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Decision 84 02 005 FEB 1 1984

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of SAN DIEGO GAS & ELECTRIC COMPANY, for Authority to revise its Energy Cost Adjustment Clause Rate, to revise its Annual Energy Rate, and to revise its Electric Base Rates in Accordance with the Electrical Revenue Adjustment Mechanism established by Decision 93892.	Application 83-07-16 (Filed July 8, 1983)

Barton M. Myerson, Randall W. Childress, William L. Reed, and Jeffrey L. Guttero, Attorneys at Law, for San Diego Gas & Electric Company, applicant.
John W. Witt, City Attorney, by William J. Shaffran and Steven A. McKinley, Deputy City Attorneys, for the City of San Diego; F. E. John and T. D. Clarke, by Gay M. Phillips, Attorneys at Law, for Southern California Gas Company; Allen R. Crown, Attorney at Law, for California Farm Bureau Federation; and Harry K. Winters, for University of California; interested parties.
Richard Rosenberg, Attorney at Law, for the Commission staff.

INTERIM OPINION

I. Summary of Decision

In this interim opinion, we adjust San Diego Gas & Electric's (SDG&E) Energy Cost Adjustment Clause (ECAC) rate, Annual Energy Rate (AER), and Electric Revenue Adjustment Mechanism (ERAM) rate. The calculated adjustments would produce a net reduction of revenue of $65.5 million. However, in Decision (D.) 83-11-091

issued November 22, 1983, we already have ordered SDG&E to lower its ECAC rate to reduce revenues by $38.9 million. That reduction was ordered to offset a rate increase allowed for SONGS Unit 2. Accordingly, at this time we pass through to the ratepayer only the remaining $26.6 million.

We find SDG&E to have been unreasonable in entering into the 1979 Restated Agreement with Tesoro. An appropriate disallowance will be determined after further hearings.

II. Introduction

Application (A.) 83-07-16 is SDG&E's ECAC and AER forecast for the period beginning November 1, 1983.

After SDG&E filed the application, the Commission issued D.83-08-048 in Order Instituting Investigation (OII) 82-04-02, which established a new 92% ECAC/8% AER split for SDG&E and ordered proportional inclusion of all energy costs in both the ECAC rate and the AER. The decision also set the interest rate for Bankers' Acceptances as SDG&E's carrying cost on oil in inventory.

On September 7, 1983, the Commission issued D.83-09-007 in A.82-02-40 and A.82-03-63, which adjusted SDG&E's ECAC rate and AER to reflect the ratemaking treatment of San Onofre Nuclear Generating Station (SONGS) Unit 2.

SDG&E modified its showing to reflect the effects of both D.83-08-048 and D.83-09-007.

A prehearing conference was held on August 15, 1983. Twenty-four days of evidentiary hearing were held from August 25, 1983 to November 28, 1983. SDG&E presented eleven witnesses, and staff presented five.

Opening briefs were due December 16, 1983 and reply briefs on December 23, 1983. Staff requested a one week extension of time which was granted. SDG&E and the City of San Diego (City) timely filed opening briefs on December 23, 1983. Staff filed its opening brief on the Tesoro Suspension Agreement on December 27, 1983. Staff filed a supplementary brief covering the forecast issues on January 3, 1984. SDG&E filed a reply brief on January 5, 1984.

III. Issues

The issues raised by A.83-07-16 are important and varied. The usual forecast issues, i.e., prediction of SDG&E's energy costs, for the period November 1, 1983 to October 31, 1984 must be addressed. This annual endeavor to estimate test year oil, gas, purchased power, nuclear, and other energy costs overshadows the biennial general rate proceedings since SDG&E's energy costs are most of the utility's total operating costs. In addition, the increase of the AER from 2% to 8% of SDG&E's energy costs quadrupled the amount of energy expense that is recovered through a base rate based on test year estimates. Consequently, the estimates of SDG&E's energy costs to be adopted in our forecast are more important than before.

A.83-07-16 also includes a reasonableness review of the period July 1, 1982 to April 30, 1983. SDG&E is required to come forward with percipient witnesses and show that the management of its energy expense in the review period was "prudent and reasonable." While the staff generally identifies several reasonableness issues, intervenors frequently develop and pursue their own issues through the hearing and briefing process. Thus, all of the reasonableness issues often are not well-defined until the proceeding has been submitted.

The Commission also held over from the prior reasonableness review proceeding for SDG&E, A.82-08-014, the matter of the Tesoro Suspension Agreement. Extensive hearings were held in A.82-08-014 in which SD&GE, staff, and Tesoro-Alaskan Petroleum Corporation (Tesoro) presented witnesses on the Tesoro Suspension Agreement. However, the Commission deferred a decision to this proceeding and directed the staff to investigate further the circumstances surrounding the negotiation of the Suspension Agreement so the Commission would know more about the negotiation process before ruling on the agreement.

