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Decision 89 09 095 SEP 27 1989 ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of San Diego Gas & Electric Company for approval of electric service contract with the United States of America.	Application 88-11-047 (Filed November 21, 1988)

OPINION

Summary

This ex parte decision finds that the Electric Service Contract (contract) between San Diego Gas & Electric Company (SDG&E) and the United States Navy (Navy) is reasonable and adequately protects the interests of SDG&E's ratepayers. SDG&E is authorized ratemaking treatment of contract revenues under the Electric Revenue Adjustment Mechanism (ERAM).

Filing

This is an application in which SDG&E seeks Commission determination that the contract between SDG&E and the Navy for the sale and purchase of electricity is reasonable and prudent, that it adequately protects the interests of SDG&E's ratepayers, and that SDG&E may recover the revenue differential through ERAM.

The application was originally filed under the Expedited Application Docket (EAD) procedure adopted in Commission Resolution ALJ-159.

The Division of Ratepayer Advocates (DRA) filed a timely protest arguing that the application should be handled as a normal application rather than under the EAD procedure since it does not comply with the EAD guidelines in the two areas addressed below. DRA additionally argues that the guidelines preclude SDG&E from using the EAD process because it will likely need additional capacity during the period of the contract. Guidelines for special contracts were set out in Decision (D.) 88-03-008 in Investigation

(I.) 86-10-001, the Commission's investigation into ratemaking mechanisms to respond to changing conditions in the electric industry. D.88-03-008 states:

> "The term of a special contract conforming to the guidelines should not extend into any year when forecasts indicate that additional capacity will be needed to meet target reserve margins. The purpose of allowing special contracts is to take advantage of existing excess capacity." (D.88-03-008, p. 16.)

DRA notes that in the most recent SDG&E annual Energy Cost Adjustment Clause (ECAC) proceeding, Application 88-07-003, both SDG&E and DRA recommended an Energy Reliability Index of 1.0. This means that qualifying facility capacity would be valued at the full cost of the combustion turbine proxy for capacity. Thus, SDG&E does not have existing excess capacity.

SDG&E acknowledges that the application does not comply with the EAD requirements in two ways.

First, the term of the agreement is 10 years with provisions for two additional 10-year extensions. Under the EAD guidelines set forth in D.88-03-008 for contracts designed to deter self-generation, the term of the contract can be no longer than five years. (D.88-03-008.)

Second, the contract has a floor price for energy based on the Energy Cost Adjustment Clause/Annual Energy Rate (ECAC/AER). This differs from the D.88-03-008 requirement that the floor price for energy be equivalent to the utility's Standard Offer No. 1 (SO 1) energy price.

As a result of the above, the Administrative Law Judge ruled that this application should be redocketed as a regular application. The redocketing occurred on December 22, 1988.

Since no parties opposed the application, and no parties requested hearings, this matter is being handled ex parte.

Contract

The contract covers the purchase of electricity under 18 Navy accounts at three sites:

1. The Naval Facilities at Point Loma and the Naval Air Station at North Island.

2. The Naval Training Center/Marine Corps Recruit Depot.

3. The 32nd Street Naval Station.

The contract has three separate 10-year periods, with the first beginning December 1, 1989. The second 10-year period can be cancelled only by the Navy. Either party may cancel the third 10-year period.

Under the contract the Navy guarantees to take 89.5 megawatts (MW) of baseload electricity on a take-or-pay basis; it must pay the base rates for 89.5 MW whether or not it takes the full amount.

The Navy may take electricity in excess of the 89.5 MW contract baseload amount, with the excess billed at the normal SDG&E tariff rates.

The Navy may continue to take up to 9.4 MW from generation facilities not owned by SDG&E.

The pricing is based on the applicable tariff rates less a 5% discount from SDG&E's base rates for the first 10-year period. The discount from base rates increases to 15.5% in the subsequent contract periods. The base rates are the tariff rates less the ECAC/AER rates.

The contract floor price is the applicable ECAC/AER rate plus the most current adopted marginal demand cost for generation, transmission and distribution, as that marginal cost might change over time.

SDG&E is allowed to continue to site four combustion turbines on Navy property, rent free.

In an SDG&E system emergency, the combustion turbines on Navy property will supply dedicated service to meet the Navy's requirements.

