ALJ/GLW/btr

Decision 89 08 027 AUG 3 1989

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

ORIGINAL

Application of Pacific Gas and Electric Company to assume certain contingent liabilities pursuant to the Agreement between the Pacific Gas and Electric Company and the Southern San Joaquin Valley Power Authority for Transmission Capacity.

(U 39 E)

Application 88-04-013
(Filed April 5, 1988)

Bruce R. Worthington, Stuart K. Gardiner, and Mark R. Huffman, for Pacific Gas and Electric Company, applicant.
Severson, Werson, Berke & Elchior, by Steven W. Waldo, Attorney at Law, for Shasta Dam Area Public Utility District, protestant.
Kronick, Moskovitz, Tiedemann & Hirard, by Edward J. Tiedemann, Attorney at Law, for Southern San Joaquin Valley Power Authority; Marron, Reid & Sheehy, by Melanie S. Best, for Transmission Agency of Northern California; and Law Office of Dian M. Grueneich by Barry Epstein, Attorney at Law, for Positive Resolution of Powerline Problems; interested parties.
James Scarff, Attorney at Law, and Mike Burke, for the Division of Ratepayer Advocates; and Douglas Long, for the Commission Advisory and Compliance Division.

OPINION

I. Summary

This decision grants Pacific Gas and Electric Company (PG&E) authority pursuant to Public Utilities (PU) Code § 830 to assume certain contingent liabilities under the "Agreement Between

Pacific Gas and Electric Company and the Southern San Joaquin Valley Power Authority For Transmission Capacity" (Agreement).

II. Background

In April 1988 PG&E applied for authorization, pursuant to PU Code § 830, to assume certain contingent liabilities under the Agreement between PG&E and the Southern San Joaquin Valley Power Authority (Authority).

A prehearing conference was held on July 21, 1988. At the prehearing conference Administrative Law Judge (ALJ) Wheatland ruled regarding the scope of this proceeding. He ruled that the Commission would not conduct a general inquiry into the prudence of the overall agreement, nor a general inquiry into the prudence of the California Oregon Transmission (COT) Project itself. The parties were permitted to introduce evidence regarding the nature of the transaction, the effect of the Agreement on the financial condition of PG&E and the effect of this contract on municipal bypass of PG&E's system.

Based on these rulings, PG&E, the Division of Ratepayer Advocates (DRA), and the Authority filed prepared testimony. A hearing was held on February 27, 1989. Following the hearing, the parties filed concurrent opening and concurrent reply briefs. The matter was submitted upon filing of reply briefs on March 17, 1989.

III. Summary of the Evidence

A. The California Oregon Transmission (COT) Project

In 1984 several California utilities (both municipal and investor owned), the Authority, the California Department of Water Resources and the Western Area Power Administration (WAPA) executed a memorandum of understanding (MOU). The MOU proposed the construction of a 500 kV transmission line between Oregon and

California. As a condition of approving federal participation in the project, the U.S. Secretary of Energy required that a 3.125% share of the COT Project be allocated to certain local government agencies who had previously expressed an interest in participating in the COT Project, but who had not received a share of the project in the original MOU. In 1985, WAPA allocated a portion of this share to the Authority. The Authority is a joint power agency which was expressly established for the purpose of participating in the COT Project.

The Authority has agreed to become a participant in the COT Project, agreeing to construct, finance, and own 2.0625% of the COT Project transfer capability. The Authority plans to finance its share of the project through the issuance of long-term fixed-rate taxable debt of $8 to $10 million.

B. Formation of the Agreement

While the Authority was a customer of PG&E, it was not an electric utility. Therefore, after it received a share of the proposed transmission project, certain legislation was introduced into the California Legislature which would permit the authority to operate as a utility.

At the same time that the Authority sought to enter the utility business, it approached PG&E with an offer to assign its allocation to PG&E in return for a discount on its electric rates. After negotiations, PG&E and the Authority entered into the Agreement, dated February 12, 1988, which is the subject of this proceeding.

C. Summary of the Agreement

Under the Agreement, the Authority proposes to assign the exclusive use of its project transfer capability (transmission rights) to PG&E, in exchange for certain payments from PG&E, referred to as Project Benefit Payments (PBP). The PBP, which will commence upon the commercial operation of the COT Project, is based on the difference between the cost of retail electric power to the

Authority's members and the cost to them if they obtained their electric power through use of the Authority's transmission rights, purchasing needed support services from PG&E.