During hearing on the present application, the City argued that not only the Suspension Agreement entered into in 1982 but also the underlying 1979 Restated Agreement between Tesoro and SDG&E was at issue. The City pointed out that prior Commission decisions expressly held the 1979 record period open for review by the staff or intervenors. (See D.91106, 2 CPUC 2d 572, 576-577, issued December 19, 1979 and D.91545, 3 CPUC 2d 503, issued April 15, 1980.) The City then requested that SDG&E provide a witness on the 1979 Restated Agreement. The presiding administrative law judge (ALJ) ruled in favor of the City and ordered SDG&E to present a witness and further testimony on the 1979 Restated Agreement. SDG&E filed a motion to overturn the ALJ's ruling but provided a witness under protest. We affirm the ALJ's ruling and consider the 1979 Restated Agreement to be within the scope of this reasonableness review as clearly stated in our prior decisions. Furthermore, we consider any discretionary action by utility management which directly affects energy expenses incurred in the record period to be within the scope of our reasonableness review even if the action was taken before the record period. SDG&E's motion to overturn the ALJ's ruling is denied.

In summary, the areas at issue in A.83-07-16 consist of (1) the appropriate forecast for the November 1, 1983 to October 31, 1984 period (forecast period), (2) the reasonableness review of the July 1, 1982 to April 30, 1983 period (record period), (3) the Tesoro Suspension Agreement, and (4) the 1979 Restated Agreement between SDG&E and Tesoro.

Despite the extended hearing schedule, evidence and testimony on the record period was not received. So, further hearings will be held for this Area (2). In this Interim Opinion, we will address the forecast issues and decide the reasonableness of the Tesoro Suspension Agreement as well as the 1979 Restated Agreement.

IV. ECAC/AER Forecast

As discussed earlier, SDG&E's forecast showing was adjusted several times throughout the proceeding to account for the effects of Commission decisions issued after the application was filed. The last update was received as Exhibit 43, which shows a net revenue reduction of $57.3 million. This estimated reduction is based upon an ECAC rate decrease of .311¢/kWh, an AER increase of .181¢/kWh, and an Electric Revenue Adjustment Mechanism (ERAM) rate decrease of .426¢/kWh.

The centerpiece of SDG&E's forecast presentation is Exhibit 4 which explains the forecast resource mix. The resource mix was developed in the following manner:

1. SDG&E's Economic Research & Forecasting Department developed an electric sales estimate for the forecast period using an econometric model which estimates average use by customer type and customer additions by quarter. From this sales estimate, SDG&E derived a system energy requirement of 12,140 Gigawatthours (GWHR).

2. SDG&E's Electric Operations Department developed a purchased energy estimate based on historical trends and existing contracts with other utilities. (Also, see Exhibit 22.)

3. SDG&E's Nuclear Department developed an estimate of SONGS generation with the operator, Southern California Edison (SCE).

4. The above data then was entered into SDG&E's production costing program which accounts for unit heat rates, capacity factors, forced outages, spinning reserve requirements, planned maintenance, and resource additions in determining SDG&E's fossil generation requirements. This program is a computer simulation of SDG&E's system.

5. The maximum amount of gas available to burn is derived from the production costing program's prediction of fossil generation requirements.

6. SDG&E's Gas Planning Department then provides its prediction of the level of service SDG&E should expect from its supplier, the Southern California Gas Company (SoCal).

7. Next, any fossil generation requirements which cannot be met by burning gas are assumed to be met by low sulfur residual oil (LSFO) burn unless additional oil burn is required for inventory control.

8. SDG&E calculated its required LSFO inventory level using three methodologies and selected an average inventory level for the forecast period.

9. SDG&E considered the level of LSFO deliveries under its Hawaiian Independent Refinery Incorporated (HIRI) contract in the forecast period, determined that contract deliveries exceeded its LSFO requirements by 1-1.3 million barrels, and evaluated the most economic disposal method, i.e., burn, store, sell, underlift, etc. SDG&E decided that the projected excess should be burned.

10. Finally, SDG&E derived a resource mix with its production cost program after including the effect of the LSFO inventory control burn which the program otherwise would not have projected. The resulting resource mix which includes SONGS Unit 2 generation is as follows:

Resource	GWHR	% of Total Mix
Purchased Energy	5,074.2	41.79
Nuclear Generation	1,335.3	11.00
Natural Gas	3,813.3	31.41
Diesel Oil	0.2	0.00
LSFO	1,918.7	15.80
Total	12,141.7	100.00

SDG&E did not include SONGS Unit 3 generation in the forecast resource mix as nuclear generation because the impact of that facility's commercial operation on the ECAC rate and the AER in the forecast period will be examined in the rate base offset proceedings. (Natural gas is used as the "avoided cost" proxy for the expected SONGS Unit 3 generation in the above resource mix.)

SDG&E's forecast process was examined throughout the hearing, sometimes in minute detail. SDG&E was required to supplement its original showing with additional testimony on its purchased power estimate, SONGS Unit 2 projected capacity factor, and HIRI contract obligations. The staff and the City were given ample opportunity to cross-examine SDG&E's witnesses, to conduct further discovery, and if desired to present additional witnesses. This time-consuming procedure was permitted in recognition of the increased importance of the forecast underlying the AER.

