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Decision 90 06 022 JUN 06 1990

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Pacific Gas and Electric Company for an expedited order approving an amendment to a Power Purchase Agreement with O'Brien California Cogen II Limited regarding a deferral of the purchase of long-term capacity and energy, curtailment of energy, and increase in nameplate rating. U39E)	Application 90-03-003 (Filed March 1, 1990)

OPINION

Summary of Decision

This decision approves the "Settlement Agreement, Mutual Release and Covenant Not to Sue" (Agreement) executed May 3, 1990 by Pacific Gas and Electric Company (PG&E) and O'Brien California Cogen II Limited (O'Brien).

Background

The Original Contract

On June 14, 1985 and June 18, 1985, respectively, O'Brien's predecessor in interest, O'Brien Energy Systems, Inc. and PG&E signed a Standard Offer 2 (SO 2) Power Purchase Agreement (PPA) for purchases and sales of energy and capacity from a cogeneration Qualifying Facility (QF) located in Salinas, California. Article 2(b) of the PPA described the project as a 42,000 kW generating facility. Under the PPA, O'Brien was required to operate the Project and begin energy deliveries to PG&E on or before June 18, 1990.

Events Leading Up to Renegotiation

On April 29, 1989, O'Brien submitted to PG&E a written notice of an alleged force majeure event based on a decision by the Monterey Bay Air Pollution Control District (APCD) to require a new

environmental assessment of the project. That decision is evidenced by a letter from the APCD to the City of Salinas dated April 17, 1989. O'Brien claimed that the alleged force majeure event suspended the PPA's requirement that the project commence operations on or before June 18, 1990.

On August 24, 1989, PG&E advised O'Brien that PG&E did not believe that the APCD's action was a force majeure event. PG&E believed that the cause for the requirement of a new environmental assessment was O'Brien's proposed increase of the project's generator nameplate rating to 49,500 kW, which also constituted a modification of the PPA in violation of its terms and conditions. PG&E also advised O'Brien that the PPA would not be modified to accommodate the increase in nameplate rating because the project was not viable.

O'Brien responded that the change in nameplate rating was not the basis for the new environmental assessment, and that concerns about the project's water consumption in view of a severe drought in the Salinas Valley triggered the new environmental assessment. O'Brien claims that these concerns were beyond O'Brien's control.

PG&E and O'Brien executed a "Settlement Agreement, Mutual Release and Covenant Not To Sue" in January, 1990. This earlier agreement has been superceded by the Agreement executed by PG&E and O'Brien on May 3, 1990. By its "Amended Application", filed May 4, 1990, PG&E tenders the May 3, 1990 Agreement for Commission review and approval.

PG&E's Request for Relief

Specifically, PG&E seeks a Commission order "on or before May 30, 1990" which finds that terms of the Settlement Agreement are reasonable, that PG&E's ratepayers will be served adequately by the Agreement, that PG&E's entering into the Agreement is prudent, that all payments to be made pursuant to the Agreement and PPA as modified are reasonable in the year in which they were made, that

PG&E is authorized to recover all such payments through PG&E's Energy Cost Adjustment Clause, and that CPUC approval of the Agreement is final and not subject to further reasonableness review, and approving the Agreement as executed. Operation of the Agreement is conditioned on Commission approval.

Terms of the Settlement Agreement

The parties have agreed to settle their dispute over whether O'Brien is entitled to an amended PPA for deliveries commencing after June 18, 1990 from its upgraded 48 MW facility. The Agreement contains the following significant terms:

> The nameplate rating of the QF's generating equipment is changed from 42 MW to 48 MW.
>
> The term of agreement is increased from 20 to 30 years.
>
> O'Brien's obligation to provide firm capacity is amended from 38.5 MW for twenty years to 38.5 MW during the first eighteen years (the first period) and then 41.5 MW during years nineteen through thirty (the second period).
>
> The firm capacity price under the PPA during the first period is $191 per kW year subject to the same adjustments for capacity reduction and termination that applied to capacity payments under the original PPA. During the second period it will be $92 per kW year.
>
> If O'Brien should fail to deliver the firm capacity, O'Brien will pay PG&E liquidated damages according to a stipulated schedule. The rate for damages is calculated in terms of dollars per kilowatt not delivered and range from $154.80 if the non-delivery occurs in year one to $1023.92 for non-delivery during year 21. No liquidated damages for non-delivery of firm capacity were specified the original PPA.
>
> The five-year operation date shall be suspended until and including June 18, 1991, a year after the original PPA operation date. No increase in energy or capacity prices is caused by this extension of time. If O'Brien does not begin

energy deliveries to PG&E from the Project by June 18, 1991, the PPA shall terminate.

PG&E shall not pay O'Brien for any capacity, whether firm or as-available, generated by the project before September 1, 1990.

