PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

ENERGY DIVISION **RESOLUTION E-4027**
December 14, 2006

R E S O L U T I O N

Resolution E-4027**.** Pacific Gas and Electric Company for approval the amended and restated power purchase agreement between PG&E and Fresno Cogeneration Partners, L.P., pursuant to the Restructuring Advice Letter filing (RALF) procedure adopted in Decision (D.) 98-12-066.

By Advice Letter (AL) 2872-E filed on August 8, 2006.

SUMMARY

This resolution approves Pacific Gas and Electric Company's (PG&E) request approval of the amended and restated power purchase agreement (Amended and Restated PPA) between PG&E and Fresno Cogeneration Partners, L.P. (Fresno).

This Resolution approves the amended and restated power purchase agreement (Amended and Restated PPA) between PG&E and Fresno Cogeneration Partners, L.P. (Fresno or Fresno Cogen), as submitted by Pacific Gas and Electric Company (PG&E). The Amended and Restated PPA restructures two existing Qualifying Facility (QF) agreements totaling 33 megawatts (MW)[1] from a "must-take" delivery profile under which PG&E is required to purchase all power regardless of customer demand and market alternatives – to an economic, "as-needed" profile.

The Amended and Restated PPA is one of three agreements submitted for approval. The other two agreements are (1) a consent to assignment, which assigns the Santa Maria PPA from Santa Maria to Fresno upon which Fresno agrees to terminate it; and (2) the Santa Maria Dispatch Agreement – which

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[1] The Fresno Cogeneration Project is 25 MW and the Santa Maria Cogeneration Project is 8 MW, both have the same majority beneficial owner.

obligates Santa Maria to back up generation from the Fresno project until local transmission constraints are removed, work for which is now under way and is scheduled for completion in the second quarter of 2007.

The resolution grants the relief requested with the exception that the total requested shareholder incentive award has been reduced to 48.6% of the amount requested in AL 2872-E.

BACKGROUND

On August 8, 2006, PG&E filed AL 2872-E requesting approval of the Amended and Restated PPA between PG&E and Fresno Cogen. The Amended and Restated PPA will allow PG&E to (1) dispatch the Fresno Project when power is needed and economical, resulting in lower power procurement costs; and (2) terminate the Santa Maria Cogen, Inc. PPA.

PG&E has also requested approval of two companion agreements: the Santa Maria Dispatch Agreement and the Consent to Assignment Agreement. Together with the Amended and Restated PPA, these three agreements will accomplish the restructuring of two PPAs into one, while preserving PG&E's rights to dispatch generation capacity equal to the combined capacity for both plants and reduce capacity payments.[2]

PG&E requests that the Commission issue a resolution finding that:

(i) The Amended and Restated PPA is reasonable;

(ii) PG&E is authorized to recover all payments under the Amended and Restated PPA in PG&E's Energy Resource Recovery Account ("ERRA") including an above-market portion in the Ongoing Competition Transition Charge (Ongoing CTC), or any other cost recovery mechanism subsequently authorized by the Commission, subject only to PG&E's prudent administration of the Amended and

[2] AL 2872-E contains a detailed account of contract history for both PPAs which we opt to note, but not directly include here.

Restated PPA; and

(iii) PG&E may recover of the requested shareholder incentive amount associated with this PPA restructuring, as authorized by the Commission in D.95-12-063 as modified by D.96-01-009.

Energy Payments

Currently, the Fresno and Santa Maria projects are under a contract energy price from the PG&E/Independent Energy Producers (IEP) Settlement Agreement approved in D.06-07-032. Specifically, Fresno and Santa Maria are on the variable energy price option for natural gas-fired QFs at a fixed heat rate of 8,700 Btu/kWh and a variable O&M payment of $2/MWh. Previously, the QFs were on the five-year fixed energy priced amendments at 5.37 cents/kWh, pursuant to D.01-06-015.