Only a few issues related to SDG&E's forecast emerged in the briefs submitted by the parties. First, SDG&E and staff disagree on the appropriate level of LSFO inventory. Second, SDG&E and staff differ on the predicted capacity factor for SONGS Unit 2. Last, staff contends that the HIRI contract and the related Chevron transportation agreement will impose excessive and unwarranted costs on the ratepayer; however, staff does not make a specific proposal of disallowance or other Commission action. These differences when combined amount to a total difference of only $2.206 million or .4%. The AER portion of this difference is only $176,477. (Exhibit 47, p.1.) We conclude that the parties essentially now agree that SDG&E's forecast resource mix is reasonable. Accordingly, we substantially adopt SDG&E's forecast resource mix.

Despite our adoption of SDG&E's forecast, we must emphasize that SDG&E's management of 92% of its energy costs in the forecast period will be subject to reasonableness review in a forthcoming proceeding. The purpose of the forecast and the derived AER is to predict as best we can what SDG&E's energy costs will be at this single point in time and to set a base rate for 8% of these costs in

the AER. SDG&E will retain the difference between the AER revenue and 8% of its actual energy costs within its earnings cap limitation of ± 120 basis points. SDG&E should have some incentive to lower costs because the larger AER is in effect.

In choosing a forecast now, we are not in any way endorsing SDG&E's "plan of action" for the forecast period. Rather, we are troubled by several aspects of SDG&E's Fuel Management Plan as presented in its testimony. We will comment on several of our concerns now to alert SDG&E and the other parties that we intend to closely examine SDG&E's fuel management decisions in the next reasonableness review proceeding.

First, we are concerned with the constraints that the HIRI contract has placed on SDG&E. The contract forces SDG&E to burn volumes of LSFO beyond the volumes called for under Efficiency Dispatch of the utility's generation system. The contract also prevents SDG&E from switching to Incremental Cost Dispatch which is SDG&E's lowest cost dispatch method. Moreover, we are aware that HIRI is willing to negotiate an underlift of the contract volumes. Limited negotiations between SDG&E and HIRI have already occurred. Thus, SDG&E has an opportunity to reduce its LSFO burn. Despite the foregoing, SDG&E insists that an underlift will not occur in the forecast period.

We question SDG&E's continuing belief that a long-term LSFO supply is the only "reasonable course of action." The alleged benefits of SDG&E's long-term LSFO contracts have failed to materialize while the cost of these agreements has been instrumental in SDG&E charging one of the three highest electric retail prices in the country. We expect SDG&E to aggressively pursue all available options in solving its LSFO oversupply problem as well as the associated Chevron transportation charges. We repeat that SDG&E's management in this area will be scrutinized and questioned.

Second, we remain concerned about SDG&E's calculation of an appropriate LSFO inventory. SDG&E's analysis again relies upon a worst case scenario. The analysis is based only upon the utility's ability to replenish its LSFO inventory in an emergency situation. No consideration was given by SDG&E to other resource options such as purchased power. While SDG&E maintains that the oil-order option is not the only option SDG&E management could choose, it is the only option SDG&E considered in determining its minimum winter and summer LSFO inventories. Furthermore, as pointed out by staff witness Danner, SDG&E's analysis does not attempt to arrange the schedule of oil deliveries to coincide with the required oil burn. Focusing only upon this single scheduling factor, Danner was able to derive an average LSFO inventory 400,000 barrels lower than SDG&E's. This limited study by Danner shows that affirmative action by SDG&E management can substantially reduce the level of SDG&E's LSFO inventory. We choose to adopt Danner's inventory level of 1,006,000 barrels because we are convinced that SDG&E's analysis does not adequately consider affirmative management action in an emergency situation.

Finally, we choose to adopt staff's capacity factor for SONGS Unit 2. The staff has used the same capacity factor that was used to adjust SCE's ECAC rate and AER. We see no reason why a different number should be used for SDG&E.

In summary, we adopt SDG&E's entire forecast, apart from its requested LSFO inventory level and SONGS Unit 2 capacity factor. The ECAC rate decrease of .385¢/kWh and AER increase of .174¢/kWh are shown in Table 1. These rate adjustments combined with an ERAM rate decrease of .426¢/kWh amount to a net reduction of revenue of about $65.5 million as compared to SDG&E's request of $57.3 million. The difference of $8.2 million is due to our adoption of a lower LSFO

inventory level ($1.4 million), SONGS Unit 2 capacity factor (.8 million), and the removal of Tesoro underlift payments ($6 million) from the total expenses. Recovery of the Tesoro underlift payments will be addressed in the next section of this decision.

Consistent with our recent decision in SDG&E's general rate case (D.83-12-065) the System Average Percentage Change Method will be used to allocate the revenue changes flowing from this decision among customer classes.

