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PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Item #10 (Rev. 1)
AGENDA ID 13907
ENERGY DIVISION **RESOLUTION E-4714**
May 21, 2015

REDACTED

R E S O L U T I O N

Resolution E-4714. Southern California Edison Company (SCE) seeks approval of agreements with Watson Cogeneration Company.

PROPOSED OUTCOME:

- Approve with modification the agreement between SCE and Watson pursuant to the terms of the Combined Heat and Power Program Settlement Agreement.

SAFETY CONSIDERATIONS:

- The power purchase agreement approved for this existing CHP facility will, based on information before the Commission, be operated consistent with prudent practices.

ESTIMATED COST:

- Actual costs are confidential at this time.

By Advice Letter 3151-E Filed on December 17, 2014.

SUMMARY

This Resolution approves with modifications a materially-modified Combined Heat and Power Request for Offers (CHP RFO) Pro Forma Power Purchase Agreement (PPA) that Southern California Edison (SCE) executed with Watson Cogeneration Company (Watson) for energy and capacity from its cogeneration facility. This offer was bilaterally negotiated between SCE's second and third CHP RFOs.

Under the CHP PPA, the Watson combined cycle gas turbine topping cycle cogeneration facility will undergo operational changes. This Resolution accepts SCE's request to count 385 MW toward SCE's MW Target. However, the type of

operational change is not consistent with the methodology required to determine GHG Credits within the CHP Program Settlement Agreement. Thus, this Resolution denies the request to count the purported changes as a GHG Credit accountable toward SCE's GHG Emissions Reduction Target.

The Resolution rejects a payment term under the CHP PPA that is associated with the disallowed GHG Credit. However, other payments contained within the Agreement are reasonable and shall be recovered in rates.

BACKGROUND

Background on Relevant terms of the CHP/QF Settlement

On December 16, 2010, the Commission adopted the Qualifying Facility and Combined Heat and Power Program Settlement Agreement with the issuance of D.10-12-035. The Settlement resolves a number of longstanding issues regarding the contractual obligations and procurement options for facilities operating under legacy and qualifying facility contracts.

The Settlement establishes MW procurement targets and GHG Emissions Reduction Targets the investor-owned utilities (IOUs) are required to meet by entering into contracts with eligible CHP Facilities, as defined in the Settlement. Pursuant to D.10-12-035, the three large electric IOUs must procure a minimum of 3,000 MW of CHP and reduce GHG emissions consistent with the California Air Resources Board (CARB) Scoping Plan, currently set at 4.8 million metric tonnes (MMT) by the end of 2020.

Per Section 4.2 of the Settlement Term Sheet, the IOUs are directed to conduct Requests for Offers (RFO) exclusively for CHP resources as a means of achieving their MW and GHG Emissions Reduction Targets. In addition, per Section 4.3 of the Settlement Term Sheet, bilaterally negotiated and executed CHP PPAs are included among the procurement options in the CHP Program. Pricing, terms, and conditions will be determined according to the executed and approved PPA. The use of an independent evaluator (IE) is required for bilateral negotiations between an IOU and its affiliate, but the use of an IE is elective for other negotiations.

Background on AL 3151-E

Watson Cogeneration Company is an Existing CHP Facility that operates four parallel gas turbine-driven power generator/heat recovery steam generator trains, two parallel steam turbine-driven power generators, auxiliary equipment, and a substation. Watson is owned 51% by Tesoro and 49% by NRG and provides steam to the Tesoro Los Angeles Refinery.[1] It currently delivers energy and capacity to SCE under a Transition PPA that expires July 1, 2015.[2]

In June 2014, Watson approached SCE to initiate bilateral negotiations for a subsequent PPA. SCE evaluated Watson's offer using the methodology of SCE's recently-completed CHP RFO 2, and the offer compared favorably in value to the contracted facilities that have received Commission approval.[3] SCE completed negotiations with Watson on October 28, 2014 and finalized contract language on November 13, 2014.

SCE requests that the CPUC find that the CHP PPA count for 385 MW toward the MW Target. SCE proposed that Watson would change their operations and requested to count a reduction of 0.025 MMT toward their GHG Target.

NOTICE

Notice of AL 3151-E was published in the Commission's Daily Calendar. SCE states that a copy of the Advice Letter was mailed and distributed in accordance with Section 4 of General Order 96-B.

[1] On August 8, 2012, Tesoro purchased assets from BP West Coast Products including the Carson Refinery that is located adjacent to Tesoro's Wilmington Refinery (U.S. Securities and Exchange Commission Form 10-K for Tesoro Corporation for FY 2012 (Tesoro SEC 10-K for 2012)), http://tsocorp.com/refining/los-angelescalif/, and http://maps.nrg.com/#watson

[2] Watson's previous affiliation with SCE and material modifications to the Standard Form Transition PPA required Commission approval and were found to be reasonable and negotiated fairly in Resolution E-4537.

