Decision 84-12-026 December 5, 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)

(See Decision 84-02-005 for appearances.)

Additional Appearances

Pillsbury, Madison & Sutro, by Richard W. Odgers, Attorney at Law, for San Diego Gas & Electric Company, applicant.
John W. Witt, City Attorney, by Leslie J. Girard, Deputy City Attorney, for the City of San Diego, interested party.
Rufus G. Thayer, Attorney at Law, for the Commission staff.

FINAL OPINION

I. SUMMARY OF DECISION

We order the San Diego Gas & Electric Company (SDG&E) to refund $45,060,000 to its ratepayers. In our interim opinion, Decision (D.) 84-02-005, we found that SDG&E's 1979 Restated Agreement (Agreement) with Tesoro-Alaskan Petroleum Corporation (Tesoro) was unreasonable. This refund returns to the ratepayers some of the excessive fuel costs caused by the Agreement over the period July 1, 1982 to December 31, 1983. We do not disallow any expenses incurred over the January 1, 1979 to June 30, 1982 period to avoid adjustment of prior reported earnings for SDG&E.

We also grant the staff motion for disclosure and direct SDG&E to serve the documents which were the subject of the motion on all parties to this proceeding.

We deny SDG&E's motion to overturn the Administrative Law Judge's (ALJ's) evidentiary rulings. The ALJ properly excluded SDG&E prepared testimony which simply reargued the reasonableness of the Agreement. The ALJ also properly admitted staff testimony which sought to measure the actual consequences of the Agreement.

II. BACKGROUND

On February 1, 1984, the Commission issued an Interim Opinion, D.84-02-005, which found, inter alia, that SDG&E's Agreement with Tesoro was unreasonable. The Commission ordered that further hearings should be held to receive evidence on the actual consequences of the Agreement and the financial impact on SDG&E of a disallowance. The Commission wanted to consider this additional evidence before a disallowance is determined.

On February 3, 1984, the ALJ held a second Prehearing Conference (PHC) to schedule the further hearings ordered in D.84-02-005. At the start of this PHC, SDG&E made a motion to remove the ALJ as the assigned hearing officer for the proceeding. SDG&E presented a written Motion to Disqualify ALJ and asked that the PHC be continued until the motion was ruled upon. The ALJ denied SDG&E's request for a continuance and took the Motion to Disqualify ALJ under submission. A schedule was set for the mailing of prepared testimony and the further hearings. The ALJ also ordered SDG&E to disclose certain documents and other information related to fuel procurement for the period 1975-1983.

On March 1, 1984, SDG&E filed a Motion For Establishment of 10 Day Rule (Rule 68) As Basis For Filing of Prepared Testimony In

Penalty Phase Hearings. The ALJ instructed SDG&E to mail any completed testimony under the schedule set at the second PHC and to mail any additional testimony before the next PHC.

On March 2, 1984, SDG&E filed an Application For Rehearing of D.84-02-005. This application was referred to the Appellate Section of the Commission's Legal Division.

On March 5, 1984, the assigned Commissioner issued a ruling denying SDG&E's Motion To Disqualify ALJ. At the Commission's Meeting on March 7, 1984, the assigned Commissioner reported his ruling to the full Commission.

On March 19, 1984, the ALJ held a third PHC. At this PHC, the Commission staff asked for clarification on the scope of this phase of the proceeding. The staff argued that much of the testimony prepared by SDG&E for this phase of the proceeding relitigated issues already decided in the Interim Opinion, D.84-02-005. The staff then moved to exclude SDG&E's prepared testimony from this phase of the proceeding. The City of San Diego (City) joined in staff's motion. SDG&E responded that it was not attempting to relitigate D.84-02-005 in its prepared testimony and requested leave to submit by letter legal authorities supporting its position on the appropriate measure of damages. The ALJ allowed all parties to submit letters on the relevant legal authorities and took staff's motion under submission. In addition, the ALJ set a new hearing schedule to allow time for review of the parties' letters and a ruling on staff's motion.

On April 9, 1984, hearing was held to receive the testimony of two SDG&E witnesses: William A. Abrams and R. Lee Haney. Staff and City cross-examined these two witnesses.

On April 25, 1984, SDG&E filed a Petition Requesting Commission Ruling on Motion To Disqualify ALJ. In this petition, SDG&E requested that the full Commission approve or deny the assigned Commissioner's ruling issued March 5, 1984.

On May 2, 1984, the ALJ issued a ruling granting staff's and City's motion to exclude the prepared testimony of SDG&E witnesses John O'Leary, Arlon Tussing, and William Hughes. The ruling also excluded portions of SDG&E witness Michael Niggli's testimony. Staff had moved for the exclusion of Niggli's entire prepared testimony.

By letter dated May 21, 1984, SDG&E asked that the Commission defer a denial of its Application for Rehearing until after the Commission issues a decision on a disallowance. However, if the Commission was inclined to grant rehearing, then SDG&E said a deferral would be unnecessary. This request also was referred to the Appellate Section.

Additional hearings were held on May 22-24 and June 1, 1984. Testimony from SDG&E's remaining witness, Michael Niggli, and staff's witnesses, Russell Copeland and Ray Czahar, were received during these hearings. In addition, SDG&E witness Abrams sponsored some rebuttal testimony.

On May 22, 1984, the ALJ informed SDG&E that the full Commission at its March 7, 1984 Meeting already had confirmed the assigned Commissioner's ruling on SDG&E's Motion To Disqualify ALJ. Therefore, SDG&E's April 25, 1984 Petition Requesting Commission Ruling On Motion To Disqualify ALJ was moot. This is apparently in error since no minute order reflecting this action was entered. The ALJ further advised SDG&E that it must file an appeal of the assigned Commissioner's ruling if it intended to pursue this matter any further. No such appeal was filed nor was the matter raised in briefs. We hereby affirm the assigned Commissioner's ruling.

On the last day of hearing, June 1, 1984, SDG&E orally requested that the ALJ issue a proposed report pursuant to Rule 78. Rule 78 provides that a written petition for a proposed report shall be filed before the conclusion of hearing. However, staff and City did not object to SDG&E's oral request. At this time, SDG&E also stated that the company previously had given documents to Commissioners or their aides which had not been served upon the parties. Staff and City asked that these documents be produced and served upon the parties. The ALJ took this motion to compel discovery under submission.

Opening briefs were filed by SDG&E, staff, and City on July 9, 1984. Closing briefs were filed on July 23, 1984. The ALJ's Proposed Report was issued on September 14, 1984. Exceptions to the report were filed by SDG&E, staff, and City on October 4, 1984. Oral argument before the Commission en banc was held on October 29, 1984.

III. SUMMARY OF EVIDENCE

Additional evidence was received on two subjects: (1) the financial impact of a disallowance, and (2) disallowance calculations based on the actual consequences of the Agreement.

A. Financial Impact

1. SDG&E Evidence

SDG&E sponsored two witnesses on the financial impact of a disallowance: William Abrams and R. Lee Haney. Abrams is a vice president at Duff and Phelps, Inc., an investment research organization. Haney is a vice president and treasurer of SDG&E. Both witnesses testified that a disallowance based on the Agreement will have an adverse impact on SDG&E's credit rating and cost of capital.

Abrams explained how Duff and Phelps determines credit ratings and how SDG&E's credit rating would be affected by a disallowance. Abrams testified that credit ratings are based primarily on the financial integrity of the company. He stated that the stability and protection of the company's income stream are very important in measuring a company's financial strength. Abrams also testified that regulation is a key factor in judging a utility company. Regulation is evaluated by the company's ability to earn a realistic rate of return, the cash quality of earnings, the stability of earning trends, and moderation of the company's need to finance externally. Both the historical and the forecast financial performance of the company are considered here.

Abrams testified that recent Commission actions have raised concerns in the investment community about the company's financial risk. Abrams singled out the 1983 change of the Annual Energy Rate (AER) from 2% to 8%, the prudency review of SONGS 2 and 3 construction costs, the target capacity factor for SONGS 2, the rate base treatment of SONGS 1, and the ratemaking treatment of the Sun Desert plant site as examples of increased financial risk to SDG&E.

In Abrams' opinion, a disallowance due to the Agreement will have two significant impacts on SDG&E. First, a disallowance would raise interest expense since the common equity base would be reduced causing the capital structure to be more leveraged. Second, the investment community would regard a disallowance as a major signal of regulatory deterioration in California. This perception would engender the belief that SDG&E faces increased risk on all other matters before the Commission. Abrams further stated that this adverse opinion on California regulation could be applied to all electric and/or gas utilities in California, not just SDG&E.

Abrams concluded that any adverse decision in this proceeding would trigger a special review of SDG&E's credit rating. He warned that if SDG&E's rating is lowered, then SDG&E's financing costs could increase for some time.

Haney testified that any disallowance based on the Agreement will cast a cloud over the financial standing of SDG&E and every other California utility. In Haney's opinion, the financial community will perceive that the Commission may at any time penalize a utility for earlier actions even when those actions have gone unchallenged for years.

Haney also testified that investors seek out utilities for their stability in earnings. In his opinion, a disallowance in this proceeding could lead to renewed earnings volatility and could even precipitate a reversal of the company's steady financial progress.

Haney testified that any disallowance in this proceeding should be considered with the other significant regulatory issues facing SDG&E. The Commission should be aware that the combination of adverse decisions on the retention of SONGS 1 and the Sun Desert site in rate base and the prudency of SONGS 2 and 3 construction costs could have a harmful impact on the company's financial standing.

Haney suggested that if the Commission desires to minimize the impact on the company's cost of capital, then the earnings cap of 120 basis point adopted in D.83-08-048 could be used in this proceeding. This earnings cap, using the current authorized rate base of $1.7 billion and a 43% common equity ratio, is about $8.8 million.

Abrams also filed some rebuttal testimony in which he tried to quantify the impact of a disallowance on SDG&E after assuming that a refund had been ordered in 1983. If a disallowance of $65 million had been ordered by the Commission, Abrams estimated that the company's interest expense would have increased by $14.4 million to maintain a 3.0 times interest coverage. Abrams then concluded that such a refund to ratepayers would be a short-lived boon and a long-term increase to utility rates because of the increased interest expense.

2. <u>Staff Evidence</u>

Staff presented one witness on the financial impact of a disallowance on SDG&E, Ray Czahar. Czahar analyzed the impact of an assumed $70 million disallowance. He estimated that the after-tax impact of a $70 million disallowance on SDG&E would be $34.3 million.

Czahar first reviewed SDG&E's key financial indicators for the period 1978-1982. He then forecast SDG&E's cash generation capital requirements and external financing for the period 1984-1988. From this historical and prospective analysis, he determined that SDG&E's financial record has shown steady improvement from 1978-1982 and should continue to improve in future years.

Czahar then analyzed the impact of a $34 million reduction in 1984 common equity earnings on SDG&E. He found that this reduction would not severely alter SDG&E's financial position after 1984. He also found that a $70 million disallowance will not damage SDG&E's credit worthiness so that the utility's ability to deliver safe and reliable service to its customers is threatened.

