Decision 11-05-005 May 5, 2011

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking to Integrate and Refine Procurement Policies and Consider Long-Term Procurement Plans.	Rulemaking 10-05-006 (Filed May 6, 2010)

DECISION MODIFYING NEW GENERATION AND LONG-TERM CONTRACT COST ALLOCATION MECHANISM PURSUANT TO SENATE BILL 695

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DECISION MODIFYING NEW GENERATION AND LONG-TERM CONTRACT COST ALLOCATION MECHANISM PURSUANT TO SENATE BILL 695

1. Summary

This decision modifies the Cost Allocation Mechanism (CAM) adopted in Decision 06-07-029.[1] These modifications are to ensure that the CAM is consistent with provisions of Senate Bill 695 (Stats. 2009, ch. 337).

Specifically: 1) we eliminate the utilities' ability to elect (or decline to elect) CAM treatment for generation resources; 2) we allow CAM treatment for utility-owned generation; and 3) we change the duration of CAM treatment to match the duration of the underlying contract.

2. Background

Senate Bill (SB) 695, enacted in 2009, contained a range of provisions relating to direct access and utility procurement of generation resources. At issue here is SB 695's creation of new Public Utilities Code Section 365.1(c), which addresses allocation of the costs of certain generation resources procured by the utilities.

Specifically, the language that is the primary focus here is:

> (c) Once the commission has authorized additional direct transactions pursuant to subdivision (b), it shall do both of the following:
>
> (1) Ensure that other providers are subject to the same requirements that are applicable to the state's three largest electrical corporations under any programs or rules adopted by

[1] Decision (D.) 06-07-029 was modified in D.07-11-051. All cites to D.06-07-029 incorporate the modifications made to that decision in D.07-11-051, unless otherwise noted.

the commission to implement the resource adequacy provisions of Section 380, the renewables portfolio standard provisions of Article 16 (commencing with Section 399.11), and the requirements for the electricity sector adopted by the State Air Resources Board pursuant to the California Global Warming Solutions Act of 2006 (Division 25.5 (commencing with Section 38500) of the Health and Safety Code). This requirement applies notwithstanding any prior decision of the commission to the contrary.

(2) (A) Ensure that, in the event that the commission authorizes, in the situation of a contract with a third party, or orders, in the situation of utility-owned generation, an electrical corporation to obtain generation resources that the commission determines are needed to meet system or local area reliability needs for the benefit of all customers in the electrical corporation's distribution service territory, the net capacity costs of those generation resources are allocated on a fully nonbypassable basis consistent with departing load provisions as determined by the commission, to all of the following:

(i) Bundled service customers of the electrical corporation.

(ii) Customers that purchase electricity through a direct transaction with other providers.

(iii) Customers of community choice aggregators.

(B) The resource adequacy benefits of generation resources acquired by an electrical corporation pursuant to subparagraph (A) shall be allocated to all customers who pay their net capacity costs. Net capacity costs shall be determined by subtracting the energy and ancillary services value of the resource from the total costs paid by the electrical corporation pursuant to a contract with a third party or the annual revenue requirement for the resource if the electrical corporation directly owns the resource. An energy auction shall not be required as a condition for applying this allocation, but may be allowed as a means to establish the energy and ancillary services value of the resource for purposes of determining the net costs of capacity to be recovered from customers pursuant to this paragraph, and the

> allocation of the net capacity costs of contracts with third parties shall be allowed for the terms of those contracts.
>
> (C) It is the intent of the Legislature, in enacting this paragraph, to provide additional guidance to the commission with respect to the implementation of subdivision (g) of Section 380, as well as to ensure that the customers to whom the net costs and benefits of capacity are allocated are not required to pay for the cost of electricity they do not consume.

The Cost Allocation Mechanism (CAM) adopted by the Commission in Decision (D.) 06-07-029, in the 2006 Long-Term Procurement Proceeding Rulemaking (R.) 06-02-013, fundamentally addresses the same issue. Accordingly, the Commission must now make sure that its administration of the CAM is consistent with the requirements of SB 695.

