Decision 05-08-005 August 25, 2005

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of San Diego Gas & Electric Company (U 902 E) for Adoption of Cost Recovery and Ratemaking Mechanisms Relative to SDG&E's Acquisition and Operation of the Palomar Energy Center.	Application 04-11-003 (Filed November 1, 2004)

OPINION APPROVING APPLICATION

San Diego Gas & Electric (SDG&E) requests approval for the cost recovery and ratemaking mechanisms necessary to allow SDG&E to recover its reasonable and prudent costs of acquiring, owning, and operating a 500 megawatt (MW) (base load)/555 MW (peaking load) combined cycle natural gas-fired generation plant located in Escondido, California (Palomar Energy Center). SDG&E is obligated to acquire and operate the Palomar Energy Center pursuant to the Turnkey Acquisition Agreement between SDG&E and Palomar Energy, LLC (a subsidiary of Sempra Energy Resources) dated January 29, 2004, (the "Turnkey Acquisition Agreement).

The Commission approved the Turnkey Acquisition Agreement in Decision (D.) 04-06-011. SDG&E requested that the Commission, in that decision, also approve specific cost recovery and ratemaking proposals necessary for SDG&E to recover its ownership and operation costs for the facility. However, other than stating that "SDG&E is authorized to recover the costs of this generation-owned asset through the established 10.90% return on equity (ROE),"[1] the Commission declined to act on SDG&E's cost recovery proposals. Consequently, SDG&E proposes in this application a cost recovery plan in order to obtain certainty on the costs and expenses it can recover through rates for owning and operating the Palomar Energy Center before actually acquiring the facility. The plan essentially consists of a monthly revenue requirement and a variable operations and maintenance (O&M) rate that, collectively, will allow SDG&E to recover its costs. The plan incorporates the heat rate incentive mechanism approved in D.04-06-011. SDG&E assumes ownership and operation of the Palomar Energy Center June 1, 2006. SDG&E is not requesting either a rate increase or rate change in this application.

This application requests approval of: (1) a fixed monthly revenue requirement of $7,600,100 subject to update prior to going into effect on the first month of commercial operation of the Palomar Energy Center, (2) a variable O&M rate of $3.08 per megawatt hour (MWh) subject to update prior to going into effect on the first month of commercial operation of the Palomar Energy Center, and (3) an overall cost recovery regulatory plan addressing the length of time the foregoing will be in effect, the balancing accounts in which revenues from the foregoing will be accumulated, and how additional items like fuel costs, heat rate incentives, reliability must run (RMR) revenues, and imputed franchise fee payments to the city of Escondido will be handled.

SDG&E proposes that all Palomar Energy Center costs, consisting of actual fuel costs and authorized fixed and variable non-fuel costs, should be recovered

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[1] D.04-06-011, Ordering Paragraph # 6, *mimeo.*, at 81.

in SDG&E's commodity rates through SDG&E's Schedule Electric Energy Commodity Costs (EECC) except for costs allocated to the RMR function which should be recovered from all customers through the reliability service (RS) rate component.[2] The non-fuel costs proposed for recovery from the in-service date of the Palomar Energy Center until the implementation date of SDG&E's next general rate case/cost of service case (GRC/COS) are: (1) a fixed monthly revenue requirement of $7,600,100, subject to adjustment prior to the Palomar Energy Center going into service for changes in certain cost components and updates to cost escalation factors; and (2) a variable O&M rate of $3.08 per MWh of generated output to recover variable O&M non-fuel costs that is also subject to adjustment (for updates to cost escalation factors) prior to the Palomar Energy Center going into service. The fixed monthly revenue requirement and variable O&M rate should be reset in SDG&E's next GRC/COS proceeding, projected to occur in 2008.