Under § 5.3.2 of the Agreement, if the PBP for any year is less than the annual financing cost of the debt securities issued to finance the Authority's share of the project, the Authority may elect to convey title of its interest in the COT Project to PG&E. If title to the Authority's interest is conveyed, PG&E would also assume all liability for the Authority's debt obligations used to finance its share of the project. The PBP is estimated to be less than the cost of debt in the first year after commercial operation of the COT Project and each year thereafter.

The Authority also has the right to convey title and related liabilities to PG&E if a court or regulatory body finds a provision of the PBP invalid, thereby lowering the PBP or adversely affecting the assignment of the COT Project transfer capability to PG&E.

The Agreement becomes effective upon Commission approval pursuant to PU Code § 830. PG&E is not obligated to make payments or assume liabilities under the Agreement until after the commercial operation of the COT Project.

Each of the parties seem to see the general nature and purpose of the contract differently.

To PG&E this Agreement has two primary advantages:

1. PG&E will retain the ability to sell power at retail to the Authority's members, and

2. PG&E will have use of additional transmission capacity to the Pacific Northwest.

From the Authority's perspective, the nature of the Agreement is that of a 20-year lease of transmission capacity:

> "While the Agreement includes a detailed formula for determining the annual Project Benefit Payments (the PBP) to be paid by PG&E to the Authority, the Agreement is really a relatively

simple one in its essential terms...in which the Authority will lease to PG&E for twenty years the use of its project transfer capability for annual payments, but the Agreement requires Commission approval because under certain contingencies PG&E may be required to assume the Authority's indebtedness for its share of the capital costs of the Project."

To DRA, the Agreement is structured to "appear as if PG&E were merely leasing" the Authority's transmission capacity, but is in fact a discount on a retail tariff. Although Authority members would continue to pay PG&E the retail tariff rate, DRA argues, the PBP serves as a kickback. DRA stresses that the price for leasing transmission capacity is normally based on the embedded cost of the line, but in this Agreement, the price PG&E would pay for using the COT Project capacity bears no relation whatsoever to the embedded cost of the line. Therefore, DRA views the Agreement as providing a special discounted retail rate, disguised as a lease payment.

IV. Discussion

A. Financial Effects of the Agreement

PU Code § 830 provides:

"No public utility shall assume any obligation or liability as guarantor, endorser, surety, or otherwise in respect of the securities of any other person, firm, or corporation, when such securities are payable at periods of more than 12 months after the date thereof, without having first secured from the Commission an order authorizing it so to do. Every such assumption made other than in accordance with the order of the Commission authorizing it is void."

The power of public utilities to issue evidence of indebtedness, to create liens on their property or to assume or guarantee liabilities of others is recognized under California law

to be a special privilege, subject to regulation and control of the Commission. (PU Code § 816.)

PG&E's witness, Mr. Richard Miram, described the Agreement in his prepared testimony. Under the Agreement, PG&E assumes a contingent liability. Under § 5.3.2 of the Agreement, the Authority may require PG&E to assume its financial costs for its share of the COT Project. This financial cost is estimated to be approximately $10 million.

Another PG&E witness, Ms. Laura Gilmore, addressed the financial impact to PG&E if PG&E were required to assume the liability contained in the Agreement. Ms. Gilmore assumed debt at an 11.5% interest rate, for a term of 20 years, and that the financial structure, business and operating conditions for PG&E in 1992 (when the Agreement is assumed to be effective) are the same as those reflected in PG&E's 1987 end of year financial statements. Ms. Gilmore analyzed two scenarios: A most likely scenario, in which PG&E assumes the authority's debt of $10.3 million and PG&E is allowed to include the interest expense in rates; and a worst case scenario, in which the COT Project incurs a 50% cost overrun, PG&E assumes a debt of $15.4 million and PG&E is not allowed to include the interest expense in rates.

Ms. Gilmore concluded that even under the worst case scenario, PG&E's assumption of this debt would have no effect on PG&E's debt rating or ability to raise additional capital.

DRA does not dispute that $10 to $15 million in additional debt will have no significant effect on PG&E's debt structure. However, DRA questions whether Ms. Gilmore's worst case scenario captures the potential liability to PG&E. First, DRA notes correctly that nothing in the agreement limits PG&E's liability to a particular number. However, DRA does not suggest that PG&E's liability could exceed the estimate by 50%. In the absence of such evidence, we find PG&E's worst case scenario to be reasonable.

