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Decision 90-09-088 September 25, 1990

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of the Southern California Edison Company (U 338-E) for: (1) Authority to Increase Its Energy Cost Adjustment Billing Factors, Increase Its Annual Energy Rate, and Increase Its Electric Revenue Adjustment Billing Factor Effective June 1, 1988; (2) Authority to Implement Modifications to its Energy Cost Adjustment Clause as More Specifically Set Forth in this Application; (3) Authority to Revise the Incremental Energy Rate, the Energy Reliability Index, and Avoided Cost Pricing; (4) Review of the Reasonableness of Edison's Operations During the Period from December 1, 1986, through November 30, 1987; and (5) Review of the Reasonableness of Edison Payments to Qualifying Facilities Under Nonstandard Contracts During the Period from December 1, 1984, through November 30, 1987.	Application 88-02-016 (Filed February 11, 1988)

(See Appendix A for Appearances.)

I N D E X

I N D E X

FIRST OPINION IN REASONABLENESS REVIEW PHASE
KERN RIVER COGENERATION COMPANY CONTRACT

I. Introduction

For more than a decade, this Commission has been committed to the inclusion of cogeneration and small power production in electric utility resource plans consistent with applicable law and utility resource needs. Although the availability of standard offers adopted for the purchase of such power has changed over the years to meet changing energy needs, the Commission's recognition of the benefits and the basic need for qualifying facilities (QFs) has not. To the extent that it is carefully integrated into a utility system, a qualifying facility can still provide least cost, efficient or renewable electricity generation from facilities which can be less capital intensive, can be quicker to develop, and, to the extent our adopted rules and safeguards are followed, can expose ratepayers to less risk than traditional utility plant.

In the course of determining the prices and terms under which utilities purchase QF power, the Commission has endeavored to ensure that ratepayers remain indifferent to the source of the utility's energy supply, whether from the utility itself or from the QF. We have also sought to ensure that a negotiated QF contract creates no greater risk for ratepayers or inequities for other QFs than one of the Commission's adopted standard offers.

With this background in mind, this decision examines the reasonableness of the negotiation, execution, and administration of a single nonstandard QF contract between the Southern California Edison Company (Edison) and the Kern River Cogeneration Company (KRCC). Pursuant to a partnership agreement, the Southern Sierra Energy Company (SSEC), an Edison affiliate, owns a 50% partnership share of KRCC, with the other 50% held by Getty Energy Company (Getty), now part of Texaco Producing, Incorporated.

Our review of this agreement is significant for a number of reasons. First, this case marks the Commission's first review of a nonstandard contract involving one of Edison's QF affiliates. Second, the contract has raised issues related to imprudency and self-dealing by Edison in its actions related to tho contract.

Based on our careful and thorough review of the record in this case, we conclude that Edison did in fact act imprudently in the negotiation and execution of the KRCC contract. A total disallowance of $48,370,708 for the three-year record period has been ordered based on this imprudency. Further, we find that certain actions taken by Edison have reflected a disregard for the appearance of self-dealing and, in some instances, have resulted in Edison placing KRCC's interests ahead of those of its ratepayers. This situation has created the need for the Commission to ensure that safeguards are in place, as contemplated by the Commission in approving Edison's holding company, to prevent self-dealing in the future.

In making these findings, we wish to assure the QF community that this decision does not alter our previously stated commitment to QF resources. In fact, this order recognizes the value of the Kern River project to Edison's ratepayers and seeks to preserve Edison's power purchases from KRCC by encouraging contract reformation.

Our directives in this decision are aimed solely at providing a regulatory response to a utility which chose not to conform to the letter or intent of Commission decisions in effect from the time of Edison's negotiation of the KRCC project to its request to recover costs associated with that contract. By taking such action, the Commission has sought to protect both Edison's ratepayers and other QFs by preserving the integrity of the regulatory process.

II. Background

This application, filed by Edison on February 11, 1988, included three requests: (1) an increase in Edison's electric rates based on increases in revenue requirements related to Edison's Energy Cost Adjustment Clause (ECAC), (2) approval of the reasonableness of Edison's operations for the 1987 reasonableness review period, and (3) approval of the reasonableness of its nonstandard contracts with qualifying facilities for a three-year period beginning December 1, 1984. Review of Edison's application was divided into two phases: a forecast phase to address Edison's rate increase request, and a reasonableness phase to consider "traditional" ECAC reasonableness issues for the record period 1987 and reasonableness issues centered on QF nonstandard contracts for the period between December 1, 1984, and November 30, 1987.

A decision in the forecast phase was issued on September 22, 1988, authorizing an increase of $471 million in ECAC related revenues for Edison. This opinion represents the first of three decisions to be issued in the reasonableness phase and addresses the reasonableness of the nonstandard contract between Edison and KRCC, a qualifying facility.

In November and December 1988, the Commission's Division of Ratepayer Advocates (DRA) submitted its reports in the reasonableness phase. DRA's report on the reasonableness of the qualifying facility contracts at issue in this proceeding was submitted on December 5, 1988, following a lengthy investigation.

On December 14, 1988, a prehearing conference was held in this proceeding to consider outstanding discovery requests and to establish a schedule for the reasonableness phase of this application. By Administrative Law Judge (ALJ) ruling dated January 19, 1989, the reasonableness phase was further bifurcated into two phases. The first phase was to address the "traditional" ECAC reasonableness issues and the reasonableness of Edison's execution and administration of the KRCC contract. All other issues were reserved for Phase 2.

In accordance with this ruling, hearings were held in Phase 1 between February 21, 1989, and March 10, 1989, with rebuttal hearings held between April 3, 1989, and April 13, 1989, and on June 27, 1989, for a total of 23 days of hearing. Concurrent opening briefs were filed on June 26, 1989, by DRA and Toward Utility Rate Normalization (TURN) and on June 27, 1989, by Edison and the Cogenerators of Southern California (CSC) and KRCC, filing jointly. In discussing their joint brief, CSC and KRCC will be referred to as KRCC. CSC is an industry organization of which KRCC is a member. Reply briefs were filed on August 15, 1989, by Edison, DRA, and KRCC. On October 31, 1989, an agreement between KRCC and DRA regarding the content and service of late-filed Exhibit 183 (KRCC management committee meeting minutes) was approved.

III. Scope of Review

Prior to hearings on the KRCC contract, the issue of the scope of review of this contract in an ECAC proceeding was raised. This issue was eventually the subject of a Commission decision (D.89-01-047).

The events leading to the issuance of D.89-01-047 commenced with DRA's filing of a motion to compel production of relevant information on March 23, 1988. The information sought by DRA included the KRCC financial statements, the KRCC partnership records, and the names of the officers of the CSC. In support of its request, DRA asserted that its review of the reasonableness of Edison's purchase power agreements required "a clear understanding of the corporate relationships between Edison and its various subsidiaries and affiliates, both organizational and operational, at the time these nonstandard agreements were negotiated." (DRA

Motion at p. 1.) DRA also expressed the view that the reasonableness review of nonstandard agreements, particularly those involving Edison's subsidiaries, required consideration of contract terms and overall contract costs, risks, and obligations.

In its filing, DRA indicated that Edison had allowed DRA to inspect and take notice of KRCC's 1985 and 1986 financial statements, but not to receive a copy. According to DRA, Edison's refusal to supply the KRCC partnership documents stemmed from objections of Getty, the partner of Edison's QF affiliate in the Kern River enhanced oil recovery project. DRA indicated in its motion that it understood Getty to have asserted that the sole relevant issue in this ECAC proceeding was "'a determination of whether payments to KRCC under its Parallel Generation Agreement with SCE are above those which it would receive under a standard offer.'" (DRA Motion, at p. 10.) Getty never directly presented its concerns to the Commission, except to the extent of joining a reply filing submitted by CSC.

On March 31, 1988, CSC filed a motion to limit discovery and to establish the scope of this proceeding. In this motion, CSC sought the denial of DRA's discovery requests. Additionally, CSC asked the Commission to define the "scope of [this] proceeding as a determination of whether Edison's payments to nonstandard contracts were reasonable in light of the payments it would have made under the standard offer contracts or projected avoided costs as available at the time of execution". (CSC Motion at pp. 21-22.)

On April 4, 1988, both CSC and Edison filed responses to DRA's discovery motion. CSC renewed its position that the information requested by DRA was beyond the scope of this proceeding as defined by CSC. Edison indicated that, based on Getty's objections, it had refrained from producing the material requested by DRA. Edison also stated that it shared Getty's concerns although it remained willing to provide the information under its control if directed to do so by the Commission.

On April 11, 1988, DRA replied to the responses of CSC and Edison to its motion. This reply focused in large part on the apparent lack of cooperation by Edison in providing the requested information, and the failure of Getty to file on its own behalf stated objections to the production of this material. DRA also opposed any attempt to narrowly define the scope of the reasonableness inquiry related to nonstandard contracts. In particular, DRA asserted that "[t]he terms of a negotiated contract which alter the risks to the ratepayer are no less important than the pricing provisions." (Id., at pp. 8-9.)

On April 21, 1988, Edison responded to DRA's response and to CSC's motion to limit discovery and establish the scope of the proceeding. In this filing, Edison stated its position that, having demonstrated that avoided costs were the basis of payment under a nonstandard contract, Edison was entitled to recover those payments through its rates.

On April 22, 1988, CSC replied to the responses of DRA and Edison. For the first time in any of these filings, CSC was joined by Getty. In its reply, CSC again argued that the information sought by DRA was "far outside the scope of this proceeding and border[ed] on harrassment." (CSC Reply, at p. 4.)

In an ALJ ruling of November 17, 1988, the parties were directed to meet and confer regarding DRA's March 23 discovery request. This meeting took place on December 2, 1988, and was followed by a letter to DRA from certain of the parties offering a conditional response to DRA's request. DRA rejected this offer on the ground that its terms unreasonably limited the scope of discovery.

In December, 1988, DRA also set in motion requests aimed at either a reevaluation by the Commission of its decision to approve a holding company structure for Edison or consideration of issues related to self-dealing by Edison in this proceeding. The holding company had emerged as a result of the Commission's approval on January 28, 1988, of Edison's proposed plan to reorganize and create a holding company structure. (D.88-01-063, Application (A.) 87-05-007.)

Of importance to this proceeding, this structure involved the creation of the SCE Holding Company (SCECorp) with two separate, wholly owned subsidiaries. Of these two subsidiaries, one was Edison, a regulated entity, and the other was the Mission Group, an unregulated, nonutility subsidiary. Among the subsidiaries of the Mission Group was the Mission Energy Company of which SSEC is a subsidiary. SSEC is Getty's partner in KRCC.

On December 5, 1988, DRA filed a motion in A.87-05-007 requesting modification of D.88-01-063, and consolidation of that application with this proceeding. This latter step was required since the modifications requested by DRA were largely based on evidence which DRA intended to present in this proceeding. According to DRA, this evidence would show that Edison's dealings with its QF affiliates had abused its ratepayers and unaffiliated QFs and that the Commission's current regulations had or could not adequately protect ratepayers and unaffiliated QFs from these self-dealing abuses.

On December 14, 1988, a prehearing conference was held in this proceeding to establish a schedule for Edison's ECAC reasonableness review. At that time, the ALJ directed DRA to file its December 5 petition in this proceeding as well. This step was taken to ensure proper consideration of all of the allegations included and relief requested in this filing. DRA made this filing on December 27, 1988.

The relief sought by DRA in its holding company petition and ECAC motion was aimed at prohibiting or strictly limiting Edison's ability to enter new purchase power agreements with QF affiliates. DRA also asked the Commission to order Edison's divestiture of all ownership in all QF/Edison ventures which sell electricity to Edison. In the absence of divestment, DRA sought the imposition of an "affiliate cost adjustment." This adjustment would flow through to Edison's ratepayers the profits Edison's QF affiliates earn above Edison's authorized return or, as an alternative, profits in excess of the average return earned by California QFs.

