Decision 08-12-045 December 18, 2008

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application for Expedited and *Ex Parte* Approval Of Termination Of Standard Offer No. 2 Power Purchase Agreement Between Pacific Gas and Electric Company (U 39 E) and Diamond Foods Inc.	Application 08-07-029 (Filed July 17, 2008)

DECISION APPROVING SETTLEMENT REGARDING STANDARD OFFER NO. 2 POWER PURCHASE AGREEMENT

This decision approves a settlement between Pacific Gas and Electric Company (PG&E) and Diamond Foods Inc. (Diamond Foods) concerning a Standard Offer No. 2 power purchase agreement (PPA) that PG&E signed with the predecessor of Diamond Foods, Diamond Walnut Growers, Inc. (Diamond), in August 1984.[1] Under the PPA, PG&E purchased firm capacity and energy from the qualifying facility owned by Diamond until Diamond Foods shut down the facility in November 2005, largely because of difficulties in meeting the emission requirements set by the local air quality board.

The settlement we approve today will result in cancellation of the PPA, as well as the dismissal of (1) a lawsuit that PG&E has brought against Diamond Foods, and (2) cross-claims that Diamond Foods has asserted against PG&E. The

[1] On July 26, 2005, Diamond merged with and into Diamond Foods, and as a result the PPA was assigned to Diamond Foods by operation of law.

decision also authorizes PG&E to credit to rates the payments it will be receiving from Diamond Foods pursuant to the settlement agreement.

1. Background

On August 6, 1984, PG&E and Diamond entered into a PPA for firm capacity and energy to be generated at Diamond's facility, a cogeneration plant located in Stockton, California. The facility was to be powered by biomass in the form of walnut shells. The agreement the parties used was a Commission-approved standard form qualifying facility (QF) contract that is commonly referred to as a Standard Offer No. 2 (SO2) contract. Under this PPA, Diamond committed to make available and deliver to PG&E a contract capacity of 4,150 kilowatts (kW) for a period of 28 years, until August 2012.

According to the application, from 1984 until 2004 Diamond generally performed its obligations under the PPA in a manner that entitled it to full capacity payments. In order to earn the full capacity payments, Diamond was required to deliver its full contract capacity to PG&E five days per week, 13 hours per day, at a capacity factor of at least 80% (excluding maintenance outages). (Application, p. 2.)

Sometime in 2004, however, Diamond began to have difficulties in meeting the requirements for full capacity payments. In September 2004, for example, PG&E invoked provisions of the PPA that allowed it to place Diamond on probation for failure to deliver at Diamond's full contract capacity in August 2004.[2] At the same time as the probation began, PG&E demanded that Diamond

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[2] This allegation appears on pages 5-6 of the complaint that PG&E filed against Diamond Foods, Inc. in January 2006 in the Superior Court in and for the City and

Footnote continued on next page

establish prior to November 2005 that it could reliably deliver at its contract commitment of 4,150 kW. When Diamond failed to do so, PG&E informed Diamond Foods that as of December 1, 2005, it would reduce the capacity commitment under the PPA to 3,601 kW, "the level at which the facility appear[ed] to be able to operate according to the facility metering data during the probationary period." (PG&E Complaint, p. 6.)

According to the PG&E Complaint, PG&E learned through a newspaper article on October 17, 2005 that Diamond Foods had closed the cogeneration plant in Stockton and terminated all its employees. (*Id.*) On November 21, 2005, PG&E sent Diamond Foods a letter demanding that it either generate energy sufficient to fulfill its commitments under the PPA, or PG&E would consider the PPA terminated as of December 1, 2005. (Application, p. 2.) PG&E's letter also demanded that if Diamond Foods would not be performing under the contract, Diamond Foods must also refund the capacity overpayments PG&E had made, since Diamond's performance under the PPA had lasted only 21 years instead of the 28 years originally contracted for. PG&E also withheld payment for energy deliveries in October and November 2005 totaling over $197,000. (PG&E Complaint, p. 7.)

