PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

ENERGY DIVISION **RESOLUTION E-4212**
November 21, 2008

PUBLIC
R E S O L U T I O N

Resolution E-4212. GRANTING the request of Pacific Gas and Electric Company's Request to Amend Standard Offer No. 1 Power Purchase Agreement with Town of Scotia, LLC.

By Advice Letter 3193-E, filed on January 11, 2008.
PG&E filed a supplemental Advice 3193-E-A, on August 12, 2008.
PG&E filed supplemental Advice 3193-E-B, on September 29, 2008.

SUMMARY

This Resolution approves the Pacific Gas and Electric Company request to amend Standard Offer No. 1 Power Purchase Agreement with Town of Scotia, LLC.

By Advice Letter (AL) 3193-E, filed on January 11, 2008, Pacific Gas and Electric Company (PG&E) requests to amend its Standard Offer No. 1 (SO1) power purchase and sale agreement (PPA) between Town of Scotia, LLC. (Scotia) and PG&E (Amendment).[1] The Amendment suspends for eight years Scotia's ability to unilaterally terminate the PPA in exchange for an increase in the price to a fixed price for the entire term of the eight-year agreement.

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[1] At the time AL 3193-E was filed, the generating asset associated with the PPA was owned and operated by Pacific Lumber Company (PALCO), which had sought protection under Chapter 11 of the U.S. Bankruptcy Code on January 18, 2007, and was operating as a Debtor in Possession. Since that time, as a result of the bankruptcy case, PALCO's assets were split and ownership of the generating station was transferred to the Town of Scotia, LLC. (Scotia). Therefore, this resolution contemporaneously refers to the current owner, Scotia, as PG&E's counterparty under the Amendment and retrospectively refers to the previous owner, PALCO, as PG&E's counterparty under the original SO1 PPA as previously amended.

This resolution (1) adopts the Amendment without modification and (2) approves the Amendment in its entirety, including payments to be made by PG&E pursuant to the Amendment, subject to the Commission's review of PG&E's administration of the Amendment.

BACKGROUND

The federal Public Utility Regulatory Policy Act (PURPA) was passed in 1978 to encourage the development of cogeneration and small power production facilities (qualifying facilities or QF), including renewable power facilities such as biomass.[2] PURPA established the QF program, which shares similar goals with the California Renewables Portfolio Standard (RPS) program to promote renewable sources of electricity.

The RPS program was established by Senate Bill 1078 [3] and codified by California Pub. Util. Code Section 399.11, et seq. The statute required that a retail seller of electricity such as PG&E purchase a certain percentage of electricity generated by eligible renewable energy resources (ERR). On September 26, 2006, Governor Schwarzenegger signed Senate Bill (SB) 107,[4] which officially accelerates the State's RPS targets to 20 percent by 2010. In a series of decisions, the Commission has determined the baseline of ERR for each RPS-obligated load-serving entity (LSE) for the purpose of RPS compliance.[5] A significant percentage of PG&E's RPS baseline is composed of QF generation, including purchases under the Scotia contract.

Under the QF program, Scotia currently sells renewable power to PG&E from its 32.5 megawatt (MW) biomass facility in Scotia, California. PALCO (now Scotia) and PG&E (Parties) initiated their original SO1 PPA on January 17, 1986. The Parties original SO1 PPA has been previously amended.

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[2] 16 U.S.C. Section 796(17)(A).

[3] Chapter 516, Statutes of 2002, effective January 1, 2003 (SB 1078)

[4] Chapter 464, Statutes of 2006 (SB 107)

[5] See D.06-07-032; D.04-06-014; and D.06-10-050

On July 5, 1988 the Parties executed a First Amendment, which set the delivery limit to 20 MW. In the July 14, 2001 Second Amendment, PALCO accepted the 5.37 ¢/KWh energy price offered to all QFs during the energy crisis. (See Decision (D.)01-06-015.) A January 10, 2003 Letter Agreement revised the delivery limit to 22 MW. A May 4, 2006 Letter Agreement raised the delivery limit to 28.8 MW for a five-year period. In a May 8, 2006 Amendment to the PPA, PALCO accepted the terms of the "IEP Settlement," which the Commission approved in D.06-07-032. The current SO1 PPA, as amended, has no specified termination date, and gives Scotia (then PALCO) the unilateral right to terminate the PPA.