In the event that the Commission chose not to take any of these actions, DRA asked that all future Edison QF affiliate transactions be limited to standard contracts, and that reporting about QF affiliate purchases be increased. DRA concluded, however, that any of its requests, except for a direct prohibition on new QF/affiliate contracts, should await the conclusion of hearings in this proceeding.

On January 3, 1988, Edison and CSC responded to DRA's motion and petition, asking that DRA's requests be denied. In its response, Edison expressed the view that current Commission safeguards against public utility self dealing were sufficient to protect the ratepayers' interests and should not be rescinded. Edison also contended that nothing alleged by DRA justified modification of those safeguards. Further, Edison concluded that DRA's proposed alternate relief was unfair, unnecessary, overbroad, adverse to the ratepayers' interest, beyond the Commission's jurisdiction to grant, and contrary to federal and state policy.

In its response, CSC focused on the impact of consolidating the holding company application with this proceeding. CSC stated that such consolidation would (1) significantly complicate and confuse the proper focus of the present ECAC reasonableness review, (2) unreasonably expand the scope of this review, and (3) prejudice the interests of the non-Edison parties to the nonstandard contracts subject to review. The foundation for these objections was CSC's continuing position that the reasonableness review of QF nonstandard contracts in ECAC was limited to whether the payment stream included in a nonstandard contract was less than or comparable to the expected avoided costs of the applicable standard offer. Using this standard, CSC argued that the existence of any self-dealing by the utility was irrevelant to the reasonableness review of a nonstandard contract when that contract includes risks and costs no greater than that of the applicable standard offer.

On January 18, 1989, DRA replied to Edison's and CSC's responses to its motion. In responding to Edison's objections, DRA indicated that no Commission regulation would have prevented the abuses DRA alleged had occurred relative to contracts to be considered in this proceeding. In contrast to CSC, DRA expressed its position that its evidence of Edison's relations with its QF affiliates was completely relevant to a reasonableness review.

On January 27, 1989, the Commission issued D.89-01-047 in this proceeding and a companion decision (D.89-01-048) in A.87-05-007. By these decisions, the Commission denied DRA's motion and petition seeking modification of D.88-01-063 and consolidation of A.87-05-007 with this proceeding. The Commission, however, granted DRA's motion to compel filed on March 23, 1988. Specifically, this order provided: "[Edison] is directed to produce all of the information requested by DRA in that motion to the extent that it is within Edison's power and control." (D.89-01-047, at pp. 30-31.)

In addition, the Commission in D.89-01-047 denied CSC's motion of March 31, 1988, and ordered the following:

> "The scope of the pending reasonableness review in this proceeding shall include consideration of all facets of Edison's negotiation, execution, and administration of its nonstandard contracts. In particular, the Commission will apply close scrutiny to those nonstandard agreements entered between Edison and its QF affiliates including consideration of any evidence of self-dealing by Edison in these transactions." (D.89-01-047, Ordering Paragraph 4, at p. 31.)

In support of this order, the Commission had analyzed applicable decisions which had been in effect prior to the filing of this application. In particular, the Commission noted that its approval of Edison's proposed reorganization in D.88-01-063 had been conditioned on Edison following certain guidelines in the operation of its holding company to preserve the Commission's ability to regulate Edison effectively. Among the conditions imposed was access by the Commission to all information necessary to thoroughly analyze Edison's costs and to monitor the relationships between Edison and its nonutility affiliates. (D.89-01-047, at p. 13.)

In D.89-01-047, the Commission emphasized that, although broad rules governing Edison's relationship with its QF affiliates had not been specified in D.88-01-063, we had found:

> "In keeping with all relevant Commission decisions, we will expect Edison to minimize the cost of service for its regulated operations and to deal fairly and evenhandedly with all QFs; we will be prepared to examine any evidence to the contrary if and when it is presented. The other conditions we impose should preserve the information relevant to such an investigation as well as our staff's ability to examine such information." (D.88-01-063, at p. 35; cited in D.89-01-047, at p. 14.)

On the basis of this provision, the Commission concluded in D.89-01-047 that DRA should have the opportunity to present evidence of self-dealing. Because the forum for presenting such evidence had not been identified or limited to the holding company in D.88-01-063, the Commission concluded that based on the adopted schedule in this proceeding, this ECAC was "well-suited to our consideration of DRA's asserted evidence of Edison's self-dealing." (D.89-01-047, at p. 15.) The Commission also found, however, that DRA's allegations did not, as yet, require the reopening of A.87-05-007 or the modification of D.88-01-063.

We did, however, reject Edison and CSC's assertion that an ECAC reasonableness review of a QF nonstandard contract is based solely on the comparability of price streams between the nonstandard agreement and the applicable standard offer. We found instead that, beginning with D.82-01-103[1] and continuing through more recent decisions relating to QF contracts, "our review of the reasonableness of nonstandard agreements has reached far beyond specific price terms." (D.89-01-047, at p. 17.)

We noted that early in the QF program we had determined that the object of nonstandard negotiations was to produce a contract which was the "economic equivalent of the standard offer." (D.82-01-103, at p. 91.) The Commission's application of this standard had led us to find that the "economic balance represented by the standard offer should be maintained in negotiated contracts" and that this "economic balance is not limited to the exchange of dollars between the parties." (13 CPUC 2d at p. 124; cited in D.89-01-047, at p. 20.) Specifically, we found that our review of the reasonableness of a nonstandard agreement had required us to consider the following:

> "the negotiations leading to execution of the agreement; all benefits and risks to be incurred by the utility's ratepayers; the certainty of the QF's technology and the integrity and viability of the project; the prevailing financial and legislative climates; the impact of unique contract terms on the utility's bond rating, interest coverage, and ability to raise capital; the societal benefits of the development of a particular project; the timeliness of the capacity being added to the utility's system; the operating flexibility

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1 This decision was issued in Order Instituting Rulemaking (OIR) 2, the Commission's generic proceeding for establishing guidelines for standard offer and nonstandard offer contracts between utilities and QFs. D.82-01-103 and others affecting QF contracts are discussed throughout this decision.

> afforded the utility by the QF (i.e, dispatchability or curtailment); and the manner of payment. (See, e.g., D.82-04-087, 82-07-021, 86-09-040, 86-10-044, 87-03-068, 87-07-023, 87-07-086, 87-09-080, 88-03-036, 88-05-030, and 88-08-021.)" (D.89-01-047, at p. 21.)

In D.89-01-047, we also found that our decisions had made clear that the introduction of the utility as a partner to the agreement necessarily raised other separate and distinct issues which the Commission had committed itself to examine in each instance. These issues included (1) the impact of utility ownership of the QF on competition and the regulated aspects of its operation, including the impact on its ratepayers, (2) the terms of the agreement as compared to the applicable standard offer, and (3) the approach used by the utility in negotiating agreements with affiliated QFs as compared to non-affiliated QFs. (D.89-01-047, at pp. 17-18.) In this regard, we cited D.82-01-103 which had required "greater scrutiny" of utility operations by the Commission when an affiliate was involved.

In D.89-01-047, we concluded:

> "All of these orders lead to the obvious conclusion that our examination of nonstandard contracts in an ECAC reasonableness review are in no way limited to the issue of price as urged by Edison and CSC. For transactions between a utility and an affiliated QF in particular, we are obligated to review the negotiations, all contract terms, and the ownership relation between the parties. These steps are necessary to ensure that the agreement was reasonable and fair to the utility's ratepayers and to all QFs." (Id., at p. 22.)

We found in D.89-01-047 that the documents sought by DRA seemed to be only the most basic information that DRA would require to determine the relations between Edison and the QFs with whom it had entered nonstandard agreements. DRA's proposed evidence of self-dealing was also found to be clearly within the scope of our reasonableness review. (D.89-01-047, at p. 22.)

IV. Standard of Review

Our review of D.89-01-047 above reflects that the scope of a reasonableness review of a QF nonstandard contract, especially one with a utility affiliate, was never intended by the Commission to be as limited as Edison and CSC had urged. The fact that this review takes place in an ECAC proceeding does nothing to alter that conclusion. By permitting a great deal of latitude to Edison in presenting its case before the Commission in this proceeding, we find that a sufficient record on issues related to the reasonableness of the KRCC contract and any related self-dealing has been developed.

We begin this portion of the decision by examining the basic standards by which the Commission is to judge the reasonableness of the KRCC contract and Edison's management decisions related to its negotiation, execution, administration, and presentation to this Commission. In this regard, we note that the "reasonable and prudent act" for both traditional and QF-related utility decisions results from "the exercise of reasonable judgment in light of facts known or which should have been known at the time the decision was made." (D.87-06-021, at p. 19.) For this reason, this section also examines the regulatory and legislative conditions which were known or should have been known to Edison at the time of its negotiation and execution of the KRCC contract. We conclude with a summary of Commission decisions issued after execution of the KRCC contract which are applicable to our review of the contract and our consideration of appropriate remedies.

A. Basic Standards of Reasonableness Review

In our review of the reasonableness of any utility action, the Commission has applied certain general principles. The starting point of the review of both traditional and QF decisions by the utility has been the same. Namely, the event or contract is to be reviewed based on facts that are known or should have been known by the utility management at the time. This standard is used to avoid the application of hindsight in reviewing the reasonableness of a utility decision.

In a recent decision considering the reasonableness of a proposed amendment of a standard offer agreement, we noted our obligation to protect ratepayer interests in determining its reasonableness. Specifically, we concluded:

> "Utilities are held to a standard of reasonableness based upon the facts that are known or should be known at the time. While this reasonableness standard can be clarified through the adoption of guidelines, the utilities should be aware that guidelines are only advisory in nature and do not relieve the utility of its burden to show that its actions were reasonable in light of circumstances existent at the time. Whatever guidelines are in place, the utility always will be required to demonstrate that its actions are reasonable through clear and convincing evidence." (D.88-03-036, at p. 5.)

Similarly, with respect to the review of nonstandard agreements, the Commission has found: "While any power purchase agreement based on suspended interim Standard Offer 4 would appear costly at the present time, we find that it is reasonable to evaluate [these] agreements in light of the actual Commission directives and economic conditions in effect at the time of the parties' negotiations." (D.86-06-060, at p. 26.)

Our decisions reviewing the reasonableness of utility actions have also provided certain guidelines which can be applied to utility decisions affecting traditional utility plant, as well as QFs. Among them, the Commission has found:

1. The act of the utility should comport with what a reasonable manager of sufficient education, training, experience and skills using the tools and knowledge at his disposal would do when faced with a need to make a decision and act;

2. The Commission, as the agency charged with oversight and economic regulation of the monopoly utilities, has a legitimate concern not only with the outcomes of the utilities' decisions, but also the process employed to arrive at a particular decision;

3. The reasonable and prudent act is not limited to the optimum act, but includes a spectrum of possible acts consistent with the utility system need, the interest of the ratepayers, and the requirements of governmental agencies of competent jurisdiction;

4. The action taken should logically be expected, at the time the decision is made, to accomplish the desired result at the lowest reasonable cost consistent with good utility practices.

5. The greater the level of money, risk and uncertainty involved in a decision, the greater the care the utility must take in reaching that decision;

6. The burden rests heavily upon a utility to prove with clear and convincing evidence, that it is entitled to the requested rate relief and not upon the Commission, its staff, or any interested party to prove the contrary.

(D.83-05-036, 11 CPUC 2d 474, 475 (1983); D.86-10-069, at pp. 31-32; D.87-06-021, at pp. 19-20; D.87-12-071, at p. 32; and D.89-02-074, at pp. 8-9.)