When Diamond Foods failed to respond to PG&E's demand letter, the utility filed the PG&E Complaint in January 2006. In its answer, Diamond Foods alleged that the capacity overpayments sought by PG&E were an unlawful "penalty clause." In addition, Diamond Foods asserted cross-claims against PG&E based on the utility's withholding of the energy payments due for October

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County of San Francisco (PG&E Complaint). The PG&E Complaint is attached as Exhibit 3 to the Declaration of Shari Hollis-Ross in support of the application.

and November 2005, as well as claims for breach of contract and breach of the implied covenant of good faith and fair dealing. Diamond Foods also sought an accounting with respect to the entire 21 years during which the cogeneration facility had operated, owing to unexplained charges that PG&E had occasionally imposed during the 21-year period.

Settlement discussions between PG&E and Diamond Foods began even before the filing of the PG&E Complaint and continued intermittently through April 2007, when the parties reached a tentative settlement. However, the terms of this settlement had to be renegotiated, and agreement on final terms was not reached until April 30, 2008. The settlement agreement was finally executed on June 19, 2008, and filing of the instant application followed approximately a month later.

The basic terms of the Settlement Agreement are simple. First, the parties agree that the PPA will be deemed terminated as of December 1, 2005. Second, PG&E will dismiss its lawsuit against Diamond Foods, and Diamond Foods will dismiss its cross-claims against PG&E; both dismissals will be with prejudice. Third, Diamond Foods and PG&E will release all claims they have against each other, whether known or unknown.

Finally, Diamond Foods will make certain payments to PG&E, which will be credited to PG&E's ratepayers through either the Energy Resource Recovery Account (ERRA) or the Modified Transition Cost Balancing Account (MTCBA). PG&E has moved that the amount of these payments be kept confidential, and for the reasons discussed in more detail below, we agree that such confidential treatment is appropriate.

2. Standards for Reviewing QF Contract Settlements

The Commission has traditionally evaluated proposed QF settlements under the same standards that it uses for other settlements. Those standards are set forth in Rule 12.1(d) of our Rules of Practice and Procedure (Rules), which provides in full:

> "The Commission will not approve settlements, whether contested or uncontested, unless the settlement is reasonable in light of the whole record, consistent with law, and in the public interest."[3]

In determining whether a QF settlement satisfies the three standards in Rule 12.1(d), PG&E notes that Commission decisions have considered a number of factors, including:

- Whether the settlement reflects the relative risks and costs of continued litigation;
- Whether the settlement fairly and reasonably resolves the disputed issues and conserves public and private resources;
- Whether the agreed-upon settlement terms fall within the range of possible outcomes if the parties had continued to litigate their dispute;
- Whether the settlement negotiations were at arm's length and without collusion, whether parties were adequately represented, and how far the proceedings had progressed when the parties settled, and
- Whether the dispute between the QF and the utility presents a colorable claim that raises substantive issues of law or fact.

[3] Recent decisions in which QF settlements have been approved using these factors include D.06-05-034 and D.06-07-032.

(*See* D.00-11-041 at 6-7 (citing cases); D.00-05-046, 6 CPCU3d 201, 202-03.) In the discussion below, we consider these five factors in the context of this case.

3. Discussion

As noted above, recent Commission decisions have identified five factors that are relevant in determining whether a proposed QF settlement meets the standards in Rule 12.1(d). In order to understand the application of those factors to this case, it is first helpful to understand the theory behind PG&E's lawsuit against Diamond Foods. The application describes it as follows:

> "PG&E's capacity payments to Diamond were based on a contractual rate set forth in the PPA. Because Diamond committed to a 28-year term for delivery of its contract capacity and commenced deliveries in 1984, PG&E paid Diamond $135/kW-year for firm capacity pursuant to the PPA firm capacity price schedule . . . This capacity payment price was higher than the price paid to facilities that elected shorter capacity delivery terms. The PPA provided, however, that if Diamond failed to complete its entire 28-year contract capacity delivery commitment, it would be required to refund a portion of the capacity payments with interest.
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> "Since Diamond only delivered firm capacity for 21 years, PG&E should have paid Diamond $125/kW-year for firm capacity[,] and the refund PG&E sought was based on the difference between the $135 and $125 prices, with interest, going back to PG&E's first firm capacity payment in September 1984." (Application, p. 4.)

