurisdiction By Imposing Resource Adequacy Requirements On ESPs

AREM and Constellation (collectively, "the ESPs") allege that the Commission lacks jurisdiction to impose resource adequacy requirements on ESPs. According to the ESPs, Public Utilities Code section 394(b)(10) only permits the Commission to determine whether an ESP has demonstrated "technical and operational ability," and does not allow us to impose resource adequacy requirements on ESPs. The ESPs further assert that section 394(b)(10) merely requires an ESP to provide information to the Commission demonstrating that it has "the skills and expertise necessary to operate as an ESP," and that the Commission performs only a licensing function with respect to evaluating ESPs under section 394(b)(10). (AREM App., at pp. 5-6; Constellation App., at p. 2.) Finally, the ESPs claim that section 394(f) conflicts with our interpretation of section 394(b)(10) because section 394(f) provides that registration with the Commission does not constitute regulation of the rates or terms and conditions of service offered by ESPs. (AREM App., at p. 6; Constellation App., at pp. 2-3.) These allegations of legal error lack merit.

There is no dispute that section 394(b)(9)-(10) requires the Commission to ascertain that an ESP possesses "technical and operation ability" and "financial viability" before registering with the Commission. The only dispute is whether these terms permit us to impose resource adequacy requirements on ESPs. In D.04-01-050, we interpreted section 394 to allow the imposition of resource adequacy requirements. Our interpretation of the Public Utilities Code is entitled to substantial deference. (See, e.g., *Southern California Edison Co. v. Peevey* (2003) 31 Cal.4th 781, 796.)

Our requirement that ESPs procure reserves sufficient to serve their entire load is a legitimate exercise of our duty under section 394(b) to protect consumers by ensuring that ESPs have the financial, technical and operational ability to meet their contractual obligations. (See D.04-01-050, at pp. 37-43.) Our imposition of resource adequacy requirements on ESPs is a logical implementation of our jurisdiction to determine an ESP's operational capability, because adequacy of resources directly affects an ESP's capability to operate. In addition, our authority to demand proof of technical and operational capability from ESPs, as provided in section 394(b)(10), must be read in conjunction with section 394.25(b)(3), which authorizes the Commission to suspend or revoke an ESP's registration if evidence indicates that the ESP is not financially or operationally capable of providing the offered electric service. (See, e.g., *DeVita v. County of Napa* (1995) 9 Cal.4th 763, 778-9 (when statutes touch upon a common subject, they should be construed in reference to each other).) Taken together, and viewing the statutory scheme as a whole, the Commission may determine whether an ESP possesses technical, operational, and financial viability before registration, and retains continuing jurisdiction to reassess these factors as circumstances may require.

The ESPs also assert that our interpretation of section 394(b)(10) conflicts with our interpretation of section 394(f) because section 394(f) provides that registration with the Commission does not constitute regulation of the rates or terms and conditions of service offered by ESPs. (See AREM App., at p. 6; Constellation App., at pp. 2-3.) This argument lacks merit because section 394(f) is not relevant to the issue of resource adequacy, and in any event the imposition of resource adequacy requirements does not constitute regulation of ESPs in violation of section 394(f). Section 394(f) states that "[n]othing in this part authorizes the commission to regulate the rates or terms and conditions of service offered by electric service providers." By imposing resource adequacy requirements on ESPs, however, the Commission is in no way setting rates, terms and/or conditions with respect to the service offered by ESPs. Rather, we merely require that, in order to register with the Commission, ESPs must demonstrate technical and operational ability and financial viability. Imposing these *pre-registration* requirements on ESPs does not constitute regulation of the rates, terms or conditions of service of ESPs, but instead ensures that only sufficiently qualified ESPs enter the utility service marketplace. Under this approach, an ESP "remains free to request whatever pricing and other terms it desires from the customer," while the resource adequacy requirements ensure that "the failure of an ESP to procure sufficient reserves does not affect *all other* customers on the grid." (D.04-01-050, at p. 40 (emphasis in original).)

Finally, Constellation challenges D.04-01-050 on the ground that the Decision contains certain "factual errors" in articulating a basis for the imposition of resource adequacy requirements on ESPs. (Constellation App., at pp. 4-7.) Section 1757 provides that parties may challenge a Commission decision on the ground that the decision is not supported by "substantial evidence in light of the whole record" pursuant to section 1757(a)(4).