Table 1

ECAC-AER Derivation

	M$
Purchased Energy	200,527.0
Nuclear Generation	18,090.0
Natural Gas	217-269.3
Diesel Oil	34.0
LSFO	114,680.0
Subtotal Fuel and Purchased Energy	550,600.3
Plus New Albion Resources	1,610.3
Plus Variable Wheeling Expenses	2,059.3
Underlift Payments (Chevron Transp.)	928.185
Carrying Cost of Oil In Inventory	4,175.98
Total Expenses	559,374.165
ECAC - 92%	514,624.195
AER - 8%	44,749.970
ECAC offset rate decrease	.320¢/kWh
ECAC balancing rate decrease	.065¢/kWh
ECAC rate decrease	.385¢/kWh
AER increase	.174¢/kWh
Adopted AER	.429¢/kWh

V. 1979 Restated Agreement

SDG&E entered into the original agreement with Tesoro in July, 1974. The original agreement provided SDG&E with maximum LSFO deliveries of 10,000 barrels/day (bbl/d) from 1975 to 1980 and 5,000 bbl/d in 1981. This agreement was executed after the Commission encouraged the electric utilities to enter into long-term contracts with LSFO suppliers. (D.81931 issued September 25, 1973, 75 CPUC 713.)

The original agreement was amended on February 5, 1976 (Amendment No. 1) and on January 16, 1978 (Amendment No. 3). After Amendment No. 3 took effect, the maximum contract volumes had doubled to 20,000 bbl/d from 1978 to 1980 and to 10,000 bbl/day in 1981.

On January 1, 1979, the Restated Agreement took effect. Under the Restated Agreement, SDG&E was obligated to receive 17,000 bbl/d in 1979 and 1980, 18,000 bbl/d in 1981, 16,000 bbl/d in 1982, and 7,000 bbl/d in 1983. The Restated Agreement lowered contract deliveries in 1979 and 1980 by 3,000 bbl/d but increased contract deliveries by 8,000 bbl/d in 1981, 16,000 bbl/d in 1982, and 7,000 bbl/d in 1983. This renegotiation increased SDG&E's total contract deliveries from Tesoro by 9,125,000 barrels.

SDG&E maintains that the Restated Agreement seemed reasonable in late 1978. At that time, SDG&E's oil inventories had reached maximum operating levels due to the unexpected availability of natural gas and purchased energy. In addition, the disposal cost of LSFO in the spot market exceeded the economic benefit of burning natural gas. Accordingly, SDG&E tried to negotiate a reduction of contract volumes with Tesoro so that the utility could burn available natural gas.

Tesoro was unwilling to negotiate any volume reductions unless SDG&E would agree to a long-term extension of the contract. SDG&E tried to evaluate the benefits of a short-term reduction in LSFO deliveries against the risks of a contract extension beyond 1981.

SDG&E asserts that during this period the long-term outlook for natural gas as a powerplant fuel was very pessimistic. For example, the 1977-1980 California Gas Reports showed levels of service to P-5 customers to be below 20% in 1982-1983. SDG&E believed that little or no powerplant gas would be available in the early 1980's.

Because of these pessimistic gas availability forecasts, SDG&E's projections of long-term LSFO requirements were increased. These projections were revised in November, 1978 to perform an analysis of the contract changes being negotiated with Tesoro. The revised projections showed that SDG&E's LSFO requirements had a 75% probability of not exceeding 13.5 million barrels in 1979, 13.7 million barrels in 1980, 13.9 million barrels in 1981, 11.2 million barrels in 1982, and 9.9 million barrels in 1983. SDG&E claims the above forecasted requirements exceeded the contractual commitments the utility was considering at that time.

In the utility's view, the Restated Agreement enabled SDG&E to reduce its LSFO volumes in the short-term and to accept more natural gas as it became available in 1979 and 1980. In return for this short-term benefit, SDG&E exposed itself to what was then perceived as "a relatively insignificant possibility that LSFO supply would exceed requirements in 1982 and 1983."

In addition, SDG&E points out that HIRI, the utility's other supplier, had at times declared the possibility of a force majeure reduction of contract volumes. SDG&E asserts that the Restated Agreement gave SDG&E in Tesoro, a LSFO supplier dependent on domestic sources of crude in addition to HIRI, a supplier dependent on foreign sources.

SDG&E's fuel procurement strategy at that time was to depend on the spot market for no more than 5-10% of LSFO requirements. Thus, using the utility's November, 1978 revised projections of LSFO requirements, SDG&E's strategy called for a firm contract supply of 12.2-12.8 million barrels in 1979, 12.3-13.0 million barrels in 1980, 12.5-13.2 million barrels in 1981, 10.1-10.6 million barrels in 1982, and 8.9-9.4 million barrels in 1983. The balance of the forecast requirements could be obtained on the spot market or from other resources.

Under the Restated Agreement, SDG&E agreed to receive from Tesoro about 6.2 million barrels of LSFO in 1979 and 1980, 6.6 million barrels in 1981, 5.8 million barrels in 1982, and 2.6 million barrels in 1983.