In applying the first of the five factors for assessing a proposed QF settlement -- whether the settlement reflects the relative risks and costs of continued litigation— it is also important to understand the claims Diamond Foods has interposed against PG&E. Diamond Foods argues not only that the return of "excess" capacity payments would amount to enforcing an unlawful penalty clause, but also that PG&E suffered no damage as a result of the closure of the Diamond cogeneration plant. The basis for this argument is that at the time of closure, PG&E had less expensive sources of capacity available to it, including some that used renewable resources. (*Id.* at 5.) PG&E states that while it believes it would prevail over Diamond Foods at trial, "jury trials can be unpredictable," and that "the contract provisions at issue have never been tested before a civil court in active litigation." (*Id.* at 7.)

Since PG&E estimates the costs of litigating its case against Diamond Foods at $450,000 (which includes the costs of handling the likely appeal), and it is possible that a jury would reject PG&E's theory of liability, we agree with PG&E that the settlement is reasonable in light of the relative risks and costs of continued litigation.

We think that the foregoing risk analysis also addresses the second factor mentioned in some of our QF decisions; *viz.*, whether "the settlement fairly and reasonably resolves the disputed issues and conserves public and private resources." (D.00-11-041 at 6.) The likely costs of trial and appeal, added to the risk that a jury might reject PG&E's capacity overpayment theory, make the amount that PG&E has agreed to accept from Diamond Foods quite reasonable. Moreover, since the settlement agreement calls for dismissal of both PG&E's lawsuit and the cross-claims, plus mutual releases by both parties of all claims they have against each other (whether known or unknown), the terms of the settlement will end the litigation between the parties and so help to conserve public and private resources.

The analysis of litigation risk set forth above also addresses the third factor mentioned in the QF settlement decisions; *viz.*, whether the settlement terms "fall clearly within the range of possible outcomes had the parties fully litigated the dispute." (*Id.*) The amount that Diamond Foods has agreed to pay – which will be credited to PG&E's ratepayers -- is reasonable when compared with the costs of trial and appeal, plus the risk that PG&E might not prevail in a jury trial on its capacity overpayment theory.

The fourth group of factors mentioned in the QF cases—whether the settlement negotiations were at arm's length and without collusion, whether parties were adequately represented, and how far the proceedings had progressed when settlement was reached—is also satisfied here. The facts that (1) PG&E's lawsuit was filed in January 2006, (2) the parties began settlement discussions even before this lawsuit was filed, (3) a tentative settlement was not reached until April 2007, and (4) a final settlement was not agreed upon until April 2008, are all strong evidence that this was a hotly-contested dispute and that the settlement involves no collusion. Similarly, it is evident that both sides were adequately represented, since, in addition to their in-house counsel, PG&E and Diamond Foods both retained experienced and capable outside counsel to assist them in the discovery, motion practice and settlement negotiations that took place in connection with PG&E's Superior Court action.

There can also be little doubt that the dispute between the parties over how much, if any, compensation PG&E was entitled to for excess capacity payments satisfies the fifth standard described above for evaluating QF settlements; *viz.*, whether the dispute between the parties involves a significant claim raising substantive issues of law and fact. As the application states:

> "Diamond asserted claims for breach of contract, accounting, breach of good faith and fair dealing and unjust enrichment. As discussed earlier, while PG&E believes it is in a position to mount a substantial defense to Diamond's claims regarding the validity of the liquidation clause and market replacement of renewable power, Diamond's cross-claims certainly raise[ ] substantive factual and legal issues. There is no doubt that the Settlement Agreement is

> both reasonable and advantageous to PG&E and its ratepayers to be decided independent of prior Commission decisions . . . [A]lthough the Commission has on occasion explained its policies concerning the standard offer PPAs, it has refrained from interpreting those contracts, instead leaving the issue of contract interpretation to the courts. *See* . . . D.93-11-019, 52 CPUC2d 87 (1993). Diamond's suit, therefore, raises substantive factual and legal questions for the court and a jury to decide." (Application, p. 9.)