In rejoinder to Abrams' rebuttal testimony, Czahar testified that if one includes the savings from a lowered common equity base in Abrams' calculation, then the net revenue increase attributable to a $65 million disallowance should amount to $2.2 million not $14.4 million. Czahar stated this would be a one-time revenue increase.

B. Disallowance Calculations

SDG&E presented one witness, Michael Niggli, on disallowance calculations. Staff also presented one witness, Russell Copeland, on this subject.

1. SDG&E Calculations

SDG&E's witness testified that although the company has prepared several calculations, the company believes that no disallowance is appropriate. After presenting each calculation, Niggli added the disclaimer that the calculation should not be used as the basis for a disallowance since the company believes no disallowance is appropriate. The company's efforts throughout this phase of the proceeding were devoted to a refutation of any evidentiary basis for a disallowance.

The first calculation prepared by SDG&E was $97 million. Niggli explained that this figure represented his initial estimate of the actual costs and benefits of the Agreement. In making this calculation, Niggli assumed that the different oil volumes taken under the Agreement could have been replaced by natural gas. Under this assumption, the Agreement could have increased SDG&E's fuel costs by $97 million.

Niggli immediately pointed out that his $97 million calculation was based upon the erroneous assumption that all additional oil volumes under the Agreement could have been replaced with natural gas. Niggli testified that due to supply flow limitations and power plant gas availability, natural gas could not have completely replaced oil in late 1981 and early 1982. If the actual availability of gas is considered, then his $97 million calculation is reduced to $47 million. The present value of the benefits and detriments underlying this figure, valued as of January 1, 1984, is $33 million.

In supplemental testimony, Niggli reduced this $33 million calculation by subtracting prior Commission disallowances of SDG&E fuel costs. Niggli subtracted a fuel disallowance of $6.88 million already ordered in D.82-12-056 and $13 million in unrecovered fuel oil carrying costs. These two adjustments on a present value basis amount to $26.5 million. The $33 million calculation minus these costs is $6.55 million.

Last, Niggli points out that the record already contains data which could be used as a punitive disallowance. In SDG&E's 1979 analysis of the Agreement's costs and benefits, the company had assumed a 50% probability of a $1 barrel penalty for rejected natural gas. Therefore, SDG&E maintains that an acceptable method for calculating a disallowance would be a $.50/barrel penalty for each additional barrel of oil (9.1 million barrels) the company agreed to take under the Agreement. Under this method, the disallowance would amount to $4.55 million. Again, SDG&E emphasizes that although the method exists, it does not believe any disallowance is justified or appropriate.

2. Staff Calculation

Staff witness Russell Copeland recommends a disallowance of $65,008,000.

Copeland first assumed that SDG&E had not signed the Agreement and instead received the low sulfur fuel oil (LSFO) volumes specified in the prior 1974 Tesoro contract, as amended. Copeland further assumed (1) that SDG&E could have burned all available natural gas from 1979-1983, (2) that SDG&E could have disposed of any excess LSFO on the spot market, and (3) that SDG&E could have acquired any needed LSFO above contract volumes on the spot market.

Under the above assumptions, Copeland calculated what SDG&E's total fuel costs would have been for the period 1979-1983 without the Agreement. The natural gas burn and the price of natural gas were derived from SDG&E's operating records and confirmed by data requests to SDG&E's natural gas supplier, the Southern California Gas Company. The amount of natural gas available to SDG&E from 1979-1983 and the price of that gas were taken from these recorded data. The disposal cost of LSFO and the acquisition price of LSFO on the spot market were derived from Lundberg Survey Inc. monthly reports on LSFO prices in Southern California. Here Copeland found that a range of LSFO prices is shown in the Lundberg reports. If one chose from this range the LSFO prices most favorable to SDG&E (high buying price, low selling price), Copeland found that a disallowance of $26,954,000 could be calculated. However, if one selected the LSFO prices least favorable to SDG&E (low buying price, high selling price), then a disallowance of $114,446,000 could be calculated. The range between these "minimum" and "maximum" calculations is $87.5 million.

Realizing that this variation was too large, Copeland refined his analysis. He compared SDG&E's recorded LSFO sales with Lundberg reported prices at the time of each sale. He found that SDG&E had sold its LSFO at a price 70¢ per barrel below the average sales price shown in the Lundberg reports. As a result, Copeland used the Lundberg average price minus 70¢ per barrel as SDG&E's disposal cost. Since Copeland could not find any recorded LSFO purchases by SDG&E to compare with the Lundberg reported prices, he used the Lundberg average price as SDG&E's acquisition price. With these refined disposal costs and acquisition prices for LSFO, Copeland calculated his recommended "mid-range" disallowance of $65,008,000. This figure represents the difference between SDG&E's recorded fuel costs with the Agreement and what SDG&E's fuel costs would have been without the Agreement under Copeland's assumptions.

Copeland also testified that under this method he has subtracted from his recommended disallowance a prior fuel-related penalty of $6.88 million already imposed by the Commission. (See D.82-12-056, pp. 31, 33.)

IV. POSITIONS OF THE PARTIES

A. SDG&E

SDG&E believes that no disallowance or penalty can be justified. Although the Commission in its Interim Opinion, D.84-02-005, asked for evidence on the actual consequences of the Agreement, SDG&E argues that the Commission has failed to identify a standard or alternative course of action which the company should have followed against which the actual consequences of the Agreement can be measured. For this reason, SDG&E submits the actual consequences of the Agreement cannot be determined.

SDG&E contends that the ALJ erred in excluding SDG&E's prepared testimony on the course of action that a reasonable and properly motivated utility would have followed in 1978-1979. Without this type of evidence, SDG&E submits that the Commission cannot fix a disallowance.

SDG&E further contends that the ALJ erred in admitting staff's testimony. SDG&E argues that the staff's calculated disallowance is based on an alternative course of action that realistically was not available to SDG&E. In addition, SDG&E asserts that the staff's disallowance is not limited to the consequences of the Agreement. SDG&E believes that the staff's evidence cannot serve any purpose in calculating the actual consequences of the Agreement and should have been stricken from the record.

Finally, SDG&E submits that any disallowance ordered by the Commission must be proportional to the wrongdoing identified in D.84-02-005. SDG&E states that the only wrongdoing identified in the decision was improper procedures and motivations. SDG&E argues that a penalty for improper procedures and motivations should not exceed the $4.55 million shareholder burden which SDG&E purportedly sought to avoid when it entered into the Agreement.

B. Staff

Staff submits that its proposed $65 million disallowance is the only calculation which covers all actual consequences of the Agreement. Staff further argues that its recommended disallowance should be adopted by the Commission since its financial analysis shows that a disallowance of $70 million will not have any lasting financial impact on SDG&E or on the ratepayers.

Staff contrasts SDG&E's evidence with its own showing on the financial impact of a disallowance.

Staff first describes SDG&E witness Abrams' testimony as nothing more than a general description of the securities rating procedures at Duff and Phelps. Staff then characterizes SDG&E

witness Haney's testimony as just a complaint about the Commission's adverse decision on the Agreement.

Staff asserts that its own witness Czahar has presented a well-disciplined analysis consisting of an historical evaluation of SDG&E's key financial indicators from 1978-1982, a forecast of cash generation, capital requirements, and external financing for the period 1984-1992, and a forecast of pre- and after-tax interest coverage from 1984-1988. From this analysis, the staff has concluded that SDG&E's financial outlook is very promising. SDG&E's financial position is so secure that staff believes a disallowance of $70 million will not severely alter SDG&E's financial standing after 1984. If a $70 million disallowance was imposed by the Commision in 1984, staff has found that although the utility's earnings and interest coverage would be lowered in 1984, SDG&E's basic financial position after 1984 would be largely unaffected.

Staff asserts that its affirmative forecast has been substantiated by SDG&E's directors. Staff points out that on May 21, 1984 the directors increased the quarterly common stock dividend 7.1% from 49¢ per share to 52.½¢ per share. Staff notes that SDG&E's directors authorized this dividend increase because they felt the company's financial position had improved despite the uncertainties of a disallowance due to the Agreement and the prudency review of SONGS 2 and 3 construction costs.

Staff submits that the inescapable conclusion to be drawn from the evidence in the record is that a disallowance on the order of $70 million will not materially impair SDG&E's improving financial prospects nor result in substantial adverse consequences to the ratepayer.

Staff next addresses the various calculations on the actual consequences of the Agreement.

Staff states that despite the Commission's clear directive in D.84-02-005, SDG&E has not presented any meaningful calculations in this phase of the proceeding. Staff claims that SDG&E ignored D.84-02-005 and instead chose to produce testimony by several consultants attacking the Commission's decision. Staff submits that this testimony was properly excluded by the ALJ.

In contrast to SDG&E's showing, staff asserts that its witness Copeland has presented a thorough analysis covering all possible consequences of the Agreement. Staff claims it has meticulously reviewed the company's operations on a day-by-day basis for the period 1979-1983. Staff claims that in this review it has compared SDG&E's actual recorded fuel costs with the Agreement against an extrapolation of the company's fuel costs without the Agreement. The staff chose not to look at the Agreement by itself because the source of LSFO (HIRI, Tesoro, spot market) is not distinguishable after it enters SDG&E's inventory. The staff believes that its method, unlike the company's simplistic calculations, has properly accounted for all consequences that may have flowed from the Agreement.

Staff maintains that the utility has not presented any calculation as an affirmative showing. Instead, SDG&E attempts only to disassociate itself from the $97 million calculation it had previously disclosed to the Commission. Staff notes that the company's witness has disavowed some of his own calculations when he testified that his $97 million figure was based upon incorrect assumptions.

Staff submits that the only well-reasoned calculation of a disallowance has been provided by the staff. The company's disavowal of its own figures simply underscores the unreliable methodology used by the company. The staff concludes that its disallowance of $65 million should be adopted by the Commission.

C. City

City believes that the staff presented the more credible evidence on the financial impact of a disallowance and on the consequences of the Agreement. Accordingly, City submits that the staff's recommended disallowance should be adopted. Alternatively, City suggests that the Commission may impose a disallowance based upon the economic difference between the Agreement and the underlying 1974 contract with Tesoro, as amended.

City asserts there is a need for a substantial disallowance in this proceeding. City concedes that SDG&E has changed its fuel procurement practices since 1979; however, City contends that a substantial disallowance is necessary to ensure that the company keeps current with the most advanced techniques. City also states that the company's shareholders should bear the economic burden of the Agreement so they will exert pressure on SDG&E's management to continually update the company's fuel procurement procedures.

City divides the financial impact of a disallowance into two categories: (1) the immediate dollar impact on SDG&E's balance sheet and the concurrent effect on the company's ability to provide service, and (2) the effect on the market's perception of the company's financial stability and the concurrent long-term effect on the company's ability to raise capital. City finds that while (1) is easy to measure, (2) is relatively difficult to determine.