[3] Resolutions E-4681 and E-4682.

PROTESTS

Advice Letter 3151-E was not protested.

DISCUSSION

On December 17, 2014, SCE filed Advice Letter AL 3151-E which requests Commission approval of a PPA with Watson Cogeneration.

Specifically in this Advice Letter, SCE requested that the Commission:

1. Approve the Agreement in its entirety;
2. Find that the Agreement and SCE's entry into the Agreement are reasonable and prudent for all purposes, subject to further review with respect to the reasonableness of SCE's administration of the Agreement;
3. Apply 385 MW associated with the Agreement toward SCE's Settlement MW procurement Target of 1,402 MW of CHP capacity;
4. Apply 25,709 MT associated with the Agreement toward SCE's Settlement GHG Emissions Reduction Target.
5. Find that the Agreement is automatically compliant with the Emissions Performance Standard; and
6. Find that the costs of the Agreement shall be recovered through SCE's Cost Allocation Mechanism.

Energy Division evaluated the Agreement based on the following criteria:

- Consistency with D.10-12-035, which approved the QF/CHP Program Settlement including:
  - Consistency with Definition of CHP Facility and Qualifying Cogeneration Facility
  - Consistency with MW Counting Rules
  - Consistency with GHG Accounting Methodology
  - Consistency with Cost Recovery Requirements
- Need for Procurement
- Cost Reasonableness

- Public Safety
- Project Viability
- Consistency with the Emissions Performance Standard
- Consistency with D.02-08-071 and D.07-12-052, which respectively require Procurement Review Group (PRG) and Cost Allocation Methodology Group participation.

In considering these factors, Energy Division also considered the analysis and recommendations of an Independent Evaluator.[4]

Consistency with D.10-12-035, which approved the QF/CHP Program Settlement:

On December 16, 2010, the Commission adopted the QF/CHP Program Settlement with the issuance of D.10-12-035. The Settlement Term Sheet establishes criteria for contracts with Facilities including:

Consistency with Definition of CHP Facility and Qualifying Cogeneration Facility

To be eligible to count towards Settlement MW and GHG goals, all CHP Facilities, excluding those that convert to Utility Prescheduled Facilities, must meet the federal definition of a qualifying cogeneration facility under 18 C.F.R. § 292.205 by the term start date and through the duration of the proposed PPA, and must also maintain QF certification. With reference to the federal regulations, the Settlement establishes minimum operating and efficiency requirements for topping-cycle facilities, establishes efficiency standards for bottoming-cycle facilities, and, for certain new facilities, mandates compliance with a fundamental use test.

As stated in Section 1.02(a) of the CHP PPA, Watson is an Existing CHP Facility, which means that it: is a Qualifying Cogeneration Facility[5]; meets the definition

[4] Per Settlement Term Sheet 4.2.5.7: "Each IOU shall use an Independent Evaluator (IE) similar to that used in other IOU RFO processes. It is preferable that the IE have CHP expertise and financial modeling experience." However, the use of an IE in a bilateral negotiation is optional since Watson and SCE are no longer affiliated companies.

[5] Exhibit A of the CHP RFO Pro Forma PPA defines "Qualifying Cogeneration Facility" as a generating facility that: (a) complies with 18 C.F.R. § 292.203 et seq. and (b) has filed with FERC

Footnote continued on next page

of "cogeneration" under the Public Utilities Code Section 216.6; and satisfies the GHG Emissions Performance Standards set forth in Public Utilities Code Section 8341. The efficiency and emissions requirements of the facilities pursuant to these definitions are enumerated in the Confidential Appendix of this Resolution.

Watson meets the definition of a CHP Facility and Qualifying Cogeneration Facility, consistent with the eligibility requirements of the QF/CHP Settlement.

Consistency with Settlement MW Counting Rules

Per Settlement Term Sheet Section 5.2.3.1, Watson is an Existing CHP Facility. Watson is a gas-fired Topping Cycle CHP Facility that exported and delivered electric power with a QFID of 2053 per SCE's July 2010 Qualifying Facilities Semi-Annual Status Report. The MWs counted for the CHP RFO PPA executed with Watson will be the published Contract Nameplate value of 385 MW. This is appropriately reflected in the Advice Letter.

The total 385 MW Contract Nameplate value for Watson will count toward SCE's MW procurement target.