B. Regulatory and Legislative Conditions--1976 - 1988

The application of the above principles to QF purchase power agreements is further defined by regulations and decisions governing utility purchases of QF power which were in effect at the time of the utility's negotiation and execution of the agreement. This law is the foundation for the "knowledge" that should have been used by Edison's management in negotiating, executing, or administering the KRCC contract or seeking cost recovery before this Commission. Other facts or circumstances influencing Edison's decisions related to the KRCC contract are discussed in the following section.

Because our review of the KRCC contract in this proceeding involves Edison actions over almost a ten-year period, we will examine the applicable legislation and Commission decisions by time period. Included in this summary are two orders (Resolution E-1938 (Procter & Gamble Contract) and D.82-12-055 (an Edison general rate case)) cited by Edison or its personnel as influencing certain of its decisions.

1. Commission Decisions and State and Federal Regulations -- 1976 to 1984

a. 1976 to 1981

In 1976 the California Legislature added a chapter to the Public Utilities Code entitled "Private Energy Producers" for the purpose of encouraging private energy production as a means of meeting the state's energy needs. (PU Code, Sec. 2801, et al.) On December 19, 1979, this Commission issued D.91109 specifically recognizing the value of alternate resources. In this order, the Commission concluded that these resources promoted the efficient use of fuels, the diversification of a utility's resource plan, an independence from foreign fuel sources, a contribution to system reliability, shorter construction lead times than traditional utility plant, and a shift in the cost of constructing a facility from the utility to the private power producer.

In recognition of these benefits, the Commission in D.91109 authorized the Pacific Gas and Electric Company (PG&E) to pursue cogeneration with energy and capacity payments to be based on PG&E's full avoided costs. This decision directed PG&E to file price offers consistent with these findings.

In the same time frame, federal legislation was adopted to promote the development of cogeneration and small power production. (Public Utility Regulatory Policies Act of 1978 (PURPA).) Section 210 of PURPA required electric utilities to offer to purchase power from cogeneration and small power production facilities, defined as qualifying facilities or QFs.

As required by PURPA, the Federal Energy Regulatory Commission (FERC) adopted final rules implementing Section 210 of PURPA in February, 1980. At the heart of these rules was the requirement of each utility to purchase QF power at a rate equal to the utility's avoided cost of generating the power itself or purchasing it elsewhere. The implementation of the Section 210 rules was reserved to state regulatory authorities and was to commence within one year of the issuance of the rules.

In response to this legislation, the Commission issued OIR 2 on September 3, 1980. The purpose of this proceeding was to establish standards governing the prices, terms, and conditions of electric utility purchases of electric power from qualifying cogeneration and small power production facilities.

Prior to the issuance of OIR 2, the Commission, on March 4, 1980, had directed Edison to file proposed contract terms and provisions for the purchase of energy and capacity from cogenerators and small power producers based on full avoided costs. (Resolution E-1872.) Edison submitted its first such price offer in April, 1980.

In July, 1981, the Commission issued D.93364 (6 CPUC 2d 423) granting a request by San Diego Gas and Electric Company (SDG&E) for approval of its cogeneration agreement with the Kelco Division of Merck & Co., Inc. (Kelco). The decision included a description of the project being proposed and the terms of the agreement between SDG&E and Kelco. The Commission noted that at that time the issue of whether to issue advance approval of "nonstandard" contracts was before the Commission in OIR 2. Nevertheless, the Commission felt that it could grant such approval for the five years of the contract without interfering with that policy decision.

The Kelco contract was then examined in terms of its deviation from a "standard offer" which SDG&E had filed with the Commission at that time and the benefits to be realized from the contract by SDG&E's ratepayers. The Commission noted that the contract provided for an energy payment equal to 90% of SDG&E's avoided energy cost. There was assurance for Kelco, however, of a "floor" on energy payments over the first five years.

In D.93364, the Commission noted that SDG&E, while seeking approval for the entire contract, had made it appear that the only significant deviation between the Kelco contract and its standard offer was in the price term in the beginning years. The Commission had then assumed that for the remaining term of the contract the contract was consistent with the standard offer. Instead, the Commission discovered an additional "nonstandard" term related to curtailment.

The Commission "found it unacceptable that this difference was not mentioned when the contract was originally tendered for review." (Id., at p. 429.) Without any analysis of this term in the record, the Commission decided that it could not give advance approval for the second ten years of the agreement. SDG&E could therefore expect normal ECAC review for payments made during that time.

The Commission concluded:

> "Should any applicant seek advance approval in the future, it must identify all substantial differences between the contract and the utility's standard offer. Failure to identify all differences in the contract for which approval is requested may cause us to deny the application." (Id., at p. 429.)

On October 6, 1981, the Commission issued Resolution E-1938 in response to an advice letter request by Edison for Commission authorization of a power purchase agreement between Procter & Gamble and Edison.[2] The Commission determined that General Order 96-A, under which Edison had made its filing, did not apply to such purchased power agreements and that Commission authorization was not required for the contract to become effective. Further, reasonable costs associated with the contract could be recovered through ECAC rates. In reaching these conclusions, the Commission had reasoned:

> "Edison's apparent purpose for requesting prior Commission authorization of cogeneration contracts is to support its later requests for recovery of purchased power expenses in ECAC proceedings. Generally speaking, we do not think the resolution process is appropriate for this purpose at the present time. In order to verify that the prices of the agreements are based on Edison's avoided costs, the Commission would have to examine at an evidentiary hearing testimony concerning Edison's actual avoided costs. This cannot be done by examining an agreement as presented here." (Resolution at p. 2.)

b. <u>January 21, 1982--D.82-01-103</u>

On January 21, 1982, the Commission ordered the four major California electric utilities to file standard offers for power purchases from qualifying facilities based on avoided cost principles. The decision was made in response to the Commission's own policy, state legislation encouraging the development of qualifying facilities, and federal regulations requiring the Commission to implement the FERC Section 210 rules.

2 The contract, upon which Edison relied in drafting the KRCC agreement, became an exhibit in this proceeding. (Exhibit 115.)

(1) The Standard Offer

D.82-01-103 addressed a number of issues relevant to the development and filing by the utilities of standard offers for power purchases from QFs. In defining the standard offer, the Commission stated:

> "[Standard offer] is the expression widely used by the parties to describe the terms and conditions associated with the utility's obligation to purchase from a QF at the utility's avoided cost. The standard offer is available to all QFs, and represents a complete transaction including prices, interconnection requirements, and other relevant factors. A central aspect of all such offers will be the standard rates for purchase." (D.82-01-103, at p. 23.)

The Commission also found: "The rate has relevance only in relation to the mutual obligations of the parties. In this decision we consider the nature and extent of such obligations. The result is the standard offer." (Id., at p. 24.)

With respect to the recovery of costs under the standard offer, the Commission concluded:

> "The standard offer has particular significance in terms of the existing and anticipated ratemaking treatment to be afforded utility purchases of energy and capacity provided by QFs. Purchases under the standard offer are per se reasonable and a utility's expenses for such purchases are recoverable in the same fashion as other purchased power expenses (in ECAC proceedings, for the larger utilities) without further review. Purchases at rates, terms, or conditions other than the standard offer are recoverable through ECAC or other appropriate procedures subject to a showing of reasonableness." (Id., at p. 24.)

In the decision, the Commission set forth the basic parameters for the four types of standard offers each utility was to file: a standard offer for as-available capacity and energy (Standard Offer 1), a standard offer for firm capacity based on short-run avoided costs and a longer-term commitment (Standard Offer 2), a standard offer for QFs smaller than 100 kW in size (Standard Offer 3), and finally, a standard offer to be based on long-run avoided costs (Standard Offer 4). Under D.82-01-103, the utilities, including Edison were to file Standard Offers 1 and 2 within 45 days of the effective date of the order. The offers were to become effective two weeks after the date of filing. Provision was also made for the filing by application of each utility's proposed Standard Offer 4.

The standard offer was to be available to all QFs for acceptance and was to be consistent with the terms and conditions of D.82-01-103. (D.82-01-103, at p. 162.) Standard Offers 1 and 2 were to be the subject of subsequent compliance hearings.

(2) Nonstandard Contracts

In D.82-01-103, the Commission expressed the view that, having provided for a standard offer intended to be widely applicable to QFs of diverse characteristics, there should be less need for parties to negotiate nonstandard contracts. The Commission even questioned whether it actually wanted nonstandard contracts to be written.

Because the Commission could envision cases in which nonstandard terms might benefit both the QF and the utility's ratepayers, however, we concluded that such contracts could be negotiated. The object of these negotiations, however, was "to produce a contract that [was] the economic equivalent of the standard offer." (Id., at p. 91; emphasis added.) Payments pursuant to nonstandard contracts were to be "recoverable through ECAC upon a showing of the reasonableness of such payments." (Id.)

Due to this ratemaking treatment of nonstandard contracts, the Commission considered the propriety of advance approval of nonstandard agreements. The Commission concluded that it was "not legally compelled to provide for advance review of nonstandard contracts." (Id., at p. 100.) Nevertheless, the Commission decided to provide such review concluding that without it creative nonstandard offers could be stymied and QF development would suffer. (Id., at p. 101.)

The Commission observed that the type of nonstandard contracts which it anticipated would generally involve the following: "some sort of debt guarantee, levelized payment or payment floor which reduces risks for QFs and places those risks upon ratepayers." (Id., at p. 101.) It was the Commission's view, that in "return for taking such risks, ratepayers are afforded some reduction on avoided cost payments." (Id.)

As an example of a nonstandard contract benefitting both ratepayers and the QF, the Commission cited SDG&E's agreement with Kelco. The Commission observed that this contract appeared desirable for all parties, including ratepayers, and concluded: "We can imagine other such contracts which benefit ratepayers. We will entertain such applications within the guidelines established." (Id., at p. 102.)

The guidelines announced by the Commission were as follows:

> "The guiding principle for nonstandard contracts upon which applications should be based is that the contract terms, taking into account the associated risks, should not be more than expected avoided costs under the standard offer. Ratepayers are expected in most non-standard offers to accept some technological or market risk, in which ratepayers should be returned compensating benefit. Applications for nonstandard contracts should clearly state all the differences between the contract and

> the standard offer, and identify all gains and costs for ratepayers. The application should further demonstrate why ratepayers should either be indifferent to or prefer the nonstandard contract over the standard contract. In the rare event that the nonstandard offer is above avoided costs, an explanation of how ratepayers otherwise benefit should be presented. In all cases, the burden is on the applicant to demonstrate why the nonstandard offer is in the ratepayers' interest. We must caution all parties that the Commission will review these contracts as a banker reviews a loan application, with scrutiny and skepticism. While we want to encourage QF development, we do not wish to burden ratepayers in the process." (Id., at p. 103.)

The Commission then set forth the procedures to be followed by the utilities in seeking advance review:

> "We ask that utilities submit only those offers for which the utility has significant questions about whether we would find the offer prudent. Once the Commission has reviewed and expressed its opinion as to the consistency of a contract price and terms with avoided cost principles, utilities should be expected to use these principles to sign similar contracts without review. We will attempt to handle applications for projects less than 10 MW thorough ex parte procedures. Applications over 10 MW will generally require hearings. Exceptions may be made depending upon the novelty of a particular application, or the degree of ratepayers' exposure." (Id. at p. 104.)

The Commission also asked QFs to seek financial support through other institutions and "not through nonstandard offers." (Id., at p. 104.)

The Commission concluded that it would not be involved in negotiating nonstandard offers. Rather, utilities were to negotiate with QFs in good faith, and the Commission would review the contract for approval or disapproval.

(3) Utility Ownership of QFs

In D.82-01-103, the Commission found that PURPA permitted a utility to own up to 50% of a cogeneration or small power facility. The Commission concluded that such facilities should therefore be eligible for full avoided costs under the conditions adopted for all QFs.