City says the immediate impact of a $65-70 million disallowance on SDG&E's balance sheet has been shown in staff witness Czahar's direct testimony and SDG&E witness Abrams' rebuttal testimony. City finds staff's testimony to be more credible for several reasons. First, Czahar analyzed the impact of a disallowance in 1984 and later years through 1992. On the other hand, Abrams evaluated only the impact of a refund ordered in 1983. He conducted no analysis for 1984 or future years. Second, City points out

Abrams' calculation of a $14 million revenue increase to cover the increased interest expense was wrong. Czahar saw that Abrams had failed to include the financial consequences of a reduction in retained earnings. When this factor is considered, Abrams' calculated figure of $14 million drops to $2.2 million. City notes that Czahar's correction of Abrams' calculation was not challenged by SDG&E. Accordingly, City submits that Czahar has proven to be the more accurate and credible witness on this matter. Therefore, the Commission should find that a $70 million disallowance will not affect SDG&E's financial position.

Regarding the market's perception of a disallowance, City emphasizes that two major bond rating houses recently have upgraded SDG&E's rating on bonds, debt, and stock. These agencies raised SDG&E's credit ratings knowing that a disallowance as high as $100 million has been suggested in this proceeding. City also notes that SDG&E's stock has continued to sell above book value during this proceeding. To City, the financial market has demonstrated that SDG&E's financial outlook is sound despite the prospect of a substantial disallowance in this proceeding.

City believes there are two ways to calculate the actual consequences of the Agreement.

First, City asserts that staff witness Copeland's calculated disallowance fairly measures all the consequences of the Agreement. City finds that Copeland has compared the actual events under the Agreement with the course of action SDG&E reasonably could have followed without the Agreement. City asserts that each of Copeland's assumptions is reasonable. In City's view, SDG&E should have burned all natural gas that was available and sold more expensive LSFO on the spot market. City asserts that Copeland's recommended disallowance of $65 million is reasonable and should be adopted.

City describes a second way of calculating a disallowance as the economic difference between the Agreement and the underlying 1974 contract, as amended. In its brief, City has calculated this difference as $74 million based on data drawn from staff and SDG&E exhibits in the record.

City submits that a disallowance of $65 million or $74 million should be adopted by the Commission.

V. ISSUES

The issues raised in this phase of the proceeding are as follows:

1. Should the Commission's fixing of a disallowance be tempered by the financial impact on SDG&E and its ratepayers?
2. Which disallowance calculations best represent the actual consequences of the Agreement?
3. Did the ALJ err in excluding the prepared testimony of SDG&E's hired consultants and in admitting staff's testimony on the consequences of the Agreement?
4. Should the motion of staff and City to compel disclosure of documents be granted?

VI. DISCUSSION

A. Financial Impact

In our Interim Opinion, D.84-02-005, we stated at page 22 that "...we will consider the financial impact of a disallowance on SDG&E since the ratepayer ultimately may bear some of that impact." In response to this statement, both staff and SDG&E have presented testimony and evidence on this matter. However, the nature of the two presentations is very different.

SDG&E's direct testimony did not include any specific analysis of SDG&E's financial position or of the impact of a particular disallowance on SDG&E. Instead, this testimony was limited to general predictions of adverse consequences which lacked any reference to SDG&E's financial circumstances. For example, both witnesses proclaimed that a disallowance in this proceeding would lead to a market perception of regulatory decline in California which could adversely affect all California utilities. Clearly, both witnesses sought to avoid any examination of SDG&E's current financial position. One witness, Abrams, initially testified that it would be "impossible" to quantify the impact of a disallowance in advance. However, he later proceeded in his rebuttal testimony to quantify the impact of a $65 million refund made in 1983.

Even the general observations of financial decline offered by SDG&E's witnesses were made without the most rudimentary analysis. For example, one SDG&E witness testified that the Commission's Interim Opinion, D.84-02-005, signaled a change in the standard of review in California. Yet this same witness conceded that he had not read any other Commission decision which addressed the reasonableness and prudency of a utility's actions. An SDG&E witness also testified that the Commission's D.83-08-048 which raised SDG&E's AER from 2% to 8% increased SDG&E's risk of loss <u>without</u> any offsetting opportunity for gain. Yet, he made this judgment without conducting any review of the gains or losses experienced by SDG&E under its 2% AER even though he agreed this would be one analytic way of determining whether SDG&E actually faced any increased risk under the revised AER procedures. (It is interesting to note that on August 13, 1984, the Southern California Edison Company filed a Comparative AER Analysis For the Period May 1, 1983 through May 31, 1984 as ordered in D.83-08-048 and reported that its recorded AER revenues exceeded adopted revenues by $50 million. Clearly, the opportunity for utility gains under the Commission's revised AER procedures is substantial.)

SDG&E's predictions of financial gloom and doom have not been substantiated by the investment community. Rather, on April 4, 1984, the Wall Street Journal reported that both Moody's Investors Service, Inc. and Standard & Poor's Corp. raised SDG&E's credit ratings. These two rating agencies increased SDG&E's ratings with the full knowledge that a substantial disallowance could be imposed in this proceeding. SDG&E's Annual Report for 1983 which was released some time in March 1984 states that SDG&E expects the ALJ to recommend a substantial disallowance. And SDG&E representatives had visited both rating agencies several weeks before the upgrade was announced and informed the agencies that possible penalties as high as $100 million have been suggested in this proceeding. Clearly, both agencies determined that despite the prospect of a substantial disallowance in this proceeding, SDG&E's improved financial position warranted higher credit ratings.

The staff's presentation was markedly different from SDG&E's showing. Staff performed a detailed review of SDG&E's past financial performance and prepared an objective forecast of SDG&E's capital requirements in future years. Staff analyzed the impact of an assumed $70 million disallowance and found that a disallowance of this magnitude will not severely alter SDG&E's basic financial position after 1984. During cross-examination, the staff witness further stated that a disallowance up to $120 million will not have an adverse financial impact on SDG&E. In his opinion, SDG&E is in an excellent financial position with or without a disallowance because the construction of SONGS 2 and 3 now is completed and because SDG&E is able to normalize its income taxes.

The staff's presentation on the financial impact of a disallowance was complete and convincing. We are persuaded that SDG&E's financial position is so secure that our fixing of a disallowance up to $70 million should not be constrained by financial impact considerations.

We note that SDG&E submitted rebuttal testimony to the staff presentation after cross-examining the staff witness. In this testimony, SDG&E attempted to show that the adverse impact on the ratepayer of a $65 million disallowance in 1983 could be quantified at some $14.4 million a year in increased interest expense. The staff demonstrated that this figure was substantially overstated since it failed to include the decreased revenues due to lower equity costs. Even using SDG&E's assumption of the required interest coverage, the correct figure, taking into account lower equity costs and higher debt costs, is only $2.2 million. We recall that SDG&E's witness during cross-examination on his direct testimony stated that a disallowance would lower equity revenues and raise debt costs. However, his later submitted rebuttal testimony focused only on the higher debt costs. The failure of this witness to present a complete calculation reflects adversely on his assertions. Our findings on this issue are made with great confidence in the staff presentation. However, even absent the staff showing, we would find SDG&E's presentation to be unreliable and lacking in credibility.

B. Disallowance Calculations

We will address SDG&E's, staff's, and City's disallowance calculations in turn.

1. SDG&E

SDG&E has calculated figures ranging from $97 million to $4.55 million.

The $97 million figure was the first calculation made by SDG&E witness Niggli. This figure is based on the assumption that the lower and higher LSFO volumes stated in the Agreement respectively were replaced by natural gas and displaced available natural gas. However, Niggli subsequently found that the higher LSFO volumes in late 1981 and early 1982 could not have completely displaced natural gas. Therefore, according to Niggli, the $97 million ovestates the detriments attributable to the Agreement in late 1981 and early 1982.

The next figure explained by Niggli is a $33 million calculation. This figure takes into account the limited availability of natural gas in late 1981 and early 1982. In addition, the figure includes LSFO sales losses incurred during this same timeframe which are attributable to the Agreement. This figure purportedly is based upon a comparison of 1974 contract volumes, as amended, with the actual Tesoro deliveries. (However, the final contract volumes shown in Niggli's work papers do not match the recorded Tesoro deliveries shown in the company's data response.) Finally, for this calculation Niggli used present worth factors to value all calculated benefits and detriments of the Agreement on a January 1, 1984 basis.

We find several problems with this second figure. Apart from his inclusion of LSFO sales losses, it is apparent that Niggli has focused only on adjustments which will reduce his $97 million figure. Niggli testified that an exhaustive search and review of SDG&E's operating records revealed that natural gas could not have completely replaced the additional LSFO obligations assumed in the Agreement for late 1981 and 1982. Recognition of this limitation reduced the calculated detriments of the Agreement. On the other hand, Niggli declined to make similar adjustments for the "benefit" period of 1979 to mid-1981 when LSFO contract volumes were lowered.

For example, in January 1979, SDG&E did not burn any natural gas. Nonetheless, Niggli has included a benefit of $1,051,830 for this month based on the erroneous assumption that a lower LSFO volume in this month enabled SDG&E to burn more gas. In January 1981, SDG&E burned 267 MMcf of natural gas equivalent to about 40,000 barrels of LSFO. Yet Niggli has included a benefit in this month of replacing 164,300 barrels of LSFO with natural gas. Thus, he has overstated the actual benefits of the Agreement.

Furthermore, Niggli testified that he did not consider LSFO inventory levels in his calculation. If SDG&E had unused tank capacity, the company would have been able to burn available natural gas whether or not it was obligated to receive higher or lower LSFO volumes under the Agreement. Therefore, if SDG&E had enough tank capacity to store excess LSFO, the Agreement's lower volumes from 1979 to mid-1981 would not have enabled a greater gas burn.

Niggli did not consider such actual operating conditions which would have lowered his calculation of the benefits from the Agreement. Thus, Niggli has not applied a consistent methodology in deriving his $33 million figure. This figure is substantially understated since the calculated benefits have not been adjusted to reflect actual operating conditions in the same manner in which the calculated detriments were adjusted.

In his supplemental testimony, Niggli made two adjustments to his $33 million figure. First, he subtracted a prior disallowance of $6.88 million ordered in D.82-12-056 because the staff in its calculation had deducted this amount. Although Niggli in his rebuttal testimony completely repudiated the staff's methodology, he suggests that his figure should be adjusted in the same way staff's calculation was. Second, Niggli contends that some $13 million in unrecovered LSFO inventory carrying costs should also be recognized and subtracted. As discussed earlier, Niggli did not consider LSFO inventory levels in his method. Yet despite this omission he suggests it is reasonable to subtract the unrecovered carrying costs of excess LSFO to further reduce the $33 million figure. Both of these adjustments to the $33 million figure reveal SDG&E's intent to engage in whatever maneuvers that will lead to a lower disallowance figure. The inconsistent positions taken by SDG&E confirm our belief that SDG&E's evidence should be viewed with skepticism.

The last figure offered by Niggli is $4.55 million. As stated earlier, this figure is based on the shareholder burden that SDG&E was concerned about when it was evaluating the proposed Agreement. Since we have already found in D.84-02-005 that the

Agreement was unreasonable, it would be incongruous to limit the disallowance to an assumption in the underlying company analysis.

First, the 50% probability of a penalty assumed by SDG&E is inapplicable here. SDG&E's estimation of the likelihood of a Commission penalty is not binding on or relevant to the Commission's fixing of a disallowance.

Second, the one-dollar-per-barrel difference between LSFO and gas prices assumed by SDG&E as the potential penalty was just plain wrong.