SDG&E's witness Watkins testified that SDG&E's contract with HIRI provided 14,000 bbl/d through 1984. This is equivalent to 5.1 million barrels per year. A tabulation of these contract volumes shows that SDG&E's firm contract volumes with the Restated Agreement exceed 90-95% of its forecast LSFO requirements only in 1982.

Year	90-95% of Forecast LSFO Requirements	Restated Tesoro Volumes	HIRI Volumes
	(millions of barrels)		
1979	12.2-12.8	6.2	5.1
1980	12.3-13.0	6.2	5.1
1981	12.5-13.2	6.6	5.1
1982	10.1-10.6	5.8	5.1
1983	8.9- 9.4	2.6	5.1

However, Watkins neglected to mention that at the time negotiations with Tesoro were occurring, the HIRI contract volumes could have been increased at the utility's option from 14,000 bbl/d to 28,800 bbl/d upon two years' written notification. (Amendment No. 7 dated May 10, 1978.)

Therefore, SDG&E could have relied upon a range of 5.1-10.5 million barrels from HIRI in 1981-1983. However, instead of relying upon the HIRI option, SDG&E chose to extend the Tesoro agreement from 1981 to 1983. Another tabulation of SDG&E's contract volumes before the Restated Agreement shows that firm contract volumes did not exceed 90-95% of forecast LSFO requirements from 1979 to 1983.

Year	90-95% Forecast LSFO Requirements	Tesoro Volumes Before Restated Agreement	HIRI Volumes w/ Option to Increase Deliveries
		(millions of barrels)	
1979	12.2-12.8	7.3	5.1
1980	12.3-13.0	7.3	5.1
1981	12.5-13.2	3.65	5.1-10.5
1982	10.1-10.6	-	5.1-10.5
1983	8.9-9.4	-	5.1-10.5

After comparing these tabulations, we conclude that although SDG&E was able to reduce contract volumes in 1979 and 1980 by entering into the Restated Agreement with Tesoro, these short-term reductions were more than offset by the increased volume obligations in 1981-1983. SDG&E paid a heavy price since it in effect substituted a flexible option to call upon HIRI to deliver increased volumes for the extension of an inflexible take-or-pay agreement with Tesoro. SDG&E would pay very dearly for this substitution. From these facts alone, we conclude that SDG&E's decision to enter into the Restated Agreement reflects extremely poor management judgment.

What benefits did SDG&E expect to receive under the Restated Agreement? SDG&E estimated at the time that just $500,000 in fuel savings would result from the volume reductions in 1979 and 1980. This projected benefit does not equal the risk of excess LSFO in 1981-1983 that SDG&E assumed under the Restated Agreement.

SDG&E's own economic analysis of the Restated Agreement's benefits demonstrates that the modest fuel savings were not worth extension of the agreement. Watkins testified that in approving the Restated Agreement he had specifically relied upon Enclosure 1 of the utility's economic analysis. Enclosure 1 showed the probability that SDG&E would have excess LSFO under the Restated Agreement in the years 1979-1983. After reviewing Enclosure 1, Watkins said the Restated Agreement reduced the risk of excess LSFO in 1979 by about 50% since the graph indicated an approximate 80% probability of excess LSFO without the Restated Agreement and only a 30% probability of excess LSFO with the Restated Agreement. Upon closer examination, the probability difference is about 40% rather than 50%. Nonetheless, we agree that the Restated Agreement substantially reduced the risk of excess LSFO in 1979 according to Enclosure 1. A similar analysis for 1980 shows that the Restated Agreement reduced the probability of excess LSFO in that year by about 10%. However, Enclosure 1 also shows that extension of the Tesoro Agreement through 1983 had the effect of increasing the probability of excess LSFO in 1981 by 15% and in 1982 by 35%. Thus, SDG&E's own probabilistic analysis in Enclosure 1 showed at best marginal benefits from the Restated Agreement. Clearly, Watkins and the rest of SDG&E's management were concerned only about a short-term solution to the LSFO oversupply problem. Inadequate consideration was given to the added risk of excess LSFO in later years that the Restated Agreement created.

Why did SDG&E enter into the Restated Agreement? We conclude after a careful review of the evidence and testimony that SDG&E was trying to avoid Commission assessment of a $1/bbl penalty for the rejection of available gas in 1979 and 1980. The memoranda attached as Appendix D to Exhibit 44 have several references to the possibility of a $1/bbl penalty.

> "In order to make the ratepayer indifferent as to whether fuel oil would be burned in preference to cheaper natural gas, a $1/bbl penalty could be levied by the CPUC for every barrel equivalent of gas rejected."
>
> "In order to make the ratepayer indifferent as to whether oil would be burned in preference to cheaper natural gas, a $1 penalty could be levied by the CPUC for every BBLR of natural gas rejected. A fifty-fifty chance of such a penalty was assumed." (Exhibit 44, App. D, pp. 1, 6.)