Consistency with Settlement Greenhouse Gas Accounting Methodology

SCE states that Watson will "institute a change in operations" that will result in emissions reductions proposed to be 25,709 metric tonnes (MT).[6] The Confidential Appendix details the engineering basis for the reductions, showing that the derivation is inconsistent with the Settlement's requirements for GHG Credits from facilities undergoing operational changes.

Per Settlement Term Sheet Section 7.3.1.3, a CHP Facility Change in Operations or Conversion to a Utility Prescheduled Facility counts as a GHG credit for the IOUs' GHG Emissions Reduction Targets. Measurement is based on the baseline year emissions (the average of the previous two years of operational data) minus the projected PPA emissions and emissions associated with replacing 100% of the decreased electric generation at a time differentiated heat rate.

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either (i) an application for FERC certification pursuant to 18 C.F.R. § 202.207(b)(1) or (ii) a notice of self-certification pursuant to 18 C.F.R. § 292.207(a).

[6] AL 3151-E at 7.

The proposed Credit of 0.026 MMT is calculated in a manner that does not include replacement electricity or its related emissions. SCE's detail about Watson's potential for emissions reduction in Appendices A and C to the AL and Energy Division's research provide a sufficient basis to conclude that the Settlement Terms cannot support a GHG Credit from Watson's changes. Due to the market sensitivity of the description of the industrial processes modified to calculate this proposed reduction,[7] Energy Division's full analysis and conclusions are included within the Confidential Appendix.

Given that Watson cannot contribute toward a GHG Credit, per Settlement Term Sheet Section 7.3.3.1, an Existing CHP Facility with no change in operations, regardless of contract status, is considered neutral for GHG accounting purposes.

Watson's proposed 0.025 MMT reduction in emissions was not derived from the calculation for operational changes pursuant to Section 7.3.1.3 of the Settlement Term Sheet, which accounts for replacement electricity emissions, and is therefore ineligible as a GHG Credit. The procurement will be counted as Neutral toward the GHG Emissions Reduction Target.

While the Settlement Terms do not allow the proposed GHG Credit, Energy Division analyzed[8] the project to determine for the sake of argument whether disallowing [REDACTED] the GHG Credit would decrease Watson's likelihood of completing the Los Angeles Refinery Integration and Compliance (LARIC) Project. SCE provided a caveat that, according to Tesoro's representations, the Watson contract would "facilitate" the optimization and reconfiguration of the Carson and Wilmington refineries to achieve operational efficiencies, including the shutdown of a fluid catalytic cracker at Wilmington, which in total may reduce up to 225,000 MT GHG emissions.[9] [REDACTED]

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[7] AL at Appendix A-1 at C-3.

[8] This analysis may not be cited in any other AL for approval of a QF/CHP PPA, and is not dispositive of the outcome here, but is simply useful to illustrate that it is unnecessary to attribute GHG Credits to the PPA at issue.

[9] AL p. 7, Footnote 17. SCE references Watson's LARIC whitepaper in Appendix A-2 to further describe the project. However, SCE notes in Confidential Appendix A-1 at C-5 that SCE [REDACTED].

Energy Division's research on the relationship between Watson's CHP PPA and Tesoro's LARIC Project led to the conclusion that (in addition to the Settlement procurement options available to the CHP) based on other State regulatory programs and agreements to which Tesoro is subject as discussed above, Tesoro is otherwise sufficiently incented to [REDACTED] and required to integrate the refineries. The following analysis indicates that the rejection of the GHG Credit [REDACTED] will not compromise the implementation of the operational efficiency measures ([REDACTED] refinery integration) at Watson.

Cap and Trade. As a cogenerator with greenhouse gas emissions greater than 25,000 MT CO_2e, Watson is a "Covered Entity" regulated as a source of stationary combustion emissions under the California Air Resources Board's (CARB) Cap and Trade Program.[10] This existing regulation incents Watson to seek opportunities to reduce GHG emissions, which may include [REDACTED] emissions and thus their obligation to purchase allowances for compliance.[11]

Low Carbon Fuel Standard (LCFS). Tesoro Refining and Marketing Company is the majority owner of the Los Angeles Refinery, which is comprised of the Carson and Wilmington refineries that receive thermal energy from Watson. As a refinery operator, Tesoro is a "regulated party" subject to the Carbon Intensity reduction schedule under the LCFS.[12] While Watson Cogeneration Co. (not subject to the LCFS) is the entity contracted with SCE (not Tesoro), Watson is a vital component to the Los Angeles Refinery's LCFS "fuel pathway" that affects the emissions from Tesoro's product and therefore the deficits they must offset to comply with the carbon intensity requirements.[13] Watson's measures to reduce

