Decision 04-12-035 December 16, 2004

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Pacific Gas and Electric Company Proposing a Market Structure and Rules for the Northern California Natural Gas Industry for the Period Beginning January 1, 2003 as Required by Commission Decision 01-09-016. (U 39 G)	Application 01-10-011 (Filed October 9, 2001)

OPINION REGARDING PACIFIC GAS AND ELECTRIC COMPANY'S PETITIONS TO MODIFY DECISION 03-12-061

I. Summary

Today's decision addresses Pacific Gas and Electric Company's (PG&E) two petitions to modify Decision (D.) 03-12-061, and PG&E's Supplement to the Second Petition. D.03-12-061 addressed PG&E's natural gas market structure for 2004 and 2005. PG&E's petitions to modify seek to make various changes to D.03-12-061 regarding the Line 401 at-risk adjustment that was adopted in that decision.

This decision grants PG&E's "Second Petition" for modification of D.03-12-061, as changed by PG&E's reply to its Supplement to the Second Petition, by adding the paragraph that we have tailored to be inserted at page 292 of D.03-12-061. Since PG&E is no longer seeking to change its natural gas transmission rates for 2004, PG&E's original petition to modify D.03-12-061 is moot.

II. Background

D.03-12-061 was adopted at the December 18, 2003 Commission meeting. Among other things, D.03-12-061 adopted the approach that The Utility Reform Network (TURN) had proposed in the proceeding "to adjust the usage on Line 401 to reflect the risk of undersubscription and underutilization that PG&E had agreed to when Line 401 was built." (D.03-12-061, p. 286.) As a result, the Commission adopted a 95% load factor adjustment for Line 401 as part of the calculation of the system-wide load factor. (D.03-12-061, p. 292.) PG&E refers to this as the "Line 401 at-risk adjustment."

On February 24, 2004, PG&E filed its petition for modification of D.03-12-061, which we refer to as the "First Petition." According to the First Petition:

> "The purpose of this Petition for Modification, however, is not to challenge the Line 401 at-risk adjustment with respect to PG&E's gas transmission rates in the year 2004. Rather, PG&E herein merely seeks confirmation that the Commission does not intend to apply the Line 401 at-risk adjustment to *new capacity* installed long after Line 401 was built, as distinct from the original Line 401 capacity built in 1992-1993. " (PG&E, First Petition, p. 2.)

Responses to the First Petition were filed by Mirant Americas, Inc. (Mirant), the Northern California Generation Coalition (NCGC), and TURN. PG&E filed a reply to the responses on April 8, 2004.

On July 2, 2004, PG&E filed its Second Petition for modification of D.03-12-061. In the Second Petition, PG&E does not seek any change in its approved gas transmission rates for 2004, and does not seek to change the adopted load factor of 77.02% for its backbone transmission system for 2004. Instead, PG&E's Second Petition seeks to strike from D.03-12-061 "certain language and findings requiring the use of an imputed 95% load factor for a portion of PG&E's backbone transmission system known as Line 401 for the purpose of developing PG&E's 2004 backbone transmission rates." (PG&E, Second Petition, p. 1.)

TURN filed a response in opposition to the Second Petition on August 2, 2004.

On September 21, 2004, PG&E filed its "Supplement" to the Second Petition. According to PG&E, the Supplement has two purposes. The first purpose is to provide "an explanation regarding the relationship between the relief requested in the Second Petition, and the recently filed settlement of PG&E's 2005 Gas Transmission and Storage Rate Case, A.04-03-021." (PG&E, Supplement, p. 2.) The second purpose is to provide "a set of mathematical examples to illustrate how the Line 401 throughput adjustment methodology adopted in D.03-12-061 prevents full recovery of PG&E's approved backbone transmission revenue requirement at forecasted levels of throughput." (*Ibid.*)

An errata to the Supplement, which was served on September 22, 2004, made a slight change to page 8 of the Supplement.[1]

The Office of Ratepayer Advocates (ORA) and TURN filed responses to PG&E's Supplement on October 21, 2004. On October 25, 2004, PG&E filed a reply to the responses to the Supplement.

---

[1] At page 8 of the Supplement, the following sentence appeared: "Thus, PG&E incurs an unintended and unjustified financial penalty for Line 401, even when the backbone transmission system is operating at a 95% load factor." The errata corrects this sentence to read as follows: "Thus, PG&E incurs an unintended and unjustified financial penalty for Line 401, even when Line 401 is operating at a 95% load factor."

III. Positions of the Parties

A. Introduction

The First and Second Petitions, as well as the Supplement to the Second Petition, reflect an evolution of PG&E's position, and the negotiations that have taken place in A.04-03-021. PG&E's states that if its Second Petition is granted, that it agrees to withdraw its First Petition. According to PG&E, if the Second Petition is granted, it will "supersede in its entirety, and render moot, PG&E's first Petition for Modification…." (PG&E, Second Petition, p. 1.) In order to address the First and Second Petitions, we summarize the positions of the parties regarding both petitions and the Supplement.

B. First Petition

1. PG&E

PG&E seeks to modify D.03-12-061 by adding a new paragraph which would clarify that the Line 401 at-risk adjustment should only be applied to the original Line 401 facilities, which were built in 1992 to 1993, and not to the facilities that were constructed in 2002. PG&E believes that D.03-12-061 erroneously applied the Line 401 at-risk adjustment to the new Line 401 capacity that PG&E installed in 2002.

PG&E asserts that by applying the Line 401 at-risk adjustment to the facilities constructed in 2002, D.03-12-061 artificially lowers the otherwise applicable rate for the 2002 facilities. PG&E contends that applying such an adjustment deprives it of the opportunity to earn its authorized return on the 2002 facilities.