SDG&E asserts that this difference between the Tesoro price for LSFO and the GN-5 rate for gas is in accord with D.90404, 1 CPUC 2d 596 (June 5, 1979). That decision addressed the reasonableness of certain LSFO sales losses in the record period June 1, 1977 to June 30, 1978. The Commission found that SDG&E had incurred an LSFO sales loss of $5,018,800 but realized some $19.3 million in excess gas revenues. The Commission then decided that SDG&E's electric ratepayers should not bear the burden of the LSFO sales loss and disallowed this amount minus the fuel cost savings from burning gas. (1 CPUC 2d at 629-630.) In effect, SDG&E's electric ratepayers were made indifferent to this transaction. And since at that time a Supply Adjustment Mechanism (SAM) was not in effect, SDG&E, not its gas ratepayers, retained the $19.3 million in excess gas revenues reduced by the disallowed sales loss. SDG&E's gas ratepayers were not affected by the transaction. Thus, the Commission previously was simply addressing the question of whether SDG&E should have retained all the benefits of the LSFO sale without bearing any of the costs.

The Agreement was made in an entirely different set of circumstances. First, a SAM was in effect; therefore, any excess gas revenues flowed through to the gas ratepayers and were not retained by SDG&E. Second, the Agreement obligated SDG&E to purchase additional LSFO which could displace less expensive gas. The Agreement raised SDG&E's total fuel costs. D.90404 addressed a sale of excess LSFO so that SDG&E could burn more gas. This transaction lowered the company's total fuel costs.

In D.90404, the Commission ensured that the ratepayers were made indifferent to the LSFO sales loss. To reach the same result for the ratepayers in this proceeding, the Commission must consider the actual cost of gas to SDG&E or the G-61 commodity rate. The difference between the G-61 rate and the Tesoro price during the period SDG&E was reviewing the proposed Agreement, January 1979 to May 1979, was:

	\$ 7.54/bbl	January 1979
	\$ 7.26/bbl	February 1979
	\$ 8.02/bbl	March 1979
	\$ 8.26/bbl	April 1979
	\$ 8.56/bbl	May 1979
Total	\$39.64/bbl	
Average	\$7.93/bbl	

If the average price difference is inserted in Niggli's suggested method, the shareholder burden which SDG&E's management should have foreseen under the Agreement is 9.125 million barrels x \$7.93/bbl = \$72,361,000.00. A disallowance of this amount would be proportional to the wrongdoing committed by SDG&E and would be an accurate measure of the risk that should have been foreseen in SDG&E's analysis of the proposed Agreement.

In summary, SDG&E's first calculation of \$97 million is based on a consistent method which uses the different contract volume requirements; however, it does not reflect actual operating conditions in the period 1979-1983. SDG&E's subsequent adjustment of this figure to reflect actual operating conditions in late 1981 and early 1982 was not based on a consistent methodology since similar adjustments were not made for the "benefit" period. Furthermore, the work papers for this adjusted figure conflict with SDG&E's data responses. Finally, SDG&E's last method of calculating a disallowance relies upon the company's earlier analysis of the Agreement. However, this analysis used incorrect assumptions which, if corrected, yield a disallowance figure of \$72 million.

2. Staff

Staff recommends a disallowance of $65 million. As discussed earlier, this figure is based on a reconstruction of SDG&E's fuel costs for the period 1979-1983 absent the Agreement.

SDG&E protests that the staff's method goes far beyond the actual consequences of the Agreement. We agree that staff has calculated "credits" and "penalties" on LSFO quantities which exceed the volume changes negotiated in the Agreement. However, this approach does not lead us to SDG&E's conclusion that the calculated disallowance is meaningless. Rather, we conclude that the staff method is a consistent calculation of what SDG&E's fuel costs would have been if SDG&E had burned all available natural gas from 1979-1983.

Staff determined that the primary consequence of the Agreement was the rejection of available natural gas from SDG&E's fuel mix. Staff decided not to confine its analysis to the incremental volume changes of the Agreement because staff was unable to determine the supplier source of LSFO in SDG&E's inventory and in its LSFO burn. Staff, unlike SDG&E, was unwilling to assume that the Agreement's lower LSFO contract volumes necessarily enabled a higher gas burn and that the Agreement's higher contract volumes necessarily resulted in gas rejections. Instead, staff predicated its method on SDG&E's recorded LSFO burn and the recorded availability of natural gas. Reliance on these two factors eliminates the need to determine whether the Agreement's incremental volumes actually replaced or displaced natural gas. Instead, the staff was able to calculate SDG&E's fuel costs based on a maximum gas burn. The staff method implies that the Agreement turned SDG&E's management away from a gas optimization fuel mix although it would have been reasonable for SDG&E to manage its resources in this manner from 1979-1983.

The critical assumptions underlying the staff figure are the disposal cost of LSFO and the acquisition price of LSFO in the spot market. As one can see from the range of figures calculated by the staff, the use of different LSFO prices can result in a figure as low as $27 million and as high as $114 million. However, we find that staff has selected the best available guidelines in determining from within this range what these disposal costs and purchase prices reasonably would have been.

We do find two flaws in the staff calculation. First, as pointed out by SDG&E, staff has used beginning-of-the-year present value factors rather than mid-year factors. We agree with SDG&E that use of the mid-year factors is appropriate. Second, we note that staff has limited its calculated penalties for gas rejection in the months of July 1980 and January 1981, to the LSFO volumes under the 1974 contract with Tesoro, as amended. The only reason offered by staff for this limitation is that staff did not want to penalize SDG&E for taking any HIRI LSFO. However, there is no valid reason why staff's method should be limited to the underlying 1974 contract volumes. The purpose of staff's method is to maximize the gas burn and to dispose of excess LSFO, regardless of its supplier. The staff's method does not imply that the level of the Tesoro 1974 contract volumes or the HIRI LSFO volumes were unreasonable but only that SDG&E should have disposed of this LSFO if it could be replaced with gas. If one corrects these two flaws, staff's calculation is reduced to $63,647,000.

3. City

The City's alternative calculation of $74 million is based on a hybrid approach. City has used SDG&E's exhibits and data responses to calculate what the benefits of the Agreement were from 1979 to mid-1981. City then draws upon the staff exhibit to determine what the detriments of the Agreement were from mid-1981 to 1983.

The City's approach is subject to the same criticisms we have made of SDG&E and staff calculation methods.

The City's determination of benefits from the Agreement is overstated to the extent it does not recognize the actual gas burn or take into account LSFO storage availability. The City has assumed like SDG&E that the Agreement's lower LSFO volumes from 1979 to mid-1981 enabled SDG&E to burn more gas. This has not been demonstrated on this record.

The City's determination of detriments from the Agreement does recognize SDG&E's actual operating conditions since it is taken from the staff calculation. However, the City also has used improper present value factors and limitations on gas rejections.

City has not explained why this hybrid approach is appropriate other than to say that in its view this is one way to measure the economic difference between the Agreement and the underlying 1974 contract with Tesoro, as amended.

4. The ALJ's Recommended Disallowance

The record now contains three disallowance figures which may be adopted by the Commission: $97 million, $72 million, and $63 million.

The $97 million figure increases slightly to $98 million if present value factors are used. Again, this figure is based on replacement fuel costs for the different LSFO volume requirements imposed by the Agreement. It is not based upon actual LSFO deliveries or the recorded availability of natural gas but refers only to the actual contract changes with Tesoro.

The second $72 million figure is drawn from SDG&E's proposal to disallow the risk or burden assumed by SDG&E in its analysis of the proposed Agreement. Under this method, SDG&E is penalized for the risk that it reasonably should have foreseen when it signed the Agreement.

The third $63 million figure is derived under the staff method from recorded data. This method assumes that absent the Agreement SDG&E could have managed its fuel mix to take advantage of all available natural gas. This method does incorporate SDG&E's recorded LSFO burn and the recorded availability of natural gas.

In addition to these three figures, the Commission may develop its own disallowance figure drawn from the considerable evidence received in the record for this proceeding. For example, we can see from SDG&E's data responses that in 1979 SDG&E had adequate storage capacity to accept the unreduced Tesoro LSFO volumes and still burn all available natural gas. Thus, the Commission may conclude that the Agreement actually resulted in no benefits in 1979 other than a lower LSFO inventory level. And of course since SDG&E's shareholders bore excess inventory carrying costs in 1979, the ratepayers would not have received any benefit of a reduced LSFO inventory in that year. As another example, the Commission could calculate what the benefits of the Agreement were by examining actual Tesoro deliveries from 1979 to mid-1981 rather than the final contract levels. Most of these refinements would raise a disallowance figure calculated by the parties.

The ALJ proposed that the Commission adopt a disallowance of $70 million to be refunded to SDG&E's ratepayers in its ECAC balancing account. In the ALJ's view, this recommended disallowance is towards the low end of the three disallowance figures that could be adopted. According to the ALJ, since some of these figures could be increased, it is a minimal figure, when viewed in the light of Czahar's financial analysis which indicates that a $70 million disallowance will not have a lasting financial impact on SDG&E, and that a disallowance as high as $120 million will not harm SDG&E.

5. <u>The Adopted Disallowance</u>

In our Interim Opinion, D.84-02-005, we directed the parties to submit calculations on the actual consequences of the Agreement. Although we found that the Agreement was unreasonable, at that time we did not know what the effects of the Agreement were apart from the $45 million in underlift payments made under the 1982 Tesoro Suspension Agreement. At that point we could have simply disallowed the $45 million in underlift payments. However, since SDG&E claimed it had entered into the Agreement to enable a greater gas burn in 1979 and 1980, we extended the proceeding to determine what fuel savings had occurred due to the lower contract volumes in those years. It was our expectation that consideration of the fuel savings would offset some of the underlift payments. This was not the case.

After reviewing SDG&E's records, we now know that the Agreement's lower volumes for 1979 did not enable a greater gas burn or any fuel savings. SDG&E could have accepted the original Tesoro volumes and still burned all available gas in 1979. Any excess LSFO could have been stored in SDG&E's inventory. (SDG&E's average LSFO inventory level in 1979 was 1.873 million barrels while its tank capacity was 3.8 million barrels.) By entering into the Agreement, SDG&E was able to reduce its LSFO inventory carrying cost in 1979. The Agreement's lower volume in that year did not affect the gas burn. However, in 1980 and the first half of 1981, SDG&E did realize some fuel savings due to the Agreement's lower volumes. Most of the savings occurred in the first half of 1981 because the oil/gas price differential unexpectedly had increased to $24-$30 per barrel.

After mid-1981, the Agreement's extended term raised SDG&E's fuel costs. The Agreement's higher volumes in the mid-1981 to 1983 period forced SDG&E to reject cheaper natural gas, to sell excess LSFO at a loss, and to pay underlift penalties to Tesoro. In addition, the Agreement increased SDG&E's inventory carrying costs over this period. From mid-1981, the Agreement increased SDG&E's fuel expenses.