In this proceeding, we weighed all of the evidence submitted by all parties, including Constellation and AREM, in reaching our conclusion that resource adequacy requirements should be imposed on all LSEs, including ESPs. (See D.04-01-050, at pp. 183-84, 192-93, Findings of Fact 7-18, Conclusions of Law 2-7.) We found no basis for exempting ESPs from a requirement that is prospectively to be applied to all LSEs in the interest of ensuring reliable service. The Decision contains a detailed discussion of reserves and resource adequacy issues (see D.04-01-050, at pp. 10-34), and also addresses at length the factual and policy rationale for imposing resource adequacy requirements on ESPs (see D.01-04-050, at pp. 34-43). Constellation specifically alleges that there is no factual basis for the Commission's conclusion that ESPs may lack appropriate financial incentives to ensure reliable service under adverse conditions,[11] or that the drop in direct access load from 15% to 2% during the energy crisis supports the

[11] We specifically considered all of the evidence submitted by all parties on the issue of financial incentives for ESPs to ensure reliable service under adverse conditions. In particular, TURN's September 22, 2003 Reply Brief (at pp. 19-21) discusses at length the evidence presented to the Commission addressing the issue of financial incentives for ESPs. TURN specifically refutes the testimony offered by AREM witness Fulmer, and discusses the testimony offered by TURN witness Woodruff as a rebuttal to AREM's preferred evidence. TURN also notes that the CA ISO was not convinced that the contracts executed by ESPs provided sufficient assurances that ESPs will meet their peak load plus the appropriate level of reserves. (See TURN Reply Brief, at p. 19; see also CA ISO Opposition Brief, at p. 68.) In the Commission's view, this evidence demonstrated that ESPs may lack appropriate financial incentives to ensure reliable service under adverse conditions. (See D.04-01-050, at p. 40.)

Commission's imposition of resource adequacy requirements on ESPs.[12] (See D.04-01-050, at p. 40.) However, we did not rely solely on the drop in direct access load as the only factual basis for the imposition of resource adequacy requirements on ESPs. Indeed, the Decision specifically notes that "tight energy supplies and market manipulation" contributed to the ESPs' inability to provide reliable service to their customers during the energy crisis. (*Id.*) In any event, our factual determinations are entitled to substantial deference as long as they are supported by inferences reasonably drawn from the record. While Constellation may disagree with our reasoning regarding the imposition of resource adequacy requirements, such disagreement does not mean that our conclusions are not supported by substantial evidence under section 1757.

Thus, the Commission reasonably exercised its jurisdiction under Section 394 in imposing resource adequacy requirements on ESPs, and our findings in this regard are supported by substantial evidence in light of the entire record.

B. The Commission Did Not Exceed Its Jurisdiction By Imposing Forward Contracting Requirements On ESPs

Constellation next alleges that the Commission lacks jurisdiction to impose forward contracting requirements on ESPs. (See Constellation App., at pp. 3-4.) According to Constellation, the Commission's requirement that utilities, including ESPs, forward contract 90% of their monthly peak needs for the months of May-September exceeds the Commission's jurisdiction under section 394. This allegation of error lacks merit.

In D.04-01-050, we sought to achieve an appropriate balance between forward contracting and spot market purchases. (See D.04-01-050, at pp. 28-34.) We noted that, for many months of the year, the utilities already forward contract on a *de facto* basis as much as 90% of their capacity needs. (*Id.* at p. 28.) We concluded that this should not be a year-round requirement, but rather should apply only to peak summer

[12] The drop in direct access load from approximately 15% to 2% was documented in D.02-03-055. (See D.02-03-055, at pp. 8-10 and Table 1.)

months, and that the utilities may request authorization from the Commission to dip below this requirement on a case-by-case basis. (*Id.* at p. 30.) The Commission concluded that, while no party advocates extensive reliance on the spot market, "it may be both reasonable and prudent to allow for some portion of resource needs to be met through the spot market, a practice that some utilities engaged in under pre-AB1890 [Assembly Bill 1890] resource procurement." (D.04-01-050, at p. 184, Finding of Fact 14.)