In view of all the factors favoring the instant settlement, it is also clear that the three tests set forth in Rule 12.1(d) for approval of a settlement have been met. First, the settlement "is reasonable in light of the whole record" because it will terminate the disputed PPA and dispose of PG&E's lawsuit and the cross-claims of Diamond Foods. As part of the settlement, PG&E's ratepayers will also be credited with the payments made by Diamond Foods.

Second, we are satisfied that the settlement is consistent with law, because neither we nor the parties have identified any laws or prior Commission decisions with which the proposed settlement would be inconsistent.

Third, the proposed settlement is in the public interest because it will dispose of costly litigation that has already lasted two years, thus freeing up the time of the courts, the Commission and the parties to pursue more worthwhile matters. Accordingly, we will grant PG&E's application and approve the settlement.

PG&E has requested that in addition to approving the settlement, we also authorize the company "to recover the settlement payment through the Energy Resource Recovery Account ('ERRA') or the Modified Transition Cost Balancing Account ('MTCBA'), as appropriate, as a cost of PG&E's energy procurement activities." (Application, p. 3.) Interpreting this as a request for authorization to credit ratepayers through the relevant accounts with the payments Diamond

Foods will be making, we will grant PG&E's request. However, it should be noted that since the settlement here relates to an SO2 contract that was signed and went into effect before the electric restructuring process began in 1995 and 1996, a credit to ratepayers under the MTCBA is more appropriate, since a settlement relating to an early SO2 contract seems most reasonably characterized as a stranded cost or a transition cost.

4. PG&E's Request for Confidential Treatment of the Settlement Payments from Diamond Foods

In a motion filed contemporaneously with the application, PG&E requests that the amount of the payments it will receive from Diamond Foods be kept confidential, since "making this information public will give other QF entities engaged in Standard Offer contracts with PG&E information regarding PG&E's current strategic approach to resolving similarly situated contested Standard Offer contracts." PG&E also notes that it is required under the terms of the settlement agreement to keep the amount of the payments confidential.

Pursuant to Pub. Util. Code § 583, PG&E has filed under seal a full, non-public set of papers that includes the amount of the settlement payments from Diamond Foods, as well as a redacted, public version of the papers that omits only the amounts of the settlement payments.

We have granted similar requests for confidential treatment of QF settlements in many other decisions, some of which involved keeping the entire settlement agreement confidential. See, e.g., D.00-05-046, 6 CPUC3d at 203-04; D.00-11-041 at 9-10 (citing cases and granting confidential treatment for entire settlement agreement); D.02-06-074 at 6-7. We see no reason to depart from that approach here, especially since PG&E is seeking to keep confidential only the amount of the settlement payments it is receiving from Diamond Foods.

5. Category and Need for Hearing

In Resolution ALJ 176-3218, dated July 31, 2008, the Commission preliminarily categorized this proceeding as ratesetting and preliminarily determined that no hearing would be necessary. Based on the record in this uncontested proceeding, we conclude that a public hearing is not necessary, nor is it necessary to alter the preliminary determinations made in Resolution ALJ 176-3218.

6. Waiver of Comments

This is an uncontested matter in which the decision grants the relief requested. Accordingly, pursuant to Pub. Util. Code § 311(g)(2) and Rule 14.6(c)(2), the otherwise applicable 30-day period for public review and comment is waived.

7. Assignment of Proceeding

Michael R. Peevey is the assigned Commissioner, and A. Kirk McKenzie is the assigned Administrative Law Judge in this proceeding.

Findings of Fact

1. On August 6, 1984, PG&E and Diamond, the predecessor of Diamond Foods, entered into an SO2 PPA.

2. Under the terms of the PPA, Diamond was to provide PG&E with 4,150 kW of firm capacity and energy from its cogeneration facility in Stockton, California for a period of 28 years.