There are several ways of quantifying the above consequences of the Agreement. The ALJ proposed a disallowance of $70 million. This recommendation is drawn from a range of $63 million to $97 million which he finds is established in the record. We agree that the Agreement has increased SDG&E's fuel costs over the

We recall the Commission's statement in D.92496 issued December 5, 1980 that adjustments to prior record periods "could be damaging to the financial standing of California utilities because of the corresponding assumption that reported earnings would be subject to possible adjustment for years in the future." (4 CPUC 2d 701.) By confining our consideration of the disallowance to the July 1, 1982 - December 31, 1983 period, we will avoid adjustment of prior reported earnings for SDG&E.

In reviewing the full range of figures developed in this record, we conclude that the only solid figure is the underlift penalty associated with the Suspension Agreement. In making a disallowance, we will not attempt a calculation for the record period months of July, August and September 1982, because we are not comfortable calculating a figure for the oil/gas differential for these months. However we know that from October 1, 1982 to December 31, 1983, SDG&E did not receive any LSFO from Tesoro and instead paid a $6.55/bbl underlift penalty, or a total of $45,060,000 in underlift penalties. This is the amount we will disallow.

We emphasize that we will continue to review discretionary utility actions and management decisions which affect expenses in a record period even though those actions and decisions may have been made at an earlier time. For example, the reasonableness of expenses paid pursuant to a particular long-term contract will be an issue not only initially as to whether the utility should have entered the contract at all, but further in each and every record period for which rate recovery is sought, and for which the contract is in effect. Otherwise, a utility could be encouraged to enter into contracts which may yield immediate benefits but over the contract term are imprudent. Recently, we addressed this very issue in reviewing the increased coal costs resulting from the renegotiation of Edison's contract with Utah International Corp., in Edison's 1982 reasonableness review proceeding. In our decision we concluded that "The price paid under the renegotiated Utah International coal supply contract was reasonable during the review period; Edison for future

1979-1983 period by at least $60 million,[1] and perhaps as high as $97 million. We are simply not comfortable with this range of figures.

We will confine our consideration of the disallowance to expenses caused by the agreement with Tesoro in the period July 1, 1982 to December 31, 1983. Although this record period concludes April 30, 1983, we have necessarily reviewed all of the costs related to SDG&E's Tesoro agreements in this proceeding. We choose not to adjust the balancing account for the period January 1, 1979 to June 30, 1982.

We are reluctant to make adjustments to the expenses incurred in record periods for which we already have issued decisions. We already have reviewed the January 1, 1980 to June 30, 1982 period and issued decisions on the reasonableness of expenses incurred over that time period. (See D.82-04-115 issued April 28, 1982 and D.82-12-056 issued December 13, 1982). While we have only partially reviewed the 1979 record period and have retained jurisdiction to disallow fuel related expenses for that prior period,[2] the Agreement itself did not affect fuel expenses in that year, and the exclusion of this period does not change the disallowance.

We also note that inclusion of this period would raise the calculated disallowance since the Agreement did not bring about any fuel savings in 1979. The realized fuel savings in 1980 and the first half of 1981 are substantially outweighed by the later expense from rejecting natural gas, the losses on excess LSFO sales, and the underlift payments to Tesoro in the July 1, 1981 to June 30, 1982 period. Consideration of the January 1, 1979 to June 30, 1982 period increases rather than decreases the disallowance which could be imposed on SDG&E.

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[1] Even SDG&E's calculation of $33 million increases to $60.5 million when the 1979 fuel savings is removed.

[2] See the "express reservation" provisions of D.91106 issued December 19, 1979 and D.91545 issued April 15, 1980.

reasonableness periods should bear the burden of proving the reasonableness of the price paid under the renegotiated terms." (D.84-09-120, mimeo. p. 98.)

To reiterate, our primary focus is the review of the reasonableness of expenses incurred by a utility during the record period, given the existence of the contract. To accomplish this task, it may be necessary to continuously reassess the reasonableness of the contract itself. This does not mean that long-term contracts are to be discouraged in favor of "flexible" short-term contracts or that the intrinsic benefits often embodied in long-term contracts will be disregarded for ratemaking purposes. We merely state the obvious: neither utility management nor utility regulators operate in a static environment. Both must act responsibly and responsively as circumstances change. As a previous Commission so aptly stated:

> "[The utility's] theory that once it is determined that it entered into a reasonable and prudent contract, its shareholders are absolved from all risks, is not correct in that it neglects the very important factor of changed cirumstances.
>
> "Whether or not a contract should remain in effect, be abrogated, or be renegotiated should be decided by utility management. It seems obvious that normally utility management will consider a change in the status quo only when there is an incentive for it to do so. If we pass through all expenses without determining their reasonableness simply because they have been contracted for, there would never be an incentive for utility review of such expenses. Our review of the reasonableness of contract expenses with the possibility of disallowance provides management incentive to incur only reasonable costs." (D.82-12-109 10 CPUC 2d 488, 492-493.)

We fully expect this disallowance will be the last of its type for SDG&E. SDG&E does have new procedures and new personnel in its fuel procurement department. We are confident that with these changes, current management has taken the steps necessary to avoid the kind of mistakes of the past that led to the Agreement causing this disallowance.

C. ALJ Rulings

SDG&E asks the Commission to overturn the ALJ's evidentiary rulings excluding some of SDG&E's prepared testimony and admitting staff testimony.

A review of the excluded testimony shows that it was prepared to reargue the reasonableness of the Agreement. SDG&E has read the Interim Opinion, D.84-02-005 to say only that SDG&E's procedures and motivations were unreasonable, not the Agreement. SDG&E's hired consultants then were instructed to determine whether absent these unreasonable procedures and motivations, SDG&E reasonably could have entered into the Agreement. Not surprisingly, each of the consultants has concluded that the Agreement was "reasonable."

D.84-02-005 clearly states that the Agreement was unreasonable based upon the facts known to SDG&E at the time it entered into the Agreement. After the Commission found that the Agreement itself was unreasonable, the Commission went on in D.84-02-005 to discuss some of the reasons why SDG&E entered into such an unreasonable Agreement. The Commission stated that SDG&E had not conducted adequate studies, SDG&E had not properly evaluated the uncertainty of its gas forecasts, and SDG&E had attempted to shield its shareholders from certain penalties at the expense of the ratepayers. The primary finding that the Agreement was unreasonable is not dependent on the latter discussion which identifies additional conduct by SDG&E that was unreasonable.

In short, SDG&E does not accept the plain meaning of D.84-02-005 and has sought in its excluded testimony to relitigate the reasonableness of the Agreement. The ALJ has properly excluded this evidence.

We observe that D.84-02-005 was issued after the receipt of testimony from the SDG&E officer who actually signed the Agreement in 1979. Such testimony is the best evidence that could be offered of the circumstances surrounding the Agreement. The testimony of hired consultants who did not participate in the negotiation or the signing of the Agreement would pale in comparison to the testimony of such a percipient witness.

SDG&E also argues that since the Interim Opinion did not describe an alternative course of action, the Commission has not yet determined that the Agreement was unreasonable, just SDG&E's procedures and motivations. There are many reasonable courses of action that SDG&E could have followed in 1979. The Agreement was not one of them. If this truly is not apparent to SDG&E , we must conclude that despite its loud claims of improvement, SDG&E's fuel management department has not progressed since 1979.

A reasonable and prudent utility manager would not have signed the Agreement that SDG&E did. As stated in D.84-02-055, SDG&E extended its Tesoro obligation beyond the expiration date to a period when it already had under contract adequate LSFO supplies from HIRI. SDG&E signed the Agreement when its probability analysis indicated that the different LSFO volumes created just offsetting risks of excess LSFO. SDG&E signed the Agreement when its own economic analysis predicted net fuel savings of just $500,000. And SDG&E signed the Agreement, whose primary benefit supposedly was a reduction of contract volumes in 1979 and 1980 to enable an increased gas burn, when the most recent projection of LSFO requirements cited by its witness showed that LSFO requirements exceeded the total supplier volumes without any reduction in contract volumes.

A reasonable and prudent utility manager would have undertaken a course of action in which the perceived benefits outweighed the risks. SDG&E did just the opposite.

A reasonable and prudent utility manager would have recognized in 1979 that since its forecasts were highly uncertain, the company should certainly maintain and strive to increase its fuel mix flexibility to allow for unexpected conditions. As stated in D.84-02-005, SDG&E unwisely gave up the flexibility it had under the HIRI contract when it signed the Agreement. SDG&E to this day does not acknowledge that it had any flexibility under the HIRI contract. Of course, SDG&E realizes now that reliance on the flexibility of the HIRI contract was one obvious alternative to the Agreement which would have substantially lowered its fuel costs.

SDG&E's narrow interpretation of the HIRI contract provisions is not supported by the facts. As can be seen in the following table, from 1974 to 1978 SDG&E was able to negotiate large reductions of the original contract volumes without paying any underlift charges to HIRI.

Table 1

HIRI Contract Requirements - MBBL Per Year

	1975	1976	1977	1978	1979	1980
8/74 Contract	6,278	7,665	10,512	10,512	10,512	10,512
11/74 Amend. 1	5,427	7,665	10,512	10,512	10,512	10,512
2/76 Amend. 2		6,768	10,512	10,512	10,512	10,512
8/76 Amend. 4			6,935	10,512	10,512	10,512
11/77 Amend. 6				6,132	10,512	10,512
5/78 Amend. 7				5,366	5,110	5,110

By 1979, SDG&E on five occasions was able to negotiate substantial volume reductions when it became apparent that it did not need as much LSFO as the contract required SDG&E to take.

Amendment No. 7 was in effect when SDG&E signed the Agreement. SDG&E's witness Niggli testified that in his opinion Amendment No. 7 increased the flexibility in volumes SDG&E already had under the HIRI contract. This opinion is confirmed by the fact that SDG&E was able to subsequently negotiate another large reduction in the minimum contract volumes without paying any underlift charges to HIRI.

As suggested in D.84-02-005, a prudent and reasonable utility manager would have relied upon the flexibility in the HIRI contract. SDG&E literally threw this flexibility away. The company should have known that it would have been better off not signing the Agreement. We do not say now or in D.84-02-005 that the only path

SDG&E reasonably could have followed in 1979 was adherence to the status quo. In D.84-02-005, we simply have found that the Agreement was an unreasonable alternative to the status quo. Based on the facts and circumstances existent in 1979, the Agreement was a step in the wrong direction. There are perhaps more reasonable courses of action the company could have followed rather than adhering to the status quo. However, SDG&E has not attempted to present these alternatives in its testimony and instead has tried only to reargue the reasonableness of the Agreement.[3]

On the other hand, staff has presented in its testimony an alternative to the Agreement which in staff's opinion was a reasonable course of action available to SDG&E in 1979. Staff has fully accepted the finding in D.84-02-005 that the Agreement was unreasonable; SDG&E clearly has not. For this reason, staff's evidence was properly admitted while SDG&E's evidence was excluded.

SDG&E's motion to overturn the ALJ's evidentiary rulings shall be denied.

E. <u>Disclosure of Documents</u>

SDG&E admits that it has given less than six documents to Commissioners or their aides which were not served upon the parties. SDG&E was unwilling to reveal the contents of these documents and stated only that they were distributed before the Commission issued D.84-02-005.

SDG&E has not denied the relevance of these documents to this phase of the proceeding. Accordingly, we must assume that they are relevant to the determination of a disallowance in this phase of the proceeding.