SDG&E proposes that, in compliance with D.04-06-011, any rewards or penalties associated with the adopted heat rate incentive for the Palomar Energy Center will be recorded in SDG&E's Energy Resource Recovery Account (ERRA) for recovery in commodity rates. Any Palomar Energy Center-related RMR revenues received from the California Independent System Operator (CAISO) will be recorded in SDG&E's Non-Fuel Generation Balancing Account (NGBA) to offset commodity costs. Finally, the "imputed franchise fees" paid to Escondido

[2] SDG&E filed Advice Letter (AL) 1617-E on August 20, 2004 to change the name RMR to RS rates to recognize that in the future, these rates will recover California Independent System Operator (CAISO) out of market costs and must recover costs in addition to CAISO RMR costs. The effective date of the change is October 1, 2004.

on gas delivered to the Palomar Energy Center will be recorded in the ERRA for recovery in commodity rates.

The components of the fixed monthly revenue requirement for the Palomar Energy Center are: (a) rate base; (b) return; (c) depreciation; (d) taxes; and (e) O&M expenses. Certain components of the fixed monthly revenue requirement will need to be updated immediately prior to the Palomar Energy Center going into service (and therefore the fixed monthly revenue requirement going into effect) to reflect (a) base purchase price adjustments that are generally described and permitted by the Turnkey Acquisition Agreement, (b) updated escalation factors, and (c) changes to inputs used to develop the fixed monthly revenue requirement to reflect recent Commission decisions adopting changes to those inputs.

SDG&E discussed the expected values for the Palomar Energy Center's O&M costs, both fixed and variable. The fixed O&M costs include, generally, costs for O&M staff (plant staff, payroll taxes, and home office services allocation), materials and services, and other items such as insurance and equipment modifications and replacements. Variable O&M costs consist of materials and services costs, which include costs for recycled water, a Contractual Service Agreement (CSA) with General Electric International, Inc. for major maintenance and overhauls, contingency for unplanned maintenance, consumables and catalyst replacement.

Prior to filing this application, The Utility Reform Network (TURN) and SDG&E discussed its contents and various issues of concern. When SDG&E filed the application certain changes were made to address some of TURN's issues. TURN and the Office of Ratepayer Advocates (ORA) conducted discovery in this proceeding. Eventually, TURN and ORA identified three items of concern. After some discussion, TURN, ORA, and SDG&E (the Parties)[3] agreed on what they believe to be an equitable resolution of those issues such that the Parties can represent that Commission approval of the Palomar Application with the three modifications specified below is a fair, equitable, outcome and in the public interest. On that basis the Parties state that there are no longer any material issues of fact to be determined.

Summary of Palomar Application

The Palomar Application requests, and based upon the modifications addressed in B., below, the Parties recommend approval of: (1) a fixed monthly revenue requirement of $7,600,100, subject to update prior to going into effect on the first month of commercial operation of the Palomar Energy Center, (2) a variable O&M rate of $3.08 per MWh, subject to update prior to going into effect on the first month of commercial operation of the Palomar Energy Center, and (3) an overall cost recovery regulatory plan that recognizes that the fixed monthly revenue requirement and variable O&M rate will be reset in SDG&E's next GRC/COS proceeding, projected to occur in 2008.

The application states that all Palomar Energy Center costs, consisting of actual fuel costs and authorized fixed and variable non-fuel costs, should be recovered in SDG&E's commodity rates through SDG&E's EECC except for costs allocated to the RMR function which should be recovered from all customers

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[3] Counsel for the Independent Energy Producers Association (IEP), the only other party indicating an interest in this proceeding at the prehearing conference (PHC), authorized the Parties to represent the following: "IEP is not submitting testimony in this proceeding. IEP believes that the policy issues it raised at the PHC can better be addressed in other proceedings. For that reason, IEP agrees that rebuttal testimony and briefing can be waived in this proceeding."

through the RS rate component. Commodity rates that include the authorized fixed revenue requirement and the variable O&M non-fuel costs may lead to recorded revenues that are higher or lower than the authorized revenues due to higher or lower-than-expected customer sales and/or higher or lower-than-expected generation output from Palomar Energy Center. Such overcollections or undercollections of the authorized fixed revenue requirement and the variable O&M non-fuel costs will be recorded in the non-fuel Generation Balancing Account (NGBA). For each calendar year following the in-service date, the Palomar Energy Center NGBA balance will be included in SDG&E's annual NGBA advice letter filing (filed in the 4th quarter) and annual consolidated electric rate change filing (filed in December) to be recovered in commodity rates effective January 1 of the following year.