[10] California Cap on GHG Emissions and Market-Based Compliance Mechanisms, Title 17, California Code of Regulations, Sections 95801-96022

[11] [REDACTED]

[12] CARB, Regulated Parties Reporting Transactions in the LCFS Reporting Tool, October 30, 2014. http://www.arb.ca.gov/fuels/lcfs/regulatedpartiesreporting20141030.pdf

[13] CARB, Low Carbon Fuel Standard Question and Answer Guidance Document version 1.0, June 10, 2011. http://www.arb.ca.gov/fuels/lcfs/LCFS_Guidance_%28Final_v.1.0%29.pdf

emissions would improve their fuel pathway and reduce the total Credits that Tesoro needs to purchase for the LA Refinery's fuel production.[14]

Federal and State approval of Tesoro's acquisition of Carson. Tesoro's acquisition of BP's Carson refinery in 2012 was contingent upon approval from the Federal Trade Commission (FTC)[15] and California Attorney General (AG)[16] due to anti-trust concerns about Tesoro's sole ownership of two major fuel refineries. Combined, the Carson and Wilmington refineries comprise 1/3 of the CARB Gasoline production capacity in Southern California.[17] FTC found the refinery integration "is likely to reduce the cost of manufacturing CARB gasoline."[18] Under an agreement with the AG, Tesoro must maintain historical levels of fuel production to mitigate their potential to exercise market power, and sustain production levels.[19]

Comprehensively, the FTC finding that integration would make refining more economic, the AG's stipulation that the integrated refinery must continue

[14] In addition, under the CARB's proposed updated regulation the operational improvements resulting from the reconfiguration of the Los Angeles Refinery would be eligible to claim "Refinery Investment Credits" from process efficiencies. CARB, Low Carbon Fuel Standard Re-Adoption Concept Paper, p. 3-4, http://www.arb.ca.gov/fuels/lcfs/lcfs_meetings/030714lcfsconceptpaper.pdf in reference to Proposed Regulation Order Title 17, CA Code of Regulations, Section 95489(f)(1)(c) http://www.arb.ca.gov/regact/2015/lcfs2015/lcfs15appa.pdf at p. 118.

[15] FTC, FTC Closes Investigation into Tesoro's Acquisition of BP Refinery, May 17, 2013. http://www.ftc.gov/news-events/press-releases/2013/05/ftc-closes-investigation-tesoros-acquisition-bp-refinery

[16] State of California Department of Justice, California Reaches Agreement with Tesoro to Protect Jobs and Monitor Gas Prices, May 17, 2013. http://oag.ca.gov/news/press-releases/california-reaches-agreement-tesoro-protect-jobs-and-monitor-gas-prices

[17] Total = 343,000 bbl/d. California Energy Commission California Oil Refinery Locations and Capacities, November 2014 http://energyalmanac.ca.gov/petroleum/refineries.html

[18] Statement of the Federal Trade Commission In the Matter of Tesoro Corporation/BP p.l.c., FTC File No. 121-0190, http://www.ftc.gov/sites/default/files/documents/closing_letters/tesoro-corporation/bp-p.l.c./130517tesoro_bpstmtofcomm.pdf at p. 2.

[19]Letter from Attorney General Harris to CEC Chair Weisenmiller, May 17, 2013. http://oag.ca.gov/system/files/attachments/press_releases/AG%20Letter%20to%20CEC%20%28Tesoro%29.pdf

historical output, and the multiple regulatory programs that incent both Watson and Tesoro to reduce operational emissions lead the Commission to conclude that Watson and Tesoro are highly incentivized to complete the emissions reductions measures [REDACTED].

Need for Procurement

SCE's total MW procurement goal for the CHP Program is 1,402 MW, with 378 MW allocated to Target B. A procurement shortfall from CHP RFO 1 resulted in a Net MW Target B of 392 MW. SCE submitted 733.26 MW[20] for Commission approval before launching CHP RFO 3, which has a MW Target of 394 MW. Net of the approved MWs in E-4681, E-4682, and this Resolution, SCE has a remaining need of 53 MW in CHP RFO 3, which is ongoing as of this date. SCE's 2020 GHG Emissions Reduction Target is 2.15 MMT. Thus, the Watson PPA fits within SCE's remaining procurement goal.

Existing CHP Facilities in the July 2010 Semi-Annual Report

The CHP PPA contributes 385 MW and counts as Neutral toward the GHG Emissions Reduction Targets, as it is an eligible Procurement Process listed in Section 4 of the Settlement Term Sheet. Watson previously sold energy and capacity to SCE as reported in its Qualifying Facilities Semi-Annual Status Report from July 2010.