PG&E also contends that applying the Line 401 at-risk adjustment to the new facilities discourages further investment in California's natural gas infrastructure because it penalizes PG&E for constructing additional pipeline capacity. PG&E asserts that applying the adjustment to new capacity is directly contrary to the state policy of building and maintaining adequate natural gas infrastructure to serve California, and to protect against price spikes during periods of high demand. PG&E states that the use of an artificially high assumed load factor of 95% "means that the utility would need to achieve a 95% utilization of the affected facilities before it could fully recover its investment." (PG&E, First Petition, p. 6.)

According to PG&E, since D.03-12-061 does not contain any discussion about extending the Line 401 at-risk adjustment to the new facilities constructed in 2002, PG&E recommends that the following paragraph be added to the bottom of page 292 of D.03-12-061:

> "The Commission wishes to clarify that the 95% at-risk adjustment should *not* be applied to any new increment of capacity installed subsequent to the construction of the original Line 401 in 1992-1993. In particular, to the extent the Commission, either now or in the future, decides to utilize an at-risk throughput adjustment for purposes of setting Line 401 rates, such adjustment should be applied only to the Line 401 capacity established in D.94-02-042, Appendix A (*viz*., 825.195 MDth/d receipt point capacity, and 814.714 MDth/d delivery point capacity). The adjustment should not be applied to any new increment of capacity above that established in D.94-02-042." (PG&E, First Petition, p. 9.)

PG&E contends that the addition of this new paragraph would confirm that the Commission is not requiring the Line 401 at-risk adjustment to be applied to any new increment of capacity.

According to PG&E, if the First Petition is granted, there will be a slight increase in PG&E's 2004 backbone transmission rates because the adjustment will not be applied to the approximately 200 MMcf/d of capacity that was installed in

2002. Instead, the adjustment would only be applicable to the original Line 401 facilities built in 1992 and 1993. PG&E proposes to file an Advice Letter to make the changes to its load factor and to its backbone rates, and requests that the changes be made effective as of January 1, 2004.

2. Mirant

Mirant does not agree with PG&E's request to effectively lower the overall load factor. Mirant continues to believe that a higher system load factor was warranted in D.03-12-061. If the First Petition is granted, Mirant states that PG&E's backbone transmission rates will increase by about 2%. Mirant recommends that the First Petition be denied.

Mirant contends that PG&E's request to only apply the Line 401 at-risk adjustment to the original Line 401 capacity would disrupt the equitable balance that was adopted in D.03-12-061 regarding the Line 401 at-risk adjustment and the system load factor for PG&E.

Mirant also points out that D.03-12-061 ordered that future changes to the gas structure issues be addressed in the proceeding which would address the gas structure and rates beginning in 2006. Mirant asserts that the First Petition is an attempt by PG&E to relitigate the Line 401 at-risk adjustment for 2005 in A.04-03-021.

3. NCGC

NCGC recommends that the Commission reject PG&E's First Petition. NCGC asserts that the Commission correctly applied the Line 401 at-risk adjustment to the 2002 facilities, as well as to the original Line 401 facilities. NCGC contends that in D.03-12-061, the Commission "clearly agreed that at least some of the burden of 1993 and 2002 expansion costs should be allocated to PG&E." (NCGC, Response to First Petition, p. 2.)

NCGC also asserts that the use of the Line 401 at-risk adjustment is appropriate because it matches actual load factors experienced on the Redwood Path, and the overall load factor of 77.02% matches actual system-wide load factors. In the event the Commission does not reject the First Petition, NCGC contends that the issue raised by PG&E should be deferred to the comprehensive rate case to be filed in 2005 as ordered by D.03-12-061. NCGC also contends that another reason for deferring this issue is because there are factual issues concerning how much of the 2002 expansion that PG&E built should be assigned to Line 401.

4. TURN

Contrary to PG&E's assertions, TURN contends that its testimony in this proceeding, which formed the basis for the adoption of the Line 401 at-risk adjustment, did calculate the at-risk adjustment using the additional 2002 Line 401 capacity of 189 MDth/d. TURN points out that its witness was not cross examined by PG&E on these calculations, and PG&E did not address the calculations in its briefs or in its comments to the proposed decision or to the alternate proposed decision. TURN asserts that it is a "gross mischaracterization" for PG&E to claim that TURN's testimony did not refer to any of the new Redwood Path facilities installed in 2002. (TURN, Response to First Petition, p. 3.)

TURN also points out that at page 286 of D.03-12-061, the Commission did refer to how the Line 401 at-risk adjustment included a portion of the expansion capacity that was built in 2002.

TURN requests that the First Petition be denied since PG&E had the opportunity to address this issue during the proceeding, but failed to do so.

5. PG&E Reply

PG&E contends that none of the parties who responded to the First Petition addressed the argument that the application of the Line 401 at-risk adjustment to the facilities that were built in 2002 is contrary to public policy because it discourages future investment in the natural gas infrastructure.

With respect to TURN's assertion that PG&E failed to raise the application of the adjustment to the facilities constructed in 2002, PG&E states that it raised the issue in its December 8, 2003 comments to the proposed decision. PG&E also contends that although TURN's witness included the 2002 facilities in the proposed at-risk adjustment, TURN's witness never discussed why the adjustment should be applied to the 2002 facilities, and D.03-12-061 did not contain any discussion about the application of the Line 401 at-risk adjustment to the 2002 facilities. Under the circumstances, PG&E believes it is fully justified to assert that the extension of the Line 401 at-risk adjustment to the 2002 facilities may well have been an inadvertent error by the Commission.

Mirant argues that PG&E's First Petition would upset the equitable balance reached in D.03-12-061. PG&E asserts that such an argument does not justify imposing an unjust and unreasonable cost disallowance on PG&E.

Regarding the argument that the Line 401 at-risk adjustment should be addressed in the proceeding to be filed in 2005, PG&E asserts that nothing in D.03-12-061 precludes PG&E from making a showing as to why the rate should not be changed now.