Absent approval of the Amended and Restated PPA proposed in AL 2872-E, the Fresno and Santa Maria projects will continue to receive energy payments pursuant to the PG&E/IEP Settlement Agreement until September 30, 2009. After this date energy payments for these projects would be determined by the California Independent System Operator (CAISO) Day-Ahead power price. This Day-Ahead market is part of the CAISO's Market Redesign and Technology Upgrade (MRTU), currently scheduled for implementation in November 2007.

Capacity Payments

Fresno Cogen. On September 29, 1986, Fresno's predecessor-in-interest and PG&E entered into a Standard Offer 2 (SO2) PPA for the 25 MW cogeneration project. Fresno's existing SO2 PPA provides for firm capacity payments based on 25 MW for 30 years at a price of $209/kW-year. SO2 PPAs do not provide for any as-delivered capacity payments. Firm capacity payments are subject to minimum performance requirements and obligations defined in the PPA. The term of the PPA extends through March 24, 2020.

Santa Maria. On April 16, 1985, Santa Maria's predecessor in interest and PG&E entered into an Interim Standard Offer 4 PPA (ISO4) for the 8 MW Santa Maria cogeneration project. The PPA has a 30-year term for firm capacity deliveries. Under the existing PPA, firm capacity payments are based on 7 MW for 30 years at a price of $184/kW-year. Firm capacity payments are subject to minimum performance requirements and obligations defined in the PPA. The Project is also eligible for firm capacity bonus payments if its generation meets specified performance requirements. Under the existing PPA, the Santa Maria Project is paid for capacity delivered in excess of firm capacity on an as-delivered capacity basis in accordance with as-delivered capacity payment option 2.[3] On page 7, paragraph 1 of AL 2872-E, PG&E stated that the fixed, forecasted prices are set forth in Table D-2 of Appendix A of the Santa Maria PPA. However, these Appendices were inadvertently omitted from the advice letter, but provided to the Energy Division as requested.

The Commission encouraged QF contract restructuring and implementation through an expedited advice letter process

The Commission sought to encourage QF contract restructuring in its Preferred Policy Decision, D.95-12-063, as modified by D.96-01-009, by proposing an incentive mechanism to encourage the restructuring of QF contracts so that total transition costs might be reduced. Specifically, shareholders would be allowed to retain 10% of the net ratepayer benefits resulting from a renegotiation:

> "We endorse an approach that involves both a monetary incentive to shareholders and conditions which foster voluntary, nondiscriminatory negotiations. We will allow shareholders to retain 10% of the net ratepayer benefits resulting from a renegotiation, which will be reflected by an adjustment to the transition cost total." (D.95-12-063, p.132)

In D.96-12-088 (the Roadmap 2 Decision), the Commission stated its interest in "establishing a generic and possibly expedited process by which we can assess

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[3] Under ISO4 Capacity Payment Option 2, the QF will receive fixed, forecasted as-available capacity prices, which are not levelized, for up to 10 years, after which as-available capacity payments will revert to either (1) the posted as-delivered capacity price (a.k.a., the shortage cost) in the 10th year, or (2) the contractually-specified 10th year fixed capacity price, whichever is higher. To illustrate, if the posted price in the 10th year was $200/kW-year and the contractually-specified 10th year fixed capacity price was $175/kW-year, the QF would be paid $200/kW-year for as-available capacity in years 11 to 30.

the reasonableness of contract restructuring in a manner which respects the principles outlined in our Preferred Policy Decision" (D.96-12-088, p.79-80).

In 1998, the Commission adopted the Restructuring Advice Letter Filing (RALF)[4] process in D.98-12-066:

> "The restructuring Advice Letter [filing] process attached as Attachment B to this decision, shall be adopted subject to the modifications and clarifications set forth in Section 7 of this decision." (D.98-12-066, Ordering Paragraph 1).

The Commission adopted the RALF process with modifications that were not included in Attachment B to D.98-12-066 but were instead set forth in the decision. A modified version of Attachment B to D.98-12-066 was attached to a previous RALF resolution, E-3898,[5] which reflects the determinations in D.98-12-066.

