

Decision **DRAFT DECISION OF ALJ DEBERRY** (Mailed 7/11/02)

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Pacific Gas and Electric Company for an Order Approving an Amendment to the Power Purchase Agreement for Long-Term Energy and Capacity between Pacific Gas and Electric Company and Gaylord Container Corporation, a Delaware Corporation.

Application 02-01-041
(Filed January 31, 2002)

O P I N I O N

Summary

This decision denies Pacific Gas and Electric Company's (PG&E) application for approval of an amendment to the Power Purchase Agreement (PPA) between PG&E and Gaylord Container Corporation (Gaylord).

Background

In Decision (D.) 01-06-015 the Commission provided an opportunity for utilities to file voluntary qualifying facility (QF) contract amendments using three standard contract modifications¹ that would be deemed reasonable by the Commission if made prior to July 15, 2001. This date was subsequently extended to July 31, 2001 by D.01-10-069. PG&E states that on July 20, 2001, PG&E and

¹ The contract amendments allow (a) supplemental payments for one year to QFs demonstrating immediate need for such funds in order to continue operations, (b) fixed energy prices for five-years at 5.37 cents / kilowatt-hour (kWh), and (c) incentive payments to QFs for energy produced above normal operating levels.

Gaylord, a QF, entered into the first amendment to the PPA that modified the energy price in accordance with the one year option in D.01-06-015. On August 22, 2001, PG&E and Gaylord entered into the second amendment to the PPA that changed the energy price to the five-year fixed price option under D.01-06-015. However, when the “safe harbor”² date of July 31, 2001 was not extended by the Commission, the second amendment became a nullity.

On January 31, 2002, PG&E filed Application (A.) 02-01-041 for Commission approval of a Third Amendment to its PPA with Gaylord. PG&E and Gaylord entered into the Third Amendment and an Assumption Agreement on January 16, 2002.³ The Third Amendment, along with the first and second amendments, is included as an attachment to the application, while the Assumption Agreement is referenced in the application. PG&E states that the Assumption Agreement provides for the assumption of the PPA and an intrastate gas transportation service agreement by PG&E. Furthermore, PG&E states the Assumption Agreement, along with the Third Amendment, resolve certain litigation between Gaylord and PG&E. On February 11, 2002, PG&E made a Supplemental Filing in support of its application.

The Third Amendment modifies the energy price paid by PG&E to Gaylord and fixes it at 5.37 cents /kWh for a term of 3-1 / 2 years. PG&E states that if the Commission has not approved the Third Amendment by July 31, 2002,

² Safe harbor refers to the date by which D.01-06-015 contract amendments are deemed reasonable. (D.01-10-069, Findings of Fact 3, p.14.)

³ D.01-10-069 provides utilities an opportunity to negotiate amendments after the safe harbor date (July 31, 2001) that could be approved by the Commission through the filing of a new application.

the energy price in the PPA will revert to the Commission's generic short-run avoided cost (SRAC) formula.

The California Cogeneration Council (CCC) filed a response in support of PG&E's application on February 20, 2002. The CCC's response elaborates on why the Third Amendment is reasonable and in the public interest, and provides information on how the Assumption Agreement schedule for the payment of debts owed to Gaylord by PG&E. No other parties have filed responses.

On April 15, 2002, the CCC and PG&E filed a Motion For Leave to File Supplemental Information regarding the application⁴. The supplemental information is similar to information requested by ruling in A.02-01-042, and consists of an evaluation by MRW & Associates (MRW), a third-party consultant. The MRW evaluation provides information regarding projected natural gas prices, gas price volatility, Gaylord's contribution to the reliability of the electric grid, and a discussion of the litigation between PG&E and Gaylord. MRW's evaluation estimates that as a result of the 3-1/2 year fixed energy price, ratepayers will pay approximately \$3.0 million more under the Third Amendment⁵ than they would pay under current SRAC prices. However, the supplemental information filed by CCC and PG&E did not provide detailed information regarding the litigation issues between PG&E and Gaylord. Accordingly, on May 8, 2002, the Administrative Law Judge (ALJ) requested

⁴ This motion was unopposed and was granted by ALJ ruling on May 8, 2002.

⁵ Calculated on a net present value (NPV) basis using a 10% discount rate over the 3-1/2 year term of the Third Amendment.

further information specifically relating to the potential costs of litigation and the assumptions used in litigation cost calculations.