SDG&E apparently was preoccupied with the possibility of a Commission disallowance for rejected natural gas in 1979 and 1980 and entered into the Restated Agreement without adequate consideration of the possibility of excess LSFO in later years. We conclude that SDG&E was unreasonable in signing the Restated Agreement based upon the information available to SDG&E at the time it entered into the agreement.

The City in its brief takes SDG&E to task for entering into the Restated Agreement without conducting adequate studies. The City argues (1) SDG&E failed to study and analyze alternatives to the Restated Agreement, (2) SDG&E failed to analyze future trends in LSFO availability and prices, (3) SDG&E failed to analyze the Restated Agreement from the ratepayer's perspective, and (4) SDG&E chose to rely upon arbitrary and unreliable forecasts when evaluating the costs and benefits of the Restated Agreement. The City concludes that SDG&E was imprudent and unreasonable because the utility did not have sufficient information to enter into the Restated Agreement.

First, the City points out that in August, 1978, SDG&E had received the Gilbert Management Consultant's Report (Gilbert Report) introduced as Exhibit 2 in A.57780 and A.58263. The executive

summary to this report is attached as Appendix A to D.90404, 1 CPUC 2d 596 (1979). The Gilbert Report found SDG&E's documentation and alternative studies in support of its fuel decisions to be deficient. The report further stated that more structured analysis and additional studies are needed to support SDG&E's actions.

The City argues that SDG&E failed to undertake the analysis recommended in the Gilbert Report. First, SDG&E did not study the contract and its terms to see if more favorable contract provisions could be negotiated. The Gilbert Report had identified several unfavorable contract provisions which SDG&E did not even attempt to correct. Second, the utility's economic analysis did not analyze the alternatives of an underlift, sale, storage, or excess LSFO burn. The City asserts that each of these alternatives was a potential solution to the short-term LSFO oversupply. However, SDG&E chose to evaluate only the alternative of a contract extension. The City concludes that SDG&E was imprudent and unreasonable because it failed to comply with the Gilbert Report's recommendations.

Second, the City points out that SDG&E did not have forecasts of spot market LSFO availability when it decided to sign the Restated Agreement. The utility also did not have any estimates of spot market LSFO prices or contract prices for the years 1979-1983. The City maintains that without this forecast information SDG&E should not have entered into the Restated Agreement.

The City contends that the burden of any excess LSFO inventories in 1979 and 1980 would have been borne by SDG&E's shareholders since the carrying costs at that time were set in biennial general rate proceedings and were not recovered through ECAC. The City then points out that the two major costs examined by SDG&E were the carrying costs of excess LSFO inventory and the possible $1/bbl penalty for rejecting cheaper natural gas. Both

costs analyzed by SDG&E were costs to the shareholder, not the ratepayer. The City argues that SDG&E never evaluated the reasonableness of the Restated Agreement from the ratepayer's perspective. For this reason, the City characterizes SDG&E's decision to sign the Restated Agreement as imprudent and unreasonable.

Finally, the City criticizes the gas forecast used by SDG&E in analyzing the Restated Agreement. The City point out that SDG&E's gas model had consistently understated the quantity of natural gas available for powerplant use in 1975, 1976, 1977, and 1978. In late 1978, SDG&E should have been well aware that its forecasting methodology was unreliable.

The City claims that SDG&E's inaccurate gas forecasts resulted in excess LSFO situations and oil sale losses totaling $11.3 million from 1976-1978. Despite this track record, SDG&E relied upon the same gas forecasting methodology to extend its contract with Tesoro. The City asserts that SDG&E's reliance upon a historically inaccurate gas forecasting methodology was imprudent and unreasonable.

In its reply brief, SDG&E responds to each of the City's arguments.

First, SDG&E argues that any analysis of the alternatives discussed in the City's brief would have been an idle act. The utility claims that none of the alternatives was a practical option in 1979.

Second, SDG&E contends that any long-term forecasts of LSFO availability and prices would have been useless information. The utility desired to reduce its contract volumes with Tesoro and had to agree to buy more oil from Tesoro in order to reduce volumes in 1979 and 1980. Furthermore, SDG&E maintains that any long-term forecasts of LSFO prices would have been too speculative.

Third, SDG&E maintains that its decision to enter into the Restated Agreement was based primarily upon ratepayer concerns. The purpose of the agreement was to lower short-term LSFO deliveries so that cheaper natural gas could be burned. The ratepayers would have received the short-term fuel savings of the Restated Agreement, not the shareholders.

Fourth, SDG&E asserts that it relied upon the best available gas forecasts when deciding to sign the Restated Agreement. The utility emphasizes that all gas forecasts at that time proved to be inaccurate. Moreover, SDG&E points out that the City has offered no other source of information which the utility could have turned to back in 1979.

Despite SDG&E's protests, we are persuaded that the utility did not adequately study the long-term risks and liabilities posed by the Restated Agreement. Ignoring past experience, the utility chose to commit itself to long-term LSFO supplies without even considering the chance that despite pessimistic forecasts, natural gas or other alternative resources would become available. SDG&E chose instead to lock its resource mix into a take-or-pay LSFO contract through 1983 to avoid burdening its shareholders with the short-term carrying costs of excess LSFO inventory and a penalty for rejecting natural gas. Apparently, SDG&E's management also was unmoved by the Gilbert Report's recommendations which were known at that time. SDG&E's management was unreasonable in entering into the Restated Agreement.