The application also states that any rewards or penalties associated with the adopted heat rate incentive for the Palomar Energy Center should be recorded in SDG&E's ERRA for recovery in commodity rates. Any Palomar Energy Center-related RMR revenues received from the CAISO should be recorded in SDG&E's NGBA to offset commodity costs. Finally, as approved by the Commission in D.04-06-011, the "imputed franchise fees" paid to the city of Escondido on gas delivered to the Palomar Energy Center should be recorded in SDG&E's ERRA for recovery in commodity rates.

Certain components of the fixed monthly revenue requirement and the variable O&M rate will need to be updated immediately prior to the Palomar Energy Center going into service to reflect (a) base purchase price adjustments that are generally described and permitted by the Turnkey Acquisition Agreement, (b) updated escalation factors, and (c) changes to input used to develop the fixed monthly revenue requirement to reflect recent Commission decisions adopting changes to those inputs. That update advice letter filing will also serve to incorporate the agreed modifications to SDG&E's application addressed below.

Agreed Modifications to Application

With the following three modifications, the Parties agree that the Commission should approve the application. The three modifications are:

1) On page 7 of his testimony, SDG&E witness Mr. Calabreze states that SDG&E will recover the costs for its investment in the Palomar Energy Center based on a constant return on equity (ROE) of 10.90%. TURN and ORA contested this ROE because it does not reflect the currently applicable SDG&E ROE (10.37%). The Parties agreed for purpose of conciliation that the ROE that should be applied to recover SDG&E's investment in the Palomar Energy Center should be the then currently applicable ROE. The Parties recognize that SDG&E is required to file a cost of capital application on May 9, 2005, which will likely change SDG&E's currently authorized ROE effective January 1, 2006. When SDG&E files its update advice letter prior to the Palomar Energy Center entering commercial operation, SDG&E will update in that advice letter the fixed monthly revenue requirement to reflect the ROE then in effect.

2) On page 6 of his testimony, SDG&E witness Mr. Yost states that the incentive compensation loader for non-union employees should be 23.3%. Because the 23.3% includes executive incentive compensation, and in an effort to reach a conciliatory outcome, the Parties agree that the incentive compensation loader for non-union employees should be a rate of 18.0%, which represents the non-union non-executive average. When SDG&E files its update advice letter prior to the Palomar Energy Center entering commercial operation, SDG&E will update in that advice letter the fixed monthly revenue requirement to reflect an 18.0% loader for non-union employees.

3) On page 3 of his testimony, SDG&E witness Mr. Larsen states that the appropriate net salvage rate for the Palomar Energy Center steam generation unit is negative 8%. TURN disagrees and believes that an appropriate net salvage rate for the steam turbine is negative 1%, matching that of the combustion turbines. For the purpose of reaching a conciliatory result in this proceeding and avoiding the litigation of a fairly minor issue, the Parties agree that a negative 3.5% net salvage rate should be applied to the Palomar Energy Center steam generation unit. When SDG&E files its update advice letter prior to the Palomar Energy Center entering commercial operation, SDG&E will update in that advice letter the fixed monthly revenue requirement to reflect a negative 3.5% net salvage rate for the steam generator.

The Parties assert that the agreements reached on the issues addressed above are for the purpose of reaching a mutually agreeable outcome in this proceeding that is fair, reasonable, and in the public interest given all the factors and facts specific to this proceeding. The agreements reached on the disputed issues, and the Commission's adoption of those agreements, are not intended, nor should they be interpreted, as setting a precedent on the issues should they arise in the future. For example, if any of the issues are addressed in SDG&E's next GRC/COS proceeding, the Parties are free to advocate different results or positions, and the fact that any of them agreed to the specific outcome in this application should not be cited as a reason for impeachment or otherwise as a reason to preclude any of the Parties from arguing an inconsistent position.