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[3] Although one SDG&E witness, William Hughes, does identify several alternatives to the Agreement, his prepared testimony is not a measurement of the likely consequences of these alternatives against the recorded costs under the Agreement. Rather, his testimony is limited to a determination that in late 1978 none of his selected alternatives seemed better than the Agreement.

Public Utilities Code (PUC) § 1705 requires this Commission to make findings of fact and conclusions of law based on evidence in the record. The parties are entitled to examine these documents so that they may assure themselves that the Commission has properly based its ultimate decision on the record. We will direct SDG&E to serve the documents on all parties.

Findings of Fact

1. A disallowance of $70 million will not severely alter SDG&E's financial position after 1984.

2. SDG&E's financial position is substantially improved since the construction of SONGS 2 and 3 is completed and the company is able to normalize its income taxes.

3. A disallowance of $70 million will not harm SDG&E's credit worthiness or threaten its ability to provide safe and reliable service to its customers.

4. SDG&E's evidence and testimony on the financial impact of a disallowance was not supported by any analysis of SDG&E's current financial condition and lacked credibility.

5. A disallowance figure of $97 million may be calculated based on the LSFO volume differences negotiated in the Agreement and subsequent contract amendments.

6. A disallowance figure of $72 million may be calculated based on the risk that was reasonably foreseeable to SDG&E when it signed the Agreement.

7. A disallowance figure of $63 million may be calculated based on a maximum burn of natural gas that was available to SDG&E from 1979-1983.

8. Some of the disallowance figures could be increased if SDG&E's actual operating conditions from 1979 to mid-1983 are recognized.

9. SDG&E's adjustments to the $97 million figure were limited to the detriment period of mid-1981 to 1983; SDG&E did not make similar adjustments for the benefit period of 1979 to mid-1981.

10. The ALJ proposes a disallowance of $70 million based on the range of disallowance figures in the record and the staff's financial analysis.

11. SDG&E in the testimony of its hired consultants attempted to reargue the reasonableness of the Agreement.

12. SDG&E has misread D.84-02-005 to say only that the company's procedures and motivations were improper.

13. D.84-02-005 clearly states that the Agreement was unreasonable based upon the facts known to SDG&E at the time it signed the Agreement.

14. SDG&E has informally distributed documents to Commissioners or their aides which were not served on all parties to this proceeding.

15. The assigned Commissioner issued a ruling denying SDG&E's petition to disqualify the ALJ in this proceeding.

16. To eliminate any uncertainty over the outcome of this proceeding, this order should take effect on the date of issuance.

17. A disallowance of $45,060,000.00 is appropriate based on the underlift payments ($6.65/Bbl) made by SDG&E to Tesoro from October 1, 1982 to December 31, 1983.

18. Disallowance of expenses incurred in prior record periods should be avoided so that a utility's reported earnings for those periods are not affected.

Conclusions of Law

1. The disallowance adopted in this decision is just and reasonable.

2. The ALJ's evidentiary rulings were correct.

3. SDG&E should serve upon the parties the documents that it has informally given to Commissioners or their aides.

4. The assigned Commissioner's ruling declining to disqualify ALJ Wu should be affirmed.

FINAL ORDER

IT IS ORDERED that:

1. San Diego Gas & Electric Company (SDG&E) shall refund to its ratepayers $45,060,000.00 as of January 1, 1985 through its Energy Cost Adjustment Clause balancing account.

2. SDG&E's motion to overturn the Administrative Law Judge's evidentiary rulings is denied.

3. SDG&E shall, within 10 days of the date of issuance of this order, serve upon all parties all documents it has distributed to Commissioners or their aides.

4. The assigned Commissioner's ruling is affirmed.

This order is effective today.

Dated DEC 5 1984, at San Francisco, California.

DONALD VIAL
President
VICTOR CALVO
PRISCILLA C. GREW
Commissioners

I dissent,
WILLIAM T. BAGLEY, Commissioner

I dissent,
FREDERICK R. DUDA, Commissioner

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

Joseph E. Bodovitz, Executive Director

In addition to these three figures, the Commission may develop its own disallowance figure drawn from the considerable evidence received in the record for this proceeding. For example, we can see from SDG&E's data responses that in 1979 SDG&E had adequate storage capacity to accept the unreduced Tesoro LSFO volumes and still burn all available natural gas. Thus, the Commission may conclude that the Agreement actually resulted in no benefits in 1979 other than a lower LSFO inventory level. And of course since SDG&E's shareholders bore excess inventory carrying costs in 1979, the ratepayers would not have received any benefit of a reduced LSFO inventory in that year. As another example, the Commission could calculate what the benefits of the Agreement were by examining actual Tesoro deliveries from 1979 to mid-1981 rather than the final contract levels. Most of these refinements would raise a disallowance figure calculated by the parties.

The ALJ proposed that the Commission adopt a disallowance of $70 million to be refunded to SDG&E's ratepayers in its ECAC balancing account. In the ALJ's view, this recommended disallowance is towards the low end of the three disallowance figures that could be adopted. According to the ALJ, since some of these figures could be increased, it is a minimal figure, when viewed in the light of Czahar's financial analysis which indicates that a $70 million disallowance will not have a lasting financial impact on SDG&E, and that a disallowance as high as $120 million will not harm SDG&E.

5. The Adopted Disallowance

In our Interim Opinion, D.84-02-005, we directed the parties to submit calculations on the actual consequences of the Agreement. Although we found that the Agreement was unreasonable, at that time we did not know what the effects of the Agreement were apart from the $45 million in underlift payments made under the 1982 Tesoro Suspension Agreement. We could have simply disallowed the $45 million in underlift payments. However, since SDG&E claimed it had entered into the Agreement to enable a greater gas burn in 1979 and 1980, we extended the proceeding to determine what fuel savings had occurred due to the lower contract volumes in those years. It was our expectation that consideration of the fuel savings would offset some of the underlift payments.

After reviewing SDG&E's records, we now know that the Agreement's lower volumes for 1979 did not enable a greater gas burn or any fuel savings. SDG&E could have accepted the original Tesoro volumes and still burned all available gas in 1979. Any excess LSFO could have been stored in SDG&E's inventory. (SDG&E's average LSFO inventory level in 1979 was 1.873 million barrels while its tank capacity was 3.8 million barrels.) By entering into the Agreement, SDG&E was able to reduce its LSFO inventory carrying cost in 1979. The Agreement's lower volume in that year did not affect the gas burn. However, in 1980 and the first half of 1981, SDG&E did realize some fuel savings due to the Agreement's lower volumes. Most of the savings occurred in the first half of 1981 because the oil/gas price differential unexpectedly had increased to $24-$30 per barrel.

After mid-1981, the Agreement's extended term raised SDG&E's fuel costs. The Agreement's higher volumes in the mid-1981 to 1983 period forced SDG&E to reject cheaper natural gas, to sell excess LSFO at a loss, and to pay underlift penalties to Tesoro. In addition, the Agreement increased SDG&E's inventory carrying costs over this period. From mid-1981, the Agreement increased SDG&E's fuel expenses.

There are several ways of quantifying the above consequences of the Agreement. The ALJ proposed a disallowance of $70 million. This recommendation is drawn from a range of $63 million to $97 million which he finds is established in the record. We agree that the Agreement has increased SDG&E's fuel costs over the

1979-1983 period by at least $60 million,[1] and perhaps as high as $97 million. However, as stated in D.84-02-005, we will determine an appropriate disallowance from these calculations and are not bound by the arithmetic results.

We will confine the disallowance to expenses incurred in the period July 1, 1982 to December 31, 1983. We choose not to adjust the balancing account for the period January 1, 1979 to June 30, 1982 for two reasons.

First, the inclusion of this period would raise the calculated disallowance since the Agreement did not bring about any fuel savings in 1979. The realized fuel savings in 1980 and the first half of 1981 are substantially outweighed by the later expense from rejecting natural gas, the losses on excess LSFO sales, and the underlift payments to Tesoro in the July 1, 1981 to June 30, 1982 period. To our surprise, consideration of the January 1, 1979 to June 30, 1982 period increases rather than decreases the disallowance which could be imposed on SDG&E.

Second, we are reluctant to make adjustments to the expenses incurred in record periods for which we already have issued decisions. We already have reviewed the January 1, 1980 to June 30, 1982 period and issued decisions on the reasonableness of expenses incurred over that time period. (See D.82-04-115 issued April 28, 1982 and D.82-12-056 issued December 13, 1982.) We have only partially reviewed the 1979 record period. (See the "express reservation" provisions of D.91106 issued December 19, 1979 and D.91545 issued April 15, 1980.) However, since the Agreement did not affect fuel expenses in that year, the exclusion of this period does not change the disallowance.

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[1] Even SDG&E's calculation of $33 million increases to $60.5 million when the 1979 fuel savings is removed.

We recall the Commission's statement in D.92496 issued December 5, 1980 that adjustments to prior record periods "could be damaging to the financial standing of California utilities because of the corresponding assumption that reported earnings would be subject to possible adjustment for years in the future." (4 CPUC 2d 701.) By confining the disallowance to the July 1, 1982-December 31, 1983 period, we will avoid adjustment of prior reported earnings for SDG&E.

We emphasize that we will continue to review discretionary utility actions and management decisions which affect expenses in a record period even though those actions and decisions may have been made at an earlier time. For example, the reasonableness of expenses paid pursuant to a particular long-term contract will be an issue not only initially as to whether the utility should have entered the contract at all, but further in each and every record period for which rate recovery is sought, and for which the contract is in effect. Otherwise, a utility could be encouraged to enter into contracts which may yield immediate benefits but over the contract term are imprudent. Recently, we addressed this very issue in reviewing the increased coal costs resulting from the renegotiation of Edison's contract with Utah International Corp., in Edison's 1982 reasonableness review proceeding. In our decision we concluded that "The price paid under the renegotiated Utah International coal supply contract was reasonable during the review period; Edison for future reasonableness periods should bear the burden of proving the reasonableness of the price paid under the renegotiated terms." (D.84-09-120, mimeo. p. 98.)

To reiterate, our primary focus is the review of the reasonableness of expenses incurred by a utility during the record period, <u>given the existence of the contract</u>. To accomplish this task, it may be necessary to continuously reassess the reasonableness of the contract itself. This does not mean that long-term contracts are to be discouraged in favor of "flexible" short-term contracts or that the intrinsic benefits often embodied in long-term contracts will be disregarded for ratemaking purposes. We merely state the obvious: neither utility management nor utility regulators operate in a static environment. Both must act responsibly and responsively as circumstances change. As a previous Commission so aptly stated:

> "[The utility's] theory that once it is determined that it entered into a reasonable and prudent contract, its shareholders are absolved from all risks, is not correct in that it neglects the very important factor of changed cirumstances.
>
> "Whether or not a contract should remain in effect, be abrogated, or be renegotiated should be decided by utility management. It seems obvious that normally utility management will consider a change in the status quo only when there is an incentive for it to do so. If we pass through all expenses without determining their reasonableness simply because they have been contracted for, there would never be an incentive for utility review of such expenses. Our review of the reasonableness of contract expenses with the possibility of disallowance provides management incentive to incur only reasonable costs." (D.82-12-109 10 CPUC 2d 488, 492-493.)