An Administrative Law Judge's Ruling issued on September 14, 2010, directed parties to file comments on whether and how existing procurement rules should be modified to comply with the relevant provisions of SB 695.[2]

The September 14, 2010 Ruling preliminarily identified two aspects of the cost allocation provisions of SB 695 that differ from the existing CAM: 1) the eligibility of utility-owned generation resources for CAM treatment, and 2) the use of an energy auction to determine the net capacity cost for resources needed to meet system and local reliability. The Ruling also asked parties to answer the following questions:

1. How should the CAM process adopted in D.06-07-029 and D.07-09-044 be modified or refined to comply with SB 695?

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[2] *Administrative Law Judge's Ruling on Implementation of SB 695 and the Cost Allocation Mechanism (Track III)*, dated September 14, 2010.

2. How should the Commission interpret and define the term "all customers" in the context of SB 695 and existing procurement rules?
3. Pursuant to Section 365.1(c)(2)(A), should the Commission grant authorization in the proceeding to allow utility-owned generation to be eligible for CAM treatment?
4. What criteria and factors should the Commission consider when determining whether to allow utility-owned generation to be eligible for the CAM?
5. How should the Commission interpret Section 365.1(c)(2)(B) which provides that "an energy auction shall not be required" but "may be allowed as a mean to establish the energy and ancillary services value of the resources for the purposes of determining the net cost of capacity…?"
6. Aside from an energy auction, what are alternative mechanisms that can be used to determine the net cost of capacity?

Opening comments were filed by Alliance for Retail Energy Markets (AReM), California Large Energy Consumers Association, Jan L. Reid (Reid), Pacific Gas and Electric Company (PG&E) jointly with San Diego Gas & Electric Company (SDG&E), Southern California Edison Company (SCE), The Utility Reform Network (TURN), and Women's Energy Matters. AReM, the Commission's Division of Ratepayer Advocates (DRA), Reid, SCE, and TURN filed reply comments.

While parties differ in their recommended approach to reconciling the existing CAM rules with SB 695, there is general consensus that modification of the CAM rules is necessary. We agree. There are aspects of the CAM rules that are not consistent with SB 695. We are modifying the CAM rules to reconcile them with the applicable provisions of SB 695.

3. Elimination of the CAM Election Process

Under D.06-07-029, the utilities are the entities responsible for procuring new generation through long-term power purchase agreements (PPAs).[3] Commission approval for such new system resource contracts typically included an order that the utilities "shall make an election at the time they seek contract approval…whether or not they intend that the [CAM] should apply to the contract."[4]

The language of SB 695 expressly requires that the Commission "shall ensure that," under certain conditions, the net capacity costs of the specified generation resources "are allocated on a fully nonbypassable basis" to bundled utility customers, direct access customers, and community choice aggregation customers.[5] This language is mandatory, and does not provide for or allow for an election.

As TURN describes it, "SB 695 removes the right [for the utility] to elect or *not elect* CAM treatment for a resource that meets the condition of the statutes…,"[6] and that "either the Commission finds that the statutory conditions have been met and the cost-and-benefit allocation applies, or it doesn't."[7]

In short, there is no longer an election or choice whether to apply the CAM. If the statutorily-specified conditions are met, then the CAM applies. Those conditions require that the Commission make a determination that the

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[3] D.06-07-029 Conclusion of Law 7.

[4] *Id.*, Conclusion of Law 6.

[5] Section 365.1(c)(2).

[6] TURN October 1st 2010 Comments at 7.

[7] TURN October 8th 2010 Comments at 2.

generation resources in question "are needed to meet system or local area reliability needs for the benefit of all customers in the electrical corporation's distribution service territory." The criteria that the Commission will use in making this determination will be developed later in this or a successor proceeding.

4. "Benefiting Customers" and "For the Benefit of All Customers"

In D.06-07-029 and D.07-11-051, we reaffirmed our determination in D.04-12-048 that benefiting customers subject to the CAM consist of all bundled service customers, direct access customers, and community choice aggregation customers.[8] In D.08-09-012, we clarified this definition to exclude certain municipal departing load and customer generation departing load.