As for the argument that the adopted system-wide load factor of 77.02% matches the load factors that were experienced, PG&E contends that such an argument must fail because the argument does not reflect the expected decline in throughput during the 2004 rate period.

With respect to NCGC's claim that there are factual issues about the amount of capacity added in 2002, PG&E asserts that the evidence in this proceeding established the increase in receipt capacity for both Lines 400 and 401. As for the other discrepancies in the data that NCGC raised, PG&E cites to other testimony in this proceeding which support the data. Thus, PG&E asserts that there is no need for hearings before action can be taken on the First Petition.

C. Second Petition

1. PG&E

PG&E's Second Petition seeks to strike the language in D.03-12-061 that endorses the Line 401 at-risk adjustment. Specifically, PG&E requests that the text appearing at pages 291 to 292 in support of the adjustment be deleted, and that Finding of Fact 96 and Conclusion of Law 51 be modified to eliminate the references to the Line 401 at-risk adjustment. PG&E's recommended changes appear in Appendix A of the Second Petition.

PG&E seeks to modify D.03-12-061 because the adopted Line 401 at-risk adjustment penalizes PG&E by precluding it from fully recovering the overall backbone transmission revenue requirement whenever the adopted throughput forecast for the entire backbone system is less than 95% of the backbone system's total capacity. PG&E contends that if this is not corrected and it is applied to its 2005 transmission rates, its shareholders will have to absorb up to $25 million of the costs of PG&E's backbone transmission revenue requirement in 2005.

Due to PG&E's pending 2005 gas transmission and storage rate case, A.04-03-021, PG&E requests that its Second Petition be granted without delay. PG&E states that certain parties in A.04-03-021 have advocated that PG&E remains obligated in 2005 to apply the Line 401 at-risk adjustment, and the May 27, 2004 Scoping Memo in that proceeding required PG&E to include the

Line 401 at-risk adjustment in its testimony. As a result, PG&E asserts it faces a $25 million disallowance in 2005 with respect to its backbone transmission revenue requirement.

PG&E emphasizes that it cannot avoid this financial penalty because the mathematics of the Line 401 throughput adjustment "virtually guarantees PG&E a loss." According to PG&E:

> "The TURN formula, adopted in D.03-12-061, takes total system demand divided by total system capacity (including Line 300) to yield a system-wide load factor, and then subtracts that load factor from 95% to get the Line 401 adjustment. This means that even if Line 400 and Line 401 were running full, and Line 300 were empty, PG&E still would be forced to bear a large disallowance on Line 401, because the system-wide load factor has not increased. This disallowance will never go away *unless and until the entire system-wide load factor gets to the 95% level or above.*" (PG&E, Second Petition, p. 8.)

PG&E asserts that the fundamental problem with the Line 401 at-risk adjustment is "that it is completely inconsistent with the approved Gas Accord market structure and rate methodology." (PG&E, Second Petition, p. 3.) Under the Gas Accord, PG&E agreed to operate its entire gas transmission and storage system at shareholder risk and without balancing account protection. In return, PG&E received normalized rate treatment for Line 401. PG&E asserts that the backbone rate methodology adopted in D.03-12-061 upset the Gas Accord arrangement in D.97-08-055.

PG&E asserts that the Line 401 at-risk adjustment acts as a disincentive for PG&E to make any further investment in the backbone transmission system. Instead, PG&E has an incentive to retire equipment and facilities and thereby lower the system capacity in order to make the required throughput percentage.

PG&E further asserts that the Line 401 at-risk methodology is directly contrary to the state and the Commission's policy of encouraging slack capacity on the gas transmission system, and leaves ratepayers exposed to extreme spikes in gas prices and potential reliability problems. PG&E contends that a load factor of 95% is an excessive level of throughput by any measure, and that such a load factor would virtually eliminate any slack capacity in the system. PG&E notes that in R.04-01-025, the Commission stated that "*we need slack capacity* and flexibility to enhance California's access to sufficient supplies of natural gas at various times of the year and to make sure that competition at the California border is viable." (PG&E, Second Petition, pp. 8-9; R.04-01-025, p. 23.)

PG&E contends that there is nothing in the record in this proceeding that provides, nor does a close reading of D.03-12-061 reveal, any valid policy basis for imposing the Line 401 at-risk adjustment. PG&E asserts that a reading of D.03-12-061 makes it clear that the Commission:

> "… adopted TURN's Line 401 throughput adjustment proposal primarily in order to arrive at an adopted load factor (77.02%) that matched historical throughput on PG&E's backbone transmission system. It provided no compelling policy reason for imposing the Line 401 throughput adjustment." (PG&E, Second Petition, p. 10.)

Although PG&E does not challenge the 77.02% load factor adopted in D.03-12-061, and is not seeking in its Second Petition to change the approved 2004 backbone transmission rates, PG&E is requesting that the Commission strike the language from D.03-12-061 that "rationalized the 77.02% load factor on the basis of TURN's proposed Line 401 throughput adjustment." (PG&E, Second Petition, p. 14.)

PG&E contends that it submitted extensive testimony in this proceeding which demonstrated the substantial benefits of Line 401. PG&E asserts that since there was no dispute about the positive contributions of Line 401, "there is no conceivable justification on the record of this case for imposing a cost disallowance on PG&E for any portion of PG&E's backbone transmission system, including Line 401." (PG&E, Second Petition, p. 11.)

PG&E's First Petition, if granted, would result in a slight rate increase in 2004. PG&E contends it is more important to correct this rate policy for the future, commencing January 1, 2005, than to adjust the 2004 rates approved in D.03-12-061. Thus, if the Second Petition is granted, PG&E agrees to forego any rate increase in 2004, and its first Petition should be withdrawn.