By Advice Letter (AL) 3193-E, filed on January 11, 2008, PG&E requests to amend its SO1 PPA between PALCO (now Scotia) and PG&E. The Amendment suspends for eight years Scotia's ability to unilaterally terminate the PPA in exchange for an increase in the price to a fixed price for the entire term of the eight-year Agreement.

At the time AL 3193-E was filed, the generating asset associated with the PPA was owned and operated by PALCO, which had sought protection under Chapter 11 of the U.S. Bankruptcy Code on January 18, 2007, and was operating as a Debtor in Possession. Since that time, as a result of the bankruptcy case, PALCO's assets were split and ownership of the generating station was transferred to the Town of Scotia, LLC. (Scotia). Therefore, this resolution contemporaneously refers to the current owner, Scotia, as PG&E's counterparty under the Amendment and retrospectively refers to the previous owner, PALCO, as PG&E's counterparty under the original SO1 PPA as previously amended.

According to pleadings filed in the bankruptcy proceeding, the Chapter 11 proceeding was precipitated when PALCO's wholly-owned company, Scotia Pacific Company LLC (SCOPAC) was unable to make a scheduled payment on certain notes secured by SCOPAC's timberland and timber harvest rights. SCOPAC owned approximately 200,000 acres of timberland; SCOPAC's business consisted of harvesting of timber from its timberlands and selling the timber to PALCO, which converted the logs into marketable lumber in sawmills it owned. PALCO used the wood waste from its lumber business to fuel the facility that generates power for sale to PG&E.

PG&E states the timber industry in general and SCOPAC's operations specifically had become increasingly unpredictable and negatively affected by substantial and expanding regulatory constraints, ongoing litigation challenges, additional legislative effects, negative judicial decisions, weather patterns, and low lumber or log prices.

PALCO informed PG&E of the foregoing situation and the Parties began to explore means by which PALCO could continue to supply renewable power to PG&E given the challenges PALCO's fuel supplier faced as described above.

The Parties concluded that the Amendment was the best solution. From PG&E's perspective, there was a risk that PALCO (now Scotia) might elect to terminate its contract with PG&E. An Amendment would enable PG&E to retain Scotia in its renewable portfolio and give Scotia more revenue to sustain its operations. Continued deliveries from Scotia amount to approximately 0.2% of PG&E's 20% Renewables Portfolio Standard (RPS) requirement in 2010.[6]

In return for Scotia's commitment not to terminate its PPA for eight years, beginning on April 1, 2008, PG&E has agreed to pay a flat, all-in price as stated in paragraph 3.B. of the Amendment. As described in Confidential Attachment A, renewable energy under the terms of the amended PPA is attractive relative to existing and recently executed Renewable Portfolio Standard (RPS) contract alternatives and is below the 2007 Market Price Referent (MPR) for 10-year term contracts.[7]

The Amendment is subject to satisfactory approval obtained from both this Commission and the Bankruptcy Court. On July 8, 2008, the Bankruptcy Court approved Docket 3302 Confirmation Order,[8] settling the bankruptcy case

[6] Pub. Util. Code Section 399.14(a)(2) (C)

[7] Resolution E-4118

[8] In the United States Bankruptcy Court for the Southern District of Texas, Corpus Christi, Case No. 07-20027, *Judgment and Order (I) Confirming First Amended Joint Plan of Reorganization for the Debtors, as Further Modified, with Technical Amendments, Proposed by Mendocino Redwood Company, LLC., Marathon Structured Finance Fund L.P. and Official Committee of Unsecured Creditors, (II) Denying Confirmation of Indenture Trustee Plan, (III) Denying Motion to Appoint Chapter 11 Trustee* (Judge Richard S. Schmidt, dated July 8, 2008)

Footnote continued on next page

effective immediately upon entry. Pursuant to the bankruptcy order, Scotia owns the generating station; and the lumber mill, and associated timberlands, are owned by the newly formed Humboldt Redwood Company (HRC), which is itself a subsidiary of the Mendocino Redwood Company.

As described in paragraph 4.A. of the Amendment, if this Commission does not approve the Amendment by April 1, 2008, PG&E will continue to pay Scotia the current PPA prices, but will track the difference between those payments and the amounts PG&E would have paid had the Commission approved the Amendment by April 1, 2008. If, ultimately, the Commission does approve the Amendment to the satisfaction of both Parties, PG&E will pay Scotia the accrued difference. If satisfactory approval is not obtained within 12 months after PG&E has submitted this Amendment to the Commission, the Amendment will terminate and PG&E will retain the accrued difference in payments.