The contract is currently in effect, but may be terminated by either party if the Commission does not approve it by December 1, 1989. If the Commission conditionally approves or modifies it in any way, the contract terminates in 90 days, absent further agreement. If, at any time, the Commission denies the regulatory treatment SDG&E requests, SDG&E may terminate it.

Positions of Parties

A. SDG&E

SDG&E states that the contract is the result of over two years of negotiations. It retains the Navy as a customer along with a major portion of its substantial contribution to SDG&E's fixed costs. SDG&E states that absent the contract, at least 80 MW of Navy load would have left the system. The Navy load is particularly valuable to SDG&E due to its high load factor.

It is SDG&E's position that the threat of bypass by the Navy is real, and that if the contract is not approved by the Commission, the threat could become reality.

SDG&E calculates the undiscounted contract benefits to ratepayers to be a total of approximately $78 million for the first 10 years, and $37 million additional for the second 10 years. Since the third 10-year period is discretionary to both parties, SDG&E did not estimate those benefits.

SDG&E additionally values at $30 million the contract provisions that allow it to continue to site four turbines on Navy property, rent-free. That value is based on the estimated cost of relocating the turbines.

B. Division of Ratepayer Advocates (DRA)

DRA presented a report on the reasonableness of the contract, dated March 1989. Overall, DRA recommends that the Commission find the contract reasonable based on current conditions. DRA did not request hearings. However, DRA calls the Commission's attention to two troubling aspects of the contract.

First, the contract floor could be below marginal costs if marginal costs increased substantially without a corresponding increase in ECAC and base rates. This could be caused by a rapid escalation of gas prices. If gas prices doubled from current levels the contract could become uneconomic in the second 10-year period, so that present ratepayers would benefit at the expense of future ratepayers. However, the effect would not likely be that severe since other fuels or resources could substitute for gas, thereby reducing the marginal costs.

Second, the risks are unbalanced since the Navy may cancel the contract after 10 years, but SDG&E does not have that option. The Navy could cancel if the contract became beneficial to SDG&E at the Navy's expense, but if the opposite were true, SDG&E could not cancel it after the first 10 years.

DRA believes that the threat of bypass by the Navy is credible, since the Navy has two viable bypass options:

1. The Navy could purchase electricity from Energy Factors Incorporated (EFI) at rates equal to interim Standard Offer #4 (SO 4). EFI is currently constructing three cogeneration projects on Navy property, intending to sell electricity to SDG&E, and steam to the Navy, but the Navy could also purchase the electricity at SO 4 rates.

2. The Navy could bypass by constructing cogeneration facilities on-site, which could achieve costs below either tariff rates, SO 4 rates, or the contract rates. The Navy has the engineering expertise to develop, operate, and maintain such facilities, and should be able to obtain the necessary permits.

The Navy forecasts that bypass with EFI could save it $98 million over 20 years, while SDG&E forecasts that the bypass would cost the Navy an additional $112 million. DRA believes that both estimates are credible and does not favor one over the other. The large variation is caused by different forecasts of energy costs, escalation rates, and backup costs. It demonstrates the possibility of losses as well as savings for the Navy if it bypasses with EFI.

DRA performed a detailed evaluation of three scenarios to determine the contract's likely fiscal impacts on SDG&E's ratepayers.

Case 1

This compares the contract revenues with the cost to SDG&E of the EFI SO 4 contracts. This case considers that if the Navy bypasses using the powerplants EFI is constructing, SDG&E would not purchase the EFI electricity. If the Navy doesn't bypass, it assumes SDG&E would purchase the EFI electricity at SO 4 rates.

DRA estimates that the undiscounted cost to ratepayers for the first 10 years is $14 million (1986$) more under the contract than if the Navy bypassed, since the contract revenues are less than the cost of SO 4 energy to SDG&E by that amount.

During the second 10-year period, the situation reverses since the SO 4 fixed price period ends. The result for the 20-year period is an overall loss to ratepayers of $3 million. Given the accuracy of the estimates and considering that the $3 million compared to $450 million in contract revenues is less than 1%, DRA considers this as essentially a break-even situation.

DRA believes that the analysis of this scenario should concentrate on the 20-year period, since it is unlikely that the Navy would be able to bypass SDG&E by using the EFI projects after 10 years. To do so would require EFI to break its SO 4 contracts halfway through a 20-year commitment. SO 4 contracts contain significant termination penalties; it is unlikely that EFI or the Navy would be willing to incur such costs at that time.