Constellation argues that the forward contracting requirement articulated in D.04-01-050 cannot be applied to ESPs. This argument lacks merit for the same reasons that the ESPs' argument regarding resource adequacy requirements, above, lacks merit. Section 394(b)(9)-(10) requires the Commission to inquire into the technical and operational ability and the financial viability of ESPs before allowing them to be registered with the Commission. Section 394.25(b)(3) provides the Commission with ongoing jurisdiction to suspend or revoke an ESP's registration if evidence indicates that the ESP is not financially or operationally capable of providing the offered electric service. As part of our exercise of this jurisdiction, we determined that ESPs, like other LSEs, should be required to forward contract 90% of their capacity needs for five months of the year as part of an overall system of reliability requirements. (See D.04-01-050, at pp. 10-53, 184, Finding of Fact 19.) This requirement does not constitute regulation of the rates or terms and conditions of service offered by ESPs in violation of section 394(f) because the Commission is not regulating any term or condition of any contract between ESPs and their customers, and because ESPs remain free to request whatever pricing and other terms they desire from their customers. (See D.04-01-050, at p. 40.) As noted above, the reliability requirements imposed in D.04-01-050 are designed to ensure that an ESP's inaction with respect to reliability does not adversely affect all other customers on the grid. (*Id*.)

Thus, we did not exceed our jurisdiction in imposing forward contracting requirements on ESPs. However, D.04-01-050 should be modified to clarify that the forward contracting requirements articulated in D.04-01-050 apply to all LSEs, including ESPs.

C. The Commission's Imposition Of Resource Adequacy Requirements Does Not Violate The Contracts Clause

AREM asserts that requiring ESPs to satisfy resource adequacy requirements for loads served under pre-existing contracts is unlawful under the Contracts Clause of the United States Constitution. (AREM App., at pp. 9-11.) According to AREM, there is a possibility that ESP customers will refuse to pay charges associated with the Commission's reliability requirements, and accordingly some ESP contracts could be rendered uneconomic, resulting in a substantial impairment of an ESP's contractual rights. (*Id*. at p. 9.) This allegation of error lacks merit.

First, AREM expressly acknowledges the speculative nature of any future harm, stating that the Commission's resource adequacy requirements could "potentially" have a significant impact on contracts entered into before the requirements were adopted, and "may" render some ESP customer contracts uneconomic. (*Id*. at pp. 9, 11.) As AREM notes, under the Supreme Court's Contracts Clause jurisprudence, the threshold inquiry is whether state law has, *in fact*, and not in theory, operated as a substantial impairment of a contractual relationship. (See *Allied Structural Steel v. Spannaus* (1978) 438 U.S. 234, 244.) Thus, AREM's contract impairment claim is speculative at best, and AREM cites no example of an actual ESP contract that will be substantially impaired due to the Commission's resource adequacy requirements.[13]

However, even assuming that some ESP customers might refuse to pay charges associated with the requirements articulated in D.04-01-050, this does not

[13] In particular, it should also be noted that D.04-01-050 defers implementation of the resource adequacy requirement until 2008, and defers implementation of the forward contracting requirement until 2007. (See D.04-01-050, at p. 184, Findings of Fact 18-19.) AREM acknowledges that "most of its contracts now in effect will expire in the next few years." (AREM App., at p. 11.) Thus, in addition to the speculative nature of any impairment of contract rights, it is entirely possible that most of AREM's existing contracts will have expired before the resource adequacy and forward contracting requirements take effect.

amount to a Contracts Clause violation. The cases cited by AREM demonstrate that courts will find a Contracts Clause violation when the terms of a pre-existing contract are changed, resulting in a substantial impairment of contract rights. (See, e.g., *Allied Structural Steel*, *supra* (Minnesota statute substantially modifying a basic term of a pension contract violates the Contracts Clause); *Energy Reserves Group, Inc. v. Kansas Power and Light Co.* (1983) 459 U.S. 400, 413-414 (no Contracts Clause violation even though state statute extinguished utility's obligation to comply with clause that would have permitted Energy Reserves to increase the price of natural gas sold under two contracts); *General Motors Corp. v. Romein* (1992) 503 U.S. 181, 186-87 (Court did not reach issue of impairment of contract rights because there was no contractual agreement regarding the specific workers' compensation terms allegedly at issue).) AREM has not demonstrated that our imposition of resource adequacy requirements has effected any actual change to the terms and conditions of contracts between ESPs and their customers, and has not demonstrated a substantial impairment of pre-existing contract rights. Accordingly, this allegation of legal error lacks merit.

Thus, the Commission's imposition of resource adequacy requirements on ESPs does not constitute a Contracts Clause violation.

D. Request for Oral Argument

AREM has requested oral argument on its application for rehearing of D.04-01-050. Rule 86.3 of the Commission's Rules of Practice and Procedure specifies that oral argument will be considered if the application "demonstrates that oral argument will materially assist the Commission in resolving the application, and . . . raises issues of major significance for the Commission." (Cal. Code of Regs., Tit. 20, § 86.3.) In this instance, after three prehearing conferences and almost a month of evidentiary hearings, the Commission has a full understanding of the record. There are no legal issues requiring further oral argument. Accordingly, AREM's request for oral argument should be denied.