From September 1, 1990 through April 30, 1991, PG&E will pay only 50% of the applicable firm capacity price for firm capacity delivered to PG&E.

From May 1, 1990 and throughout the remaining contract term, PG&E will pay 100% of the applicable firm capacity price to O'Brien.

Throughout the term of the agreement, during all super-off peak hours, O'Brien shall physically curtail 100% of all energy deliveries from the project. The original PPA required physical curtailment only in the event of emergency or hydro-spill conditions.

Throughout the term of the agreement, on all weekends and holidays during off-peak hours, O'Brien will accept 100% economic curtailment of all energy deliveries of the project.

O'Brien agrees to accept economic curtailment of 20% energy deliveries from the project during all weekday off-peak hours. During these periods, PG&E will pay for deliveries of energy up to and including 38.4 MW at prices specified by the PPA. During that period, O'Brien will accept economic curtailment of deliveries of energy to PG&E from the project above 38.4 MW. No economic curtailment was required by the original PPA.

O'Brien will establish an irrevocable letter of credit for the amount of $207,500 with PG&E as the beneficiary no later than 30 days prior to the operation date of the facility. On the anniversary of that date each year during the first period, O'Brien must increase the letter of credit amount by both $207,500 and the amount of interest earned, calculated at the 3-month commercial paper rate on the amount established the previous year. The original PPA did not require this security.

> If the letter of credit is not maintained as required, above, PG&E's payments for firm capacity will be reduced to $186 per kW year through the first period.
>
> Prior to the nineteenth anniversary of the operation date of the facility, O'Brien must grant PG&E a security interest in the QF's facility to secure full, prompt, and unconditional performance of any obligations of O'Brien in the second period. No such security interest was provided for in the original PPA.
>
> The parties agree to refrain from suing each other over O'Brien's right to increase the size of the generating facility, right to extend the on-line date, or the merits of any claim of force majeure.

PG&E estimated that the net ratepayer benefit expected to result from Commission approval of the settlement agreement is $31.13 to $31.62 million in 1990 dollars.

Discussion

Renegotiated Contracts

The Commission has issued guidelines for the utilities to use in renegotiating contracts with QFs. A preliminary question, to be asked before any negotiations occur, is whether the QF is viable under the unamended contract. If not, the utility has nothing to gain by negotiation.

Here, O'Brien claims that it would meet its deadline for commencing operations, June 18, 1990, and thus, be viable as of the date negotiations began, but for the decision of the Monterey Bay Unified Air Pollution Control District to require a new environmental assessment under CEQA. This constitutes a force majeure, which operates to suspend O'Brien's obligation to come on-line during the period of delay, according to O'Brien.

PG&E contends that O'Brien cannot claim force majeure because the QF's own actions precipitated the further environmental review. That is, by proposing to upgrade its turbines from 41.5 MW

to 48 MW, O'Brien created the necessity for a new environmental review and its attendant delay.

O'Brien asserts that it had no knowledge of the APCD's concerns. O'Brien had provided the APCD with data to show that there would be no increase in emissions as a result of the change in project configuration. By letter dated July 1, 1988, the APCD advised O'Brien that the required modification to O'Brien's authority could be handled on an administrative basis so long as no increase in carbon monoxide emissions occurred.

In the spring of 1989, the APCD reversed itself and required environmental review out of concern not for CO emissions but for the QF's water consumption level. This issue had not been raised during the review which culminated in the issuance of a negative declaration for the original project. O'Brien states that the APCD was responding to a farmer in the Salinas Valley who was concerned about the project's water consumption and the impact it might have on his ability to use water for agricultural purposes. These concerns stemmed largely from a worsening drought in the Salinas Valley.

During the ensuing environmental review, O'Brien agreed to modify the project to save more water than the project had been expected to use, thus producing a net savings over the current water usage. However, subsequent litigation over NOx emissions levels delayed the issuance of building permits until January, 1990.

As a result of these events, the project will not be on-line any earlier than the fall of 1990.

The Commission's guidelines state:

> "The QF claiming force majeure must establish that the particular delay, and duration of delay, was unanticipated at the time the contract was entered into. The QF must also show that it was without any fault or negligence in contributing to the delay, and that it has been diligent in attempting to end the delay. The QF must also have given the

utility the required notice of the delay."
(D.88-10-032.)

O'Brien entered into its SO 2 agreement with PG&E on June 18, 1985. The QF subsequently decided to upgrade its turbines in response to the concerns of potential financial backers. Strictly speaking, O'Brien did contribute to the delay by amending its project. In this case, this change triggered a new environmental review process. Claims that a developer did not anticipate delay due to environmental review should be given little weight, because the QF should recognize that it is the policy of the state to provide the public with the opportunity to comment on the environmental impacts of development. Since the essence of the state's environmental protection law is public participation, a developer should not be heard to claim that public concern over an issue that it had not expected to be controversial constitutes a force majeure.