2. TURN

TURN points out that PG&E's Second Petition is seeking to change the policy language in D.03-12-061 regarding the adoption of the Line 401 at-risk adjustment, rather than seeking reconsideration of the numerical result as it does in its First Petition. TURN requests that the Second Petition be denied because PG&E has not presented any valid justification for eliminating any of the references "to the long-standing Commission policy of allocating a portion of the risk for underutilization of Line 401 to PG&E shareholders." (TURN, Response to Second Petition, p. 1.)

PG&E argues that imposing the Line 401 at-risk adjustment is a throwback to pre-Gas Accord policies. TURN contends, however, that PG&E does not deny that the Commission has repeatedly held that PG&E should bear the risk of underutilization of Line 401. TURN also argues that the "system-wide load factor of 87.5% included as part of the Gas Accord settlement [adopted in D.97-

08-055] reflected the settling parties' resolution of the issue of risk allocation for capacity underutilization." (TURN, Response to Second Petition, p. 2.)

PG&E's second argument is that the Line 401 at-risk adjustment is counter to the policy of promoting slack capacity on the backbone system, and that a financial penalty is imposed on PG&E anytime the system throughput falls below 95% of the total backbone system capacity. TURN contends that PG&E has not provided any factual evidence to support PG&E's contention that adopting a 77.02% rather than a 70.9% load factor is contrary to state policy.

TURN also contends that PG&E's argument that the at-risk adjustment will penalize PG&E whenever the total system load factor falls below 95% is misleading. TURN asserts that the only time PG&E suffers any adverse financial consequence is when the actual system-wide load factor is below 77.02%. According to TURN, PG&E suffers no harm when the system-wide load factor is above 77.02%.

PG&E's third argument is that the Line 401 at-risk adjustment was simply a method to achieve a certain load factor, and that Line 401 has provided numerous benefits. TURN contends that the issue is not whether Line 401 provided benefits by bringing gas to California, but rather should ratepayers have to pay additional costs "to compensate PG&E for building an 'at-risk' pipeline in a 'let the market decide' competitive environment." (TURN, Response to Second Petition, p. 6.) TURN asserts that the answer to this issue has always been no.

TURN also contends that the language which PG&E seeks to remove ignores previous Commission policy, cited approvingly in D.03-12-061, which discussed the relationship between the load factor and PG&E's risk for underutilization of Line 401.

TURN contends that the purpose of the Second Petition is to gain an advantage in A.04-03-021, wherein the parties have advocated that the Line 401 at-risk adjustment be used in PG&E's 2005 gas transmission and storage proceeding.

D. Supplement To Second Petition

1. PG&E

According to PG&E, the Supplement's first purpose is to explain the relief requested in the Second Petition and the proposed settlement in A.04-03-021. Under the proposed settlement, PG&E's gas transmission and storage rates for the period from January 1, 2005 through December 31, 2007 would be set. Even though the rates would be set under the proposed settlement, PG&E asserts that D.03-12-061 still needs to be corrected in order to give "PG&E appropriate financial incentives to continue investing in the backbone system, and to avoid prejudice to PG&E in future rate cases commencing in 2008." (PG&E, Supplement, p. 2.) Thus, PG&E's Second Petition is not rendered moot by the proposed settlement in A.04-03-021.

According to PG&E, the Line 401 at-risk adjustment penalizes PG&E any time the forecast of throughput on the system falls below 95%. Due to the adjustment, PG&E asserts that this "creates a perverse disincentive against any further investment by PG&E in the backbone transmission system." (PG&E, Supplement, p. 4.) Since planning and construction involve a multi-year process, unless the language is changed in D.03-12-061, PG&E will face a continuing economic disincentive from investing further in PG&E's backbone transmission system. Instead of perpetuating this disincentive by postponing action on PG&E's Second Petition, PG&E requests that the Commission change the language in D.03-12-061. Doing so will create the appropriate incentives for continuing investment in the natural gas transmission system.

PG&E also argues that it would be unfair and prejudicial for PG&E to be forced to proceed with a 2008 rate case under this cloud of a flawed methodology. PG&E points to how the scoping memo in A.04-03-021 required PG&E to resubmit its rate case testimony to incorporate the Line 401 throughput adjustment. PG&E is concerned that when it files its 2008 rate case, the Line 401 at-risk adjustment language in D.03-12-061 will be used as a barrier to prevent PG&E from seeking to eliminate the Line 401 throughput adjustment.

The second purpose of the Supplement is to provide some mathematical examples which PG&E asserts illustrate how the Line 401 at-risk adjustment prevents it from fully recovering its approved backbone transmission revenue requirement at forecasted levels of throughput. PG&E contends that the examples show how the Line 401 at-risk adjustment is fatally flawed, and has the unintended consequence of penalizing PG&E's entire backbone transmission system in violation of the state's policies of promoting adequate natural gas infrastructure for California. PG&E's Supplement contains three tables of mathematical examples which illustrate the effects of the Line 401 throughput adjustment.

Table 1 of the Supplement demonstrates how the adopted Line 401 at-risk adjustment operates, using the 2004 adopted demand forecast and PG&E's proposed 2005 demand forecast as presented in PG&E's June 11, 2004 filing in A.04-03-021. PG&E contends that Table 1 illustrates that the use of the adjustment increases PG&E's system-wide load factor above the forecasted load factor. According to PG&E, due to the increase in the load factor, PG&E's backbone transmission rates are decreased, which results in a built-in undercollection of PG&E's transmission system revenue requirement at the forecasted levels of throughput. Thus, PG&E can only earn its authorized return if actual throughput exceeds the higher adjusted load factor.

Table 2 of PG&E's Supplement provides an example of what can occur under a high demand scenario. The Table 2 scenario assumes that Line 400 and Line 401 are both operating at 95% capacity and that the rest of the demand is being met by the Silverado Path and Baja Path capacity. Under this scenario, even though Lines 400 and 401 are operating at 95%, the Line 401 at-risk adjustment results in a 3.07% system-wide load factor adjustment. PG&E asserts that this is an "unintended and unjustified financial penalty for Line 401, even when the backbone transmission system is operating at a 95% load factor." (PG&E, Supplement, p. 8.)