From July 1, 1982 to December 31, 1983, SDG&E incurred the following expenses due to the Agreement. In the months of July, August, and September 1982, SDG&E rejected 952,500 barrels equivalent of natural gas. The oil/gas price differential at this time was about $15. However, we will use the $7.93/bbl average difference calculated by the ALJ for the period January-May 1979. We believe that the disallowance should be limited to the price differential that was reasonably foreseeable when SDG&E entered into the Agreement. Accordingly, the disallowance for these three months is 952,500 barrels x $7.93/bbl = $7,553,325.00. From October 1, 1982 to December 31, 1983, SDG&E did not receive any LSFO from Tesoro but instead paid $6.55/bbl underlift penalty or a total of $45,060,000.00 in underlift penalties. This amount also is disallowed as a cost which was not reasonably incurred. The total disallowance then is $52,613,325.00. This amount shall be refunded to SDG&E's ratepayers through the balancing account effective January 1, 1984.

We fully expect this disallowance will be the last of its type for SDG&E. SDG&E does have new procedures and new personnel in its fuel procurement department. However, we are reminded that back in 1979 SDG&E had just received an outside consultant's review of its fuel management practices and nevertheless entered into the very Agreement causing this disallowance. Only over time will we know whether SDG&E actually has improved the substance of its management or whether it has simply changed appearances.

C. ALJ Rulings

SDG&E asks the Commission to overturn the ALJ's evidentiary rulings excluding some of SDG&E's prepared testimony and admitting staff testimony.

A review of the excluded testimony shows that it was prepared to reargue the reasonableness of the Agreement. SDG&E has read the Interim Opinion, D.84-02-005 to say only that SDG&E's procedures and motivations were unreasonable, not the Agreement. SDG&E's hired consultants then were instructed to determine whether absent these unreasonable procedures and motivations, SDG&E reasonably could have entered into the Agreement. Not surprisingly, each of the consultants has concluded that the Agreement was "reasonable."

D.84-02-005 clearly states that the Agreement was unreasonable based upon the facts known to SDG&E at the time it entered into the Agreement. After the Commission found that the Agreement itself was unreasonable, the Commission went on in D.84-02-005 to discuss some of the reasons why SDG&E entered into such an unreasonable Agreement. The Commission stated that SDG&E had not conducted adequate studies, SDG&E had not properly evaluated the uncertainty of its gas forecasts, and SDG&E had attempted to shield its shareholders from certain penalties at the expense of the ratepayers. The primary finding that the Agreement was unreasonable is not dependent on the latter discussion which identifies additional conduct by SDG&E that was unreasonable.

In short, SDG&E does not accept the plain meaning of D.84-02-005 and has sought in its excluded testimony to relitigate the reasonableness of the Agreement. The ALJ has properly excluded this evidence.

We observe that D.84-02-005 was issued after the receipt of testimony from the SDG&E officer who actually signed the Agreement in 1979. Such testimony is the best evidence that could be offered of the circumstances surrounding the Agreement. The testimony of hired consultants who did not participate in the negotiation or the signing of the Agreement would pale in comparison to the testimony of such a percipient witness.

SDG&E also argues that since the Interim Opinion did not describe an alternative course of action, the Commission has not yet determined that the Agreement was unreasonable, just SDG&E's procedures and motivations. There are many reasonable courses of action that SDG&E could have followed in 1979. The Agreement was not one of them. If this truly is not apparent to SDG&E , we must conclude that despite its loud claims of improvement, SDG&E's fuel management department has not progressed since 1979.

A reasonable and prudent utility manager would not have signed the Agreement that SDG&E did. As stated in D.84-02-055, SDG&E extended its Tesoro obligation beyond the expiration date to a period when it already had under contract adequate LSFO supplies from HIRI. SDG&E signed the Agreement when its probability analysis indicated that the different LSFO volumes created just offsetting risks of excess LSFO. SDG&E signed the Agreement when its own economic analysis predicted net fuel savings of just $500,000. And SDG&E signed the Agreement, whose primary benefit supposedly was a reduction of contract volumes in 1979 and 1980 to enable an increased gas burn, when the most recent projection of LSFO requirements cited by its witness showed that LSFO requirements exceeded the total supplier volumes <u>without</u> any reduction in contract volumes.

A reasonable and prudent utility manager would have undertaken a course of action in which the perceived benefits outweighed the risks. SDG&E did just the opposite.

A reasonable and prudent utility manager would have recognized in 1979 that since its forecasts were highly uncertain, the company should certainly maintain and strive to increase its fuel mix flexibility to allow for unexpected conditions. As stated in D.84-02-005, SDG&E unwisely gave up the flexibility it had under the HIRI contract when it signed the Agreement. SDG&E to this day does not acknowledge that it had any flexibility under the HIRI contract. Of course, SDG&E realizes now that reliance on the flexibility of the HIRI contract was one obvious alternative to the Agreement which would have substantially lowered its fuel costs.

SDG&E's narrow interpretation of the HIRI contract provisions is not supported by the facts. As can be seen in the following table, from 1974 to 1978 SDG&E was able to negotiate large reductions of the original contract volumes without paying any underlift charges to HIRI.

Table 1

HIRI Contract Requirements - MBBL Per Year

	1975	1976	1977	1978	1979	1980
8/74 Contract	6,278	7,665	10,512	10,512	10,512	10,512
11/74 Amend. 1	5,427	7,665	10,512	10,512	10,512	10,512
2/76 Amend. 2		6,768	10,512	10,512	10,512	10,512
8/76 Amend. 4			6,935	10,512	10,512	10,512
11/77 Amend. 6				6,132	10,512	10,512
5/78 Amend. 7				5,366	5,110	5,110

By 1979, SDG&E on five occasions was able to negotiate substantial volume reductions when it became apparent that it did not need as much LSFO as the contract required SDG&E to take.

Amendment No. 7 was in effect when SDG&E signed the Agreement. SDG&E's witness Niggli testified that in his opinion Amendment No. 7 increased the flexibility in volumes SDG&E already had under the HIRI contract. This opinion is confirmed by the fact that SDG&E was able to subsequently negotiate another large reduction in the minimum contract volumes without paying any underlift charges to HIRI.

As suggested in D.84-02-005, a prudent and reasonable utility manager would have relied upon the flexibility in the HIRI contract. SDG&E literally threw this flexibility away. The company should have known that it would have been better off not signing the Agreement. We do not say now or in D.84-02-005 that the only path SDG&E reasonably could have followed in 1979 was adherence to the status quo. In D.84-02-005, we simply have found that the Agreement was an unreasonable alternative to the status quo. Based on the facts and circumstances existent in 1979, the Agreement was a step in the wrong direction. There are perhaps more reasonable courses of action the company could have followed rather than adhering to the status quo. However, SDG&E has not attempted to present these alternatives in its testimony and instead has tried only to reargue the reasonableness of the Agreement.[2]

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[2] Although one SDG&E witness, William Hughes, does identify several alternatives to the Agreement, his prepared testimony is not a measurement of the likely consequences of these alternatives against the recorded costs under the Agreement. Rather, his testimony is limited to a determination that in late 1978 none of his selected alternatives seemed better than the Agreement.

On the other hand, staff has presented in its testimony an alternative to the Agreement which in staff's opinion was a reasonable course of action available to SDG&E in 1979. Staff has fully accepted the finding in D.84-02-005 that the Agreement was unreasonable; SDG&E clearly has not. For this reason, staff's evidence was properly admitted while SDG&E's evidence was excluded.

SDG&E's motion to overturn the ALJ's evidentiary rulings shall be denied.

E. Disclosure of Documents

SDG&E admits that it has given less than six documents to Commissioners or their aides which were not served upon the parties. SDG&E was unwilling to reveal the contents of these documents and stated only that they were distributed before the Commission issued D.84-02-005.

SDG&E has not denied the relevance of these documents to this phase of the proceeding. Accordingly, we must assume that they are relevant to the determination of a disallowance in this phase of the proceeding.

Public Utilities Code (PUC) § 1705 requires this Commission to make findings of fact and conclusions of law based on evidence in the record. The parties are entitled to examine these documents so that they may assure themselves that the Commission has properly based its ultimate decision on the record. We will direct SDG&E to serve the documents on all parties.

Findings of Fact

1. A disallowance of $70 million will not severely alter SDG&E's financial position after 1984.

2. SDG&E's financial position is substantially improved since the construction of SONGS 2 and 3 is completed and the company is able to normalize its income taxes.

3. A disallowance of $70 million will not harm SDG&E's credit worthiness or threaten its ability to provide safe and reliable service to its customers.

4. SDG&E's evidence and testimony on the financial impact of a disallowance was not supported by any analysis of SDG&E's current financial condition and lacked credibility.

5. A disallowance figure of $97 million may be calculated based on the LSFO volume differences negotiated in the Agreement and subsequent contract amendments.

6. A disallowance figure of $72 million may be calculated based on the risk that was reasonably foreseeable to SDG&E when it signed the Agreement.

7. A disallowance figure of $63 million may be calculated based on an maximum burn of natural gas that was available to SDG&E from 1979-1983.

8. Some of the disallowance figures could be increased if SDG&E's actual operating conditions from 1979 to mid-1983 are recognized.

9. SDG&E's adjustments to the $97 million figure were limited to the detriment period of mid-1981 to 1983; SDG&E did not make similar adjustments for the benefit period of 1979 to mid-1981.

10. The ALJ proposes a disallowance of $70 million based on the range of disallowance figures in the record and the staff's financial analysis.

11. SDG&E in the testimony of its hired consultants attempted to reargue the reasonableness of the Agreement.

12. SDG&E has misread D.84-02-005 to say only that the company's procedures and motivations were improper.

13. D.84-02-005 clearly states that the Agreement was unreasonable based upon the facts known to SDG&E at the time it signed the Agreement.

14. SDG&E has informally distributed documents to Commissioners or their aides which were not served on all parties to this proceeding.

15. The assigned Commissioner issued a ruling denying SDG&E's petition to disqualify the ALJ in this proceeding.

16. To eliminate any uncertainty over the outcome of this proceeding, this order should take effect on the date of issuance.

17. A disallowance of $52.6 million is appropriate if (1) the disallowance is limited to expenses incurred in the July 1, 1982 to December 31, 1983 period and (2) the disallowance is further limited to the risk that SDG&E reasonably should have foreseen when it signed the Agreement.

18. Disallowance of expenses incurred in prior record periods should be avoided so that a utility's reported earnings for those periods are not affected.

Conclusions of Law

1. The disallowance adopted in this decision is just and reasonable.

2. The ALJ's evidentiary rulings were correct.

3. SDG&E should serve upon the parties the documents that it has informally given to Commissioners or their aides.

4. The assigned Commissioner's ruling declining to disqualify ALJ Wu should be affirmed.

ORDER

IT IS ORDERED that:

1. San Diego Gas & Electric Company (SDG&E) shall refund to its ratepayers $52.6 million as of January 1, 1984 through its Energy Cost Adjustment Clause balancing account.

