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Decision ________________

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 Oildale Energy LLC, a California limited liability company. U 39 E	Application 02-01-042 (Filed January 31, 2002)

O P I N I O N

Summary

This opinion 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 Oildale Energy LLC (Oildale), a California limited liability company (Application).

Background

In Decision (D.) 01-06-015 the Commission provided an opportunity for utilities to file voluntary qualifying facility (QF) contract amendments using three non-standard contract modifications[1] that would be deemed reasonable by

[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.

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 Oildale, 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 Oildale entered into a 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.) 02-01-042 for Commission approval of a Third Amendment to its PPA with Oildale. PG&E and Oildale entered into The Third Amendment and an Assumption Agreement on January 16, 2002.[3] The Third Amendment, along with the first and second amendments are included as attachments 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 by both PG&E and Oildale. Furthermore, PG&E states the Assumption Agreement, along with the Third Amendment, resolves certain litigation between Oildale and PG&E. On February 11, 2002, PG&E made a Supplemental Filing in support of its Application.

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[2] Safe harbor refers to the date by which D.01-06-015 contract amendments are deemed reasonable. (D.01-10-069, Finding 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 Third Amendment modifies the energy price paid by PG&E to Oildale and fixes it at 5.37cents/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, the energy price in the PPA will revert to the Commission's generic SRAC formula.

Oildale filed a response in support of PG&E's Application on February 20, 2002. Oildale's response elaborates on why it feels the Third Amendment is reasonable and in the public interest, and provides information on Oildale's inability to operate under the SRAC energy price formula thus leading to its declaration of bankruptcy. No other parties have filed responses.

On March 15, 2002 the assigned Administrative Law Judge (ALJ) issued a ruling requesting supplemental information regarding projected energy costs and providing PG&E an opportunity to submit any other additional information to justify the Application.

Oildale and PG&E filed a Joint Response to the March 15 ruling on April 3, 2002. The Joint Response consists of an evaluation by MRW & Associates, a third-party consultant, and provides information regarding projected natural gas prices, gas price volatility, stabilization of Oildale's operations as a QF and a discussion of the settlement of litigation between PG&E and Oildale. The Joint Response estimates that as a result of the 3-1/2 year fixed energy price, ratepayers will pay approximately $4.7 million more under the Third Amendment[4] than they would pay under current short-run avoided cost (SRAC) prices. However, the Joint Response did not provide detailed

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[4] Calculated on a net present value basis using a 10% discount rate over the 3-½ year term of the Third Amendment.

information regarding the litigation issues between PG&E and Oildale. Accordingly, on May 7 the ALJ requested further information specifically relating to the potential costs of litigation and the assumptions used in litigation cost calculations.

On May 24, 2002, PG&E responded to the May 7 ruling with certain additional information on litigation and reiterated information provided in the Joint Response. However, PG&E did not provide its analysis of litigation risk stating that such information "could constitute a waiver of PG&E's attorney-client privilege and reveal attorney work product with respect to PG&E's potential strategy in the Oildale litigation."

On June 3, 2002, Oildale filed a reply to the ALJ's May 7 ruling. Oildale's reply offers that ratepayers are traditionally responsible for all prudently incurred costs of providing service, and would therefore bear any damages associated with Oildale's service to PG&E. Oildale also suggests that the 50% probability of liability is conservative and that the value of litigation may be greater than a 50% probability. Oildale states that it attempted to sell energy on the open market in the summer of 2001, but was opposed by PG&E and that this too represents potential litigation damages. Finally, Oildale expresses that if the Third Amendment is not timely approved, it will return to litigation and may seek alternative arrangements to sell energy.

Discussion

We begin our review by stating that PG&E's Application is not a request to permit Oildale's operation as a QF. Oildale 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 for 3 ½ years primarily to resolve litigation claims by Oildale against PG&E. It is this issue that weighs heavily in our analysis and determination of reasonableness.

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 Oildale, while providing benefits to PG&E by resolving Oildale'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.[5] 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."