Although recognizing such utility ownership of QFs, the Commission did express numerous concerns with this arrangement. Its greatest concerns centered on three areas:

1. Anticompetitive effect. The Commission concluded that it must consider the potential anticompetitive aspects of utility behavior. The Commission concluded: "In this regard, when a utility is approached by a large number of aspiring QFs, we must assure that its own affiliates do not receive special treatment, e.g., more rapid consideration, less difficulty in resolving interconnection issues, etc. It is important that utilities do not stifle competition in the QF market in this or in any other way." (Id., at p. 11; emphasis added.)

2. Avoided costs. The Commission stated that there was also concern that with utility ownership of QFs the utility would have an incentive to keep avoided costs high if their own affiliates could receive such prices. (Id., at p. 11; emphasis added.)

3. Utility Diversification into Unregulated Activities. Identified by the Commission as its "perhaps most important concern", was the fact that utility ownership of QFs would be a step toward utility diversification

> into unregulated activities. The Commission observed that any such diversification into unregulated ventures could have an impact on the regulated utility business for which the Commission is responsible. The Commission concluded: "Our primary concern is the protection of the financial integrity of the regulated entity (i.e., new unregulated ventures should not impair the utility's ability to raise capital, its bond rating, etc.) and the avoidance of any subsidization by the regulated entity (and thus its ratepayers) of the unregulated business.

The Commission concluded that the utility's ownership of a QF would require the following:

> "[S]uch involvement will require greater scrutiny of utility operations on our part related to the concerns addressed above. Any utility may come forward with a proposal for partial ownership of a QF and we will review these matters on a case-by-case basis, with the intent of protecting the interest of both ratepayers and any QFs who might be disadvantaged competitively." (Id., at p. 12; emphasis added.)

c. Other 1982 Decisions

Following an initial review of the standard offer filings made pursuant to D.82-01-103, the Commission directed Edison to further amend its offers to base them on avoided costs which it had not done originally. The amended offers went into effect in May 1982. (D.82-04-071.)

In the spring of 1982, the Commission provided its first review of a nonstandard contract since the issuance of D.82-01-103. (D.82-04-087, 8 CPUC 2d 673.) By application, PG&E had sought the approval of a levelized payment agreement with U.S. Windpower, Inc., (USW) and recovery of all contract payments through ECAC.

The contract which had received a "thorough review" by the Commission's staff was the subject of two days of hearing. PG&E and USW combined to explain why the nonstandard provisions of the agreement were essential to the developer, attractive to investors, and beneficial to PG&E's ratepayers. The staff review focused on Commission policy in reviewing nonstandard offers and the technical and financial risk to ratepayers created by the agreement.

The Commission concluded that the procedure followed in this case was a "good example of the 'nonstandard review process' contemplated in D.82-01-103." (Id., at p. 674.) With respect to the propriety of the agreement, the Commission found that the evidence supported the conclusion that the project would be technically successful. The Commission also focused on the fact that as compensation for a levelized payment above avoided costs in the agreements' early years, PG&E had negotiated discounts of 3%, 5%, and 10% from the avoided cost price as well as interest payments on the payment tracking account balance. The overall cost for electricity was forecasted by PG&E to be well below PG&E's avoided cost over the life of the agreement. The Commission also recognized the need to attract investors to a new and emerging technology such as wind power.

The Commission stated, however, that "[a] more troublesome issue is the question of whether PG&E's ratepayers should bear the risks and benefits presented by the Agreement." (Id., at p. 683.) The Commission concluded: "The Agreement appears to offer the ratepayers high potential rewards at little risk; the fixed price is only slightly above current avoided costs, and there are significant safeguards written into the contract to avoid ratepayer losses should the project experience early failure." Recovery of payments made under the contract in PG&E's ECAC was therefore authorized.

In the summer of 1982, the Commission considered a second request by PG&E to become a guarantor of certain bonds issued for California Power and Light Corporation (CP&L). (D.82-07-021 (9 CPUC 2d 436).) The bonds were required to finance the construction of a 49,900 kW biomass-fueled electric generating plant in Madera County. PG&E's first application for such approval had been considered deficient because the power sales agreement negotiated between PG&E and CP&L posed "unquantified risks for PG&E's customers." (9 CPUC at p. 438.)

In bringing the new application, which the Commission approved, the Commission found that PG&E had made "a crucial change" by no longer asking that "its customers bear any of the technical or financial risks presented by the facility." (Id.) PG&E's customers under the new agreement were to pay only for delivered power from CP&L, while PG&E's shareholders were to bear full responsibility for the guaranty payments previously made the responsibility of PG&E's customers.

The Commission concluded that in reviewing the second application the following analysis had been required:

> "By aiding the financing of CP&L's biomass project, PG&E is diversifying into an unregulated venture which may affect its regulated utility business. Our concern here is for the protection of PG&E's financial integrity as well as the potential for cross-subsidization by a regulated entity of an unregulated venture. Thus, we first must determine that the proposed participation does not create unacceptable financial risks for PG&E. In addition, we must preclude any cross subsidization and the related anticompetitive effects of utility behavior which might result." (Id., at p. 439.)

In December, 1982, the Commission issued two decisions affecting Edison's QF program. One related to Edison's test year 1983 general rate case (D.82-12-055, 10 CPUC 2d 155), and the other was the first decision, applicable to all of California's major electric utilities, approving specific terms of Standard Offers 1 and 2.

In Edison's TY 1983 general rate case, the Commission's staff had presented testimony that, in negotiating contracts with wind developers, Edison had been extremely reluctant to sign standard contracts at full avoided cost. Instead, Edison persuaded developers to sign nonstandard contracts at less than full avoided cost in return for Edison's offers of sale or lease of Edison-owned land, assistance in the environmental permitting process, or easing of interconnection requirements.

In staff's view, Edison's offers were used to exact substantial discounts from avoided cost which were beyond the value of Edison's offers of assistance. When Edison did offer the standard avoided cost contract, the contract contained provisions very unfavorable to QFs, none of which had been included in Edison's standard offers after May, 1982, or in Edison's signed nonstandard contracts. Staff concluded that Edison's pricing policies during 1980 and 1981 had a chilling effect on the development of QF resources within Edison's service area and were contrary to the express policies set forth by this Commission.

The Commission concluded that since January 10, 1978, Edison had been under a duty to exercise its best efforts to pursue and develop cogeneration and small power production resources using avoided cost principles. The Commission agreed with staff that Edison's pricing policies with respect to QFs had been contrary to the Commission's clear intent to base QF payments on the utility's avoided costs.

The Commission found:

> "To our great dissatisfaction Edison continued its pricing policies into 1982, as indicated by Edison's response to our decision in OIR 2 issued in January. In D.82-04-071 we suspended the initial

standard offers which were filed in accordance with the OIR 2 decision. In particular, we stated that: 'Edison's initial offers are not based on avoided costs. Inasmuch as we do not concur with Edison's position that standard offors based on avoided costs are not required nor appropriate, Edison should be required to amend its initial offers to base them on avoided costs.'

"We construe Edison's actions in early 1982 as evidencing a continuing pattern of disregard for the Commission's avoided cost policy of the past three years." (Id. at p. 258.)

In response to these actions, the Commission assessed a penalty of 10 basis points on Edison's return on equity for 1983 and 1984. The Commission observed that this penalty was one-half the penalty imposed on PG&E in 1979 for failure to promote cogeneration.

At the end of December 1982, the Commission issued D.82-12-120 (10 CPUC 2d 553) which reviewed the three short-run standard offers filed by PG&E, Edison, and SG&E in response to D.82-01-103. These offers had been the subject of 40 days of hearing in which numerous issues had been raised. D.82-12-120 addressed some of the most critical issues, including terms related to price, performance, and termination. The remaining issues (i.e., interconnection filing requirements, insurance, and miscellaneous contract terms) were left to a subsequent decision.

In D.82-12-120, the Commission reviewed its findings in D.82-01-103 regarding the differences between as-available power (Standard Offer 1) and firm power (Standard Offer 2). With respect to a firm capacity commitment by a QF, the Commission found:

"[F]irm capacity was viewed as an increase in the utility's supply of electricity with corresponding performance standards, termination provisions, and sanctions. By definition, firm power is provided in predetermined quantities at predetermined times with sufficient legally enforceable

> guarantees of deliverability to permit the purchasing utility to avoid the construction of a generating unit of the purchase of firm power elsewhere. A QF providing firm capacity was determined to avoid costs addition to those related to as-available power. This result was to be reflected in the firm capacity payment." (10 CPUC 2d at p. 568.)

In contrast to firm power, payments for as-available power would not reflect any value for contract length, notice, termination, or sanctions since such provisions would not be part of an as-available offer.

The termination provisions adopted for firm capacity Standard Offer 2 in D.82-12-120 were intended to "encourage QFs to fulfill their contractual obligations, provide reasonable certainty of the consequences of termination, and make the utility and its ratepayers whole." (Id. at p. 596.) In keeping with this goal, the Commission directed the utilities to include termination provisions in their firm capacity standard offers which met the following requirements:

1. A QF terminating with prescribed notice was required to reimburse the utility for unearned capacity payments. Interest on this reimbursement was to be charged on the basis of the Federal Reserve Board three months' Prime Commercial Paper rate.

2. Specific notice required for termination with notice was to vary depending on the amount of capacity being terminated. Specifically, the Commission endorsed the notice provisions included by PG&E and SDG&E in their standard offers. Under PG&E's proposal, QFs over 100,000 kW were required to provide five years' notice of termination.

3. For a QF terminating without prescribed notice the QF was required to refund overpayments and to cover the utilities' replacement costs for the lost or reduced capacity. The offers were to include a

> liquidated damage clause calculating this additional payment for replacement costs similar to one proposed by PG&E, modified to reflect the time needed, as indicated by the notice table, to replace the lost capacity. The utilities were also permitted in their calculation of damages to refer to future capacity prices. (See, D.82-12-120, Ordering Paragraph 5, 10 CPUC 2d at p. 641.)

The Commission concluded that reimbursement of unearned firm capacity payments was appropriate since the utility was not required to pay more than avoided costs for QF power. The Commission stated: "Any payment over this amount arising from price levelization should therefore be refunded to the utility." (Id., at p. 597.) The Commission concluded that termination provisions should also be applied to any reduction in firm capacity.

d. Commission Decisions in 1983

In May, 1983, the Commission approved a purchase power agreement between PG&E and AeroTurbine Energy Corporation related to a 126 MW wind facility. (D.83-05-043.) The Commission found that the agreement's nonstandard pricing provisions for Stage I were prudent and reasonable for the development of this commercial scale wind turbine project. The Commission also found that the operating incentives and performance standards provided in the agreement for AeroTurbine adequately limited the risk assumed by PG&E's ratepayers in the early years of the project.

The decision noted that preapproval in this case had been sought because the pricing provisions of the AeroTurbine agreement did not conform with PG&E's standard offer. In analyzing the agreement, the Commission noted that PG&E's then effective Standard Offer 1 had served as the starting point for negotiations. The decision included a detailed analysis of the contract terms and PG&E's enumeration of the several provisions of the agreement which PG&E had asserted would minimize the ratepayer's risk.

PG&E's testimony included the utility's prediction that "power purchases over the life of the Agreement will be below PG&E's avoided cost." (Id., at p. 8.) The Commission staff presented analyses by both its utilities' division and its Legal Division. The conclusion of these divisions was that the agreement struck a fair balance between the risks and benefits of this project.

On the basis of the parties' analyses of the contract, the Commission concluded that PG&E and AeroTurbine had "struck a reasonable balance of the risks and benefits created by the non-standard pricing provisions for Stage I." (Id., at p. 10.) The Commission also found that, for the risks created for ratepayers, the contract had "important compensating benefits." (Id., at p. 12.) In particular, the project would commercialize a large-scale wind technology for the first time which could produce substantial long-term benefits to ratepayers.