Per Settlement Term Sheet Sections 6.4.2.2 and 6.4.2.3, the Existing CHP Facilities that shut down during the Initial Program Period will have their previous two years of GHG emissions evaluated against the Double Benchmark. This evaluation will determine if the cessation of the Facility's operations will add to the three IOUs' total GHG Emissions Reduction Targets as a "shortfall" or subtract from it as a "surplus." The term of the CHP PPA ends after the Initial Program Period.

Therefore, the GHG emissions neutrality associated with Watson will not be calculated in the net of the GHG Debit or Credit to the IOUs' Emissions Reduction Target.

[20] 348.26 MW (CHP RFO 2 facilities) + 385 MW (Watson)

The execution of the CHP PPA contributes 385 MW to SCE's need to procure additional CHP resources to meet the remaining MW Target. The term of the PPA helps ensure that it will not cease operations during the Initial Program Period and therefore will not change the GHG Targets.

SCE's procurement of Watson is justified by its contribution to meeting SCE's remaining capacity need in the CHP/QF Settlement.

Cost Reasonableness

The Watson offer was bilaterally negotiated subsequent to SCE's CHP RFO 2. The Agreement includes a number of material modifications to the CHP RFO Pro Forma PPA. The CHP Facilities with which SCE executed contracts provided a benchmark for SCE to determine the market value of Watson's offer, which is based on the net of the discounted present value of all contract benefits and costs. SCE found the Watson offer to be of comparable net value to the other facilities procured during CHP RFO 2, regardless of whether the GHG Credit is accepted or disallowed. Energy Division has verified this assertion. Given Watson's contribution to SCE's remaining MW Target and comparable costs to other projects on a MW basis, the costs associated with the procurement are reasonable. A detailed explanation of the contract costs are in the Confidential Appendix.

The costs associated with the Watson CHP PPA are just and reasonable.

Cost Recovery

In D. 10-12-035, the Commission determined that the utilities should procure CHP resources on behalf of non-IOU load-serving entities and allocate the net capacity costs and associated benefits to those entities.[21] In AL 3151-E, SCE requests to recover the costs of the Agreement through the Cost Allocation Mechanism.

On January 17, 2012, the Commission made effective SCE AL 2645-E as of November 23, 2011, which authorized SCE to revise its New System Generation Balancing Account to recover the net capacity costs of CHP contracts as it was directed by D.10-12-035.

[21] D. 10-12-035, p. 56 and Settlement Term Sheet Section 13.1.2.2

SCE is authorized to recover costs in accordance with Section 13.1.2.2 of the Settlement Term Sheet and AL 2645-E, consistent with the directives of the QF/CHP Settlement.

Public Safety

California Public Utilities Code Section 451 requires that every public utility maintain adequate, efficient, just, and reasonable service, instrumentalities, equipment and facilities to ensure the safety, health, and comfort of the public.

Based on the information before the Commission, Watson will change operations. The CHP PPA requires Watson to operate in accordance with Prudent Electrical Practices. This requirement includes a number of provisions to ensure that the generating facilities are operated safely and reliably, including ensuring sufficient staff, maintenance, monitoring and testing, etc.

SCE provided a list of safety violations found at the facilities according to government, industry-based, or internal standards or requirements. Energy Division assessed that the four prior Occupational Health and Safety Administration (OSHA) violations,[22] which were all corrected, do not pose or indicate a level of risk to the public sufficient to reject the approval of the agreement.

The Agreement includes safeguards and requirements to ensure that the operation of Watson will not result in any adverse safety impacts to the public or Watson's employees.

Project Viability

Watson is an Existing Qualifying Cogeneration Facility as defined in the Settlement Term Sheet and CHP RFO Pro-Forma PPA. It has operated since the 1980s, providing steam for a refinery's industrial processes. Therefore the project faces minimal project development risk. Additional information about the viability of the project is included within the Confidential Appendix.

Watson has a long operating history and therefore is a viable project.

[22] AL at 6.

Consistency with the Emissions Performance Standard

California Public Utilities Code Sections 8340 and 8341 require that the Commission consider emissions costs associated with new long-term (five years or greater) power contracts procured on behalf of California ratepayers.

D.07-01-039 adopted an interim Emissions Performance Standard ("EPS") that establishes an emission rate for obligated facilities to levels no greater than the GHG emissions of a combined-cycle gas turbine power plant. Pursuant to Section 4.10.4.1 of the CHP Program Settlement Term Sheet, for PPAs longer than five years submitted to the CPUC in a Tier 2 or Tier 3 advice letter, the Commission must make a specific finding that the PPA is compliant with the EPS.