VI. Tesoro Suspension Agreement

Since we have found the underlying 1979 Restated Agreement to be unreasonable, the issues raised by the 1982 Tesoro Suspension Agreement now are moot. Although we find that SDG&E produced a percipient witness on the 1982 issue and thus met its procedural burden of proof, our finding that the 1979 agreement was unreasonable eliminates the necessity to consider whether we would have found SDG&E's presentation on the 1982 contract adequate from a reasonableness perspective. However, the Suspension Agreement did mitigate the losses imposed by the Restated Agreement and will be considered in our eventual calculation of a disallowance.

Although we do not address the merits of staff's case attacking SDG&E's negotiation of the Suspension Agreement, we will state that SDG&E procedurally met its burden of proof on this matter. SDG&E provided all available documentation of its negotiation efforts and percipient witnesses to explain the transaction. The lack of more extensive documentation or the failure to call all possible percipient witnesses are matters left to SDG&E's judgment in the presentation of its case. This record is sufficient to render a decision.

VII. Measure of Damages

We direct SDG&E and staff to prepare for the further hearings in this matter a calculation of the actual consequences of the 1979 Restated Agreement. For example, any realized fuel savings in 1979 and 1980 due to the lower contract volumes should be offset against the actual costs that accrued in 1981-1983 due to a less economical resource mix or from underlift payments. Other tangible costs or benefits may be used in the calculation.

From this calculation, we will determine an appropriate disallowance. In making the ratepayer whole for the consequences of SDG&E's decision to enter into the 1979 Restated Agreement, we will consider the financial impact of a disallowance on SDG&E since the ratepayer ultimately may bear some of that impact.

SDG&E and staff shall prepare and serve upon all parties testimony showing a calculation of the economic consequences of the Restated Agreement within 20 days from today.

Findings of Fact

1. In A.83-07-16, SDG&E requests adjustment of its ECAC rate, AER, and ERAM rate for a net revenue reduction of $57.3 million.

2. SDG&E's forecast resource mix is reasonable and should be adopted, apart from SONGS Unit 2 generation.

3. The staff's capacity factor for SONGS Unit 2 is consistent with the capacity factor adopted in D.83-09-025 for SCE.

4. SDG&E's calculation of an LSFO inventory does not adequately consider affirmative action by management in an emergency situation.

5. SDG&E's requested LSFO inventory level is excessive.

6. The staff's LSFO inventory level of 1,006,000 barrels is more reasonable than SDG&E's and should be adopted.

7. An ECAC rate decrease of .385¢/kWh, an AER increase of .174¢/kWh, and an ERAM rate decrease of .426¢/kWh are reasonable based on the adopted forecast and LSFO inventory level.

8. The above rate adjustments would produce a net revenue reduction of $65.5 million.

9. On November 22, 1983, the Commission issued D.83-11-091 in A.82-02-40 and A.82-03-63 which ordered SDG&E to reduce its ECAC rates by $38.9 million.

10. On December 12, 1983, SDG&E filed tariff schedules as ordered in D.83-11-091 which lowered its ECAC rate by .396¢/kWh.

11. Since an ECAC decrease of $38.9 million has already occurred, the net reduction of revenue of $65.5 million should be reduced by $38.9 million; SDG&E's ECAC rate should increase by .011¢/kWh rather than decrease by .385¢/kWh.

12. At the time SDG&E entered into the 1979 Restated Agreement, the utility had a long-term contract with HIRI for LSFO deliveries through 1984 with an option to increase deliveries in 1981, 1982, and 1983.

13. At the time SDG&E entered into the 1979 Restated Agreement, the utility projected fuel savings of just $500,000 from the agreement.

14. The 1979 Restated Agreement eliminated the flexibility in contract volumes SDG&E had in the HIRI contract and substituted an inflexible take-or-pay obligation to Tesoro.

15. The utility's economic analysis showed the 1979 Restated Agreement reduced the probability of excess LSFO in 1979 and 1980 but increased the probability of excess LSFO in 1981 and 1982.

16. At the time SDG&E entered into the 1979 Restated Agreement, the perceived benefits did not outweigh the risks shown in the utility's own analysis.

17. SDG&E was preoccupied with the possibility of a $1/bbl penalty for rejecting cheaper natural gas when it entered the 1979 Restated Agreement.

18. SDG&E entered into the 1979 Restated Aggreement to shield its shareholders from the carrying costs of an excess LSFO inventory in 1979 and 1980.

19. SDG&E did not conduct adequate studies before entering into the 1979 Restated Agreement.

20. SDG&E did not follow the recommendations of the Gilbert Report before entering into the 1979 Restated Agreement.

21. At the time SDG&E entered into the 1979 Restated Agreement, the utility had not considered the possibility that more natural gas would be available than was forecast even though the utility's gas forecasting methodology had consistently understated the volumes of natural gas that became available in 1975, 1976, 1977, and 1978.