According to PG&E, Table 3 of PG&E's Supplement illustrates how the Line 401 throughput adjustment mechanism results in a financial disincentive for expanding capacity. Table 3 assumes that system wide demand has not changed, but Line 300 has been expanded by 200 MDth/d and the demand for supplies accessed by Line 300 has increased.[2] Under this scenario, the Line 401 throughput adjustment results in a higher change in load factor (7.45%) as compared to the base case in Table 1 (6.78%). This higher load factor change, which PG&E states is a result of the Line 401 at-risk adjustment, acts as a financial disincentive for further expansion, even though the expansion might

[2] PG&E notes that such a scenario could occur if LNG facilities are built to the south of PG&E's service territory and PG&E customers seek to access this potentially cheaper supply.

provide significant financial benefits to PG&E's customers through lower cost gas supplies.

2. ORA

ORA contends that the Supplement, as well as the Second Petition, should be rejected. ORA asserts that the Supplement and the Second Petition raise material issues of fact about the financial impact of the Line 401 at-risk adjustment, which is more properly addressed in PG&E's 2008 rate case.

ORA points out that neither the Supplement nor the Second Petition seek to change the rates that were adopted for 2004 in D.03-12-061. ORA notes that the proposed settlement in A.04-03-021 will set rates for the three year period of 2005 through 2007. Under the proposed settlement, PG&E will file a general rate case application in February 2007 to establish rates for 2008. ORA asserts that there is no need to waste limited resources to address an issue that has no near term financial impact.

As TURN noted in its response to PG&E's Second Petition, PG&E experiences no harm under the Line 401 at-risk adjustment so long as the actual load factor is greater than 77%. ORA asserts that the adjusted load factor appropriately puts PG&E at risk for the recovery of its investment in Line 401, which PG&E agreed to at the time the Line 401 project was certificated. ORA also contends that PG&E has substantially mitigated a large amount of risk associated with Line 401 through Southern California Edison Company's buyout of its capacity contract.

As for PG&E's argument that the Line 401 throughput adjustment creates a disincentive for investment, ORA asserts that "it is not clear why there would be an immediate need for backbone investments given a forecasted load factor for 2004 on the order of 71%." ORA points out that this leaves a system-wide slack capacity factor of 29% for 2004. ORA also notes that the proposed settlement in A.04-03-021 assumes load factors of 74%, 75% and 76.5% for 2005 through 2007. Although these load factors were negotiated, ORA contends that these load factors imply a significant slack capacity factor.

PG&E's Supplement contends that it would be unfair to proceed using the Line 401 at-risk adjustment methodology for 2008. ORA argues that the Commission is free to change prior decisions at any time upon notice and opportunity to be heard, and that PG&E can propose eliminating the Line 401 throughput adjustment in its 2008 rate case just as PG&E did in its 2005 rate case.

3. TURN

TURN asserts that PG&E's Supplement contains a new argument in support of its Second Petition. PG&E's argument is that the Line 401 at-risk adjustment will continue to discourage further investment in the backbone transmission system unless the language in D.03-12-061 is changed.

TURN asserts that the Supplement is either moot or several years premature because the pending proposed settlement in A.04-03-021 would fix PG&E's gas transmission rates through 2007. PG&E's Supplement makes it clear that PG&E is not seeking to alter the proposed settlement reached in A.04-03-021.

If the Commission is concerned that PG&E might refuse to invest in any needed system capacity expansions over the next three years, TURN suggests an alternative approach. Instead of eliminating the Line 401 at-risk adjustment language from D.03-12-061, as PG&E proposes, TURN recommends that the following language be added before the last paragraph on page 292 of D.03-12-061:

> "The at-risk adjustment adopted today may result in a disincentive for PG&E management to invest in backbone

> expansions in the absence of load growth increases, because the adjustment becomes larger if system capacity is increased and the throughput forecast remains unchanged. The adjustment should not impact any investments in existing transmission infrastructure which do not increase backbone capacity. While we do not foresee that PG&E would invest to increase backbone backbone capacity without an expectation of load growth, we are mindful not to provide disincentives for lumpy capacity investments in advance of load growth. Since PG&E's backbone rates have been fixed by Settlement until 2007, we anticipate that the Line 401 at-risk adjustment may be modified after 2007 by applying it only to capacity prior to the Redwood Path capacity expansion of 2002. A sample calculation of the methodology we could endorse is presented in Appendix A."[3] (TURN, Response to Supplement, p. 7, App. A.)

TURN asserts that the Line 401 at-risk adjustment language should remain in D.03-12-061 because it explains the history and the reasons for adopting the adjustment.

TURN proposes that to remove the disincentive against future investment, while retaining the Line 401 at-risk adjustment, the Commission should only apply the adjustment to the original Line 401 capacity that was constructed in 1992 to 1993, and not to any new capacity constructed after that time, such as the Redwood Path expansion in 2002. TURN contends that this is essentially what PG&E proposed in its First Petition. Under TURN's proposed calculation, in the event of a system expansion, the resulting change in the load factor (between adjusted and unadjusted) would remain the same as without the expansion, assuming there is no load factor growth.

---

[3] TURN's reference to the "sample calculation" and to "Appendix A" appears to refer to the mathematical example that is shown in Table 1 at page 5 of TURN's response to the Supplement.

4. PG&E Reply

PG&E filed a reply to the responses of ORA and TURN. PG&E notes that except for ORA and TURN, no other party that uses PG&E's backbone transmission system filed any opposition to the Second Petition or to the Supplement. PG&E states that this lack of opposition is significant because the costs of Line 401 are allocated exclusively to these other parties, and PG&E's core customers are completely insulated from any of the Line 401 costs. PG&E asserts that "TURN and ORA are seeking to obtain for core ratepayers an undeserved windfall, in the form of lower transmission rates, under the pretext of keeping PG&E 'at risk' for Line 401 cost recovery." (PG&E, Reply, p. 10.)