The EPS applies to all energy contracts that are at least five years in duration for baseload generation, which is defined as a power plant that is designed and intended to provide electricity at an Annualized Plant Capacity Factor greater than 60 percent.

Under the CHP PPA, Watson will operate for 7 years. Therefore this procurement qualifies as a "long term financial commitment" per D.07-01-039. The EPS applies to the generating units because the facility's capacity factor exceeds 60%. However, because Watson uses combined-cycle gas turbines that were in operation as of the January 25, 2007 effective date of the D.07-01-039, it is automatically EPS compliant.

Watson is automatically compliant with the Emissions Performance Standard as its combined cycle gas turbines were operational on the effective date of D.07-01-039.

Consistent with D.02-08-071 and D.07-12-052, PG&E's Procurement Review Group ("PRG") and Cost Allocation Mechanism ("CAM") Group were notified of the CHP PPA.

SCE presented information about the proposed Watson CHP PPA to its PRG and CAM groups on November 5, 2014.

SCE has complied with the Commission's rules for involving the PRG and CAM groups.

Independent Evaluator Review

Pursuant to Section 4.3.2 of the Settlement Term Sheet, SCE elected –but was not required– to use independent evaluator (IE) Merrimack Energy to monitor and

evaluate the integrity of its negotiations and submitted the independent evaluator's report (IE Report) as an appendix to AL 3151-E.[23]

SCE opted to utilize an independent evaluator during the bilateral negotiations.

COMMENTS

Public Utilities Code section 311(g)(1) provides that this resolution must be served on all parties and subject to at least 30 days public review and comment prior to a vote of the Commission. Section 311(g)(2) provides that this 30-day period may be reduced or waived upon the stipulation of all parties in the proceeding.

The 30-day comment period for the draft of this resolution was neither waived nor reduced. Accordingly, this draft resolution was mailed to parties for comments on April 17, 2015.

Summary of Commenter Positions

SCE, Watson, and the Office of Ratepayer Advocates (ORA) submitted timely comments on May 11, 2015. ORA supports the rejection of the GHG Credit on the basis of Settlement Term Sheet Section 7.3.1.3, while SCE and Watson request reconsideration.

SCE states that while the Watson GHG Credit (if approved) would make little impact,[24] it has worked diligently and in good faith to meet the aggressive GHG Emissions Reduction Target. It adds that "based on the market response in CHP solicitations to date it is unlikely the goal is achievable."[25] However, the Commission responds to Watson's comments and maintains the finding that the proposed Credit is not eligible.

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[23] Merrimack Energy Group, Inc. and New Energy Opportunities Independent Evaluator Report Bilateral Negotiation and Power Purchase Agreement with Watson Cogeneration Company, December 2014.

[24] The proposed 25,709 MT represents 1.2% of SCE's GHG Target.

[25] SCE Comments to E-4714 at 1. The Commission acknowledges SCE's improved consideration of CHP procurement toward the GHG Target compared to SCE's strategies discussed in E-4553.

Discussion of Settlement Terms

Watson provided legal citations regarding contract interpretation. As a preliminary matter, we note that the rule regarding interpretation of contracts is set forth in 1 Witkin, *Summary of California Law*, Contracts, Sections 750 et seq. The issue to be decided here is not what the rules provide, but whether the interpretation herein is a reasonable one, and we conclude that it is.

Watson claims erroneously that Energy Division rejects the Credit because Section 7.3.1.3 of the Settlement "renders the only eligible or qualifying change in operations as a conversion to a [Utility Prescheduled Facility]."[26] Watson does not meet that requirement. Contrary to Watson's assertion, the Draft Resolution does not assume that the only qualified change in operations is conversion to a UPF. Watson references Settlement Terms[27] showing that non-UPF operational changes are allowed. It asserts that it engaged in such a change, which was accepted by SCE and the IE, and thus is eligible for a GHG Credit.

However, Watson's references to the Term Sheet fail to establish that its operation changed in a manner that is eligible under the Settlement. Consistent with the Commission's previous conservative reading of the contentiously-negotiated Settlement,[28] we do not find that it is within the meaning of the Settlement. First, Watson does not meet the Settlement's definition of a "Physical Change" that the PPA states would enable a "Change In Operations" (which except for the formula in Section 7.3.1.3 the Term Sheet does not describe). Second, in the absence of an alternative description of operational changes, we examine the GHG Accounting Methodologies' use of the Double Benchmark that derives GHG Credits from a thermal host's avoidance of conventional boilers. Watson's savings are derived from changes in fuel use at the CHP facility, not the thermal host.

[26] Watson Comments to E-4714 at 6.

[27] Watson Comments at 5, footnote 14 referencing 1.2.1.4, 7.3.1.2, 7.3.3.1, 7.4.3, 8.4.1.