Except for the pricing terms and Scotia's ability to terminate the PPA, the Amendment modifies no other provisions of the Parties' PPA.

PG&E requests the Commission to:

1. Adopt the Amendment without change;
2. Approve the Amendment in its entirety, including payments to be made by PG&E pursuant to the Amendment, subject to the Commission's review of PG&E's administration of the Amendment;
3. Find that any stranded costs that may arise from the PPA are subject to the provisions of D.04-12-048 that authorize recovery of stranded renewables procurement costs over the life of the contract. The implementation of the D.04-12-048 stranded cost recovery mechanism is being addressed in Rulemaking 06-02-013; and
4. Adopt the Amendment such that it will have no effect upon the RPS eligibility of the project.

In support of its request, PG&E submitted confidential information under the confidentiality protection of Section 583 of the Public Utilities Code and General Order 66-C. Pursuant to the Administrative Law Judge's Ruling Clarifying

Interim Procedures for Complying with Decision 06-06-066, issued August 22, 2006, in Rulemaking 05-06-040, a separate Declaration of Confidential Treatment regarding the confidential information was filed concurrently with PG&E's request.

The nature of the confidential information was contract terms, including pricing, and a comparison of levelized $/MWh between Scotia and other recently authorized and in negotiation renewable energy contracts. (See Confidential Appendix A.)

On August 12, 2008, PG&E filed a supplemental Advice 3193-E-A in which it submitted copies of the original SO1 contract and subsequent amendments and agreements.

On September 29, 2008, PG&E filed supplemental Advice 3193-E-B in which PG&E argued that the similarity between the Commission's QF and RPS programs permits the Commission to approve the Amendment using the advice letter process. Their argument is based on five basic premises:

1. The RPS and QF programs share similar goals of encouraging renewable energy, including biomass, generation.
2. QFs may qualify as eligible renewable energy resources, pursuant to the California Energy Commission's (CEC) RPS certification process, and generation from such facilities may be counted for RPS compliance, pursuant to SB 107. [9]
3. A significant percentage of PG&E's RPS baseline is composed of QF generation.
4. The Commission permits use of the advice letter process to approve both RPS contracts, resulting from an RPS solicitation, and QF contracts, under the Restructuring Advice Letter Filing (RALF) for review of QF contract restructurings.
5. Therefore, since the Amendment is a contract with an RPS-certified facility whose generation counts towards PG&E's RPS obligations, it should be treated similar to an RPS contract, even though it does not clearly fall within either of the processes discussed in item 4 above.

[9] Chapter 464, Statutes of 2006 (SB 107).

NOTICE

Notice of AL 3193-E was made by publication in the Commission's Daily Calendar. PG&E states that a copy of the Advice Letter was mailed and distributed in accordance with Section 3.14 of General Order 96-B. PG&E states that a copy of the request excluding the confidential appendices was sent electronically and via U.S. mail to parties listed in the advice letter and the service lists for R.01-10-024 and R.06-05-027. Non-market participants who are members of PG&E's Procurement Review Group and have signed appropriate Non-Disclosure Certificates received the request and accompanying confidential attachments by overnight mail.

PROTESTS

There were no protests.

DISCUSSION

PG&E emphasized that, absent the Amendment, Scotia (or its successor) could terminate the agreement at any time without penalty. If Scotia wanted to switch to another buyer, it presently could do so without breaching the contract. Article 7 of the SO1 contract provides that the agreement remains in effect after execution "until terminated by Seller." With the Amendment in place, if Scotia sought to sell to another party, PG&E would have the remedies available to it under Contract Law that it would not otherwise have under the unmodified SO1 PPA. Under the unmodified SO1 PPA there are no minimum performance requirements, nor is the Seller required to post security. PG&E states that in the event of a breach of the Amendment, PG&E would have the ability to seek damages for the difference between the market price of replacement power and the contract price. PG&E argues that the real benefit of the Amendment is that it suspends Scotia's termination right for eight years, and gives PG&E customers the ability to collect damages in the event of a breach.