Under SB 695, if the Commission determines that generation resources "are needed to meet system or local area reliability needs for the benefit of all customers in the electrical corporation's distribution service territory," then

> [T]he net capacity costs of those generation resources are allocated on a fully nonbypassable basis consistent with departing load provisions as determined by the commission, to all of the following:
>
> (i) Bundled service customers of the electrical corporation.
>
> (ii) Customers that purchase electricity through a direct transaction with other providers.
>
> (iii) Customers of community choice aggregators.[9]

[8] D.06-07-029 at 26 n. 21.

[9] Section 365.1(c)(2)(A).

The question arises whether this language is consistent with our prior determinations.

Regarding the definition of customers responsible for generation cost allocation under SB 695, PG&E/SDG&E, SCE and TURN note that the statute plainly refers to all bundled, direct access, and community choice aggregation customers.[10] However, PG&E/SDG&E believe that "the statute language is not exclusive; nor does the statute limit the application of the SB 695 cost allocation mechanism *only* to bundled, [direct access] and [community choice aggregation] customers."[11] Similarly, DRA and TURN believe that under Section 365.1(c)(2)(A), the Commission retains the discretion to determine whether it is to apply the CAM to various categories of "departing load" customers as the Commission has done in the past.[12] PG&E/SDG&E recommend that these determinations not be revisited.[13]

We agree with PG&E/SDG&E, SCE and TURN that SB 695 provides clear guidance on bundled service, direct access and community choice aggregation customers' cost responsibility. We also agree with PG&E/SDG&E that our prior determinations in D.08-09-012 on customers subject to the nonbypassable charge and the CAM process do not need to be revisited.

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[10] PG&E/SDG&E October 1, 2010 Comments at 4; SCE October 1st 2010 Comments at 6; and TURN October 1st 2010 Comments at 5.

[11] PG&E/SDG&E October 1st 2010 Comments at 4.

[12] DRA October 8th 2010 Comments at 2 and TURN Oct 1st 2010 Comments at 5.

[13] PG&E/SDG&E October 1st 2010 Comments at 4.

5. Eligibility of Utility-Owned Generation for the CAM

D.06-07-029 declined to approve the CAM for utility-owned generation.[14] SB 695, however, expressly provides that utility-owned generation is eligible for the CAM under certain conditions, specifically in the event that the Commission "orders" an electrical corporation to obtain that generation "to meet system or local area reliability needs for the benefit of all customers in the electrical corporation's distribution service territory."[15]

No party disputes that SB 695 allows the costs of utility-owned generation to be allocated among all load serving entities if the statutory conditions are met, but AReM argues for conditions or limitations on CAM treatment for utility-owned generation.

AReM argues that the language requiring the Commission to "order" the procurement of utility-owned generation means that such generation developed on the utility's own initiative would not be eligible for the CAM.[16] This interpretation would appear to preclude the Commission from ordering procurement of utility-owned generation (eligible for CAM) if that generation was proposed by a utility for the first time in an application. In other words, the Commission would have to act first to order the utility to procure utility-owned generation, rather than approve a request from the utility that it be allowed to procure such generation. We decline to put such a narrow definition on the word "order." If a Commission order authorizes the procurement of

[14] D.06-07-029 at 4.

[15] Section 365.1(c)(2)(A).

[16] *Id*. at 13.

utility-owned generation, that counts as an "order" under SB 695, regardless of whether the Commission or the utility was the first to come up with the idea.

AReM also argues that utility-owned generation projects "should be permitted only when competitive options are completely unavailable."[17] This condition unnecessarily ties the Commission's hands, as the Commission would then not be able to select (and CAM) a highly attractive utility-owned generation project if any competitive option, regardless of the comparative merits, was somehow available. This interpretation is not in, nor supported by SB 695, and we decline to impose such a tortured and restrictive interpretation.

Finally, AReM argues that "the ability for the Commission to allow CAM treatment for [utility-owned generation] does not create any preference for such resources."[18] We agree. The language of SB 695 appears to be placing utility-owned generation and independent generation on a relatively equal footing, and should not be read to favor utility-owned generation over other kinds of generation.