NOTICE

Notice of AL 2872-E was made by publication in the Commission's Daily Calendar. Pacific Gas and Electric Company states that a copy of the Advice Letter was mailed and distributed in accordance with Section III-G of General Order 96-A.

PROTESTS

There were no protests to Advice Letter 2872-E.

DISCUSSION

Energy Division has reviewed the advice letter. The Amended and Restated PPA will allow PG&E to (1) dispatch the Fresno Project when the power is needed

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[4] Restructuring Advice Letter Filing ("RALF") Procedure For Review of QF Contract Restructurings.

[5] E-3898, www.cpuc.ca.gov/Published/Final_resolution/41760.htm regarding PG&E AL 2537-E.

and economical for PG&E, resulting in lower power procurement costs; and (2) obligate the Santa Maria project to provide to back up generation for the Fresno project until local transmission constraints are removed (work for which is now under way and is scheduled for completion by second quarter of 2007), and (3) terminate the Santa Maria Cogen, Inc. PPA.

PG&E has complied with the RALF requirements

The restructuring advice letter shall contain the following categories of information ("a" through "h") shown below, including all relevant work papers and other relevant supporting documents, per Section 3 of the RALF procedure.[6]

a. Identification of the QF[s], location of the QF[s'] generating facility, brief description of the generating facility size, type of technology and other pertinent or unique characteristics.

Originally, the Fresno Cogen Project was a nominally rated 26 MW natural gas-fired combined-cycle cogeneration plant supplying process steam to its thermal host which dries agricultural products. The primary energy cycle was powered by a refurbished FT4 natural gas turbine generator set and waste heat was supplied to a Heat Recovery Steam Generator (HRSG) which in turn powers a steam turbine. However, in December of 2004, Fresno completed a repower of the facility as required by a previous contract amendment and is now nominally rated at 50 MW. The Fresno Project is located at 8105 B South Lassen Avenue, San Joaquin, California. However, under the proposed contract restructuring, only 33 MW will be under contract to PG&E.

The Santa Maria Project is an 8 MW simple cycle gas-fired power plant with one "Mars 90" gas turbine generator as the prime mover. The unfired HRSG coupled to the exhaust of the gas turbine is strictly for process steam production used to make ice. The Santa Maria Project is located at 802 South Hanson Way, Santa Maria, California.

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[6] The RALF requirements are reproduced here as Attachment 1 to E-3898, a modified version of Attachment B to D.98-12-066, which reflect determinations made in D.98-12-066.

b. Ownership of the QF project[s] and related companies, including affiliate relationships of the parties involved in the transaction, if any.

The Fresno Project is owned by a limited partnership known as Fresno Cogeneration Partners, LP ("FCPLP"), a California limited partnership, with Fresno Cogen Inc. as its general partner. FCPLP acquired the Fresno project in 1994 from a subsidiary of Northwest Natural Gas. Harold E. Dittmer (HED) owns a majority beneficial interest in FCPLP. FERC originally certified the Fresno Project as a QF on January 26, 1988 (FERC docket number QF88-134-001). At that time the Fresno Project was entirely owned by a subsidiary of Northwest Natural Gas and had no electric utility ownership. Since 1994, it has been owned by Fresno Cogeneration Partners, LP. Since the time of its original FERC certification, the Fresno Project has been recertified once to reflect an ownership change. PG&E Corporation and its affiliate, Pacific Gas and Electric Company, are not affiliated in any way with any of the foregoing companies.

The Santa Maria Project was developed by Santa Maria Associates, LTD with Bonneville Pacific Corporation as its general partner. FERC originally certified the Santa Maria Project as a QF on February 11, 1986 (FERC docket number QF85- 644-000). In December 1994, Santa Maria Associates, LTD sold all of its rights and interest in the project to Santa Maria Cogen, Inc., the current owner. HED owns a majority beneficial interest in the Santa Maria Cogen Inc., or "Santa Maria." Since the time of its original FERC certification, Santa Maria has been recertified five times to reflect a combination of ownership changes, configuration changes, and the addition of an ice making facility. PG&E Corporation and its affiliate, Pacific Gas and Electric Company, are not affiliated in any way with any of the foregoing companies.

c. A detailed description of the historical operational performance of the project[s], including historical production and compliance with performance and efficiency monitoring standards.