Second, DRA states that PG&E could be liable for the Authority's COT Project operations and maintenance expenses (O&M). DRA claims that PG&E did not quantify these costs. In response, PG&E characterizes DRA's assertion as a "flight of fancy":

> "Since DRA did not ask the question, PG&E did not realize that DRA wanted to address the issue. There is simply no way, based on the existing record, to answer the question of whether O&M costs were included in PG&E's analysis of its possible assumption of the contingent liability."

We are not satisfied with PG&E's response to DRA. Since the contract itself clearly imposes potential liability for O&M costs, the burden rests on the Applicant, not DRA, to quantify the potential impacts of this liability and to reflect this analysis on the record. In the absence of such a showing, the only reasonable inference to be drawn from the record, is that PG&E did not include these costs in its analysis of the contingent liability. Although PG&E has failed to clarify whether O&M costs were included in its analysis of the possible assumption of contingent liability, such a failure is not sufficient grounds for rejecting the application. We cannot conceive of circumstances, even under PG&E's worst case scenario, where the assumption of O&M expenses for this share of the transmission project could materially affect PG&E's financial well-being.

Third, DRA states that PG&E could assume indirect liability for the Authority's share of any costs for improving the transmission system "South of Tesla." PG&E responds that a reading of the Agreement shows that the contract does not obligate PG&E to finance the South of Tesla improvements. We agree with PG&E that the contract does not obligate PG&E to assume liability, directly or indirectly, for improvements to the transmission system South of Tesla. Assuming, for the sake of argument, that the costs of such improvements were incurred in the overall project costs, PG&E's

worst case scenario should capture the potential impact of this added cost.

In summary, we find that the potential assumption by PG&E of the liability of the Authority, pursuant to the terms of the agreement will not have any effect on PG&E's debt rating, financial condition or ability to raise capital.

B. Reasonableness of the Overall Agreement

Throughout this proceeding, DRA has argued strenuously for a broad review of the reasonableness of the overall agreement. DRA argued at the second prehearing conference that the Commission should consider the instant application in the context of the economics of PG&E's participation in the entire COT Project. After careful consideration of the arguments of the various parties, ALJ Wheatland ruled that the prudency of the COT Project and the prudency of the overall contract would not be reviewed in this proceeding.

Despite this ruling, DRA's prefiled written testimony continued to argue for broadening the scope of this proceeding. PG&E moved to exclude these portions of DRA's testimony. The motion was granted.

DRA's Opening Brief further argues for a broad review of the reasonableness of the overall agreement. DRA contends that the project benefits are unreasonable and that such payments represent special contract rates. DRA also challenges the value of the transmission rights to be obtained by PG&E and asserts that PG&E has made no showing of need for this transmission capacity. DRA continues to insist that consideration of these issues should not be deferred until a subsequent Energy Cost Adjustment Clause (ECAC) proceeding.

PG&E has responded to DRA by correctly observing that the Commission typically limits the scope of § 830 proceedings to an examination of the impact of the proposed transaction on the utility's financial structure. If the proposed transaction will

not adversely affect the financial soundness of the utility, the Commission typically reserves the right to review the prudence of the transaction at a later date. For example, in Decision (D.) 85-07-012 we authorized San Diego Gas & Electric Company (SDG&E) to engage in tax-exempt industrial development revenue bond financing of up to $150,000,000, including the unconditional guarantee of the obligations of the City of San Diego and others participating in the financing. Although the proceeds of this financing would be used for various capital expenditures, we did not review the prudence of these expenditures. Instead, we expressly stated that we did not, by that decision, determine that SDG&E's construction budgets are necessary or reasonable for ratemaking purposes. These issues are normally tested in general rate proceedings.

Similarly, in this proceeding, there is no need to review the prudence of the debt of the Authority which PG&E will guarantee. If the COT Project is eventually constructed and if ownership of the Authority's transmission rights and liabilities is assumed by PG&E, PG&E will be required to obtain Commission approval before the costs of acquisition may be placed in rates. And if the COT Project is constructed and if PG&E makes project benefit payments to the Authority, PG&E will be required to demonstrate the prudence of such payments before they are recovered in rates.

We must reject DRA's suggestion that it would be more efficient to review the reasonableness of the agreement at this time. Until such time as the scope, timing, cost and necessity of the COT Project is fully defined, we have insufficient information to determine the value of the Authority's transmission capacity.