PG&E and Oildale estimate that the additional $4.7 million in energy payments represents a 10% premium over estimated SRAC energy payments during the term of the Third Amendment. The additional payments result from the differential between the higher energy costs at 5.37 cents/kWh and lower SRAC energy costs estimated at 4 to 4.9 cents/kWh. The Joint Response argues that in return for these greater energy prices, ratepayers receive an "insurance policy" through market stability by avoiding potentially greater SRAC energy

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

prices as a result of potentially greater gas prices.[6] PG&E and Oildale also argue that approval of the application will improve the local Oildale economy and decrease the likelihood that Oildale would cease operations as a QF.

In assessing these arguments, we believe that while market stability is valuable, under D.01-06-015 we have previously approved amended contracts using fixed prices for PG&E QFs, thus already providing significant market stability. Furthermore, although PG&E and Oildale argue that gas prices might rise in the future, gas prices might also decline, thus causing energy at fixed prices to be more costly.

With regard to the continued operation of Oildale, we are concerned about the continued viability of QFs generally, and the economic and energy system effects when QFs cease operation. 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 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, Oildale chose one of the options under D.01-06-015 and amended its contract that provides supplemental payments to Oildale. 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

[6] 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.

(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 Oildale assert that the Third Amendment, along with the Assumption Agreement, will resolve substantial litigation and avoid potential damages claimed by Oildale against PG&E. PG&E and Oildale calculate that the value of these claims is at least $45 million[7] based on termination of the PG&E-Oildale contract and future lost capacity and bonus capacity payments. PG&E and Oildale also contend litigation costs may include other potential damages associated with Oildale's inability to sell on the open market during the summer of 2001 and capacity payments due Oildale during February 2001 through July 2001 when Oildale was partially or fully offline. PG&E and Oildale then apply a 50 percent probability that Oildale would prevail in its claims to conclude that the value of potential litigation ($22.5 million) greatly exceeds the $4.7 million premium that ratepayers would pay under the Third Amendment.

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 Oildale'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 7 ruling requesting specific information on these matters. The ALJ also required a response solely from PG&E and not a joint response with Oildale. In

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[7] Net present value calculated at a 10% discount rate over the remaining term of the contract (2002-2015)

its response,[8] PG&E contends that disclosure of PG&E's litigation risk analysis could constitute a waiver of PG&E's attorney-client privilege and reveal attorney work product. We acknowledge the importance of confidentiality in matters of litigation, however, utilities are provided with legal options under Public Utilities Code Section 583 and General Order 66-C that maintain confidentiality while providing us with necessary information to determine the reasonableness of an application. In similar utility applications, litigation risk, analysis and costs have been submitted for our examination and review under protective order.[9] PG&E has chosen not to use these options in its application or responses to ALJ rulings. As a result, we are unable to conclude whether PG&E's litigation assumptions and estimate of potential litigation costs, when compared to the premium energy costs in the Third Amendment, are reasonable, and therefore that the Application is in the public interest.

Furthermore, it is difficult to understand why PG&E or Oildale have not submitted the Assumption Agreement in the Application or responses to ALJ rulings. PG&E and Oildale assert that this is a vital document in understanding the settlement agreement and resolving the litigation between PG&E and Oildale. 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 litigation and other issues.

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8 Response of PG&E to ALJ's Ruling Requesting Supplemental Information, filed May 24, 2002.

9 See, for example, D.02-04-014, in A.01-11-033, approving Southern California Edison Company's application for approval of Settlement Agreement with NP Cogen, Inc.

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, 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 determinations made in Resolution ALJ 176-3083 to determine that hearings are not necessary.

Comments on Draft Decision

The draft decision of ALJ DeBerry in this matter was mailed to the parties in accordance with Public Utilities Code Section 311(g)(1) and Rule 77.7 of the Rules of Practice and Procedure. Comments were filed by Oildale on July 22, 2002 and by PG&E on July 29, 2002.

Oildale asserts that the draft decision mischaracterizes the application and overlooks the primary benefits of the contract amendment, which include insulating ratepayers from volatile gas prices and preserving a much-needed 40 MW cognerator. Oildale contends that the application contains sufficient information to conclude that it is in the public interest, reasonable in light of the whole record, and consistent with applicable law.