The Commission concluded, however:

> "This contract should not be viewed as a precedent for other contracts between utilities and small power producers. The price being paid to [AeroTurbine] in Phase I is high, as is the ratepayer's exposure to technological risk. For technologies not in such a critical state of development, or which are without such vast potential, we would not necessarily find these contract provisions to be reasonable." (Id., at p. 21.)

In June 1983, the Commission reiterated its conclusion in D.82-01-103 that utilities were to negotiate nonstandard contracts in good faith. The Commission also found that sanctions could be imposed for bad faith negotiations. (D.83-06-109.)

On September 7, 1983, the Commission issued D.83-09-054 (12 CPUC 2d 604) approving interim Standard Offer 4, a long-term offer to be based on the utility's long-run avoided cost.

The standard offer was the result of negotiations between the utilities, QFs, and Commission staff. The Commission noted that the offer was interim only in the sense that it might ultimately be replaced by a different costing methodology or contract terms. Until then, however, QFs and utilities were to fully rely on the options adopted for Standard Offer 4 in D.83-09-054. The Commission also concluded: "Potential QFs who find they cannot use Standard Offer #4, as approved today, still have the option of pursuing a negotiated nonstandard contract with utilities." (12 CPUC 2d at p. 609.)

In approving interim Standard Offer 4, the Commission made the following observations:

> "[W]e have never said that QF power must be developed at <u>any</u> cost, but rather that it should be developed with reasonable cost to ratepayers when viewed in the longer term perspective. In the long run, if we do a reasonable job of valuing and pricing QF power, the ratepayers should be indifferent as to whether eventually needed capacity is supplied by QFs or electric utilities." (<u>Id</u>., at p. 611; emphasis original.)

While capacity payments and most contract terms under Standard Offer 4 were to mirror those in Standard Offers 1 and 2, three different energy payment options were made available. Among them was Energy Payment Option 3. Under this option, energy prices were to be based on (1) a forecast of the utilities' incremental energy rates and (2) actual utility costs for incremental fuel.

The Commission found that Option 3, "while probably most attractive to oil and gas cogenerators", would be available to all QF technologies. (<u>Id</u>., at p. 630.) With respect to cogenerators, the Commission observed: "We recognize the benefits of having oil and gas cogenerators on the system to displace the utilities' incremental oil and gas generation units, but only to the extent that: (1) cogeneration results in a more efficient use of fossil fuels (i.e., the cogenerator's actual incremental energy rate is lower than the utility's) and, (2) California's resource base, no matter how well it can be diversified, may require some oil and gas generation units to meet demand." (Id., at p. 631.) The Commission expressed the concern, however, that Option 3 "could, over time, provide incentives to oil and gas cogenerators that are not commensurate with the benefits described above." (Id.) In particular, the Commission found:

> "Whereas Options #1 and #2 place the entire risk that a QF's actual production costs may be higher than our projections of avoided costs, Option #3 removes the risk associated with fuel-price variability from fossil-fuel cogenerators. Instead ratepayers are exposed to all of the fuel price variations, which can be very significant for oil and gas. Furthermore, providing a band around the incremental energy rate forecast mitigates some of the potential efficiency benefits that oil and gas cogenerators can add to the system." (Id.)

Nevertheless, the Commission ultimately decided to approve the use of Option 3 for all utilities.

On October 19, 1983, the Commission issued D.83-10-093, the second of three orders addressing the price and contract terms of Standard Offers 1 and 2. This decision resolved the majority of issues remaining from the first order (D.82-12-120): date of determination of contract capacity value, revisions in capacity tables, QF payment schedules, requests for energy sale conversions, data filings, interconnection requirements, insurance requirements, interconnection costs, interconnection orders, standardization of contract terms, varying the standard offer, relations with governmental entities, relations with third parties, and right of first refusal, QF abandonment, and contract assignment.

Only a few issues relating to Standard Offers 1 and 2 remained for the third order (D.84-03-092). These included definition of certain contract terms and the applicability of certain remedies, including dispute resolution.

With respect to insurance, the Commission concluded that the utilities should be directed to require QFs to provide general liability coverage of no more than $1 million per occurrence. Further, the utilities were advised that "any costs incurred by the utility resulting from liability exposure greater than $1 million shall be recovered through rates." (D.83-10-093, 13 CPUC 2d at p. 111.) The Commission found that this determination was reasonable "since the risks to the ratepayers, given the QFs' current safety record, appears very small at this time."

C. Commission Decisions From 1985 to 1988

In March 1984, the Commission issued its third and final order on Standard Offers 1 and 2 (D.84-03-092, 14 CPUC 2d 489). The issues addressed in this decision related to certain contract terms, QFs under 100 kW, PG&E's standby tariffs, data on avoided transmission and distribution costs, access to computer models, and conversion of contracts.

During 1984 and 1985, there were few decisions requiring changes in the standard offer terms. Instead, the Commission focused on requests to approve nonstandard contracts (see, e.g., 84-05-047) and eventually the need to suspend the standard offers due to QFs exceeding the capacity needs of the utilities.

In D.84-05-057, Commission reviewed an application for approval of a power purchase contract between SDG&E and NCRRA. The decision reviews application, contract terms, and technical and economic risks of the contract. The contract was approved and included the following nonstandard provisions: adjustments in energy price and QF option of switching from price formula adopted for energy to schedule of prices based partly upon 90% of SDG&E's forecast prices appearing in its Standard Offer 4. These terms were negotiated to enhance financing of the project. SDG&E

analyzed the risks and benefits of the agreement by comparing projected results of the nonstandard pricing provisions with the Standard Offer 4 contract.

From August, 1984, through April, 1985, the Commission addressed the need to suspend Standard Offer 4. The first action taken by the Commission in this regard was the suspension of PG&E's Standard Offer 4, Payment Option 3 for QFs over 50 MW. This action, resulting in D.84-10-098, was based on assertions by PG&E of QF capacity in PG&E's service territory exceeding PG&E's needs. The suspension was to remain in effect until December 5, 1984.

During an en banc oral argument on November 5, 1984, to discuss the suspension of the PG&E standard offer, Edison asserted for the first time that it could be faced with a similar problem of QF capacity oversupply. In response to this situation, Edison recommended (1) the suspension of all standard offers for projects over 50 megawatts, (2) the continued encouragement of nonstandard contracts for projects over this size limit, with the use of the Commission approval process as desired, and (3) consideration of the status of Standard Offer 4 in an appropriate proceeding. These requests and statement of potential oversupply were restated in comments filed with the Commission on November 16, 1984.

In December, 1984, the suspension of PG&E's Standard Offer 4, Payment Option 3 was continued. (D.84-12-027.) The Commission concluded with respect to Edison, however: "We have no basis to extend this suspension to the interim Standard Offer 4 of either Southern California Edison Company or San Diego Gas and Electric Company." (D.84-12-027, at p. 3.)

Later that month, the Commission issued its decision in Edison's 1985 test year general rate case. In contrast to its position at the earlier en banc hearing, Edison had argued the following in its general rate case:

> "Edison submits that the marketing effort to encourage new [QF] projects will need to be increased due to these obstacles [difficulty in

> obtaining siting and permit approvals, scheduled expiration of the federal energy tax credits in 1985, the lower avoided cost payment rates and uncertainty among developers regarding the long-run standard offer]. More important is the Commission's continued commitment to support and encourage developers through the series of hurdles required to bring a project on-line. In any event, Edison argues that the presence of these obstacles reinforces the need to maintain a vigorous program to support the development of renewable and alternative resources." (Id.)

In February, 1985, the Commission addressed a motion filed by Edison on January 31, 1985, for an "Emergency Ex Parte Interim Order" to suspend its Standard Offer 4, Payment Option 3. Although the Commission did not find that the information provided by Edison in its motion reflected an "emergency" on the order of that presented by PG&E, we concluded that continued availability of SO4, Payment Option 3 for QFs over 50 MW "may place Edison at some risk of having QF energy supplies exceed Edison's needs in the very near future." (D.85-02-069 at p. 2.) A suspension of Edison's Standard Offer 4, Payment Option 3, was made effective until April 17, 1985.

On April 17, 1985, the Commission ordered the complete suspension of Standard Offer 4 for all utilities pending comments on this action. (D.85-04-075.) On July 10, 1985, the standard offer, as adopted by D.83-09-054, was suspended in its entirety for all utilities for an indefinite period.

In December, 1985, the Commission, in an SDG&E ECAC proceeding, considered the reasonableness of a nonstandard power purchase agreement involving a former SDG&E subsidiary. (D.85-12-104, 20 CPUC 2d 66.) In this reasonableness review, the Commission focused on payments flowing from SDG&E to Applied Energy Inc. (AEI), a former SDG&E subsidiary. In 1983, SDG&E had divested itself of the ownership of AEI with the purchase of AEI by Energy Factors, Inc.

The issue in this proceeding centered on whether SDG&E, under the terms of a nonstandard purchase power agreement, had paid too much for energy from a cogenerator in which SDG&E had a 20% ownership interest. The Commission also considered whether the agreement should be modified.

The Commission commended the staff for bringing the issue before it, but found that the staff's evidence was flawed by the absence of a consistent theory or standard on which to test the payments under the contract or the SDG&E - Energy Factors relationship. SDG&E had argued that over time, the pluses and minuses of the payment formula under the agreement balanced out and that its ratepayers were economically indifferent. An interested party, the Utilities Consumers Action Network (UCAN), however, had urged the Commission to treat Energy Factors no different than any other similarly situated cogenerator and to reform the contracts so that the agreement conformed to a standard offer.

In adopting UCAN's suggestions, the Commission found:

> "The best way to establish an arms-length relationship between SDG&E and its former subsidiary is to treat AEI in the same manner as any other cogenerator in the utility service territory. A standard offer price relationship is best [sic] standard to use at this time. Standard Offer 2 most closely fits the facts of the current relationship. We will, therefore, reduce the balancing account by $4,318,299 (through October 1985) and order SDG&E to recompute the balancing account in this same manner to provide a more accurate result for the year 1985 which we have estimated. Also payments charged to ratepayers in the future will be computed in this manner until SDG&E and AEI arrive at some different contractual arrangement. This result will also be carried into the forecast period." (D.85-12-104, 20 CPUC 2d at 70.)

During the period following the suspension of interim Standard Offer 4, the Commission embarked on a course of developing a final Standard Offer 4 methodology and offer. In 1987, the

Commission issued D.87-05-060 which was viewed as a further step toward the implementation of a final Standard Offer 4 and the reinstitution of Standard Offer 2, which had been suspended in 1986 (D.86-03-069).

By D.87-05-060, the Commission set forth the process by which Standard Offer 4 would become available to QFs. One of the last steps of this process was the announcement by the utility of "the availability of long-run standard offer contracts based on the capacity and the fixed and variable costs of the avoidable resource(s)". (D.87-05-060, at p. 5.) The utility would then accept bids from QFs for these contracts with the winning bidder signing the agreement upon compliance with the Qualifying Facility Milestone Procedure.

Of importance to this proceeding, the Commission in D.87-05-060, permitted utilities to accept bids from their QF affiliates under certain conditions. In particular, the utility was required to provide equal access to the public of the market, technical, or similar data transferred to its QF affiliates under the same terms and conditions it was made available to the utility's affiliates.

In allowing utilities to accept bids from their QF affiliates, we found that "the auction process itself helps ensure the propriety and reasonableness of utilities' dealings with their QF affiliates." (Id. at p. 17.) We also concluded that "the utilities' obligation to compete fairly arises not only under antitrust law but also, in our view, under the Public Utilities Code. Any favoritism shown by a utility to its QF affiliate may result in unreasonable expenses that must be borne by shareholders, not ratepayers." (Id.)