It would be reasonable to expect that an amendment to a project that has the potential to increase emissions would trigger additional review. Whether O'Brien's reliance on an APCD staff memo stating that the change could be handled administratively was reasonable or not, we need not address. In fact, O'Brien could not have anticipated the drought, now in its fourth year, that put a premium on its water consumption. The QF's potential water usage, and not the potential for increased CO emissions, was the concern which a citizen sought to address through the environmental review process.

O'Brien has diligently resolved the issue by redesigning its process so that the upgraded facility will use less water than the host facility currently uses. Also, O'Brien notified PG&E of the potential delay within 10 days of receiving a copy of the APCD letter to the City of Salinas stating that further environmental review was required, and that if it did not obtain a new negative

declaration by August 15, 1989, it would require an extension of the five-year on-line requirement.

We find that there is a significant possibility that a trier of fact would conclude that O'Brien's performance on the firm delivery date was frustrated by a force majeure, and that the circumstances preventing performance existed from April 1989 through January 1990. Given this likelihood, O'Brien has a colorable claim that it is entitled to payments under the original PPA for deliveries commencing approximately 10 months after the original on-line date. Thus, it was appropriate for PG&E to renegotiate the PPA if O'Brien demonstrated that it was otherwise "viable" under the Commission's guidelines.

In D.88-10-032, the Commission set out factors which should be considered as a whole in determining the viability of a QF's project before the utility agrees to modify a QF contract. O'Brien addressed these criteria in the "Prepared Testimony of Sanders D. Newman," the General Counsel of O'Brien Cogeneration Inc. I, the general partner of O'Brien California Cogen II Limited. Mr. Newman asserts the following:

> O'Brien executed a completed "Project Description and Interconnection Study Cost Request Form" on July 7, 1989, within the forty-five day deadline set out in the QF Milestone Procedure.
>
> O'Brien had signed a long term lease with the host facility and an "Amended and Restated Energy Supply Agreement" on July 15, 1988 to obtain site control for the term of the PPA.
>
> O'Brien and PG&E had signed an agreement to establish an escrow account for this project on July 19, 1985, and the $5 per kW project fee, totalling $210,000 was place in escrow on June 6, 1985.
>
> The Monterey Bay Unified Air Pollution Control District issued an Authority to Construct to O'Brien on December 30, 1986. FERC has certified the project as a QF, and the City of Salinas has

advised O'Brien that the initial set of building permits are ready for issuance.

By letter dated July 8, 1988, PG&E stated its intent to provide gas service to the proposed project.

O'Brien had signed a Turnkey Construction Contract for construction of the project on June 23, 1988. The contractor guaranteed completion of the project by December 31, 1989, absent force majeure. As of this date, over $30 million has been spent for engineering and equipment procurement under the terms of the contract. All of the major equipment is currently on order or warehoused near the site. Virtually all engineering has been completed, demolition at the site is completed, and construction is expected to begin shortly.

Project financing was arranged in July of 1988. A construction loan of $45.5 million was obtained. An equity commitment of $13.7 has been made by a third party. Over $30.0 million has been drawn on the construction loan to finance engineering and equipment.

A project cash flow demonstrates economic viability.

O'Brien asserts that it is a proven QF developer, with five major cogeneration projects under construction, five under development, and more than six bio-gas generation projects using methane from landfills. O'Brien is publicly traded on the American Stock Exchange.

Taking the above assertions as a whole, it appears that O'Brien was indeed "viable" as of the time the parties entered into negotiations, and we will proceed to evaluate the terms of the renegotiated contract.

Ratepayer Benefits Under the Renegotiated Contract

The benefits to ratepayers resulting from a contract modification is measured as the net present value of the difference between the costs under the renegotiated contract and some other alternative. Based on the foregoing finding of viability, the original PPA is the appropriate alternative to use.

PG&E claims that the net ratepayer benefits range from $31.13 to $31.62 million. The benefits due to differences in firm capacity payments are calculated to be $4.39 to $4.88 million in net present value terms. The benefits due to 100% economic curtailment of all super off-peak energy deliveries are estimated at $14.13 million, and the benefits due to physical curtailment are estimated at $10.35 million. Finally, the value of economic curtailment of 20% of energy deliveries on weekdays is estimated at $2.26 million.

The Commission Advisory and Compliance Division (CACD) has reviewed these figures and confirmed to the Commission that they represent ratepayer benefits as quantified under the Commission's generally accepted methodology. Specifically, the net present value of the reduction in payments to O'Brien under the renegotiated contract over the 30-year term of the renegotiated contract is $31.13 to $31.62 million, depending on differences between forecasts of avoided capacity costs.