CAM treatment of utility-owned generation resources is permissible under SB 695 if the statutory conditions are met. If the Commission determines that a utility-owned generation resource is needed for system or local area reliability for the benefit of all customers in a utility distribution service territory, then cost allocation applies on a nonbypassable basis, consistent with our departing load provisions established in D.08-09-012.

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[17] AReM October 1st 2010 Comments at 13.

[18] *Id.* at 13.

6. Use of Energy Auction to Calculate Net Capacity Cost

In D.06-07-029, we adopted the conceptual framework of a CAM process under which "the costs and benefits of the energy component [are] assigned to those that value the energy the most, as demonstrated through an auction or similar mechanism."[19]

In D.07-09-044, we adopted an unopposed settlement outlining products and processes that govern the utilities' administration of the new resource contracts and periodic energy auctions.[20] Under the rules established in D.06-07-029 and D.07-09-044, if the Commission allows a particular resource contract to receive CAM treatment, then an energy auction necessarily follows.[21] If there are no bidders participating in the energy auction, then the utility is to use an alternate methodology to calculate the net capacity cost.[22]

Some parties believe that, under SB 695, the Commission cannot *require* the utility to use an energy auction as a condition for the resource to receive CAM treatment, but it can *allow* one to be conducted by the utility voluntarily.[23] Reid

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[19] D.06-07-029 at 31.

[20] Parties to the Settlement Agreement include AReM, Aglet Consumer Alliance, Barclays Bank, PLC, Constellation Energy Commodities Group, Inc., Constellation NewEnergy Inc., DRA, J. Aron & Company, Mirant California, LLC, Mirant Corporation, Mirant Delta, LCC, PG&E, SCE, SDG&E, TURN, and Western Power Trading Form.

[21] D.07-09-044 Appendix A Section IX.

[22] *Id.* Section IX(B) provides the methodology to calculate the net cost of capacity if there are no bidders participating in an energy auction.

[23] AReM October 1st 2010 Comments at 13; DRA October 8th Comments at 5; PG&E/SDG&E October 1st 2010 Comments at 5; SCE October 1st 2010 Comments at 8; and TURN October 1st 2010 Comments at 8.

appears to support the Commission having continued authority to require an auction, and for the Commission to use an auction.[24]

PG&E/SDG&E recommend that the energy auction process be eliminated in total because "the energy auctions that have been conducted to date have been complicated, time consuming and not particularly effective."[25] SCE, the only utility that has conducted energy auctions under the CAM process, disagrees with PG&E/SDG&E, and argues that utilities should still have the option to conduct an energy auction.[26]

The auction-related language of SB 695 is in fact somewhat unclear:

> An energy auction *shall not be required* as a condition for applying this allocation, *but may be allowed* as a means to establish the energy and ancillary services value of the resource for purposes of determining the net costs of capacity to be recovered from customers pursuant to this paragraph, and the allocation of the net capacity costs of contracts with third parties shall be allowed for the terms of those contracts.[27]

The passive voice of this language makes it somewhat confusing who it applies to. If it said that "utilities are not required to conduct an energy auction, but may choose to do so," it would be clear that the utilities get to make the choice whether or not to conduct an auction. But the code section is directed at the Commission, not the utilities, so the choice would appear to rest with the Commission. It is clear that an auction is permissible, so the Commission is not

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[24] Reid October 1st 2010 Comments at 11-12.

[25] PG&E/SDG&E October 1st 2010 Comments at 5.

[26] SCE October 8th 2010 Comments at 8.

[27] Section 365.1(c)(2)(B).

barred from using an auction. The question becomes whether the Commission can *require* the use of an auction.

On one hand, the language that says an auction "shall not be required" could possibly be read to bar the Commission from requiring an auction. On the other hand, the language that directs the Commission that an auction "may be allowed," gives the Commission authority to use an auction.

The statute neither requires nor prohibits the use of an auction, but allows the Commission, not the utilities, to choose to use an auction. The Commission is not required to use an auction, but may do so. If the utilities are given the choice to either use or not use an auction, then the Commission does not get a choice – the utilities do. If the utilities choose to not use an auction (as PG&E and SDG&E seem inclined), then the ability to choose an auction has been taken away from the Commission. Since the statutory language is directed at the Commission, not the utilities, and gives the Commission the choice, the only interpretation consistent with the intent of the statutory language is that the Commission can choose to require an auction.