Oildale believes that it is important in the current energy environment to preserve a QF such as Oildale, an in-state energy generator that does not manipulate prices and is willing to continue operations at a “modest and temporary premium over SRAC prices”. Oildale further argues that the draft decision pays lip-service to Oildale’s plight, and gives little value to having the additional 40 MW on California’s energy grid. Oildale asserts that operation of this QF provides market stability and contributes to ensuring sufficient QF energy is available. Oildale states that the energy markets, both electric and gas, continue to be unstable and a fixed energy price, consistent with the fixed energy prices given other QFs, benefits ratepayers.

Oildale concludes there is ample information in the record regarding litigation costs. Oildale believes that the benefits of protecting against greater gas costs, and securing operation of a much needed, reliable QF are adequate to justify the application. Oildale also asserts that the draft decision does not give value to the settlement of litigation based on the information provided in responses to ALJ rulings. Accordingly, Oildale believes no value has been ascribed to the settlement of litigation between Oildale and PG&E in the draft decision. Oildale believes all of the information provided by Oildale and PG&E is sufficient to conclude that the application is reasonable in light of the whole record and consistent with applicable law.

PG&E also asserts that the draft decision incorrectly focuses on the resolution of litigation and ignores the principal benefits in the application including avoiding volatile gas prices and helping Oildale to return to operation as a QF. PG&E argues against divulging its litigation risks, citing attorney-client privilege or revelation of attorney work product, and states that the litigation risk analysis already provided, in addition to the other benefits cited, are sufficient to justify the application. Attached to PG&E's comments is a September 21, 2001 decision of the San Francisco Division of the United States Bankruptcy Court for the Northern District of California regarding another QF. PG&E asserts this decision provides additional evidence of the challenges PG&E faces regarding breach of contract claims by Oildale.

We will not further argue the issue of litigation risk. We have given PG&E ample opportunity to provide this element, confidentially, in order to justify the application, apart from the other benefits PG&E and Oildale ascribe to the application. Whether PG&E views the litigation risk in the same manner as portrayed by its consultant MRW and Associates is uncertain from the information provided.

With regard to the other benefits offered by Oildale and PG&E, we have carefully reviewed Oildale's and PG&E's contentions apart from the resolution of litigation. While avoiding gas price variances is useful, almost 70% of the total QF energy capacity for the three major California utilities operates under contracts at fixed energy prices. As a result there already exists a substantial "insurance policy" with regard to changing gas prices.

Although returning Oildale to financial health is a worthy goal, there are many worthy business ventures throughout the State that could be assisted by increasing ratepayer costs. Oildale was given the opportunity to choose the fixed energy price that it now requests back in June 2001; however, it choose a one-year supplemental payment alternative that it now believes is inadequate to meet its financial requirements. QFs are not public utilities and we do not regulate management decisions made by QFs. As has already been said, our relationship to QFs is governed by federal and state law through PURPA and Section 390. Therefore, we must weigh the benefits for ratepayers of the proposed amendment, primarily a resolution of undetermined litigation costs, against additional ratepayer costs ($4.7 million). We conclude that those benefits are not equivalent to the costs and therefore this application is not in the public interest and should be denied.

Findings of Fact

1. PG&E filed A.02-01-042, January 31, 2002 requesting Commission approval of a Third Amendment to PG&E's PPA with Oildale.

2. On July 20, 2001, PG&E and Oildale 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 Oildale 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 Oildale estimate that under the Third Amendment, PG&E will pay approximately $4.7 million more for energy then PG&E's energy payments using the current generic SRAC formula, on a net present value basis.

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

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

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

8. 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, or the settlement agreement with Oildale, is in the public interest.

O R D E R

IT IS ORDERED that:

1. Pacific Gas and Electric Company's application approving an amendment to the Power Purchase Agreement between Pacific Gas and Electric Company and Oildale Energy LLC is denied. This denial is without prejudice to the applicant filing a subsequent 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 02-01-042 is dismissed.

3. This proceeding is closed.

This order is effective today.

Dated ____________________________, at San Francisco, California.