PG&E responded to the May 8 ruling on May 24, 2002, stating that the settlement of litigation between Gaylord and PG&E is not contingent on the Commission's approval of the Third Amendment to the PPA.

Discussion

We begin our review by stating that PG&E's application is not a request to permit Gaylord's operation as a QF. Gaylord currently operates as a QF and under the amended contract receives supplemental payments above SRAC prices. Instead, this is an application that requests ratepayers to pay higher energy costs to improve market stability.

PG&E asserts that the Third Amendment and the Assumption Agreement constitute a settlement agreement that provides a fixed energy price, above projected SRAC energy prices, and other benefits to Gaylord, while providing benefits to PG&E by resolving Gaylord's claims against PG&E. Therefore, we review the application using the Commission's settlement rules as a standard of review. These rules are found in Rules 51 to 51.10 of the Commission's Rules of Practice and Procedure.⁶ The settlement rules provide in pertinent part that "the Commission will not approve a stipulation or settlement, whether contested or uncontested, unless the stipulation or settlement is reasonable in light of the whole record, consistent with law and in the public interest."

⁶ All references are to the Commission's Rules of Practice and Procedure unless otherwise noted.

PG&E and Gaylord estimate that the additional \$3.0 million in energy payments under the Third Amendment represents a 10% premium over maintaining current pricing in the PPA. The additional payments result from the differential between the higher energy costs at 5.37 cents/kWh and lower SRAC energy costs forecasts, estimated at 4 to 4.9 cents/kWh. PG&E and CCC argue that in return for these greater energy prices ratepayers receive an “insurance policy” through market stability by avoiding potentially higher SRAC energy prices as a result of potentially higher gas prices.⁷ PG&E and CCC also argue that approval of the application will improve the reliability of the local Bay Area electric grid and decrease the likelihood that Gaylord would cease operations as a QF.

While we believe market stability is valuable, under D.01-06-015 we previously approved amended contracts using fixed prices for PG&E QFs providing significant market stability. Although PG&E and CCC argue that gas prices might rise in the future, gas prices might also decline, causing energy at fixed prices to be even more costly than the estimated 10% premium.

With regard to the continued operation of Gaylord, we are concerned about the continued viability of QFs generally, QFs contribution to the electric grid, and the economic and energy system effects when QFs cease operations. Our concern has been expressed in numerous decisions including D.01-03-067 (p.34) where we ordered utilities to pay QFs on a going forward basis; D.01-06-015 (pp.4-5) where we provided non-standard amendment opportunities

⁷ SRAC payments to QFs are based on a formula that includes a gas price index. If the gas price increases, the SRAC payment increases; while lower gas prices reduce SRAC payments.

to QFs that were automatically deemed reasonable and in D.01-10-069 (p.11) where we provided an opportunity for utilities and QFs to continue to negotiate contract amendments after the safe harbor date and apply for our approval through the filing of an application. As noted by PG&E, Gaylord chose one of the options under D.01-06-015 and amended its contract so that Gaylord receives supplemental payments above SRAC prices. Although we have taken these actions to help bring stability to the electricity market, utility energy and capacity payments to QFs are defined by the Public Utility Regulatory Policies Act of 1978 (PURPA) and Pub. Util. Code § 390, and using these definitions each QF must determine whether it will operate based on its unique economic circumstances.

PG&E and CCC assert that the Third Amendment, along with the Assumption Agreement, will resolve substantial litigation claimed by Gaylord against PG&E⁸. PG&E and CCC calculate that the value of these claims is at least \$15 million⁹ based on termination of the PG&E-Gaylord contract and future lost capacity and capacity bonus payments. PG&E and CCC also contend litigation costs may include other potential damages associated with Gaylord's inability to sell on the open market during the summer of 2001. PG&E and CCC then apply a 50 percent probability that Gaylord would prevail in its claims to conclude that the value of potential litigation (\$7.5 million) substantially exceeds the \$3.0 million premium that ratepayers would pay under the Third Amendment.

⁸ Supplemental Information filed jointly by PG&E and CCC, April 15, 2002.

⁹ NPV calculated at 10% discount rate over the remaining term of the contract (2002-2012).