On January 28, 1988, the Commission issued its decision in Edison's holding company application. (D.88-01-063.) D.88-01-103 has been discussed in the previous section of this decision on the scope of review of this proceeding.

For purposes of this section, we note our findings in that order regarding the conditions of our approval of Edison's new corporate structure. The purpose of the conditions which we imposed was to ensure that there would be "no diminution of the Commission's ability to regulate Edison effectively or Edison's ability to provide reliable utility service at reasonable rates." (D.88-01-063, at pp. 21-22.)

In particular, the adopted conditions were designed (1) to ensure that all costs incurred by Edison resulting from its affiliates' activities were recovered from the affiliates, (2) to provide the Commission with access to all information necessary to thoroughly analyze Edison's costs and to monitor the relationships between Edison and its nonutility affiliates, (3) to ensure Edison ratepayers were insulated from all effects of nonutility activities, (4) to preserve the regulatory control which the Commission currently has over Edison's activities, and (5) to ensure the financial health of the utility's operations. One of the specific conditions imposed on Edison was the requirement that Edison ensure that the Commission has access to books and records of the holding company and each of its affiliates and their joint ventures. It was our expectation that Edison and its affiliates would either promptly comply with a Commission request for information or prepare an immediate showing to demonstrate why the request was allegedly beyond the bounds of jurisdiction or relevance.

In D.88-01-063, we rejected DRA's recommendation to prohibit Edison from entering into any new contracts for power with QF affiliates in Edison's service territory. DRA had made this recommendation based on the potential for self-dealing between the utility and its QF affiliates to the detriment of the utility's ratepayers. Our rejection of this request was based on the existing safeguard of the QF bidding process adopted in D.87-05-060.

In 1988, as it had in previous years, the Commission considered and reviewed numerous applications by utilities for approval of nonstandard purchase power agreements and amendments to existing standard offers. (D.88-03-036, D.88-05-030, D.88-08-021, D.88-08-054, D.88-09-038, D.88-10-038, D.88-12-32, D.88-12-095.) In each of these cases, the focus of the Commission's decisions was on the ratepayer benefits to be realized from the agreement and the existence of ratepayer economic indifference.

In rejecting one request by PG&E for approval of a nonstandard agreement, the Commission found it inappropriate to shift the development risk of a QF project to ratepayers by allowing the extension of five-year deadlines on operation. (D.88-12-032, at p. 17.) The Commission further found that in reaching its decision, "we merely apply our stated policy that concessions sought by the utility should be proportionate to the extent and significance of the modifications sought by the QF." (Id., at p. 18.)

In our previous section, we have discussed the impact of D.89-01-047 on the scope of review in this proceeding. This decision, issued prior to the commencement of hearings in this case, also included a number of findings regarding Edison's presentation of its case before the Commission.

In particular, we expressed concern in D.89-01-047 that Edison's pleadings submitted up to that time had reflected an "apparent attempt to shield information from DRA on the basis of objections from its QF partners" (D.89-01-047, at p. 22). We further stated that it had been our intention with the imposition of the conditions and safeguards in D.88-01-063 and OIR 2 "that the utility would not use its non-regulated activities to hinder our legitimate inquiry into its regulated activities." (Id.) Because of these circumstances, we reiterated Edison's obligation to demonstrate the reasonableness of its actions through clear and convincing evidence.

V. The KRCC Contract

In the preceding section, we have examined the standard of review to be applied to the KRCC contract. We now turn to the terms of the agreement itself and the factual record related to its negotiation, execution, and amendment, and the approach taken by Edison in presenting the contract to the Commission for review. Based on the applicable legislation and Commission decisions summarized above, a critical issue in our review of the KRCC contract is its comparability with then-existing standard offers and, in turn, the extent to which, if at all, the contract at the time of its execution exposed Edison's ratepayers to greater risk than the standard offer. Of concern also is any evidence of favoritism by Edison toward KRCC.

To provide a better understanding of the factual record in this case, we begin this section with a summary of the major differences between the KRCC contract at the time of its execution and the standard offers. Both Standard Offer 2 and Standard Offer 4, two offers which provide for firm capacity payments, were in effect during the contract's negotiation and execution.

Following this comparison of contract terms, the factual record of the negotiation and execution of the KRCC contract will be summarized. This section will be followed by a review of the subsequent amendments to the contract and Edison's actions in responding to D.89-01-047 and presenting its case on the reasonableness of the KRCC contract to the Commission.

A. KRCC Parallel Generation Agreement Terms--January 16, 1984

The KRCC contract was executed on January 16, 1984. The KRCC contract, as executed on January 16, 1984, provides for the purchase by Edison from KRCC of 170 MW of minimum contract capacity for 20 years. Provision is made for increasing the minimum contract capacity during the term of the project. (Exhibit 109, App. B, Sec. 1.)

The project itself is defined by the contract as "a combustion turbine generator heat recovery steam generator

Cogeneration Facility" located at the Kern River Oil Field, near Bakersfield, California. The combustion turbines have a nominal electrical rate of 284 MW at 80 degrees fahrenheit. (Exhibit 109, PGA, at p. 1.)

It is DRA's position, largely undisputed by Edison or KRCC, that it is most appropriate to compare the KRCC contract to Standard Offer 4, Energy Payment Option 3. In discussing the KRCC contract terms below, this offer will be a major point of reference, but note will also be taken of any relevant provisions of Standard Offer 2.

DRA's challenge to the KRCC contract stems from the many terms of the agreement which differ from the Commission's standard offers. It is DRA's position that the KRCC nonstandard contract terms were not only at odds with the standard offers and Commission directives in effect during its negotiation and execution, but resulted in exposing Edison's ratepayers to greater risks than the standard offers without any compensating benefits. Edison and KRCC argue that the agreement was in the interests of Edison's ratepayers and was required at the time of its execution to meet an Edison resource need and to respond to regulatory pressures. The positions of the parties are reviewed at greater length in the next section.

1. Energy Price Provisions

The KRCC contract relies on a nonstandard formula for determining energy payments. In general, the on and mid-peak energy payments are derived from the product of Edison's avoided fuel cost, a 0.96 discount factor, Edison's contract heat rate, and the net kilowatthours delivered to Edison.

As defined by the contract, Edison's contract heat rate is based on the average heat rate of Edison's gas and oil units. The contract includes a fixed heat rate floor and ceiling through the life of the contract (20 years). The contract heat rate floor is set at 9300 Btu/kWh, with the ceiling set at 11,500 Btu/kWh. In addition, the contract provides that only oil or gas is to be considered the marginal fuel under the KRCC contract when calculating the average heat rate, except for a maximum of 1,000 off-peak hours during which time the average of gas, oil, and coal prices will be used when oil or gas is not the marginal fuel.

In contrast, Energy Payment Option 3 of Standard Offer 4 is tied to the system incremental heat rate, as opposed to the utility's average heat rate. Further, the standard offer uses the actual marginal fuel to calculate the actual IER. Fixed heat rate floors and ceilings are provided under the standard offer for 13 years, as compared to 20 years under the KRCC agreement.

Additionally, the forecasted IERs to be used in conjunction with Energy Payment Option 3 provided annual IER values beginning in 1985 below 9300 Btu/kWh. The average of these annual values forecasted through 1997 is 8827 Btu/kWh. (Exhibit 105, Appendix D.)

2. <u>Capacity Price Provisions</u>

Under Standard Offers 2 and 4, the capacity price paid to QFs is tied to the capacity price schedules submitted on a quarterly basis by the utility and approved by the Commission. The capacity price under a standard offer is determined by the capacity price in effect during the year in which the QF begins firm deliveries to the utility. Under both Standard Offers 2 and 4, the QF has the option of basing this price on the Standard Offer 2 Capacity Payment Schedule in effect at the time of contract execution or at the time of firm operation. Edison's capacity price schedule in effect at the time of the execution of the KRCC contract provided forecasted capacity prices for on-line dates through 1988.

Additionally, the standard offer provides for additional capacity to be paid at a full Standard Offer 1 price only if the capacity is available 100% of the on-peak hours. As-available capacity under the standard offer can receive no bonus payments.

The standard offer also requires that the utility must agree in order to increase the contract capacity.

In contrast, the KRCC contract, at the time of its execution on January 16, 1984, fixed the actual capacity payment to be made by Edison to KRCC. Specifically, Edison agreed to pay KRCC a capacity payment of $143.00/kW-year for the minimum contract capacity (170 MW). The value of additional contract capacity was to be determined based on the year in which it was delivered and upon the length of the commitment, "as determined from the then prevailing 'Annual Capacity Payment Table' as filed with the Commission". (Exhibit 109, App. B, Sec. 2 (b).)

At the time of the execution of the KRCC contract and the commencement of firm operation of the project (August 1985), Edison's filed capacity price schedule provided for a capacity payment of $143/kW-year for energy deliveries beginning in 1986 and a capacity payment of $132/kW-year for energy deliveries beginning in 1985. Under the terms of the KRCC contract, KRCC was entitled to commence firm operation of the project as early as June 8, 1985. (Exhibit 109, PGA, Sec. 14.3.) KRCC commenced firm operation in August 1985, and began at that time to receive capacity payments, as provided by the contract, of $143/kW-year.

Additional capacity provided by KRCC receives the full as-available capacity price if the capacity is available 80% of the summer peak hours. KRCC can qualify for a bonus payment if this capacity is provided for more than 85% of the summer on-peak hours. Prior to its date of operation, KRCC could increase the contract capacity from 170 MW to 284 MW unilaterally.

3. <u>Termination Provisions</u>

In our prior section on Commission decisions in effect at the time of the negotiation and execution of the KRCC contract, reference was made to D.82-12-120. In that order, issued December 30, 1982, the Commission adopted the guidelines to be followed for termination provisions under Standard Offer 2. Under

Standard Offer 4, these same principles are applied to reductions in firm capacity. (Exhibit 105, SO 4, Sec. 9.1.2.6.) The "Capacity Reduction" section of Standard Offer 4 can effectively result in termination of the contract as the contract capacity can be reduced to zero.

The significant features of the termination or capacity reduction provisions of the Standard Offers 2 and 4 filed by Edison and in effect in 1983 (Exhibits 104, 105, and 106) are the following:

(1) Written notice of termination being provided by the QF to the utility, the length of which varied depending upon the amount of capacity being terminated or reduced up to the maximum capacity any QF could have. This notice ranged from 12 months for a capacity reduction of 25,000 kW or under to 60 months (5 years) for capacity reductions over 100,000 kW.

(2) A refund being provided by the QF to Edison equal to the difference between capacity payments paid by Edison up to the time of Edison's receipt of the reduction notice and the total capacity payments which Edison would have paid if based on the adjusted capacity price. The refund was to be paid with interest based on the Federal Reserve Board's three months prime commercial paper rate.

(3) The requirement of Edison to make capacity payments, based on the adjusted capacity price for the amount of contract capacity being reduced, from the date the reduction notice was received to the date of actual capacity reduction.

(4) Reduction of capacity by the QF without notice provided that the QF provided Edison with the refund described above and an amount equal to "(i) the amount of Contract Capacity being reduced times (ii) the difference between the Current Capacity Price and the Contract Capacity Price, times (iii) the number of years and

> fractions thereof (not less than one year) by which the Seller (QF) has been deficient in giving prescribed notice." (Exhibit 105, SO 4, Sec. 9.1.2.6 (d).) If the current capacity price was less than the contract capacity price, only the refund described in item (2) above was due.