2. SDG&E's motion to overturn the Administrative Law Judge's evidentiary rulings is denied.

3. SDG&E shall, within 10 days of the date of issuance of this order, serve upon all parties all documents it has distributed to Commissioners or their aides.

Decision 84 12 026 DEC 5 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)

(See Decision 84-02-005 for appearances.)

Additional Appearances

Pillsbury, Madison & Sutro, by Richard W. Odgers, Attorney at Law, for San Diego Gas & Electric Company, applicant.
John W. Witt, City Attorney, by Leslie J. Girard, Deputy City Attorney, for the City of San Diego, interested party.
Rufus G. Thayer, Attorney at Law, for the Commission staff.

FINAL OPINION

I. SUMMARY OF DECISION

We order the San Diego Gas & Electric Company (SDG&E) to refund $52.6 million to its ratepayers. In our interim opinion, Decision (D.) 84-02-005, we found that SDG&E's 1979 Restated Agreement (Agreement) with Tesoro-Alaskan Petroleum Corporation (Tesoro) was unreasonable. This refund returns to the ratepayers some of the excessive fuel costs caused by the Agreement over the period July 1, 1982 to December 31, 1983. We do not disallow any expenses incurred over the January 1, 1979 to June 30, 1982 period to avoid adjustment of prior reported earnings for SDG&E.

On May 2, 1984, the ALJ issued a ruling granting staff's and City's motion to exclude the prepared testimony of SDG&E witnesses John O'Leary, Arlon Tussing, and William Hughes. The ruling also excluded portions of SDG&E witness Michael Niggli's testimony. Staff had moved for the exclusion of Niggli's entire prepared testimony.

By letter dated May 21, 1984, SDG&E asked that the Commission defer a denial of its Application for Rehearing until after the Commission issues a decision on a disallowance. However, if the Commission was inclined to grant rehearing, then SDG&E said a deferral would be unnecessary. This request also was referred to the Appellate Section.

Additional hearings were held on May 22-24 and June 1, 1984. Testimony from SDG&E's remaining witness, Michael Niggli, and staff's witnesses, Russell Copeland and Ray Czahar, were received during these hearings. In addition, SDG&E witness Abrams sponsored some rebuttal testimony.

On May 22, 1984, the ALJ informed SDG&E that the full Commission at this March 7, 1984 Meeting already had confirmed the assigned Commissioner's ruling on SDG&E's Motion To Disqualify ALJ. Therefore, SDG&E's April 25, 1984 Petition Requesting Commission Ruling On Motion To Disqualify ALJ was moot. This is apparently in error since no minute order reflecting this action was entered. The ALJ further advised SDG&E that it must file an appeal of the assigned Commissioner's ruling if it intended to pursue this matter any further. No such appeal was filed nor was the matter raised in briefs. We hereby affirm the assigned Commissioner's ruling.

On the last day of hearing, June 1, 1984, SDG&E orally requested that the ALJ issue a proposed report pursuant to Rule 78. Rule 78 provides that a written petition for a proposed report shall be filed before the conclusion of hearing. However, staff and City reasonableness periods should bear the burden of proving the reasonableness of the price paid under the renegotiated terms." (D.84-09-120, mimeo. p. 98.)

To reiterate, our primary focus is the review of the reasonableness of expenses incurred by a utility during the record period, <u>given the existence of the contract</u>. To accomplish this task, it may be necessary to continuously reassess the reasonableness of the contract itself. This does not mean that long-term contracts are to be discouraged in favor of "flexible" short-term contracts or that the intrinsic benefits often embodied in long-term contracts will be disregarded for ratemaking purposes. We merely state the obvious: neither utility management nor utility regulators operate in a static environment. Both must act responsibly and responsively as circumstances change. As a previous Commission so aptly stated:

> "[The utility's] theory that once it is determined that it entered into a reasonable and prudent contract, its shareholders are absolved from all risks, is not correct in that it neglects the very important factor of changed cirumstances.
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> "Whether or not a contract should remain in effect, be abrogated, or be renegotiated should be decided by utility management. It seems obvious that normally utility management will consider a change in the status quo only when there is an incentive for it to do so. If we pass through all expenses without determining their reasonableness simply because they have been contracted for, there would never be an incentive for utility review of such expenses. Our review of the reasonableness of contract expenses with the possibility of disallowance provides management incentive to incur only reasonable costs." (D.82-12-109 10 CPUC 2d 488, 492-493.)

We fully expect this disallowance will be the last of its type for SDG&E. SDG&E does have new procedures and new personnel in its fuel procurement department. WE ARE CONFIDENT THAT WITH THESE CHANGES, CURRENT MANAGEMENT HAS TAKEN THE STEPS NECESSARY TO AVOID THE KIND OF MISTAKES OF THE PAST THAT LED TO THE AGREEMENT CAUSING THIS DISALLOWANCE. ~~However, we are reminded that back in 1979 SDG&E had just received an outside consultant's review of its fuel-management practices and nevertheless entered into the very Agreement causing this disallowance.~~ Only over time will we know whether SDG&E actually has improved the substance of its management or whether it has simply changed appearances.

C. ALJ Rulings

SDG&E asks the Commission to overturn the ALJ's evidentiary rulings excluding some of SDG&E's prepared testimony and admitting staff testimony.

A review of the excluded testimony shows that it was prepared to reargue the reasonableness of the Agreement. SDG&E has read the Interim Opinion, D.84-02-005 to say only that SDG&E's procedures and motivations were unreasonable, not the Agreement. SDG&E's hired consultants then were instructed to determine whether absent these unreasonable procedures and motivations, SDG&E reasonably could have entered into the Agreement. Not surprisingly, each of the consultants has concluded that the Agreement was "reasonable."

D.84-02-005 clearly states that the Agreement was unreasonable based upon the facts known to SDG&E at the time it entered into the Agreement. After the Commission found that the Agreement itself was unreasonable, the Commission went on in D.84-02-005 to discuss some of the reasons why SDG&E entered into such an unreasonable Agreement. The Commission stated that SDG&E had not conducted adequate studies, SDG&E had not properly evaluated the uncertainty of its gas forecasts, and SDG&E had attempted to shield its shareholders from certain penalties at the expense of the ratepayers. The primary finding that the Agreement was unreasonable is not dependent on the latter discussion which identifies additional conduct by SDG&E that was unreasonable.

In short, SDG&E does not accept the plain meaning of D.84-02-005 and has sought in its excluded testimony to relitigate the reasonableness of the Agreement. The ALJ has properly excluded this evidence.

We observe that D.84-02-005 was issued after the receipt of testimony from the SDG&E officer who actually signed the Agreement in 1979. Such testimony is the best evidence that could be offered of not acknowledge that it had any flexibility under the HIRI contract. Of course, SDG&E realizes now that reliance on the flexibility of the HIRI contract was one obvious alternative to the Agreement which would have substantially lowered its fuel costs.

SDG&E's narrow interpretation of the HIRI contract provisions is not supported by the facts. As can be seen in the following table, from 1974 to 1978 SDG&E was able to negotiate large reductions of the original contract volumes without paying any underlift charges to HIRI.

HIRI Contract Requirements - MBBL Per Year

	1975	1976	1977	1978	1979	1980
8/74 Contract	6,278	7,665	10,512	10,512	10,512	10,512
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8/76 Amend. 4			6,935	10,512	10,512	10,512
11/77 Amend. 6				6,132	10,512	10,512
5/78 Amend. 7				5,366	5,110	
5,110						

substantial volume reductions when it became apparent that it did not need as much LSFO as the contract required SDG&E to take.

Amendment No. 7 was in effect when SDG&E signed the Agreement. SDG&E's witness Niggli testified that in his opinion Amendment No. 7 increased the flexibility in volumes SDG&E already had under the HIRI contract. This opinion is confirmed by the fact that SDG&E was able to subsequently negotiate another large reduction in the minimum contract volumes without paying any underlift charges to HIRI.

As suggested in D.84-02-005, a prudent and reasonable utility manager would have relied upon the flexibility in the HIRI contract. SDG&E literally threw this flexibility away. The company should have known that it would have been better off not signing the Agreement. We do not say now or in D.84-02-005 that the only path

Public Utilities Code (PUC) § 1705 requires this Commission to make findings of fact and conclusions of law based on evidence in the record. The parties are entitled to examine these documents so that they may assure themselves that the Commission has properly based its ultimate decision on the record. We will direct SDG&E to serve the documents on all parties.

Findings of Fact

1. A disallowance of $70 million will not severely alter SDG&E's financial position after 1984.

2. SDG&E's financial position is substantially improved since the construction of SONGS 2 and 3 is completed and the company is able to normalize its income taxes.

3. A disallowance of $70 million will not harm SDG&E's credit worthiness or threaten its ability to provide safe and reliable service to its customers.

4. SDG&E's evidence and testimony on the financial impact of a disallowance was not supported by any analysis of SDG&E's current financial condition and lacked credibility.

5. A disallowance figure of $97 million may be calculated based on the LSFO volume differences negotiated in the Agreement and subsequent contract amendments.

6. A disallowance figure of $72 million may be calculated based on the risk that was reasonably foreseeable to SDG&E when it signed the Agreement.

7. A disallowance figure of $63 million may be calculated based on an maximum burn of natural gas that was available to SDG&E from 1979-1983.

8. Some of the disallowance figures could be increased if SDG&E's actual operating conditions from 1979 to mid-1983 are recognized.

9. SDG&E's adjustments to the $97 million figure were limited to the detriment period of mid-1981 to 1983; SDG&E did not make similar adjustments for the benefit period of 1979 to mid-1981.

10. The ALJ proposes a disallowance of $70 million based on the range of disallowance figures in the record and the staff's financial analysis.

11. SDG&E in the testimony of its hired consultants attempted to reargue the reasonableness of the Agreement.

12. SDG&E has misread D.84-02-005 to say only that the company's procedures and motivations were improper.

13. D.84-02-005 clearly states that the Agreement was unreasonable based upon the facts known to SDG&E at the time it signed the Agreement.

14. SDG&E has informally distributed documents to Commissioners or their aides which were not served on all parties to this proceeding.

15. The assigned Commissioner issued a ruling denying SDG&E's petition to disqualify the ALJ in this proceeding.

16. To eliminate any uncertainty over the outcome of this proceeding, this order should take effect on the date of issuance.

17. A disallowance of 45,060,000.00 is appropriate based on the underlift payments ($6.65/Bbl) made by SDG&E to Tesoro from October 1, 1982 to December 31, 1983.

18. Disallowance of expenses incurred in prior record periods should be avoided so that a utility's reported earnings for those periods are not affected.

<u>Conclusions of Law</u>

1. The disallowance adopted in this decision is just and reasonable.

2. The ALJ's evidentiary rulings were correct.

3. SDG&E should serve upon the parties the documents that it has informally given to Commissioners or their aides.

4. The assigned Commissioner's ruling declining to disqualify ALJ Wu should be affirmed.

O R D E R

IT IS ORDERED that:

1. San Diego Gas & Electric Company (SDG&E) shall refund to its ratepayers $45,060,000.00 as of January 1, 1984 through its Energy Cost Adjustment Clause balancing account.

2. SDG&E's motion to overturn the Administrative Law Judge's evidentiary rulings is denied.