This interpretation is consistent with the Commission's responsibilities pursuant to Public Utilities Code Section 380(b) to achieve all of the following objectives in establishing resource adequacy requirements: "(1) Facilitate development of new generating capacity and retention of existing generating capacity that is economic and needed. (2) Equitably allocate the cost of generating capacity and prevent shifting of costs between customer classes. (3) Minimize enforcement requirements and costs." Nothing in this statutory scheme or the legislative history of SB 695 supports the parties' contention that the Commission abdicates its authority in favor of offering the utilities a menu of options for the utilities to determine the net capacity costs and benefits of system

resources. It is the Commission's duty, not that of the utilities, to "equitably allocate the cost of generating capacity…"

While the Commission may choose to employ an auction, it may also choose not to use an auction. Accordingly the Commission can, consistent with SB 695, use another method for determining net capacity cost. The Commission acknowledges that the existing energy auction mechanism adopted in D.07-09-044 may need to be revised. Consideration of non-auction processes and revisions to the auction methodology will occur in later phases of this proceeding or in a successor proceeding.

7. Term of CAM Application

Section 365.1(c)(2)(B) provides that "the allocation of the net capacity costs of contracts with third parties shall be allowed for the terms of those contracts." In D.06-07-029, we established that CAM treatment of contracts last no more than ten years:

> New generation approved by this Commission and eligible for the cost allocation mechanism will receive cost recovery for a period of up to 10 years. We limit the maximum term of any cost paid by all customers to the term of the contract, or 10 years, which ever is less, from the time that the new unit comes online.[28]

For a contract that meets the statutory condition for cost allocation, DRA, SCE and TURN argue that SB 695 requires the cost allocation be allowed for the entire term of the contact.[29] PG&E/SDG&E note that "the CAM process is

[28] D.06-07-029 at 27.

[29] DRA October 8, 2010 Comments at 2; SCE October 1st 2010 Comments at 6; and TURN October 1st 2010 at 5.

limited to ten years, while SB 695 does not have any duration limit,"[30] but do not offer any opinion on whether the Commission retains the discretion to place a duration limit on the CAM. And while DRA and SCE believe that this limitation should be removed,[31] AReM recommends that the contractual terms of procurement eligible for cost allocation be for the shortest possible to minimize nonbypassable charges and ensure that the reliability supply portfolio remains flexible to changing load conditions.[32]

For utility-owned generation cost allocation, AReM notes that, since SB 695 only addresses the term of the cost recovery for PPAs, the Commission will need to determine the appropriate time period for cost recovery for a utility-owned generation project if it is ordered by the Commission under the necessary conditions provided by SB 695.[33]

SB 695 requires us to allocate a contract's net capacity cost for the full term of the contract if we determine that the contract meets the necessary statutory conditions. Our prior ten-year limit on cost allocation is inconsistent with the clear language of the statute. Accordingly, the CAM now applies for the actual term of the contract, even if that contract term is longer than ten years.

Nothing in SB 695 limits the Commission's authority to limit contract durations in this or other proceedings, but CAM treatment now must correspond

[30] PG&E/SDG&E October 1st 2010 Comments at 3.

[31] DRA October 8th 2010 Comments at 2 and SCE October 1st 2010 Comments at 6.

[32] AReM October 1st 2010 Comments at 6.

[33] *Id.*

to the length of the contract.[34] While we could limit the contracts at issue here to ten years in length, we decline to do so at this time, as that would result in a de facto differentiation between contracted resources and utility-owned resources.

Regarding cost allocation for utility-owned generation, AReM correctly observes that SB 695 is silent on the cost recovery duration of utility-owned generation cost allocation. The simplest approach, and clearly allowable under SB 695, is to allow cost allocation for utility-owned generation for as long as it meets the statutory requirements.

Whether or not this is a good approach, however, is not clear, nor is it clear whether this approach results in outcomes consistent with the statutory intent of providing equivalent treatment of utility and non-utility-owned generation resources. Accordingly, it is essential that we develop a methodology to properly compare and evaluate PPAs versus utility-owned generation bids in a competitive solicitation, as well as developing a method for applying the CAM to utility-owned generation.