Thus, as PG&E's counsel stated, § 830 approval does not grant the utility a right to subsequently recover any costs that are incurred under the Agreement. PG&E remains at risk for

justifying these costs in a subsequent prudency review "and," he said, "we are prepared to do so." (PHC-2, p. 35.)

C. DRA's legal objections

Apart from § 830, DRA's Opening Brief raises various legal objections to approval of the Agreement. First, DRA argues that the PBPs represent special contract rates which require prior approval under General Order 96-A and D.88-03-008. PG&E responds that the Agreement does not change in any way the retail rates to be paid by the Authority's members for the power they purchase from PG&E at retail.

PG&E is correct. Although the lease payments will provide a financial benefit to the Authority's members and while this benefit will indirectly reduce the cost of power purchased from PG&E, the tariff rates are not altered by the Agreement and the rules regarding "special contracts" are inapplicable to this particular contract.

Second, DRA argues that the Agreement violates PU Code § 1001 and General Order 131-C. These provisions, taken together, require a public utility to obtain a certificate of public convenience and necessity (CPC&N) prior to beginning construction of a transmission line.

We find nothing in the Agreement which violates § 1001 or General Order 131-C. If PG&E participates in the COT Project it will necessarily seek a CPC&N from this Commission. DRA speculates that if the COT Project is configured such that it is owned solely by municipal utilities, PG&E would be exempt from the requirements of § 1001. Nevertheless, even under such a scenario, PG&E's ratepayers are not at risk for the costs of construction. In such circumstances, if only municipal utilities construct the project and if the Authority's interest is eventually transferred to PG&E, PG&E must still receive the consent of this Commission before recovering the acquisition costs in rates.

Finally, DRA argues that PG&E is incurring or guaranteeing debt for an improper purpose. By analogy to § 818, DRA suggests that a utility is prohibited from issuing debt for purposes which are reasonably chargeable to operating expenses. Therefore, DRA reasons, transmission capacity leases are normally charged to operating expenses and not a proper subject for debt financing.

The flaw in DRA's argument, as PG&E observes, is that PG&E is not assuming contingent liability for the purpose of making lease payments. All lease payments (PBPs) will be expenses incurred in the ordinary course of business, and will be paid just as any other expense is paid. Lease payments under the Agreement will not be paid from or secured by debt obligations.

Only if PG&E assumes the Authority's debt obligations and acquires title to the Authority's share of the COT Project will PG&E assume a debt obligation within the meaning of § 818. Of course, if debt is assumed for the purpose of acquiring a capital asset, it is unlikely that we would find the costs of such acquisition to be chargeable to operating expenses.

Findings of Fact

1. PG&E, a California Corporation, operates as a public utility under the jurisdiction of this Commission.

2. The Southern San Joaquin Valley Power Authority is a joint powers agency which was expressly established for the purpose of participating in the COT Project.

3. The Authority has agreed to construct, finance, and own 2.0625% of the COT Project transfer capability. The Authority plans to finance its share of the project through the issuance of long-term fixed-rate taxable debt of $8 to $10 million.

4. PG&E and the Authority entered into the Agreement, dated February 12, 1988.

5. Under § 5.3.2 of the Agreement, the Authority may elect to convey title of its interest in the COT Project to PG&E. If

title to the Authority's interest is conveyed, PG&E would also assume all liability for the Authority's debt obligations used to financed its share of the project.

6. Even under PG&E's worst case scenario, PG&E's assumption of this debt would have no effect on PG&E's debt rating or ability to raise additional capital.

Conclusion of Law

The application should be granted to the extent set forth in the order which follows.

O R D E R

IT IS ORDERED that Pacific Gas and Electric Company, on or after the effective date of this order, may assume as guarantor, endorser, surety or otherwise the contingent liability as set forth in the "Agreement Between the Pacific Gas and Electric Company and the Southern San Joaquin Valley Power Authority for Transmission Capacity."

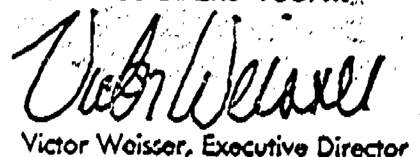
This order is effective today.

Dated AUG 3 1989, at San Francisco, California.

G. MITCHELL WILK
President
FREDERICK R. DUDA
JOHN B. OHANIAN
PATRICIA M. ECKERT
Commissioners

Commissioner Stanley W. Hulett, being necessarily absent, did not participate.

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



Victor Weisser, Executive Director