[28] As discussed in E-4537, E-4569, E-4529, E-4632, and E-4648.

Furthermore, Watson states that the IE supports its interpretation of the Settlement. In fact, the IE qualifies its support of the GHG Credit and concludes: "*The question for the Commission* is whether the change required of Watson as a result of the Watson PPA is fairly a change in operation within the meaning of the Settlement Agreement."[29] (Emphasis added.) While the IE makes its own recommendation to support the credit, it does not make the determination of whether the change meets the Settlement requirements. That determination is for the Commission, and Energy Division finds that the Settlement does not allow the credit for the two reasons detailed below. Energy Division has discretion to disagree with the IE, and does so here.

First, except for the formula in Section 7.3.1.3, there are no Settlement terms that describe what a non-UPF operational change entails physically (in terms of equipment) or from an energy standpoint (input or output). We find that the proposed change in Watson's compressor fuel use[30] does not constitute an operational change intended by the Settlement. Exhibit P at 2 of the Confidential PPA relies on the use of a "Physical Change" to enable a "Change In Operations." Energy Division agrees with ORA that the measure is not a Physical Change, as Section 7.3.1.2 requires.[31] ORA reviewed the Confidential Appendices and concluded that Watson will not undergo a Physical Change.[32] Likewise, the IE concurred that Physical Changes "would not be implemented by Watson."[33]

Second, the GHG Credit Accounting Methodologies illustrate the meaning of the Settlement. The Double Benchmark measures the GHG emissions that otherwise would exist if the CHP facility did not exist. [34] It assumes emissions from separate heat and power are avoided by preventing a thermal host from using

[29] IE Report at 35.
[30] Watson Comments at 6.

[31] A CHP that has undergone a Physical Change is defined in the Term Sheet as one that has been Repowered (at 73), Expanded (at 67), or implemented a Fuel Change (at 35).

[32] ORA Comments to E-4714 at 2.

[33] IE Report at 35.

[34] The Double Benchmark, defined at 66, is used to account Credits from New CHP (7.3.1.1), Shutdown CHP with continuing thermal needs (7.3.1.4.1), and all Debits (7.3.2).

80% efficient boilers and grid electricity generated with a heat rate of 8,300 BTU/kWh. Critical to this accounting construct is the assumption that the *thermal host* associated with the CHP forgoes boiler-made heat. The Settlement does not allow for the possibility that a facility may count as a GHG Credit by eliminating steam use that is not used productively by its host or that does not directly result from the production of electricity. Watson's alleged change does not meet this requirement because the asserted measure at the *CHP Facility* changes fuel usage while electric and thermal energy production remains constant. For these reasons we find that Watson is not eligible for a GHG Credit under the Settlement.

Discussion of Other State Regulatory Programs and Agreements

Watson moves to strike alleged *dicta* in the Draft Resolution on other regulatory programs that it claims were insufficient to incent the operational change to assert that the incentive provided by the GHG Credit from the PPA is critical. Watson does not refute the existence of the regulations, but simply that they are an insufficient basis to deny the Credit.[35] To be clear, the arguments above interpreting the Settlement are adequate to reject the GHG Credit. Contrary to Watson's claim, the Draft does not presume that the regulations would have already prompted the completion of the measure. Detailed below, contractual and financial conditions may have barred Watson from implementing the measure regardless of their receipt of the PPA, with or without the Credit. However, the existence of regulations that encouraged Watson to pursue efficiency during the bilateral negotiation and that continue throughout the term of the PPA sustain the Commission's conclusion to deny the PPA's GHG Credit and associated incentives.[36] The Commission finds no evidence to suggest that disallowing the GHG Credit that is ineligible within the Settlement would compromise the future implementation of the operational change. Thus, we decline Watson's motion to strike the alleged dicta.

LCFS Uncertainty. First, Tesoro, Watson's majority owner, had financial and legal reasons not to implement the operational measure well prior to

[35] Watson Comments at 7.

[36] Draft E-4714 at 8.

negotiations with SCE. Tesoro stated in 2012 that the LCFS "could have a material adverse impact on our business, financial condition and results of operations" and cited unpredictability in the outcome of legal rulings on the LCFS' constitutionality.[37] Tesoro is a member of a trade association that contested the LCFS in court.[38] It is thus unlikely that Watson was motivated under these conditions. However, as noted in the Draft, the pending ARB regulations would provide Credits for investments in process efficiencies, which could substitute for the PPA incentive.