3. The fuel for Diamond's cogeneration facility was walnut shells, a by-product of Diamond's nut business.

4. Under the PPA, Diamond was required to deliver its full contract capacity to PG&E five days per week, 13 hours per day, at a capacity factor of at least 80% (excluding maintenance outages).

5. From 1984 until 2004, Diamond generally delivered capacity to PG&E pursuant to the PPA.

6. In September 2004, PG&E placed Diamond on probation pursuant to the terms of the PPA because of Diamond's failure to deliver its full contract capacity during August 1984.

7. At the same time PG&E placed Diamond on probation, PG&E gave Diamond notice that it would be required to demonstrate by November 2005 that Diamond could reliably deliver capacity at its contract commitment of 4,150 kW.

8. On July 26, 2005, Diamond merged with and into Diamond Foods, and as a result the PPA was assigned to Diamond Foods by operation of law.

9. When Diamond Foods failed to meet the November 2005 deadline, PG&E informed it that as of December 1, 2005, PG&E would reduce the capacity commitment and payments under the PPA to 3,601 kW, the level at which Diamond Food's cogeneration plan appeared to be able to operate reliably.

10. In late October 2005, PG&E learned through a newspaper article that Diamond Foods had closed its cogeneration facility and discharged the facility's employees.

11. On November 21, 2005, PG&E sent a letter to Diamond Foods demanding that it generate energy sufficient to fulfill its commitments under the PPA, or PG&E would deem the PPA terminated as of December 1, 2005.

12. PG&E's November 21, 2005 letter also demanded that if Diamond Foods would not be providing capacity at the full rate specified in the PPA, then Diamond Foods must return capacity overpayments representing the difference between the 21 years during which Diamond and Diamond Foods did provide

capacity, and the 28-year period during which Diamond had agreed to provide capacity when it signed the PPA in 1984.

13. In addition to the demands in its November 21, 2005 letter, PG&E also withheld payments from Diamond Foods for the capacity and energy it had delivered to PG&E in September and October 2005.

14. After Diamond Foods did not respond to the November 21, 2005 letter, PG&E filed the PG&E Complaint in January 2006. In this complaint, PG&E sought the repayment of excess capacity payments totaling $1.35 million, based on the difference in capacity prices specified in the PPA for a QF that agreed to provide firm capacity for 28 years versus one that agreed to provide firm capacity for only 21 years.

15. In its answer to the PG&E Complaint, Diamond Foods alleged that PG&E had suffered no damage as a result of the shut-down of the Diamond Foods cogeneration facility, because PG&E had less expensive capacity available to it. Diamond Foods also asserted that PG&E's demand for the return of excess capacity payments amounted to an attempt to enforce an unlawful penalty clause.

16. At the same time it filed its answer, Diamond Foods also asserted cross-claims against PG&E seeking the payments that had been withheld for September and October 2005, as well as an accounting for the payments due from PG&E for the period from 1984 through 2005. Diamond Foods also asserted cross-claims for breach of contract, breach of the implied covenant of good faith and fair dealing, and unjust enrichment.

17. The parties commenced settlement negotiations in 2006 that continued into 2007 and resulted in a tentative settlement in April 2007.

18. The terms of the tentative settlement had to be renegotiated, and PG&E and Diamond Foods did not execute a final settlement until April 30, 2008.

19. The settlement calls for (a) termination of the PPA between the parties as of December 1, 2005, (b) payments by Diamond Foods to PG&E, (c) PG&E and Diamond Foods to give each other general releases of all claims they have or may have against each other, whether known or unknown, and (d) a dismissal with prejudice of the PG&E Complaint and of the cross-claims asserted by Diamond Foods against PG&E.

20. Implementation of the above-described settlement agreement is contingent upon approval by the Commission.

21. PG&E has filed under seal a full copy of its application and the settlement agreement pursuant to Pub. Util. Code § 583. PG&E has also filed public, redacted versions of the settlement agreement and its application, both of which omit only the amount of the payments Diamond Food proposes to make to PG&E.