The Fresno Project was the subject of a dispute over compliance with FERC-mandated operating and efficiency standards for the 1989 - 1991 operating years. As discussed in AL 2872-E, previous contract amendments resolved all disputes relating to compliance with operating and efficiency standards. PG&E has not taken any issue with Fresno's operating and efficiency standards since the current owner purchased the Fresno Project in 1994.

The Santa Maria Project has never had an issue related to compliance with FERC-mandated operating and efficiency standards. Every compliance check of Santa Maria that PG&E has conducted has demonstrated that the Santa Maria Project is in full compliance with all requirements related to operating and efficiency standards. Prospectively, the past performance of the Santa Maria Project is a moot point, since it will no longer be under contract to PG&E.

d. A summary of the proposed contract restructuring.

PG&E requests Commission approval to modify two existing PPAs totaling 33 MW. The Santa Maria PPA (for 8 MW) would first be assigned to Fresno, then terminated (although Santa Maria would remain obligated to be available for dispatch until some local transmission constraints affecting Fresno are removed). The Fresno PPA would be restructured. The restructured PPA will provide for the purchase of 33 MW of energy and firm capacity from Fresno (an increase of 8 MW from the current 25 MW) for a term commensurate with that of the remaining terms of the existing Fresno and Santa Maria PPAs. Fresno's PPA will otherwise expire on March 25, 2020, and Santa Maria's on September 10, 2019, while the proposed restructured PPA would expire on February 10, 2020.

The Amended and Restated PPA would also change energy payments to reflect Fresno's actual variable costs and provide PG&E a firm capacity payment discount and daily dispatch rights. In return, Fresno's owners receive energy payments that cover their variable operating costs and would no longer be required to maintain QF status.

e. A summary of the ratepayer benefits.

Ratepayers will benefit from the proposed contract restructuring through (1) the replacement of the must-take power obligation with an option for PG&E to dispatch the Fresno facility when Fresno's power is needed and is more economic than other alternatives, and (2) the reduction of the contract capacity payment.

Under the current PPA, the Fresno Project can operate to maximize its profit by operating as a baseload resource (24 hours per day, 7 days per week) when energy prices exceed its variable operating costs. When energy prices are less than operating costs, the Fresno project can limit operations to a 13-hours per day, 5 days per week basis (excluding holidays), providing peak electrical generation to PG&E's local 60 kV transmission system. Under the Amended and Restated PPA, PG&E states that dispatch rights of the Fresno project will add significant ratepayer benefit when compared to the must-take obligations of the existing PPAs. Reduced contract capacity payments will add additional value. Energy Division agrees that the reduced contract capacity payments will add additional value. PG&E's demonstration in AL 2872-E of the present value benefit attributable to the reduced capacity payments is acceptable.

However, Energy Division considers PG&E's modeling of the proposed energy benefits of the PPA restructuring to be over-valued, for purposes of calculating a shareholder incentive award. As stated in the advice letter, PG&E quantified the present value benefits of the contract restructuring "using a 'spark-spread' option model, which is a transformed variant of the Black option valuation model" (AL 2872-E, p.11).[7] This type of model creates a series of probabilistic outcomes or benefits. The probability that these benefits will all materialize exactly as modeled is extremely uncertain, yet PG&E has proposed to calculate the shareholder incentive based upon 10% of this project amount. We are not inclined to base a specific, deterministic shareholder incentive award on the uncertain, probabilistic calculations as submitted.