The termination provisions of the KRCC contract are contained in Section 5 of that contract. (Exhibit 109.) At the time of the contract's execution, the section provided as follows:

> Section 5.1 -- Under this section, the contract shall remain in effect for twenty years from the date on which energy becomes available.
>
> Section 5.2 -- According to this section, "[i]f KRCC fails to make available Contract Capacity throughout the term of this Agreement pursuant to Section 14, Edison shall have the right to terminate this Agreement upon ninety (90) days' written notice to KRCC. If, within said ninety (90) day period following such notice, KRCC makes Contract Capacity available pursuant to Section 14, Edison's notice of termination shall not be effective for terminating this Agreement. KRCC shall exercise due diligence to correct the reason for loss of Contract Capacity and Net Energy."
>
> Section 5.3 -- This section requires KRCC to begin delivery of contract capacity of a net 170 MW by December 31, 1986. This section also provides that "[u]nless excused pursuant to this Agreement, if Edison declines to accept delivery at any time throughout the term of this Agreement, KRCC may terminate this Agreement upon ninety (90) days' written notice to Edison."
>
> Section 5.4 -- This section provides the following: "If KRCC fails to provide the required Contract Capacity, a new Contract Capacity value shall be established by the Parties upon the basis of demonstrated capacity."

> Section 5.5 -- This section provides the following: "At any time, after the retirement or defeasance of any and all debt obligations of KRCC or any subsidiary of KRCC incurred for project financing of the Cogeneration Facility, if in KRCC's opinion, its performance becomes unprofitable at any time, KRCC shall have the right to terminate this Agreement upon ninety (90) days' written notice to Edison. Upon such termination, KRCC shall pay to Edison an early termination fee to be determined in accordance with the following formula: Contract Capacity x $169 kW x (1 - X/12)) where "X" is the number of completed years of service from the date of first delivery pursuant to Section 14.3."

4. Scheduled Maintenance

Section 8.7 of Edison's Standard Offer 2 (Exhibit 104) in effect in February 1983, provided that the QF "shall make reasonable efforts to schedule routine maintenance outside the Peak Months (and during expected minimal generation periods for renewable resources) but in no event shall outages for scheduled maintenance exceed 30 peak hours during the peak months." These requirements were mirrored in Standard Offer 4 in Section 4.5.2 which similarly limited QFs to 30 hours of scheduled maintenance during peak months. The standard offers also prohibited QFs from scheduling major overhauls during peak months.

Under Section 12.1 of the KRCC contract, "[e]ach Party shall make every reasonable effort to limit the outages during on-peak and mid-peak periods to unscheduled failure of equipment directly related to electric generation." Section 8.7 of the KRCC agreement permits KRCC to perform routine maintenance during periods "when such maintenance will not adversely affect Edison's Electric System Integrity insofar as it is practicable to do so." The agreement includes no limitation on the number of hours of scheduled maintenance permitted during peak periods and no prohibition on scheduling major overhauls during peak months.

5. <u>Other Provisions</u>

In its report, DRA cited certain other provisions as also differing between the KRCC contract and the standard offers. Among them were provisions governing force majeure, a QF's warranty to maintain QF status throughout the term of the contract, and capacity derating. In its brief, however, DRA indicates that it is now persuaded by the evidence that the KRCC contract provisions governing these terms, while different from the standard offer, are not unreasonable.

A difference in the contract terms which is still at issue relates to insurance requirements. Under the KRCC agreement, "(e)ach Party shall obtain and maintain in force . . . comprehensive general liability insurance...with a combined single limit of not less than five million dollars ($5,000,000) each occurrence". (Exhibit 109, Sec. 18.1.)

Under Standard Offer 4, the QF alone is required to maintain contractual liability coverage with a combined single limit of not less than $1,000,000 each occurrence for facilities of 100 kW or greater. (Exhibit 105, Sec. 14.1.) Under Standard Offer 2, as filed by Edison in February, 1983, the QF was required to maintain a policy of $5,000,000 for each occurrence. (Exhibit 104, Sec. 18.1.) The revised Standard Offer 2, with an effective date of December 5, 1983, contained language similar to that included in Standard Offer 4. This terminology was based on the Commission's conclusions regarding insurance coverage stated in D.83-10-093. (See, 13 CPUC 2d at p. 111.)

B. <u>Negotiation and Execution of the KRCC Contract</u>

The first discussions regarding the development of a generating facility at the Kern River oil field occurred in 1975 between Getty, the predecessor to Texaco Producing Inc., and PG&E. The field, in which Getty owned or leased oil production rights, was located in PG&E's service territory, near its border with

Edison's service territory. Little progress was ever made in these discussions.

In late 1980, Claire Dedrick, then a Commissioner with this agency, was asked by a member of the Governor's staff to discuss the potential economic benefits of cogeneration development with Getty. In December 1980, Dedrick met in Bakersfield with Ed Shuler, vice-president of Getty. After explaining the benefits of cogeneration development to Shuler, Dedrick found the Getty representatives "very receptive" to this development. (Exhibit 153, at p. 4.) Based on an Edison policy announcement that the utility intended to pursue cogeneration development, Dedrick urged Getty to contact Edison.

Immediately following this meeting, Dedrick was called by a PG&E executive who indicated that PG&E intended to delete the Getty project from its list of proposed cogeneration projects because of Getty's lack of interest. Dedrick then contacted Shuler and gave him the telephone number of Ed Myers, Vice President of Edison.

Dedrick's term as a Commissioner ended on December 31, 1980. Dedrick testified that she gave "substantial encouragement" to the development of a cogeneration facility at the Kern River oil field. (Exhibit 153, at p. 5.) She did not, however, participate in any contract negotiations, was not aware of the type of contract the parties wanted, and was not part of any discussion regarding whether Edison would participate as an equity partner. She also testified that she was never shown the contract at issue in this proceeding.

Regarding Commission policy at the time of her discussions with Getty, Dedrick stated that the promotion of "cost effective cogeneration power supply" was a first priority of all five members of the Commission. (Tr. 3156.) According to Dedrick, however, it was "certainly not" the Commission's policy to advance cogeneration at any cost. (Tr. 3157.) Further, she indicated that the Commission would view both parties as "businessmen" who "should work out their arrangements on a business basis within the existing rules." (Tr. 3169.)

Early in 1981, Ed Myers and Shuler met to discuss Edison's possible involvement in the Kern River project. The proposed cogeneraton facility was to be located near Getty's Kern River oil field and would provide steam to the field for enhanced oil recovery (EOR) and electricity to Edison.

On May 21, 1981, Getty and Edison agreed to prepare a joint feasibility study of the project. In October, 1981, Black and Veatch, consulting engineers retained to prepare the study, completed the Kern River Cogeneration Feasibility Study. (Exhibit 4 of Exhibit 88.)

The Black and Veatch study analyzed the technical feasibility, reliability, economic viability, and regulatory requirements for the facility with a plant rating of 289 MW. The study concluded that risks associated with the project were manageable and that any risks related to the performance, regulation, or economics of the project were considered small or nonexistent. Getty's return on investment, based on an expenditure start date of January 1, 1982, was expected to be in the range of 46.0 to 69.1%, with the highest end of that range resulting from electricity prices based on Edison's full avoided costs. The initial fuel supply was considered the greatest uncertainty. The report concluded with the following recommendation: "Early filing of permit applications should provide a favorable position for Getty should the number of similar facilities being planned for Kern County become excessive." (Exhibit 4 of Commission Exhibit 88, at p. 6-31.)

On November 20, 1981, Ed Myers wrote Shuler that, based on Edison's and Getty's evaluation of the study, "it certainly appears this project is technically sound and offers an attractive rate of return on investment." (Exhibit 5 of Commission

Exhibit 88.) Ed Myers also stated that "based on these merits and positive initial input, the proposed project should be accelerated." (Id.) The letter proposed a joint working fund in order to file for a CEC permit, to confirm the best primary fuel source at the site, to pursue project financing options, and to structure a joint venture, a power sales agreement, and a steam sales agreement. Ed Myers also offered Edison's engineering and construction department as "ideally suited for the joint venture project." (Id.)

In this letter, Ed Myers also discussed the pricing structure. The letter referenced PURPA and indicated that Edison had published an "avoided cost" schedule. The letter stated that the project should be treated as a base load plant and should not be subject to minimum load payment restrictions. In Ed Myers' view, "a firm power purchase agreement founded on base load operation could yield a higher revenue stream by reducing the risk of substantially lower revenues during minimum load times." (Id.) Ed Myers suggested the possibility of a full capacity credit and a modified energy payment.

Specifically, Ed Myers proposed that, when oil was the incremental fuel, the combined capacity and energy payment would yield 90% of the published avoided cost. During other times, Edison proposed to pay the full capacity credit and 100% of the average cost to produce a kWh of energy from Edison's thermal power generating systems. According to Myers, "(t)his pricing structure should have the added attractions of improving the financibility [sic] of the project and be acceptable to the regulators by offering a tangible benefit for the ratepayers." (Id.)

On December 11, 1981, Shuler wrote Ed Myers to indicate that Getty corporate management had approved in principle a 300 MW cogeneration facility in the Kern River field. Shuler informed Ed Myers that consideration of a joint venture had "also received favorable comment by management." (Exhibit 6 of Commission Exhibit 88.)

On April 12, 1982, Getty and Edison entered a "Preliminary Agreement" (Exhibit 101) reflecting the parties' intent to enter a purchase power agreement for a 300 MW cogeneration facility located in the Kern River oil field. In this document, the parties also agreed to enter a joint venture for purposes of performing engineering studies, file an Application for Certification (AFC) with the California Energy Commission (CEC) and take "other preliminary action which...would permit them to construct and operate a cogeneration facility". (Exhibit 101, at p. 1.) The parties also agreed "to negotiate in good faith and make all reasonable efforts to consummate" a number of "collateral agreements," including a purchase power agreement and a joint venture agreement for the construction of the facility. (Exhibit 101.)

On June 8, 1982, Getty and Edison met. The minutes of this meeting reflect the following:

> "As a result of this meeting, Edison will continue their work on the preparation of the power sales agreement, which is desired to be negotiated and executed prior to the formation of the joint venture to avoid any conflict of interest, to develop a joint venture agreement and to investigate various financing options. It appeared from this meeting that Getty is very anxious to proceed in a fast track mode to get the joint venture going and to proceed ahead with the project." (Exhibit 9 of Commission Exhibit 88, at p. 3.)

These minutes were signed by Robert Levine. Levine was identified as one of three Edison employees present at the meeting. The other two were Michael Vogeler and James Pignatelli. Among the Getty representatives were Shuler and Charles Myers, who was described as "Energy Coordinator." Ed Myers was among the recipients of copies of the minutes.

Levine first became aware of Edison's interest in a purchase power agreement with Getty in 1981. At that time, Levine was a member of Edison's cogeneration and small power development department. His immediate supervisor was Michael Vogeler.

During this time period, Levine was assigned the task of "putting together" a purchase power agreement for the proposed Kern River project. While stating that Vogeler and he were "the primary people responsible for putting that contract together" (Tr. 1324), Levine also testified that he had a "lead role" in the negotiation of the contract, was "one of the chief negotiators" (Tr. 1392), and was the "principal contact" between Edison and Getty on a daily basis (Tr. 1328-1329).

Levine remained in this position from the start of negotiations in 1981 until the contract was executed in early 1984. In addition to negotiating the agreement, his role required him to draft the agreement; circulate the agreement for comment throughout various departments at Edison; modify the agreement, if necessary, based on those comments; and then send the contract to Getty for its review. In considering internal comments on the contracts, Levine viewed his responsibility as "taking the comments from the various departments and reviewing those and discussing those with Mr. Vogeler, and then making a decision as to which one should go in." (Tr. 1481.)