IV. CAC/EPUC'S APPLICATION FOR REHEARING

CAC and EPUC both support and challenge D.04-01-050. CAC and EPUC maintain: 1) the Commission has properly recognized the need to preserve the benefits that QF resources bring to California; 2) the Commission should clarify that the calculation of reserves for distributed generation resources in a future rulemaking should apply only to distributed generation resources, and should expressly exclude QF resources from the contemplated reconsideration; 3) the definition of a load serving entity should expressly exclude QF customer generation operations; 4) all resources have associated environmental adders and each resource must be evaluated on a comprehensive and non-discriminatory basis; 5) the State's integrated energy policy report specifically provides for the consideration of cogeneration resources as a part of the State's energy future; 6) the Commission should specifically recognize the State's QF program as an energy efficiency program to foster proper comparisons among energy efficiency programs; and 7) the terms and conditions of the 5-year SO1 contract should be consistent with the Commission-approved Uniform Offer 1 As-Available Capacity and Energy Power Purchase Agreement.

CAC/EPUC's filing was originally entitled "Motion for Clarification and Application for Rehearing…" For the most part, CAC/EPUC's allegations are requesting policy changes or clarifications. As mentioned, Public Utilities Code section 1732 and Commission Rule 86.1 provide that applications for rehearing "shall set forth specifically the grounds on which the applicant considers the order or decision of the Commission to be unlawful or erroneous." In fact, CAC/EPUC's comments are more in the nature of comments on the decision, and are therefore not appropriate after a final decision has been issued. CAC/EPUC's application must be denied because they have not raised appropriate grounds for rehearing. This denial will be without prejudice, in the event that CAC/EPUC wants to refile as a petition for modification, or a motion for clarification. However, CAC/EPUC is cautioned that it should only request specific changes or clarifications, and it should not use a filing after a decision is issued as an opportunity for general comments.

V. CWEA'S APPLICATION FOR REHEARING

CWEA challenges D.04-01-050 on the ground that footnote 89 of the Decision may, in certain circumstances, conflict with Public Utilities Code Section 399.25. CWEA explains that the Commission's obligation under 399.25 is to favor general cost recovery for upgrades that are necessary for renewables, whereas footnote 89 indicates that the supplier should pay for any network upgrades needed to ensure power deliverability under the contract. We will modify the Decision to state that the question of who pays for network upgrades necessary to ensure power deliverability under PPAs will be decided in a manner consistent with the requirements of section 399.25.

Footnote 89 to D.04-01-050 states: "In assessing deliverability for specific PPAs the utilities propose entering, we should also look to see that the supplier pays for any network upgrades needed to ensure power deliverability under the contract." It should be noted that CWEA does not allege that footnote 89 actually conflicts with section 399.25, but rather that it may "under certain circumstances" conflict with section 399.25. (CWEA App., at p. 1.) Thus, CWEA's allegation of error is speculative in nature, and no actual conflict between footnote 89 and section 399.25 is presented at this time.

Section 399.25 applies only to the Commission's actions with respect to transmission facilities that are necessary to the achievement of renewable power goals. That section provides that, where new transmission facilities are required to meet the state's renewable energy mandate, the Commission must determine whether the new facilities will provide benefit to the transmission network and are necessary to achieve the renewables portfolio standard. (See § 399.25 (b)(1).)

While CWEA does not identify a current conflict between footnote 89 and section 399.25, in the interest of clarity and consistency, we will modify footnote 89 to indicate that decisions about who pays for network upgrades to ensure power deliverability under PPAs will be decided consistent with the requirements of section 399.25.