Instead, Energy Division recommends that the net ratepayer benefit of the energy portion of the contract restructuring be determined using a more traditional, deterministic approach, based on a comparison of heat rates. The existing heat rate for this contract is PG&E's short-run avoided cost (SRAC) heat rate. The new heat rate is the proposed, contractually specified heat rate, which is confidential. The operational energy cost difference between the two contracts, at comparable levels of operation and gas prices, represents a reasonable estimate of the net ratepayer benefit of the energy portion of the contract restructuring, rather than that proposed in the advice letter. Under this approach, the net ratepayer benefit of the energy portion of the contract restructuring would still be positive, but would represent (1) a more reasonable estimate of the expected net energy benefits that might actual materialize as a result of the contract restructuring, and (2) a significantly reduced amount relative to that calculated in the advice letter.

[7] The spark-spread is the difference between the market price of power at NP15, for example, and the cost of producing electricity from a generator.

As noted above, Energy Division agrees with the capacity payment benefits as submitted, but estimates lower energy benefits. As calculated by Energy Division, the total net ratepayer benefits, including net energy and capacity benefits, are 48.6% of the amount submitted in the advice letter. Thus, the total requested shareholder incentive award should be reduced to 48.6% of the amount requested in AL 2872-E.

f. A description of any significant, pending legal or regulatory disputes between the Utility and the QF, and their resolution or status.

There are no current or anticipated legal or regulatory disputes between the parties to this proposed PPA restructuring.

g. An assessment of the QF's projected economic and operational viability under the existing contract.

The Projects are both economically viable. PG&E projects positive income from their operation every year to the end of each PPA. PG&E concludes that the Projects are well maintained by examining their operating records over the past more than 15 years. Both projects have long-established records of making reliable firm capacity deliveries under their respective PPAs, and the projects have never been placed on probation under their current ownership.

h. A detailed description of ratepayer benefits, shareholder incentive, and sensitivity analyses.

Ratepayer Benefits. The Amended PPA has several benefits: the replacement of a must-take contract with a dispatchable contract; reduced heat rate relative to current SRAC; and reduced capacity payments.

Shareholder Incentive. The Amended PPA will terminate in 2020 and the aforementioned benefits will accrue over the intervening time period. Under the RALF process, the utility is eligible for a shareholder incentive reward for accomplishing the contract restructuring. To determine that amount, PG&E first calculated the present value of the benefits of the restructured contract as compared with a forecast of SRAC energy payments and contract capacity payments based on the expected future operation of the facility. Second, PG&E calculated 10% of that present value benefit amount as the shareholder reward.

As stated above, Energy Division accepts the net ratepayer benefit valuation associated with the reduced capacity payments, but considers PG&E's modeling of the proposed energy benefits of the PPA restructuring to be over-valued, for purposes of calculating a shareholder incentive award. Energy Division proposes to calculate the energy benefits as modeled as a comparison of heat rates at comparable gas prices. As noted above, the total net ratepayer benefits, including net energy and capacity benefits, are 48.6% of the amount submitted in the advice letter. Thus, the total requested shareholder incentive award should be reduced to 48.6% of the amount requested in AL 2872-E.

i. A copy of the QF's existing contract, including any amendments.

This information is attached to AL 2872-E as Appendix H, "Original Power Purchase Agreements, including all prior amendments and agreements executed at least three years prior."

j. A copy of the executed or unexecuted restructured agreement for which approval is sought and copies of all related agreements between the QF and the Utility.

This information is attached to AL 2872-E as Appendix A, "Amended Power Purchase Agreement including all prior amendments and agreements executed within the last three years."

DRA supports the contract restructuring

The RALF procedure requires that a statement of support or neutrality from DRA be attached to any restructuring Advice Letter filing. On August 1, 2006, DRA issued a letter in support for the contract restructuring, which is attached to AL 2872-E as Partially Redacted Appendix D – DRA Letter of Support. The DRA Letter of Support reflects the advice letter as filed. Upon review, Energy Division agrees that this is a beneficial contract restructuring; however, Energy Division recommends a reduction in the shareholder incentive amount as previous described.