PG&E states that TURN acknowledges in its response "that the throughput adjustment formula developed by TURN itself does indeed penalize PG&E for future investments in the backbone system." (PG&E, Reply, p. 2.)[4] This acknowledgement about the effect of the Line 401 at-risk adjustment reinforces PG&E's fundamental point that the adjustment resurrects a pre-Gas Accord rate methodology in a Gas Accord environment, and that the adjustment affects the entire backbone transmission system, not just Line 401.

PG&E asserts that TURN's acknowledgement in its response at page 4 that extending the Line 401 throughput adjustment to the new capacity installed by PG&E in 2002, as distinct from the original Line 401 capacity, is a recognition that the Commission in D.03-12-061 committed an error. TURN also admits that this is essentially the same relief that PG&E seeks in the First Petition, but TURN

---

[4] Specifically, PG&E notes that TURN acknowledges that the throughput adjustment formula "will inherently affect the system-wide load factor." (TURN, Response to Supplement, p. 2.)

does not state whether it agrees with PG&E's request in the First Petition to increase the 2004 rates to reflect this correction.

PG&E also takes issue with the arguments of ORA and TURN and the history of the Gas Accord.

PG&E contends that TURN's proposal to add a new paragraph to D.03-12-061, does not cure the problems created by the Line 401 at-risk adjustment. PG&E asserts that TURN's proposed language "refers exclusively to system expansions in the absence of load growth, and makes no mention of system expansions in *response* to load growth or to connect new supplies, nor does it take into account investments needed to maintain existing system capacity." (PG&E, Reply, p. 11.) PG&E also asserts that TURN's proposed language refrains from addressing the fact that the adjustment "precludes full cost recovery of PG&E's gas transmission system revenue requirement even when Line 401 itself operates at 95% capacity, as long as the adopted forecast of throughput for the backbone transmission system as a whole is less than 95% of capacity." (PG&E, Reply, p. 12.)

PG&E urges the Commission to strike all the language in D.03-12-061 that endorses the Line 401 at-risk adjustment. Instead of encouraging investment in the state's energy infrastructure to protect against price spikes and price volatility, the at-risk adjustment discourages investment. PG&E asserts that striking the Line 401 at-risk adjustment language will give it the appropriate incentives to continue to maintain and to expand the backbone transmission system. If the adjustment language is not stricken, PG&E contends that "the flawed D.03-12-061 formula will hang like a cloud over PG&E's backbone transmission system for the next three years." (PG&E, Reply, p. 7.)

In the event the Commission wants to adopt TURN's proposal to add new language to D.03-12-061, PG&E proposes that the following language be inserted before the last paragraph on page 292 of D.03-12-061, instead of adopting the language that TURN has proposed:

> "In a petition for modification, PG&E has pointed out that the at-risk adjustment proposed by TURN and adopted by the Commission in this Decision for the purpose of setting PG&E's 2004 backbone transmission rates suffers from several methodological flaws. We have considered PG&E's arguments and find them to be persuasive. Specifically, the TURN formula inappropriately increases the load factor for the entire PG&E backbone system, not just Line 401, and prevents full cost recovery for the entire system whenever the adopted throughput forecast falls below 95% of backbone capacity. The Commission does not endorse rate policies that have the effect of encouraging such an extraordinarily high level of throughput on such a critical infrastructure asset, as it would discourage future transmission system investment, virtually eliminate 'slack' capacity in the system, and leave consumers exposed to extreme price spikes, price volatility and possible service curtailments. Accordingly, although we have used the TURN formula for setting rates in this one-year rate case, we do not endorse its continued use on a longer-term basis. We order that, when PG&E files its next rate application for the gas transmission system, PG&E should include a proposed load factor for backbone rates that does not perpetuate the problems with the TURN formula." (PG&E, Reply, p. A-1, App. A.)

PG&E contends that the above-quoted language improves substantially upon the language proposed by TURN. PG&E's proposed language would "(i) describe the flaws in the formula proposed by TURN in this case, and (ii) disavow the continued use of this formula in future cases." (PG&E, Reply, p. 12.)

As for ORA's argument in its response that the mathematical examples in the Supplement raise contested issues of material fact, PG&E asserts that no evidentiary hearings are needed in order for the Commission to consider the problems that the throughput adjustment formula creates.

IV. Discussion

Our approach for resolving the First and Second Petitions is to examine the Supplement and the pleadings related to the Supplement, and to determine to what extent the First and Second Petitions have been resolved by the Supplement and the related pleadings.

TURN and PG&E have each proposed adding an additional paragraph to D.03-12-061. Instead of deleting the language about the Line 401 at-risk adjustment from D.03-12-061, as PG&E suggested in its Second Petition, PG&E is now willing to add an additional paragraph to D.03-12-061 which describes how the adjustment "suffers from several methodological flaws," creates a disincentive, and directs PG&E to propose a different formula in its next rate application. PG&E's proposed paragraph was presented in its reply to the Supplement as an alternative to TURN's proposed paragraph.

TURN maintains that the references to the Line 401 at-risk adjustment should not be stricken from D.03-12-061. TURN acknowledges in its response to the Supplement that the Line 401 at-risk adjustment may act as a disincentive, and that the adjustment should only be applied to the original Line 401 capacity. This acknowledgment is a retreat from TURN's response to the First Petition, wherein TURN supported applying the adjustment to the new Line 401 capacity that was added in 2002. In its response to the Supplement, TURN proposes adding a paragraph to D.03-12-061 which states that the Line 401 at-risk adjustment "may result in a disincentive for PG&E management to invest in backbone expansions in the absence of load growth increases…,” and that the adjustment “may be modified after 2007 by applying it only to capacity prior to the Redwood Path capacity expansion of 2002.” (TURN, Response to Supplement, p. 7, App. A.)