8. Next Steps

This decision narrowly modifies our existing rules and processes to ensure compliance with the resource adequacy provisions of SB 695. In doing so, it is clear that there are some issues that remain to be resolved, including:

1. The development of policies and processes for distinguishing between system and bundled resource needs, and related cost allocation.
2. Whether there should be a test of "who benefits" under SB 695, and if so, the construction of such a test.

[34] Similarly, the Commission retains its authority to impose limits on the procurement of utility-owned generation resources.

3. The further refinement of the energy auction process.
4. The development of policies and processes to compare and evaluate PPA versus utility-owned generation bids in a competitive solicitation.
5. The development of policies and processes for applying the CAM to utility-owned generation.

We intend to further develop the record in later phases of this proceeding in order to resolve these issues.

9. Comments on Proposed Decision

The proposed decision in this matter was mailed to the parties in accordance with Section 311 of the Public Utilities Code and comments were allowed under Rule 14.3 of the Commission's Rules of Practice and Procedure.

Comments were filed by PG&E, SCE, SDG&E, DRA, TURN, Women's Energy Matters, AReM and the Marin Energy Authority (MEA).

PG&E requested clarification that this decision does not modify or alter previous decisions implementing SB 695, such as D.10-07-045 and D.10-12-035. We agree that this decision is forward-looking, and does not modify these prior decisions.

SCE (along with SDG&E and TURN) raises a number of legal, policy, and implementation issues relating to the use of energy auctions. We acknowledge that certain of these issues, particularly the implementation issues, would benefit from further analysis and refinement at such time as the Commission may consider use of an energy auction. Given the preliminary nature of this decision, no changes to the language of this decision are needed.

Reply comments were filed by PG&E, SCE, AReM, Reid, and MEA.

10. Assignment of Proceeding

Michael R. Peevey is the assigned Commissioner and Peter V. Allen is the assigned Administrative Law Judge in this proceeding.

Findings of Fact

1. The Commission adopted a cost allocation mechanism for certain generation resources in D.06-07-029, as modified by D.07-11-051.

2. Subsequent to D.06-07-029 and D.07-11-051, SB 695 addressed some of the same cost allocation issues addressed in those Commission decisions.

3. Some provisions of D.06-07-029 and D.07-11-051 are inconsistent with SB 695.

4. Some provisions of D.06-07-029 and D.07-11-051 are consistent with SB 695.

5. The choice of a utility to elect or not elect to use the CAM for a generation resource, as permitted under D.06-07-029 and D.07-11-051, is inconsistent with SB 695.

6. The Commission's definitions of "benefitting customer" in D.06-07-029 and D.07-11-051, as clarified in D.08-09-012, are consistent with SB 695.

7. The Commission's prior prohibition of CAM treatment for utility-owned generation is inconsistent with SB 695.

8. The use of energy auctions to determine net capacity cost, as permitted under D.06-07-029 and D.07-11-051, is consistent with SB 695.

9. The ten-year limit on CAM treatment of a generation contract, regardless of the term of the contract, is inconsistent with SB 695.

Conclusions of Law

1. Those aspects of D.06-07-029 and D.07-11-051 that are inconsistent with SB 695 should be modified to comply with the requirements of SB 695.

2. Those aspects of D.06-07-029 and D.07-11-051 that are consistent with SB 695 do not need to be modified.

O R D E R

IT IS ORDERED that:

1. The choice of a utility to elect or not elect to use the Cost Allocation Mechanism for a generation resource is eliminated.

2. Cost Allocation Mechanism treatment for utility-owned generation is permitted.

3. The duration of Cost Allocation Mechanism treatment of a generation contract matches the duration of the underlying contract.

4. Rulemaking 10-05-006 remains open.

This order is effective today.

Dated May 5, 2011, at San Francisco, California.

MICHAEL R. PEEVEY
President
TIMOTHY ALAN SIMON
CATHERINE J.K. SANDOVAL
MARK FERRON
Commissioners

I abstain.

/s/ Michel Peter Florio
Commissioner