COMMENTS

Public Utilities Code section 311(g)(1) provides that this resolution must be served on all parties and subject to at least 30 days public review and comment prior to a vote of the Commission. Section 311(g)(2) provides that this 30-day period may be reduced or waived upon the stipulation of all parties in the proceeding.

This is an uncontested matter in which the resolution grants the relief requested. Accordingly, pursuant to PU Code 311(g)(2), the otherwise applicable 30-day period for public review and comment is being waived.

FINDINGS

1. PG&E filed AL 2872-E on August 8, 2006 requesting approval of the amended and restated power purchase agreement between PG&E and Fresno Cogeneration Partners, L.P., pursuant to the Restructuring Advice Letter filing (RALF) procedure adopted in Decision (D.) 98-12-066.

2. In addition, PG&E requested approval of the two companion agreements (the Santa Maria Dispatch Agreement and the Consent to Assignment Agreement), that are part of the requested contract restructuring, as also filed in Advice Letter AL 2872-E.

3. AL 2872-E was not protested.

4. PG&E complied with the RALF requirements.

5. The reduced contract capacity payments associated with the PPA restructuring are a benefit to ratepayers and will add additional value; and PG&E's demonstration in AL 2872-E of the present value benefits of the change in capacity payments is acceptable.

6. PG&E's modeling of the proposed energy benefits of the PPA restructuring are over-valued for purposes of calculating a shareholder incentive award, as presented in AL 2872-E, and should instead be modeled as a comparison of heat rates at comparable gas prices.

7. The Amended and Restated PPA between PG&E and Cogen is reasonable.

8. The additional request of PG&E for approval of the two companion agreements (the Santa Maria Dispatch Agreement and the Consent to

Assignment Agreement), that are part of the requested contract restructuring, as also requested in Advice Letter AL 2872-E, should be approved.

9. PG&E should be authorized to recover all payments under the Amended and Restated PPA in PG&E's ERRA including an above-market portion in the Ongoing Competition Transition Charge (Ongoing CTC), or any other cost recovery mechanism subsequently authorized by the Commission, subject only to PG&E's prudent administration of the Amended and Restated PPA.

10. PG&E should be allowed to recover 10% of the net ratepayer benefits, based upon the estimate of the restructured PPAs as calculated by the Energy Division. This represents 48.6% of the shareholder incentive amount requested by PG&E in AL 2872-E.

11. AL 2872-E should be approved.

THEREFORE IT IS ORDERED THAT:

1. The request of Pacific Gas and Electric Company, regarding the amended and restated power purchase agreement between PG&E and Fresno Cogeneration Partners, L.P., pursuant to the Restructuring Advice Letter filing (RALF) procedure adopted in Decision (D.) 98-12-066, as requested in Advice Letter AL 2872-E, is approved.

2. The additional request of Pacific Gas and Electric Company for approval of the two companion agreements (the Santa Maria Dispatch Agreement and the Consent to Assignment Agreement), that are part of the requested contract restructuring, as also requested in Advice Letter AL 2872-E, is approved.

3. PG&E is authorized to recover all payments under the Amended and Restated PPA in PG&E's ERRA including an above-market portion in the Ongoing Competition Transition Charge (Ongoing CTC), or any other cost recovery mechanism subsequently authorized by the Commission, subject only to PG&E's prudent administration of the Amended and Restated PPA.

4. PG&E is authorized to recover 10% of the net ratepayer benefits, based upon the estimate of the restructured PPAs as calculated by the Energy Division,

which represents 48.6% of the shareholder incentive amount requested by PG&E in AL 2872-E.

This Resolution is effective today.

I certify that the foregoing resolution was duly introduced, passed and adopted at a conference of the Public Utilities Commission of the State of California held on December 14, 2006; the following Commissioners voting favorably thereon:

STEVE LARSON
Executive Director

MICHAEL R. PEEVEY
PRESIDENT
GEOFFREY F. BROWN
DIAN M. GRUENEICH
JOHN A. BOHN
RACHELLE B. CHONG
Commissioners