The respective paragraphs that PG&E and TURN seek to add to D.03-12-061 agree that the Line 401 at-risk adjustment can create a disincentive for future investment in the gas transmission infrastructure under certain circumstances. The proposed paragraphs differ though as to what circumstances can cause the disincentive to occur, and whether the Line 401 at-risk adjustment should be retained for setting future rates beginning for 2008.

The Supplement and the related pleadings address the impact of the proposed settlement in A.04-03-021, which would establish PG&E’s gas transmission rates for 2005 through 2007. As a result of the proposed settlement and the setting of rates for the next three years, PG&E is willing to leave the Line 401 at-risk adjustment language intact, rather than seeking in its Second Petition to have it stricken. However, due to the disincentive that could result from the at-risk adjustment, PG&E and TURN propose to add their respective proposed paragraphs to D.03-12-061 to resolve the disincentive issue.

PG&E is willing to withdraw the First Petition or have it considered moot if the Second Petition is adopted. The issues raised by Mirant and NCGC about the First Petition would be resolved by PG&E’s Second Petition since PG&E is no longer seeking an increase in gas transmission rates for 2004, and the rates for 2005 through the end of 2007 would be resolved by the adoption of the proposed settlement in A.04-03-021. TURN’s response to the First Petition that the at-risk adjustment was correctly applied to the new Line 401 capacity would be resolved by TURN's proposal in its response to the Second Petition that the at-risk adjustment should only be applied to capacity built before the 2002 expansion.

The Second Petition and the pleadings filed in connection with the Supplement provide us with two possible avenues for resolving the two petitions to modify D.03-12-061. The first avenue is to either strike or retain the Line 401 at-risk adjustment language in D.03-12-061. The second avenue is to either add or decline to add the additional paragraph to D.03-12-061 that TURN and PG&E have proposed.

We see no need to strike the language in D.03-12-061 that refers to the Line 401 at-risk adjustment. PG&E is no longer seeking any change to the 2004 rates, and the rates for 2005 through 2007 are the subject of a proposed settlement in A.04-03-021. If that proposed settlement is adopted, the at-risk adjustment adopted in D.03-12-061 will not affect the 2005 through 2007 rates. Thus, from the perspective of PG&E and the others who responded to the First and Second Petitions, there is no longer a need to eliminate the Line 401 at-risk adjustment language from D.03-12-061. We believe that retaining, rather than deleting, the discussion in D.03-12-061 about the Line 401 at-risk adjustment helps to explain the development of how Line 401 has been treated for ratemaking purposes and how it applies to PG&E's rates.

As shown in the mathematical examples set forth in the Supplement, PG&E has raised a valid point about how the Line 401 at-risk adjustment could create a disincentive for PG&E to invest in the gas transmission infrastructure. PG&E correctly points out that the policy of this Commission is to ensure that we have the gas transmission, distribution and storage facilities needed to meet California's natural gas needs. Accordingly, adding an additional paragraph to D.03-12-061 to address the disincentive issue is warranted.

We believe that adding language similar to what PG&E and TURN have proposed about the disincentive issue will address the issues raised by PG&E in its First Petition, and in its Second Petition as changed by PG&E's reply to the Supplement. Although TURN and PG&E have proposed that their respective paragraphs be added to D.03-12-061, their proposed paragraphs reflect the bias of their positions. Instead of adopting their proposed paragraphs, we will adopt the paragraph which follows. This paragraph is a hybrid of what PG&E and TURN proposed in response to the Supplement, and which balances the competing interests. The following paragraph should be added before the last paragraph on page 292 of D.03-12-061 after the line "a reasonable opportunity to recover its revenue requirement":

> "In a petition for modification of D.03-12-061, PG&E has raised the issue that the Line 401 at-risk adjustment that was adopted in this decision (D.03-12-061) for the purpose of setting PG&E's backbone transmission rates suffers from several methodological flaws, including creating a disincentive for PG&E to continue investing in the natural gas transmission infrastructure. We are cognizant of the disincentive that the Line 401 at-risk adjustment could create, and our policy of encouraging continuing investment in the gas transmission infrastructure so that consumers are protected from extreme price spikes, price volatility and service curtailments. Although we adopted the Line 401 at-risk adjustment for setting rates, and a proposed settlement in A.04-03-021 proposes to set rates for 2005 through 2007, PG&E is free to propose a different methodology for calculating its backbone rates when it files its next rate application for its gas transmission system."

The adoption of the above paragraph will resolve the concerns that PG&E raised in its First and Second Petitions and the Supplement to the Second Petition, and the concerns of the other parties. In addition, it leaves the door open for PG&E to propose how the rates for the Redwood Path should be calculated in PG&E's next rate application, while recognizing the need for continuing investment in the gas transmission infrastructure. Accordingly, PG&E's Second Petition, which has been changed as a result of PG&E's reply to the Supplement, should be granted by adding the above paragraph before the last paragraph on page 292 of D.03-12-061 after the line "a reasonable opportunity to recover its revenue requirement." All other relief that PG&E and the other parties seek with respect to the Second Petition and the Supplement should be denied.

PG&E's First Petition should be deemed moot since PG&E is no longer seeking to change its 2004 gas transmission rates.

This proceeding should remain open until the petition for modification of D.03-12-061 that was filed by Duke Energy North America and Duke Energy Trading and Marketing is resolved.

V. Comments on Draft Decision

The draft decision of the ALJ in this matter was mailed to the parties in accordance with § 311(g)(1) of the Public Utilities Code and Rule 77.7 of the Rules of Practice and Procedure. PG&E filed its comments to the draft decision on December 6, 2004, and a reply to PG&E's comments was filed by TURN on December 13, 2004. We considered PG&E's requested change, but did not adopt the change.