Therefore **IT IS ORDERED** that:

1. The discussion under heading (2) "Revision of SRAC Prices" on pages 56 to 58 of Decision (D.) 03-12-062 is deleted and replaced with the following discussion:

> All three utilities contend that revision of the current SRAC methodologies for determining QF energy and capacity payments is needed. For many years now, SRAC has been approximated through time-differentiated energy prices (set once a month) and time differentiated capacity prices (set annually). There is evidence on the record in this proceeding for some time periods the current SRAC energy pricing methodology has yielded prices in excess of spot market prices.
>
> Although, the evidence presented here raises questions and supports the need to revisit SRAC pricing system, the utilities' have not demonstrated the SRAC formula is inadequate or that it exceeds avoided costs in violation of PURPA. Moreover, this procurement proceeding is not the appropriate forum to review the SRAC pricing formula. The current SRAC formula was considered and adopted in D.01-03-067 and D.02-02-028, and this formula was upheld on appeal. (*Southern California Edison Co. v. Public Utilities Comm.* (2002) 101 Cal. App. 4th 982.)
>
> The concern exists, however, that the SRAC pricing formula may need to be revised in light of the current energy market. Therefore, the Commission should carefully consider how to modify the SRAC methodology and whether to seek legislative changes to Pub. Util. Code section 390. Because it is important that current methodologies to establish SRAC be critically evaluated and modified where necessary, we are directing Commission staff to immediately begin work on a draft Order Instituting Rulemaking (OIR) that will examine and propose appropriate modifications to the SRAC methodology.

2. Item 4 in the first full paragraph of page 11 of D.04-01-050 is modified as follows:

> (4) establishes a requirement that LSEs, including ESPs, forward contract 90% of their summer (May through September) peaking needs (loads plus planning reserves) a year in advance;

3. The third sentence in the first full paragraph of page 30 of D.04-01-050 is modified as follows:

> Therefore, we will require LSEs, including ESPs, to forward contract for 90% of their summer monthly peak needs.

4. The following is added as footnote 36 to D.04-01-050 on page 30, at the end of the sentence modified in Ordering Paragraph 3, above:

> Imposing forward contracting requirements on all LSEs, including ESPs, is consistent with the briefing and testimony submitted to the Commission by the ISO. The ISO has supported consistent resource adequacy requirements for all LSEs to ensure that an adequate quantity of electrical resources (generation, transmission and demand-side) has been procured in advance and is available to meet anticipated peak load and reserve requirements. (See ISO Opening Brief, September 15, 2003, at p. 20; see also Testimony of Pettingill and Sheffrin, Exhibit 87, June 23, 2003, at page 2.)

5. The text of footnote 89 in Decision (D.) 04-01-050 is deleted and replaced with the following language:

> In assessing deliverability for specific PPAs the utilities propose entering, we should look to see that the supplier pays for any network upgrades needed to ensure power deliverability under the contract, but should also maintain consistency with the requirements of section 399.25.

6. The discussion regarding SDG&E's Electric and Gas Procurement Committee beginning on page 72 of the Decision is modified as follows:

The third full paragraph, which begins with "Exhibit 70 shows . . . " is deleted and replaced with the following paragraph:

> Revised Exhibit 70 (filed on February 23, 2004, in Advice Letter 1569-E) shows that (1) 7 of the 9 members of SDG&E's Electric and Gas Procurement Committee represent both SoCalGas and SDG&E and 2 of those 7 also have responsibilities at Sempra, the parent company of both utilities; (2) Sempra's Energy Risk Management Oversight Committee, the analytical platform supporting enterprise-wide energy risk-management activities, contains members

> from both the regulated and unregulated affiliates; and (3) Sempra's Project Review Committee, which reviews and approves all transactions in excess of $10 million and commitments with important policy implications, has no members from SDG&E or SoCalGas among its 11 members except for the Group President of SoCalGas and SDG&E.

7. Finding of Fact 19, at page 184 of D.04-01-050, is modified as follows:

> It is reasonable to adopt a 90% level of forward contracting for summer (May through September) peaking needs for each LSE (including ESPs) at one year in advance. We should allow the LSEs the flexibility to justify to the Commission, on a case-by-case basis, excursions below this level. It is appropriate to defer implementation of this requirement to 2007.

8. On page 74 of the Decision, in the first sentence, the acronym "SEU" is replaced by "SoCalGas and Sempra." The acronym "SEU" in the last sentence of the second paragraph is replaced by "Sempra." The acronym "SEU" in the first sentence of the fourth paragraph is replaced by "Sempra and SoCalGas's"

9. Rehearing of D.03-12-062, as modified, is denied.

10. Rehearing of D.04-01-050, as modified, is denied. CAC/EPUC's application for rehearing of D.04-01-050 is denied without prejudice, in the event CAC/EPUC wants to present its concerns to the Commission in another type of filing.

This order is effective today.

Dated July 8, 2004, at San Francisco, California.

MICHAEL R. PEEVEY
President
CARL W. WOOD
LORETTA M. LYNCH
GEOFFREY F. BROWN
SUSAN P. KENNEDY
Commissioners