However, in our review of the alleged benefits of physical curtailment, we became aware that although the payment stream to this QF may be reduced by $10.3 million net present value, it is not clear that the cost of energy to ratepayers will be reduced by the identical amount. That is because of the methodology employed to determine the avoided cost of energy.

Under the current QF pricing methodology, the Commission first forecasts the cost of the utility system (including long-run avoided cost QFs in the resource plan) to generate all kWh consumed

(QFs out). Then, a forecast of the cost of generation under a utility resource plan that includes short-run avoided cost QFs (QFs in) is made. The difference between these two costs is calculated. This dollar amount is divided by the number of kWh provided by the short-run avoided cost QFs. The result is the avoided energy cost, expressed as cents per kWh, paid to short-run avoided cost QFs.

The total cost to ratepayers is defined by the QFs out run. Any operational curtailment will only affect the QFs in run, because kWh which are not generated by a QF will be generated by the utility. The curtailment would reduce the number of kWh for which the cost of non-utility generation is to be paid. The result is a higher price for those QFs who were not curtailed. Since the total cost to ratepayers has not changed, ratepayers see no benefit from the physical curtailment of a QF.

This problem has been recognized by CACD and acknowledged by utility representatives. It should be explored further in subsequent proceedings. The effect of this analysis would be to reduce the anticipated benefits of this renegotiated contract by approximately $10.3 million. This still leaves a benefit of $20.8 to $21.3 million.

We find that the renegotiated contract, with its quantifiable reduction in costs over the term of the contract, its security guarantees, and its avoidance of litigation, provides a net benefit to ratepayers. It is a reasonable resolution of valid disputes raised by both parties. Therefore, PG&E's request for approval should be granted.

Findings of Fact

1. On June 18, 1985, O'Brien California Cogen II Limited (O'Brien) and Pacific Gas and Electric Company (PG&E) entered into a Standard Offer 2 (SO2) agreement whereby PG&E agreed to purchase firm capacity from O'Brien's Qualifying Facility (QF) with a nameplate rating of 42 MW for 20 years.

2. In April of 1989, O'Brien advised PG&E that it could not deliver firm capacity by its on-line date, June 18, 1990, due to force majeure.

3. The parties disagree over whether O'Brien has the right to change unilaterally the size of its generating facilities from 42 MW to 48 MW while maintaining the same level of capacity deliveries as provided for under the SO2 contract, and whether the project is viable as a 42 MW facility.

4. O'Brien and PG&E have entered into a Settlement Agreement, Mutual Release and Covenant Not to Sue (Agreement) which settles the disputes between the parties to the mutual benefit of both parties.

5. A cumulative water shortage in the vicinity of the generating facility, resulted in the environmental review, which O'Brien itself triggered with its facility upgrade. The environmental review required more time than anticipated because of public concern over the water shortage.

6. The QF had met all of the factors to be considered as a whole by the utility in determining the viability of a QFs project.

7. PG&E properly entered negotiations with O'Brien to amend the SO2 power purchase agreement.

8. The Agreement executed on May 3, 1990 by PG&E and O'Brien serves the ratepayer interest because it resolves legitimate disputes between the parties without the cost and delay of litigation, it provides a reduction in payments made under the power purchase agreement with a net present value of $20.8-$21.3 million, and provides PG&E's ratepayers with substantial security in the case of non-performance by O'Brien.

Conclusions of Law

1. There is a significant probability that a trier of fact would conclude that the circumstances which prevented O'Brien from delivering capacity by its on-line date constituted force majeure.

2. But for the force majeure, O'Brien would have been "viable" at the time of contract negotiation.

3. PG&E acted reasonably when it executed the Agreement with O'Brien.

4. All payments for delivery of energy and capacity to be made pursuant to the Agreement between O'Brien and PG&E shall be reasonable in the year in which they were made.

5. Commission approval of the Agreement should be final and not subject to further reasonableness review.

ORDER

IT IS ORDERED that:

1. The "Settlement Agreement, Mutual Release and Covenant Not to Sue" (Agreement) executed on May 3, 1990 by O'Brien California Cogen II Limited and Pacific Gas and Electric Company (PG&E) is approved.

2. PG&E is authorized to recover all payments made for energy and capacity pursuant to the Agreement through PG&E's Energy Cost Adjustment Clause or any other mechanism established by the Commission which provides for PG&E's recovery of such costs.

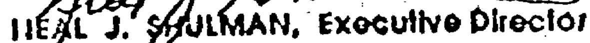
The Settlement Agreement entered into by O'Brien and PG&E on May 3, 1990 is reasonable and is approved.

This order is effective today.

Dated June 6, 1990, at San Francisco, California.

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

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



NEAL J. SHULMAN, Executive Director