Categorization and Need for Hearings

In Resolution ALJ 176-3142 dated November 19, 2004, the Commission preliminarily categorized this application as ratesetting, and preliminarily determined that hearings were not necessary. Evidentiary hearings are not necessary and it is not necessary to alter the preliminary determinations made in Resolution ALJ 176-3142.

Comments on Draft Decision

The draft decision of the Administrative Law Judge in this matter was mailed to the parties in accordance with Pub. Util. Code § 311(g)(1) and Rule 77.7 of the Rules of Practice and Procedure. No comments were received.

Assignment of Proceeding

Geoffrey F. Brown is the Assigned Commissioner and Robert Barnett is the assigned ALJ in this proceeding.

Findings of Fact

1. SDG&E should be authorized to recover through rates the costs and expenses for owning and operating the Palomar Energy Center before actually acquiring the facility.

2. A fixed monthly revenue requirement of $7,600,100 and a variable O&M rate of $3.08 per MWh, both subject to update prior to going into effect on the first month of commercial operation of the Palomar Energy Center, are reasonable.

3. SDG&E's proposed overall cost recovery regulatory plan addressing the length of time it will be in effect, the balancing accounts in which revenue will be accumulated, and how additional items like fuel costs, heat rate incentives, reliability must run (RMR) revenues, and imputed franchise fee payments to the city of Escondido will be handled, is reasonable.

4. All Palomar Energy Center costs should be recovered in SDG&E's commodity rates through its EECC except for costs allocated to the RMR function which should be recovered from all customers through the RS rate component.

5. Any rewards or penalties associated with the adopted heat rate incentive for the Palomar Energy Center will be recorded in SDG&E's ERRA for recovery in commodity rates. Any Palomar Energy Center-related RMR revenues received from the CAISO will recorded in SDG&E's NGBA to offset commodity costs. Finally, the "imputed franchise fees" paid to Escondido on gas delivered to the Palomar Energy Center will be recorded in the ERRA for recovery in commodity rates.

6. The fixed monthly revenue requirement and variable O&M rate will be reset in SDG&E's next GRC/COS proceeding, projected to occur in 2008.

7. The ROE that should be applied to recover SDG&E's investment in the Palomar Energy Center should be the then currently applicable ROE.

8. The incentive compensation loader for non-union employees should be a rate of 18.0%, which represents the non-union non-executive average.

9. A negative 3.5% net salvage rate should be applied to the Palomar Energy Center steam generation unit.

Conclusion of Law

SDG&E's cost recovery and ratemaking mechanisms necessary to recover the reasonable costs of acquiring, owning, and operating the Palomar Energy Center should be approved as modified.

O R D E R

IT IS ORDERED that:

1. San Diego Gas & Electric's (SDG&E) cost recovery and ratemaking mechanisms necessary to recover the reasonable costs of acquiring, owning, and operating the Palomar Energy Center are approved with the modifications in Ordering Paragraph 2.

2. When SDG&E files its update advice letter prior to the Palomar Energy Center entering commercial operation, SDG&E will update in the advice letter (i) the fixed monthly revenue requirement to reflect the Return on Equity then in effect, (ii) the fixed monthly revenue requirement to reflect an 18.0% loader for non-union employees, and, (iii) the fixed monthly revenue requirement to reflect a negative 3.5% net salvage rate for the steam generator.

3. No later than 30 days prior to the expected date of operation of the Palomar Energy Center, SDG&E shall file its update advice letter to comply with this order and D.04-06-011. The advice letter shall modify Schedule EECC, Reliability Services rates, the ERRA account, and to make changes to any other regulatory accounts that are required pursuant to this order. The advice letter shall be effective on the expected operation date of the Palomar Energy Center, subject to Energy Division determining that it is in compliance with this order.

4. Application 04-11-003 is closed.

This order is effective today.

Dated August 25, 2005, at San Francisco, California.

MICHAEL R. PEEVEY
President
GEOFFREY F. BROWN
SUSAN P. KENNEDY
DIAN M. GRUENEICH
JOHN A. BOHN
Commissioners