STATE OF CALIFORNIA ARNOLD SCHWARZENEGGER, G

PUBLIC UTILITIES COMMISSION
505 VAN NESS AVENUE
SAN FRANCISCO, CA 94102-3298

June 25, 2004

TO: PARTIES OF RECORD IN RULEMAKING 01-10-024

On June 9, 2004, Decision 04-06-011, the final decision of the Commission in R.01-10-024, was mailed to the parties without the dissent of Commissioners Loretta M. Lynch and Carl Wood. The dissent is now available, and is enclosed herewith.

Very truly yours,

/s/ ANGELA K. MINKIN
Angela K. Minkin, Chief
Administrative Law Judge

ANG:mnt

Attachment

***Dissenting opinion of Commissioners Loretta M. Lynch and Carl Woo*d**
to D.04-06-011 (SDG&E RFP) Palomar, Otay-Mesa #22 on 6/9/04

This Decision represents a major step forward for SDG&E by approving its first acquisition of new generating resources in many years, as well as endorsing important renewable energy and demand reduction efforts. However, the majority takes a step too far by approving SDG&E's ten-year contract with Otay Mesa. We would reject that contract, without prejudice.

There is no dispute with the fact that the Otay Mesa contract, as approved in this Decision, fails to comply with the criteria contained in SDG&E's Request for Proposals (RFP). SDG&E proposed the Otay Mesa Power Purchase Agreement (PPA) with a January 2008 start date, which falls outside the term of 2005-2007 specified in the RFP. SDG&E does not need the resources offered by the Otay Mesa PPA in the time frame of the RFP, or before June 2007. Indeed, the record indicates SDG&E needs at most 291 megawatts (MW) by 2007, which the Palomar facility alone will more than provide.[1] In short, Otay Mesa may provide significant long-term benefits, but it has nothing to do with the objectives of this particular solicitation.

One of the traps of approving Otay Mesa now is that no other entity had a fair chance to compete to provide what Otay Mesa has to offer. Indeed, other large scale bidders with transmission limitations similar to those that constrain the Otay Mesa facility were either rejected in the RFP, or discouraged from applying at all given the stated on-line requirement of June 2007. Here, the majority accepts a price negotiated in the absence of direct competition. In such a situation, Calpine had no incentive to keep its price low. The record shows that Otay Mesa was the most expensive combined-cycle option proposed by SDG&E. The majority approves it *not* because it is necessarily cost-effective, or that it is clearly the best way to meet future long-term needs, but simply because SDG&E offered it up for our consideration.

The majority suggests that Otay Mesa would serve as an insurance policy against the loss of any other planned resources. However, the stated purpose of SDG&E's solicitation was to meet local grid reliability needs, not to buy insurance. Of course, even if the purpose of the RFP was to buy insurance, virtually any power plant – indeed, almost <u>any</u> <u>number</u> of new power plants – could meet that criteria. That would be true at half the price, and it would be true at twice the price. One could buy a million dollar insurance policy for a million dollars. The fact that Otay Mesa provides insurance does not make the purchase prudent. We owe the ratepayers greater precision in our analysis.

[1] The sale of the 500+ MW facility at Palomar by Sempra to SDG&E is also approved in this Decision.

Just last January, we emphasized our preference for repowering existing facilities and for aggressively acquiring renewable resources. The Otay Mesa PPA does neither. Approving two new combined cycle plants, adding more than 1,000 MW to SDG&E's own forecast need of 291 MW, effectively forecloses other repowering or renewable options. We are concerned that renewables will have very little space in a portfolio that will be oversubscribed by hundreds of megawatts of fossil generation.

This RFP represented the first of the major utility procurement solicitations for long term resources, and sets the tone and precedent for future utility procurement solicitations. We had the opportunity here to demonstrate California's commitment to a transparent, competitive, public procurement process. This decision to approve the Otay Mesa PPA – despite the fact that it provides power only outside the time frame required by the RFP, despite the fact that SDG&E itself testified that Otay Mesa cannot meet SDG&E's local reliability needs until 2008, despite the fact that power produced at Otay Mesa will not be needed during the RFP period, and without the benefit of analyzing other projects that could have competed with Otay Mesa had they known that the RFP requirements would not be applied – sells short SDG&E's ratepayers, misses the opportunity to establish an RFP model that puts all competitors on equal footing, and violates our statutory obligation to ensure just and reasonable rates. This is, therefore, an historic decision – both in substance and in process. The Majority Decision unnecessarily gets it wrong on both counts.