21. Because the revision date of November 1, 1983 is past, this interim order should take effect on the date of issuance.

Conclusions of Law

1. SDG&E was unreasonable in entering the 1979 Restated Agreement with Tesoro because at that time the perceived benefits did not outweigh the risks shown in the utility's own economic analysis.

2. SDG&E was unreasonable because the utility failed to conduct adequate studies before entering into the 1979 Restated Agreement.

3. SDG&E was unreasonable because the utility attempted to shield the shareholders from Commission penalties and the short-term carrying costs of excess LSFO inventory at the long-term expense of the ratepayers.

4. SDG&E was unreasonable because the utility failed to adequately consider the possibility that greater quantities of natural gas than were forecast would become available despite its past experience in understating gas availability.

5. Further hearings should be held to determine the amount of any disallowance.

INTERIM ORDER

IT IS ORDERED that:

1. On or after the effective date of this interim order, SDG&E shall file, in conformance with the provisions of General Order 96-A, revised tariff schedules reflecting the following rate adjustments:

(a) ECAC rate increase of .011¢/kWh.

(b) AER increase of .174¢/kWh.

(c) ERAM rate decrease of .426¢/kWh.

The revised tariff schedules shall take effect 5 days after filing.

2. Consistent with our recent decision in SDG&E's general rate case (D.83-12-065) the System Average Percentage Change Method will be used to allocate the above revenue changes among customer classes.

3. SDG&E and staff shall prepare and serve on all parties testimony on the consequences of the 1979 Restated Agreement within 20 days from today. This testimony will be received as evidence in further hearings and will be the basis for determining an appropriate disallowance.

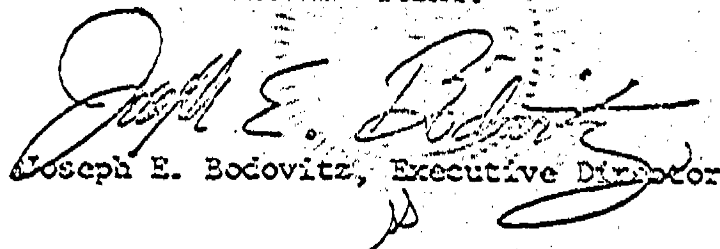
4. SDG&E's motion to overturn the ALJ's ruling on the 1979 Restated Agreement is denied.

This order is effective today.

Dated FEB 1 1984, at San Francisco, California.

LEONARD M. GRIMES, JR.
President
VICTOR CALVO
PRISCILLA C. GREW
DONALD VIAL
WILLIAM T. BAGLEY
Commissioners

I CERTIFY THAT THIS DECISION WAS APPROVED BY THE ABOVE COMMISSIONERS TODAY.



Joseph E. Bodovitz, Executive Director

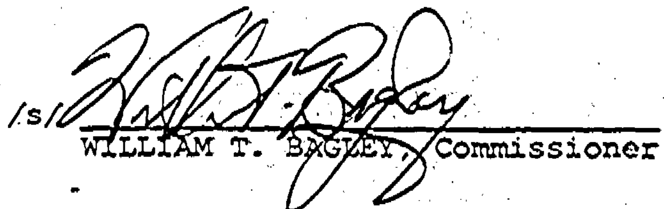
A.83-07-16
D.84-02-005

WILLIAM T. BAGLEY, Commissioner, concurring

I concur that there is a basis for the finding of "unreasonableness". Having made such a finding, the Commission now orders further hearings on the dollar amount at issue.

It would have been better to consider these two questions and to answer them in one proceeding. First of all, knowing the dollar amount would assist the Commission in determining the very question of reasonableness. Secondly, the bifurcated procedure exposes the utility, the ratepayer, and the investor to a period of financial uncertainty which benefits no one.

Pending our final decision, there will be speculation in the media and elsewhere as to the possible magnitude of "damages". Various gross amounts, the result of arithmetic rather than deliberation, will be mentioned all because the dollar amount is left open. Again, this uncertainty is helpful to no one, potentially harmful to all and could have been easily avoided by a single decision process.



/s/ WILLIAM T. BAGLEY, Commissioner

VI. Tesoro Suspension Agreement

Since we have found the underlying 1979 Restated Agreement to be unreasonable, the issues raised by the 1982 Tesoro Suspension Agreement now are moot. However, the Suspension Agreement did mitigate the losses imposed by the Restated Agreement and will be considered in our eventual calculation of a disallowance.

insert new sentences

Although we do not address the merits of staff's case attacking SDG&E's negotiation of the Suspension Agreement, we will state that SDG&E procedurally met its burden of proof on this matter. SDG&E provided all available documentation of its negotiation efforts and percipient witnesses to explain the transaction. The lack of more extensive documentation or the failure to call all possible percipient witnesses are matters left to SDG&E's judgment in the presentation of its case. This record is sufficient to render a decision.

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