Case 2

This analysis compares the expected revenues under the contract with the forecasted short-run marginal costs for SDG&E. This case is similar to SDG&E's analysis, except for the following assumptions:

1. Bypass would not occur for three years since new projects would take at least that long to complete.

2. Line losses at 7.5% are included in the cost of providing capacity to SDG&E.

3. The avoided capacity cost was increased to account for the expense of maintaining a 15% reserve margin.

DRA used SDG&E's base rate and ECAC rate forecasts for this case, as it considers them reasonable.

DRA's analysis shows an undiscounted 20-year benefit to SDG&E of $91 million with $54 million occurring in the first 10 years.

DRA believes that either this case, or Case 1, is most likely to occur.

Case 3

In this case DRA doubled the forecasted avoided energy costs to determine the impact of very inaccurate forecasts. The ECAC rates were increased 40% to correspond. While DRA believes that this case is very unlikely to occur, it does assess the somewhat worst case risks to the ratepayers.

The results show an increase in costs to SDG&E of $2 million in the first 10 years, and a total undiscounted increase over 20 years of $25 million.

DRA recommends that this case not be given much weight in determining the reasonableness of the contract.

Following is a summary of DRA's analyses:

Estimated Benefits to Ratepayers (million 1989 $)

	10 Years	20 Years (Total)
Case 1	-14	-3
Case 2	+54	+91
Case 3	-2	-25

DRA believes that another significant benefit of the contract that was not included in its analysis is the ability of SDG&E to keep its four existing turbines on Navy property. SDG&E estimates the cost of moving them at $30 million, and while DRA has not independently verified that estimate, it does agree that the cost of resiting the facilities is significant. DRA believes that this benefit should be added to the evaluations in the three cases studied.

DRA notes that if the cost of relocating the turbines is half of the $30 million estimated by SDG&E, the expected benefits are positive for Cases 1 and 2, but remain negative for Case 3, as follows:

Estimated Benefits to Ratepayers (million 1989 $)

(including $15 million credit for turbines remaining on Navy property)

	20-Year Total
Case 1	+12
Case 2	+106
Case 3	-10

DRA also considered how the proposed merger of SDG&E and Southern California Edison Company would effect the fiscal impact of the Navy contract. It concludes that the impact should be beneficial to SDG&E ratepayers due to two factors.

1. The capacity costs of Edison are lower than for SDG&E, since Edison has excess capacity. The combined capacity costs for the merged companies would also be lower, resulting in lower costs to serve the Navy. The contribution to fixed costs would be correspondingly higher.

2. DRA expects Edison's ECAC/AER rates to be higher relative to its total rates. The result is that the discount would apply to a smaller portion of the total rates, and result in more contribution to fixed costs.

Overall, DRA concludes that the expected benefits of the contract are certain enough to offset its relatively small risks. DRA recommends Commission approval.

Discussion

SDG&E requests prior approval of a non-standard contract agreement. Normally the reasonableness of such a contract would be an issue in the ECAC reasonableness review covering the past period in which the contract was in effect. However, the Commission realizes that some parties are reluctant to enter into long-term contracts without assurance by the Commission that the contract is acceptable and that the costs associated with it can be routinely recovered. Prior review may also help utilities avoid adverse commitments that can be difficult and expensive to get out of. In the past, we have issued decisions dealing with contracts of this type if adequate information on which to make such a determination is available. We will handle this application in the same manner.

Although this application does not comply with the EAD guidelines, D.88-03-008 states:

> "The utilities should recognize that the principles and the logic underlying the specific guidelines should be respected in contracts not conforming to the guidelines." (D.88-03-008, p. 5.)

First we consider the potential impact of the contract on ratepayers. SDG&E alleges benefits to ratepayers of $115 million for the initial 20 years, with about two-thirds of the benefit accruing during the first 10 years when the discount from base rates is least at 5%.

DRA's Case 2 is similar to SDG&E's analysis, and similarly concludes that substantial benefits would accrue, at $91 million to $121 million for the 20 years, depending on the assumed value of the turbine locations.

DRA's Case 1 is also likely to occur; the estimated benefits are -$3 million to $27 million, depending on the assumed value of the turbine locations.

DRA characterizes Case 3 as unlikely and we agree. Although it is difficult to predict the next 20 years, we do not give much weight to this case in determining the reasonableness of the contract.