There are many things to like about Otay Mesa, including its location close to the load center and its ability to displace RMR purchases. However, we should not have adopted this option without regard to price. There was a simple way to solve this problem. In January this year we directed the utilities to develop five-year long term plans for power procurement; our goal was – and remains -- to evaluate and approve five-year long term plans for each utility by the end of this year. We would have directed SDG&E to produce a new RFP, one that allows for proposals representing a variety of approaches for meeting long-term demand, one in which Otay Mesa would be free to compete, and one which would allow for a year-end decision in conjunction with the approval of these long-term plans. This would not have impaired Calpine's ability to meet a 2008 online date, if it were ultimately the winning bidder, and if the power the plant can produce is actually needed by that date. It would have, however, provided a much stronger incentive for Calpine to offer a competitive price.

In addition to disagreeing with the way this Decision treats the Otay Mesa project, we disagree with the majority's treatment of TURN and UCAN, which raised serious concerns about the way the parties negotiated the Otay Mesa deal.

TURN and UCAN presented evidence that indicated that there was direct involvement in the negotiations by one of the Commission's attorneys and indirect involvement by President Peevey, who is also the Assigned Commissioner. TURN and UCAN argued that this involvement constituted interference with market-based negotiations, and that this involvement outside our public processes constitutes an additional factor militating against approval of the contract.

The Decision characterizes the TURN/UCAN arguments as "scurrilous and without basis in fact." This flippant and untrue dismissal does an injustice to intervenors who raised an important and serious issue and who did their homework before making the claim. President Peevey confirmed his role and that of one of our attorneys in a subsequent ruling. In that ruling, President Peevey acknowledged his active interest and participation directly with SDG&E and Calpine, but denied any direct or indirect role in setting the terms or conditions. He went on to declare that there was nothing wrong about his intervention in this matter. In fact, he added that "to fail to do so would be a derogation of [his] responsibilities and a disservice to all of the constituencies of this Commission."

We disagree. The premise underlying approval of the Otay Mesa contract is not that it is cost-effective, because it isn't, but that it is the product of an open and competitive bidding process. The Otay Mesa negotiations do not reflect an open and competitive process. As we have already established, other base-load, post-2007 facilities were not allowed to compete fairly. But more than the highly irregular RFP process and result, this particular facility enjoyed special boosters within the agency. We cannot reach our institutional hand into the negotiating room, help to shape the outcome, and then step back and approve the results as if they reflected the integrity of the marketplace. The only way to comply with the law and due process requirements is to undertake another bidding process, and to keep ourselves, as an institution and as individuals, out of the negotiating room, off of the phones, and away from ex parte meetings that dwell on the state of the negotiations. The Wood alternate would have provided us with an opportunity to do this. The majority opinion does not.

There are other areas in which we disagree with this Majority Decision. We would have more explicitly rejected SDG&E's proposal to create a regulatory asset for Palomar and Ramco. The company's ability to earn on the ratebased acquisition price for these facilities would have provided sufficient return on the investment. We also agree TURN/UCAN that this mechanism is doubly inappropriate in relation to the Palomar purchase. Under SDG&E's contract, SER will add the cost of interest it incurs during construction to the purchase price.[2] At the very same time, SER's affiliate SDG&E seeks to receive compensation for

[2] Direct Testimony of Lad Lorenz, Ex.RFP-3, p.4.

setting aside the funds needed for the eventual transfer of the assets. Under SDG&E's proposals, its shareholders would benefit twice from this transaction. Because SDG&E and SER share the same parent company, even without the "regulatory asset", the same shareholders would already benefit from the transaction through SDG&E's future returns on equity and profits made by SER on the sale of Palomar. In addition, the Commission should have reinforced SDG&E's obligation to meet the conduct requirements for utility procurement established in our prior decisions. These include the obligation to manage prudently the contracts and to be free of fraud or negligence in acquiring and managing the assets. Although the majority opinion is silent on this point, it certainly does not waive the applicability of these conduct standards. SDG&E should be aware that it must comply. Finally, we would require SDG&E to enter into the residential air conditioning demand reduction program as originally proposed by Comverge. While it would let SDG&E continue to pursue the commercial and irrigation reductions it seeks with Comverge, the Commission should make sure we tap into the more-promising residential load and reassign the risk of that portion of the program to Comverge, as Comverge originally proposed.

For all of the above reasons, we dissent from this opinion.

/s/ LORETTA M. LYNCH
Loretta M. Lynch
Commissioner

CARL WOOD
Carl Wood
Commissioner

San Francisco, California
June 9, 2004