22. Notice of the filing of PG&E's application appeared in the Commission's Daily Calendar on July 25, 2008.

23. No protest to the application has been filed.

24. A hearing is not necessary.

25. PG&E has requested that it be allowed to pass on to ratepayers the payments it will be receiving from Diamond Foods through either the ERRA or the MTCBA, as appropriate.

Conclusions of Law

1. In view of the costs of trying and handling an appeal in PG&E's action against Diamond Foods, plus the risk that a jury would not accept PG&E's

theory of liability against Diamond Foods, the proposed settlement reasonably reflects the risks and costs of continued litigation.

2. In view of the risks summarized in COL 1, the proposed settlement fairly resolves the disputed issues between the parties, and will help to conserve public and private resources.

3. In view of the risks summarized in COL 1, the proposed settlement falls within the range of possible outcomes that would have resulted if PG&E and Diamond Foods had continued to litigate their dispute.

4. In view of the fact that PG&E's action against Diamond Foods has been pending for over two years, and that it has entailed extensive discovery and other pretrial practice as well as the involvement of outside counsel on both sides, it is clear that the parties' settlement negotiations have been at arms' length and without collusion, have involved effective representation on both sides, and have occurred after enough time has elapsed so that each party could make a realistic assessment of its odds of prevailing in the litigation.

5. The dispute between PG&E and Diamond Foods presents a colorable claim that raises substantive issues of both law and fact.

6. In view of COLs 1-5, the proposed settlement between PG&E and Diamond Foods is reasonable in light of the whole record, consistent with law, and in the public interest.

7. PG&E's application for an order approving the proposed settlement should be granted, subject to the conditions set forth in the following order.

8. PG&E should be allowed to recover and pass on to ratepayers through the MTCBA, the amount of the payments it will be receiving from Diamond Foods.

9. PG&E's motion to file under seal, pursuant to Pub. Util. Code § 583, (a) the full, unredacted version of its application, and (b) the full, unredacted version of

the July 17, 2008 declaration of Shari Hollis-Ross (to which the full, unredacted version of the settlement agreement between the parties is attached as Exhibit 1), should be granted.

O R D E R

IT IS ORDERED that:

1. The application of Pacific Gas and Electric Company (PG&E) for an order approving the Settlement Agreement between PG&E and Diamond Foods Inc. (Diamond Foods), which Settlement Agreement is attached as Exhibit 1 to the July 17, 2008 Declaration of Shari Hollis-Ross in support of the application, is granted.

2. The payments received by PG&E from Diamond Foods pursuant to the Settlement Agreement approved herein shall be credited by PG&E to ratepayers through the Modified Transition Cost Balancing Account, subject only to PG&E's prudent administration of the Settlement Agreement.

3. The July 17, 2008 motion of PG&E for leave to file confidential materials under seal is granted with respect to (a) the full, unredacted version of the application, and (b) the full, unredacted version of the July 17, 2008 declaration of Shari Hollis-Ross in support of the application, to which full, unredacted version of the Settlement Agreement is attached as Exhibit 1. The aforesaid materials are placed under seal for a period of two years from the effective date of this decision, through and including December 20, 2010, and during that period the material so protected shall not be made accessible or disclosed to anyone other than Commission staff except upon the further order or ruling of the Commission, the assigned Commissioner, the assigned Administrative Law Judge (ALJ), or the ALJ then designated as Law and Motion Judge. If PG&E

believes that further protection of the aforesaid materials is needed after December 20, 2010, then PG&E may file a motion stating the justification for further withholding of these materials from public inspection, or for such other relief as the Commission's rules may then provide. Such a motion shall explain with specificity why the designated materials still need protection in light of the passage of time involved, and shall attach a clearly identified copy of the ordering paragraphs of this decision to the motion. Such a motion shall be filed at least 30 days before expiration of the protective order set forth in this paragraph.

4. Application 08-07-029 is closed.

This order is effective today.

Dated December 18, 2008, at San Francisco, California.

MICHAEL R. PEEVEY
President
DIAN M. GRUENEICH
JOHN A. BOHN
RACHELLE B. CHONG
TIMOTHY ALAN SIMON
Commissioners