Under Case 3, the contract could result in a total 20-year benefit of -$25 million to $5 million. Weighed against the more likely Cases 1 and 2, we believe that the risk of Case 3 is outweighed by the potential benefits of Cases 1 and 2.

We agree with DRA that it would be desirable to have provisions in the contract that give SDG&E the ability to cancel after 10 years. However, that may not have been achievable, considering the economic bypass options available to the Navy. Although we could require such changes before we approve it, doing so risks that the contract would terminate, to the likely detriment of SDG&E's ratepayers. We will not risk that outcome in this instance.

The third 10-year period does not concern us since both parties have to agree before that extension can be effected. We expect SDG&E not to agree to a third 10-year period if the risks to ratepayers outweigh the potential benefits.

We conclude that the contract adequately protects the ratepayers interests, and is reasonable. We will approve it without modifications.

Ratemaking

SDG&E requested varying ratemaking treatment depending on the resolution of ERAM in I.86-10-001. A final decision has not been issued in that proceeding, but to date ERAM has not been eliminated for any of SDG&E's customers.

Therefore we will authorize ratemaking treatment under ERAM. SDG&E estimates that the revenue shortfall per year from the contract will range from $1.1 million to $1.6 million during the first 10-year term, and from $5.1 million to $7.0 million during the second 10-year period. The revenue shortfall is the amount that the contract revenues fall short of tariff rates. The shortfall will cause ERAM undercollections which will be made up in later periods by all customers taking service from SDG&E under tariff rates. The rate impact due to the shortfall is estimated to range from about 0.01 cents per kilowatt-hour (c/kWh) to 0.06 c/kWh. This small rate impact will not significantly harm SDG&E's ratepayers.

Findings of Fact

1. SDG&E seeks Commission approval of a contract for the sale and purchase of electricity with the Navy.

2. The contract involves the purchase of 89.5 MW of baseload electricity by the Navy for 10 years, with two optional 10-year periods.

3. The contract involves 18 Navy accounts grouped into three sites.

4. The contract provides for a discount from base rates of 5% during the first 10-year period, and 15.5% for the two subsequent 10-year periods.

5. The contract has a floor price equal to SDG&E's ECAC/AER energy rate plus the current marginal demand cost for generation, transmission, and distribution, as that marginal cost might change over time.

6. The contract allows SDG&E to continue to site four combustion turbines on Navy property rent-free. The turbines must provide dedicated service to the Navy during SDG&E system emergencies.

7. The Navy may cancel the second 10-year period, but SDG&E cannot.

8. Both parties must agree to the third 10-year period for it to take effect.

9. SDG&E estimates the undiscounted benefits of the contract at approximately $78 million for the first 10 years, and $37 million additional for the second 10 years.

10. DRA estimates that under the two most likely cases, undiscounted ratepayer benefits would range from -$3 million to $121 million. 11. DRA believes that the ratepayer benefits of this contract could increase if the SDG&E/Edison merger takes place.

12. The Navy has alternatives to purchasing electricity from SDG&E, both by purchasing from other parties and by constructing its own generation facilities.

13. DRA believes that the Navy's alternates are lower in cost than electricity from SDG&E under the contract.

14. DRA believes that the benefits of the contract clearly outweigh the risks, and that the contract should be approved.

15. SDG&E estimates the ERAM shortfall due to the contract to range from $1.1 million to 1.6 million per year during the first 10-year period, and from $5.1 million to $7.0 million per year during the second 10-year period. The rate impact is estimated to range from 0.01 c/kwh to 0.06 c/kWh.

<u>Conclusions of Law</u>

1. The contract between SDG&E and the Navy is reasonable.

2. SDG&E should be authorized ratemaking treatment for the contract under ERAM.

ORDER

Therefore, IT IS ORDERED that the contract between San Diego Gas & Electric Company (SDG&E) and the United States Navy is found to be reasonable, and that SDG&E is authorized ratemaking treatment under the Electric Revenue Adjustment Mechanism.

This order becomes effective 30 days from today.

Dated SEP 27 1989, at San Francisco, California.

G. MITCHELL WILK
President
STANLEY W. HULETT
JOHN B. OHANIAN
PATRICIA M. ECKERT
Commissioners

Commissioner Frederick R. Duda, being necessarily absent, did not participate.

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

Wesley Franklin

WESLEY FRANKLIN, Acting Executive Director