However, these simplified assumptions regarding litigation analysis are incomplete. It is not clear whether the analysis represents PG&E's actual litigation assumptions or how PG&E determined that Gaylord's damage claims are the responsibility of ratepayers. Therefore, in an effort to determine whether the potential litigation costs represent a reasonable estimate, the ALJ issued the May 8 ruling requesting specific information on these matters. The ALJ also required a response solely from PG&E and not as a joint response with CCC. In its response,¹⁰ PG&E states that while the proposed Third Amendment is part of an integrated settlement of litigation between Gaylord and PG&E, "the settlement of the Gaylord litigation is not contingent on the Commission's approval of the Third Amendment to Gaylord's PPA." This statement leads us to conclude that the approval of the Third Amendment is not directly related to litigation costs. Therefore, we must conclude that PG&E's litigation assumptions and estimate of potential litigation costs are irrelevant for purposes of comparison to the premium energy costs in the Third Amendment as provided in PG&E's April 15, 2002 response.

Furthermore, it is difficult to understand why PG&E or CCC did not submit the Assumption Agreement in the Application or responses to ALJ rulings. PG&E and CCC assert that this is a vital document in understanding the settlement agreement and resolving the litigation between PG&E and Gaylord. A review of the Third Amendment shows that its sole purpose is to define the increase in energy rates, while the Assumption Agreement apparently resolves

¹⁰ Response of PG&E to ALJ's Ruling Requesting Supplemental Information, filed May 4, 2002.

litigation and other issues. When separated from the litigation assumptions, the premium energy payments are unreasonable, and therefore the Application is not in the public interest.

Since we cannot conclude whether the Application is in the public interest, we need not determine whether the Application meets the two other requirements of our settlement standards, that is, whether the settlement agreement is reasonable in light of the record and consistent with law. Under our settlement rules all three requirements must be met in order to approve a settlement. Absent PG&E's showing that the potential litigation costs and assumptions are reasonable and why litigation costs or damages should be borne by PG&E's ratepayers, there is no reason to consider this application. This application should be denied.

In Resolution ALJ 176-3083 dated March 6, 2002, the Commission preliminarily categorized this application as ratesetting, and preliminarily determined that hearings were necessary. No protests have been received. Given this status public hearing is not necessary and it is necessary to alter the preliminarily determination made in Resolution ALJ 176-3083 to determine that hearings are not necessary.

Comments on Draft Decision

The draft decision of the ALJ in this matter was mailed to the parties in accordance with Section 311(g)(1) of the Public Utilities Code and Rule 77.7 of the Rules of Practice and Procedure. Comments were filed on _____, and reply comments were filed on _____.

Findings of Fact

1. PG&E filed A.02-01-041, January 31, 2002 requesting Commission approval of a Third Amendment to PG&E's PPA with Gaylord.

2. On July 20, 2001, PG&E and Gaylord entered into a First Amendment to the PPA under the one-year option approved in D.01-06-015.

3. On August 22, 2001, PG&E and Gaylord entered into a Second Amendment to the PPA that changed the energy price to a fixed price of 5.37 cents/kWh. The Second Amendment became a nullity when the safe harbor date for non-standard contract modifications was not extended beyond July 31, 2001.

4. PG&E and Gaylord estimate that under the Third Amendment, PG&E will pay approximately \$3.0 million more for energy than PG&E's energy payments using the current generic SRAC formula on a NPV basis.

5. Without Commission approval of the Third Amendment by July 31, 2002, energy payments by PG&E to Gaylord will revert to the Commission's generic SRAC formula.

6. No party has protested PG&E's Application.

7. Settlement of the Gaylord litigation is not contingent on the Commission's approval of the Third Amendment to Gaylord's PPA.

8. The Assumption Agreement was not filed with either PG&E's Application or in the responses to ALJ rulings.

9. PG&E did not provide its litigation analysis.

Conclusions of Law

1. The motion of PG&E for an expedited order is denied.

2. Energy and capacity payments to QFs are defined by PURPA and Pub. Util. Code § 390.

3. PG&E has not demonstrated that the Third Amendment to the PPA is in the public interest.

O R D E R

IT IS ORDERED that:

1. Pacific Gas and Electric Company's application for approval of an amendment to the Power Purchase Agreement between Pacific Gas and Electric Company and Gaylord Container Corporation is denied. This denial is without prejudice to the applicant filing a new application for approval of the amendment at such time that applicant can demonstrate that the amendment is in the public interest, is reasonable in light of the record, and consistent with law.
2. Application 02-01-041 is dismissed.
3. This proceeding is closed.

This order is effective today.

Dated _____, at San Francisco, California.