Transition PPA Terms. Second, payments and SCE's obligations under Watson's current Transition PPA approved by E-4537 in 2013 discouraged operational changes. The Transition PPA permitted historical electric delivery levels and established Performance Requirements to receive capacity payments that were administratively set in D.07-09-040. Pursuing an operational change during this PPA may have jeopardized performance under these terms. Additionally, SCE compensated Watson for GHG compliance costs. However, as the Draft Resolution explained, operational changes would reduce Watson's GHG obligations and thus improve the bilateral PPA's cost competitiveness with CHP RFO 2 executed PPAs, which was SCE's basis for justifying the procurement.[39]

Integration Project Implementation. Third, with recognition of the need to plan for the project only after the Carson acquisition, it is unlikely that the measure would precede the execution of the PPA that Watson maintains as critical to LARIC. Logistically, measure implementation would likely be concurrent to construction between late 2015 and 2018.[40] However, the Commission does not accept Watson's claim that the measure would not "occur without the incentives

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[37] Tesoro SEC 10-K for 2012.

1. [38] *See* *Rocky Mt. Farmers Union v. Corey*, 740 F.3d 507 (9th Cir. 2014) (decision on case challenging the Low Carbon Fuel Standard as violative of the dormant Commerce Clause; listing as an appellant a trade association, American Fuel & Petrochemical Manufacturers Association whose membership includes Tesoro). *See also* Tesoro's own website challenging the LCFS, available at http://www.acttesoro.com/issues/low-carbon-fuel-standard/.

[39] Draft E-4714 at 8 and 11.

[40] AL Public Appendix A-2 at 2 and AL Confidential Appendix B at Exhibit P.

provided by the PPA" because the value of incentives are miniscule as a proportion of the total value of the Watson PPA or the value of the acquired Carson assets to which Watson will provide steam as part of LARIC.[41]

FINDINGS

1. Commission Decision 10-12-035 directed SCE to procure 1,402 megawatts (MW) of combined heat and power (CHP) capacity by November 2015 and 2.15 million metric tonnes of greenhouse gas reductions (GHG) from CHP contracts by 2020.
2. On December 17, 2014, SCE filed Advice Letter (AL) 3151-E, seeking approval of a modified CHP Request for Offers Pro Forma power purchase agreement (PPA) with Watson Cogeneration Company (Watson), an Existing 385 MW CHP Facility, for firm energy and capacity.
3. The total 385 MW Contract Nameplate value for Watson fits within and therefore may count toward SCE's MW procurement target.
4. Watson's purported 0.026 MMT reduction in emissions was not derived from the calculation for operational changes pursuant to Section 7.3.1.3 of the Settlement Term Sheet, which accounts for replacement electricity emissions, and is therefore ineligible as a GHG Credit. The procurement will be counted as Neutral toward the GHG Emissions Reduction Target.
5. SCE's procurement of Watson is justified by its contribution to meeting SCE's remaining capacity need in the CHP/QF Settlement.
6. The costs associated with the Watson CHP PPA are just and reasonable.
7. SCE is authorized to recover costs of the four agreements in accordance with Section 13.1.2.2 of the Settlement Term Sheet and AL 2645-E, consistent with the directives of the QF/CHP Settlement.
8. The Agreement includes safeguards and requirements to ensure that the operation of Watson will not result in any adverse safety impacts to the public or Watson's employees.

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2. [41] Tesoro SEC 10-K for 2012. Tesoro acquired BP's inventory (valued at $1.3 B) at a purchase price of $1.175 B (or $1.075 B upon the satisfaction of conditions precedent).

9. Watson is automatically compliant with the Emissions Performance Standard as its combined cycle gas turbines were operational on the effective date of D.07-01-039.
10. In its execution of the Watson Agreement, SCE has complied with the Commission's requirements for consultation with the Procurement Review Group, Cost Allocation Mechanism Group, and appropriately opted to use an Independent Evaluator.

THEREFORE IT IS ORDERED THAT:

1. The request of Southern California Edison Company for authority to execute the Combined Heat and Power Request for Offers Pro Forma Power Purchase Agreement with Watson Cogeneration Company, LLC and to recover costs via the cost allocation mechanism as proposed in AL 3151-E is approved with the modifications herein.
2. The request of Southern California Edison Company to apply 25,709 metric tonnes associated with the Power Purchase Agreement toward its Settlement GHG Emissions Reduction Target is denied.

This Resolution is effective today.

I certify that the foregoing resolution was duly introduced, passed and adopted at a conference of the Public Utilities Commission of the State of California held on May 21, 2015; the following Commissioners voting favorably thereon:

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TIMOTHY J. SULLIVAN
Executive Director

Confidential Appendix

Summary and Analysis of the Agreement with

Watson Cogeneration Company

[REDACTED]