VI. Assignment of Proceeding

Loretta M. Lynch is the Assigned Commissioner, and John S. Wong is the assigned ALJ in this proceeding.

Findings of Fact

1. D.03-12-061 addressed PG&E's natural gas market structure for 2004 and 2005, and adopted the Line 401 at-risk adjustment.

2. The First and Second Petitions, and the Supplement to the Second Petition, reflect an evolution of PG&E's position and the negotiations that have taken place in A.04-03-021.

3. PG&E's First Petition seeks to modify D.03-12-061 by adding a new paragraph which would clarify that the Line 401 at-risk adjustment should only be applied to the original Line 401 facilities.

4. If PG&E's First Petition is granted, PG&E's 2004 backbone transmission rates would increase.

5. Mirant and NCGC believe that the Line 401 at-risk adjustment was correctly applied to the facilities constructed in 2002.

6. PG&E's Second Petition seeks to modify D.03-12-061 by having the Commission strike the language that endorses the Line 401 at-risk adjustment.

7. The purpose of the Supplement is to explain the relief requested in the Second Petition in relationship to the proposed settlement in A.04-03-021, and to provide some mathematical examples of the effects of the Line 401 at-risk adjustment.

8. Although TURN had taken the position that the Line 401 at-risk adjustment was correctly applied to the facilities constructed in 2002, TURN's response to the Supplement acknowledges that the adjustment may result in a disincentive for investing in future infrastructure expansions.

9. TURN's response to the Supplement proposed that instead of eliminating the Line 401 at-risk adjustment language from D.03-12-061, that an additional paragraph be added describing how the adjustment may result in a disincentive, and that the adjustment after 2007 should only apply to Redwood Path capacity built prior to 2002.

10. As an alternative to TURN's proposed paragraph, PG&E proposes that the Commission add an additional paragraph to D.03-12-061 describing how the Line 401 at-risk adjustment suffers from several flaws, including how the adjustment discourages future infrastructure investment, and that PG&E should include in its next rate application a load factor for backbone rates that does not perpetuate the problems that the adjustment suffers from.

11. As a result of the proposed settlement in A.04-03-021, which would establish PG&E's gas transmission rates for 2005 through 2007, PG&E is willing to leave the Line 401 at-risk adjustment language intact if its paragraph regarding the flaws with the adjustment is added to D.03-12-061.

12. There is no need to strike the language in D.03-12-061 that refers to the Line 401 at-risk adjustment, as requested by PG&E in its Second Petition.

13. The mathematical examples in the Supplement support PG&E's point that the Line 401 at-risk adjustment could create a disincentive for PG&E to invest in the gas transmission infrastructure.

14. The adoption of the paragraph to be added to D.03-12-061 resolves the concerns that PG&E raised in its First and Second Petitions and the Supplement, and the concerns of the other parties

Conclusions of Law

1. The respective paragraphs that PG&E and TURN seek to add to D.03-12-061 agree that the Line 401 at-risk adjustment can create a disincentive for future investment.

2. The policy of this Commission is to ensure that California has the necessary gas transmission, distribution and storage facilities to meet California's natural gas needs.

3. Adding an additional paragraph to D.03-12-061 to address the disincentive issue, similar to what PG&E and TURN have proposed, is warranted.

4. PG&E's Second Petition, which has been changed as a result of PG&E's reply to the Supplement, should be granted by adding the paragraph set forth in the discussion section of this decision before the last paragraph on page 292 of D.03-12-061.

5. All other relief that PG&E and the other parties seek with respect to the Second Petition and the Supplement should be denied.

6. PG&E's First Petition should be deemed moot.

7. This proceeding should remain open to consider the remaining petition for modification of D.03-12-061.

O R D E R

IT IS ORDERED that:

1. The July 2, 2004 "Second Petition of Pacific Gas and Electric Company for Modification of Decision 03-12-061" (Second Petition) as changed by Pacific Gas and Electric Company's (PG&E) October 25, 2004 reply "To Parties Who Responded To PG&E's Supplement To Its Second Petition for Modification of Decision 03-12-061," is granted as set forth below.

    a. Decision (D.) 03-12-061 shall be modified by adding the following paragraph before the last paragraph on page 292 of D.03-12-061 after the line "a reasonable opportunity to recover its revenue requirement:"

    "In a petition for modification of D.03-12-061, PG&E has raised the issue that the Line 401 at-risk adjustment that was adopted in this decision (D.03-12-061) for the purpose of setting PG&E's backbone transmission rates suffers from several methodological flaws, including creating a disincentive for PG&E to continue investing in the natural gas transmission infrastructure. We are cognizant of the disincentive that the Line 401 at-risk adjustment could create, and our policy of encouraging continuing investment in the gas transmission infrastructure so that consumers are protected from extreme price spikes, price volatility and service curtailments. Although we adopted the Line 401 at-risk adjustment for setting rates, and a proposed settlement in A.04-03-021 proposes to set rates for 2005 through 2007, PG&E is free to propose a different methodology for calculating its backbone rates when it files its next rate application for its gas transmission system."

b. All other relief requested by PG&E and by the other parties in connection with PG&E's Second Petition and the Supplement to the Second Petition is denied.

2. PG&E's February 24, 2004 "Petition … for Modification of Decision 03-12-061" is moot.

3. This proceeding shall remain open to address the outstanding Petition for Modification of D.03-12-061 filed by Duke Energy North America and Duke Energy Trading and Marketing.

This order is effective today.

Dated December 16, 2004, at San Francisco, California.

MICHAEL R. PEEVEY
President
CARL W. WOOD
LORETTA M. LYNCH
GEOFFREY F. BROWN
SUSAN P. KENNEDY
Commissioners