PG&E convincingly argued that the risk of Scotia terminating with PG&E and contracting with another RPS-obligated load-serving entity (LSE) is real (for the term of the Amendment). With the 10-year 2007 MPR at $92.71/MWh, Scotia has a sense of what prices might be available to it were it to seek another contract through an RPS solicitation or a bilateral agreement with another party. **Because**

the current contract price is below the MPR, Scotia has a financial incentive to leave PG&E's portfolio. If that were to happen, the cost of RPS-eligible replacement resources would likely be higher than the amended contract price. Therefore it is reasonable to conclude that the Amendment provides a good value for PG&E's ratepayers relative to the 2007 MPR and comparable renewable contracts either in negotiations or recently approved by the Commission. Confidential Appendix A contains a discussion of the pricing terms relative to renewable RFO activity and provides a market test of the amended contract price against similar projects in PG&E's portfolio.

We believe the 8-year term of the Amendment appropriately balances the potential benefit or risk of fixing a higher rate today, when renewable prices could go up or down in the next decade.

PG&E stated that the higher contract price would incent Scotia to increase the plant's output by approximately 30%, resulting in a greater contribution to PG&E's RPS portfolio. If this turns out to be true, this would add additional value for PG&E's ratepayers.

The Commission finds PG&E's argument to approve the Amendment by advice letter to be reasonable. We recognize the need to clarify the review process for renewable QF contract amendments in a formal proceeding, as we expect several similar contracts to expire in the next few years. **Our approval of this Amendment by advice letter shall not, in any way, be considered or interpreted as precedent in subsequent proceedings.**

PG&E clarified that a June 2008 ruling in PALCO's bankruptcy case, setting PALCO on a path out of bankruptcy had no bearing on the terms and conditions of the Amendment, or its pending approval before the Commission.

The Scotia (then PALCO) facility qualifies as an eligible renewable energy resource, pursuant to the California Energy Commission's (CEC) RPS certification process.

Stranded costs that may arise from the PPA are subject to the provisions of D.08-09-012 that authorize recovery of stranded renewables procurement costs over the life of the contract.

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.

All parties in the proceeding have stipulated to waive the 30-day waiting period required by PU Code section 311 (g)(1) and the opportunity to file comments on the draft resolution. Accordingly, this matter will be placed on the Commission's agenda directly for prompt action.

On October 14, 2008, PG&E, the only party to this proceeding, informed Energy Division that it waives the comment period.

FINDINGS

1. PG&E filed Advice Letter 3193-E on January 11, 2008; supplemental Advice 3193-E-A on August 12, 2008; and supplemental Advice 3193-E-B on September 29, 2008.
2. PALCO (now Scotia)[10] had been delivering renewable power to PG&E under an SO1 contract since 1986. Two amendments, two letter agreements, and a settlement agreement have previously modified the contract in its current form.
3. The Commission finds PG&E's request to approve the Amendment by advice letter to be reasonable.
4. There is a risk of Scotia terminating with PG&E and contracting with another RPS-obligated LSE, and the cost of RPS-eligible replacement resources would be higher than the current contract price.
5. The cost to PG&E ratepayers of the proposed change is below the 2007 MPR.
6. We find that the 8-year term of the Amendment appropriately balances the potential benefit or risk of fixing a higher rate today, when renewable prices could go up or down in the next decade.

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[10] Refer to footnote 1

7. Our approval of this Amendment by advice letter shall not, in any way, be considered or interpreted as precedent in subsequent proceedings.
8. Stranded costs that may arise from the PPA are subject to the provisions of D.08-09-012 that authorize recovery of stranded renewables procurement costs over the life of the contract.
9. The Amendment is reasonable and should be approved.

THEREFORE IT IS ORDERED THAT:

1. Advice Letter (AL) 3193-E, AL 3193-E-A, and AL 3193-E-B are approved.
2. The request of PG&E to find that any stranded costs that may arise from the PPA is approved subject to the provisions of D.08-09-012 that authorize recovery of stranded renewables procurement costs over the life of the contract.
3. 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 November 21, 2008; the following Commissioners voting favorably thereon:

/s/ Paul Clanon
Paul Clanon
Executive Director

MICHAEL R. PEEVEY
PRESIDENT
DIAN M. GRUENEICH
JOHN A. BOHN
RACHELLE B. CHONG
TIMOTHY ALAN SIMON
Commissioners