Levine was verbally given two guidelines by his supervisors to follow in the negotiation of a contract for the Kern River Project: to negotiate a contract with Getty at or below Edison's avoided cost and to ensure that Edison's system integrity was not jeopardized by the project. No written guidance, however, was provided to him. In response to how Edison defined at or below avoided cost at that time, Levine indicated that his point of reference was a purchase power agreement which Edison had at the time with Procter & Gamble.

The Procter & Gamble contract, which was the subject of Commission Resolution E-1938 (October 1981) discussed previously in this decision, was the only other nonstandard purchase power agreement Levine had negotiated before the Kern River project. Levine identified the Kern River contract as "the first contract Edison had with a QF after PURPA came into place." (Tr. 1344.) Levine observed that he was not aware of any other contracts involving projects of the size of the Kern River project in place during 1982 and 1983.

It was Levine's understanding of the Commission's response to the Procter & Gamble contract (Res. E-1938) that the Commission did not want to review parallel generation agreements on a case by case basis. In Levine's opinion, it was "very clear" from this resolution that it was the Commission's view "that as long as the utility felt that the contract was reasonable, the Commission saw no reason [for the utility] not to go forward with the contract." (Tr. 1430-1431.) Based on this understanding, it was also Levine's view that if "Edison felt that the agreements were reasonable and in the interests of the ratepayer, that there was no need to file those documents with the Commission and that the reasonableness of these documents would be done in an overall reasonableness proceeding." (Tr. 1496.)

As negotiations progressed in 1982 and 1983, Levine was following development on standard and nonstandard offers at the Commission "on an extremely limited basis." (Tr. 1396.) Specifically, Levine indicated that he was just vaguely familiar with the standard offers filed in 1982 and 1983. In fact, Levine could not recall whether he had read D.82-01-103 or if Edison had filed standard offers. He was unaware of whether Mr. Vogeler was more familiar with the terms of these agreements. Levine also never compared any version of the Procter & Gamble contract to standard offers on file with the Commission in 1982 or 1983 for similarities or differences.

Levine's view that the KRCC contract was "better" for ratepayers than the standard offers was not based on a comparison with standard offers, but rather on his understanding that the contract was below avoided cost. Levine based his conclusion that the contract was below avoided cost on the presence of the 96% discount factor in the energy price formula.

Levine did not believe that Edison ever considered using terms and provisions from the standard offers in the KRCC contract. Levine was also never informed that decisions regarding Commission preapproval of nonstandard agreements had been issued since the Procter and Gamble decision. He also had no specific recollection of any Commission decisions addressing utility ownership of QFs or of anyone summarizing those decisions for him. He believed that Edison had ensured an arm's length transaction between the parties by requiring the contract's circulation.

In addition to Levine, Patricia Neel-Glazier, an attorney with Edison, was assigned to negotiate the Kern River contract. Neel-Glazier referred to Levine as the "chief negotiator", while she acted as "counsel." (Tr. 2942.) Neel-Glazier began work on negotiations of the Kern River contract soon after she joined Edison in mid-1982. She continued this work through the execution of the contract in 1984. In the negotiations, Neel-Glazier was responsible for "boiler plate provisions, the nonpricing provisions and the nontechnical provisions." (Tr. 2939.) She did not draft termination provisions nor did she suggest termination language.

Neel-Glazier was the only attorney from Edison who worked on the Kern River contract. At the time, she was also negotiating an agreement with a similar project which did not go forward. Her instructions from her supervisor, a senior counsel in the contracts section of Edison's law department, were to negotiate the contract on behalf of Edison's ratepayers. She never discussed with this supervisor whether the contract should be brought to the Commission for preapproval.

With respect to her understanding of the status or impact of the standard offers during the negotiations, Neel-Glazier testified:

> "It was my understanding that the standard offers that would apply were being reviewed by the Commission at that time but had not yet been adopted, and I had also been told that Getty, who had reviewed the drafts of the standard offers, was only interested in negotiated contracts." (Tr. 2952.)

Neel-Glazier could not recall ever having read or becoming familiar with D.82-01-103 nor having any discussions with Levine regarding "any of the decisions" issued by the Commission relating to standard offers during the period of the negotiations. (Tr. 2952-2953.)

For Getty, the two employees charged with the negotiation of the Kern River contract were Charles Myers and Harley Pinson. Charles Myers defined himself as the "lead negotiator" for Getty (Tr. 2459), with legal assistance from Pinson. Charles Myers indicated that Pinson's focus was not on the pricing provisions, but rather on contract language and indemnification. Charles Myers stated that his principal contact at Edison in the negotiation of the contract was Robert Levine.

According to Charles Myers, the 20-year term of the agreement matched the 20-year life of the cogeneration project. In negotiating with Edison, Charles Myers described his "primary directive" from Getty as follows:

> "[T]o sign a parallel generation agreement that was based as much as possible on actual fuel prices that were being avoided and actual heat rates that were being discussed and, in addition, to be sure that the step-up provision was included that allowed us to convert the unused megawatts in the Texaco operation in the Kern River field to minimum dedicated capacity in the parallel generation agreement." (Tr. 2617.)

These goals were the "two primary reasons why Getty desired a nonstandard agreement." (Tr. 2510.) The "step-up" provision was required to permit Getty to dedicate more capacity to Edison when it was no longer needed in the EOR process. Getty also desired to move away from "price postings" and "IERS" and to secure "a fuel price which would relate to [Edison's] actual fuel price and a heat rate that would relate to [Edison's] actual oil and gas heat rate". (Tr. 2466-2467.) Charles Myers indicated that Getty was intent on tying "down a pricing mechanism for energy that tracked actuals as much as possible." (Tr. 2486.)

Charles Myers stated that Getty was also interested in ensuring operation of the project by 1985 in order to obtain certain tax benefits associated with the project. To this end, Getty included a number of incentives in its contract with Fluor Engineers (Fluor) who were to build the plant. Specifically, this contract provided for a lump sum payment for completion of the project by mid-December, 1985, and day-to-day bonuses for Fluor for every day that the project was completed before December, 1985.

Charles Myers indicated that Getty had insisted upon the $143 per kilowatt-year capacity price based on the start-up date of 1986 and the capacity table in effect for that year. He also understood, however, that the contract being negotiated entitled Getty "to gain capacity prices at $143 per kilowatt if you started during 1985" (Tr. 2474) and that the contract, "as proposed by Edison," did allow start-up operations to begin as early as June, 1985. (Tr. 2489.)

Charles Myers described Getty's ability to tie its price to the "true avoided cost of fuel" as a "big benefit" to Getty. (Tr. 2581.) With respect to any specific corresponding benefit which Edison might have received, Charles Myers stated: "I don't recall any specific contract provisions being exchanged one for another in any instance." (Tr. 2581.)

With respect to the standard offers, Charles Myers indicated that he felt he should be familiar with them. However, he had never read Standard Offer 2 nor had anyone, including Levine, ever referred him to that offer.

For Getty, corporate approval for the project was based on a review of the project as a whole. The specifics of the contract were never presented for corporate approval, such tasks being reserved for the "division" level of the company. (Tr. 2531.)

At Edison, beginning in the fall of 1982, Glenn Bjorkland served as the vice-president of Edison's System Development. In this department a new group, Cogeneration and Small Power Development, was formed. This group was headed by Maurice Kent, to whom Michael Vogeler, Levine's immediate supervisor, reported.

Bjorkland described himself as "the responsible officer" for Edison in the execution of the Kern River contract. (Tr. 2777.) In this role, he "established policies and gave directions to Edison personnel to protect ratepayers' interests in the negotiation of the KRCC contract." (Exhibit 148, at p. III-2.) This step was accomplished by verbally directing his managers who reported to him to remain aware that their obligation was to protect Edison's ratepayers and that no special consideration should be accorded affiliates, with greater protection being extended to ratepayers in those instances.

In this regard, Bjorkland testified that no written instructions or guidelines on contract negotiations were prepared or given to his managers. Instead, Bjorkland chose to rely on verbal communications and on his "confidence that the people that were responsible for that did the proper analysis and that I could trust their response." (Tr. 2761.)

Bjorkland stated that, while he did make verbal inquiries on the status of particular negotiations and any resulting ratepayer benefits, he did not recall taking those steps with respect to the Kern River project. Bjorkland could not recall if he was familar with the standard offers on file with the Commission at the time nor did he believe that he gave Edison personnel directives to be familiar with those offers. He was not in direct communication with Levine and "was very dependent on the responsible managers to carry out the directive and to represent the company." (Tr. 2783.) Bjorkland never participated in any comparison of the Kern River contract with Standard Offer 4.

Bjorkland also never authored nor directed the preparation of written guidelines on seeking Commission preapproval of nonstandard contracts. The decision not to seek Commission preapproval of the Kern River project was part of a general policy not to take such action "unless there was something unique or highly unusual." (Tr. 2797.) Up to the time of the execution of the Kern River contract, Bjorkland indicated that Edison had never been presented with a cogeneration project of the size of Kern River in which Edison's participation was desired.

Among the managers reporting to Bjorkland was Maurice Kent, manager of Edison's Cogeneration and Small Power Development Department and Michael Vogeler's direct supervisor. In his testimony, Kent stated that he had no direct role in the negotiation or analysis of the Kern River contract. It was Kent's understanding, however, that "we should not refuse to offer a standard contract to anyone and that we should not refuse to negotiate with anyone if they wished to negotiate." (Tr. 2831.) Kent accepted Vogeler's recommendation to sign the Kern River agreement.

Kent indicated that early drafts of the KRCC contract in late 1981 were based on the Procter and Gamble contract because no standard contracts existed. By the time Standard Offer 4 was approved, Kent considered the drafting of the Kern River contract to have been "virtually" completed. According to Kent, "Edison was convinced that Getty would not agree, at that late date, to abandon the parties' lengthy negotiations in favor of considering execution of an SO 4 contract." (Exhibit 148, at pp. II-9 to II-10.)

Kent, who stated that he was familiar with D.82-01-03, testified that it was his decision not to seek Commission preapproval of the Kern River contract. In Kent's view, "the Commission had made it clear that advance approval was to be requested only in special and limited situations." (Exhibit 148, at p. II-12; emphasis deleted.) At no point in time did Kent consider that "any of the terms of the KRCC contract up to its signing involved special conditions or situations that might have warranted preapproval." (Tr. 2852.)

Michael Vogeler described himself as the manager responsible for the negotiation of the Kern River contract. He informed those assisting in the negotiations to act at all times in the interest of Edison. While he did not negotiate the contract, "I handed it to Mr. Levine and told him to implement the principles that we had agreed upon as executives." (Tr. 3067.)

With respect to negotiations with Getty, Vogeler stated that Getty would not accept a standard offer and "insisted on a nonstandard contractual arrangement because of its concern that standard offers did not provide sufficient energy price certainty over the life of the contract." (Exhibit 152, at p. 4.) Vogeler was also certain that Getty would have refused to negotiate a lower capacity price.

Vogeler viewed Getty's concessions for receiving the energy and capacity terms which it desired as accepting less than avoided cost energy payments and becoming operational more quickly than required under the standard offers. With respect to the fixed capacity payment, it was Vogeler's view that "if that project was capable to come on line earlier than 1986, there was no logical reason to penalize them by reducing their capacity payment." (Tr. 3052.) It was also Vogeler's opinion that the benefits of providing capacity to Edison's system, on which there was a capacity need, "far outweighed any impact on the ratepayers of the difference" in available capacity prices. (Id.)

Vogeler described his motivation in encouraging the successful negotiation of the Kern River contract as resulting from the penalty assessed by the Commission in Edison's 1983 test year rate case. (D.82-12-055.) Specifically, Vogeler testified:

> "And, you know, 100 to 300 megawatt cogenoration project was large and was significant, and frankly would go a long way in my view of getting me out of trouble with the Commission, because I was the manager that was told to get that penalty off of Edison's back..." (Tr. 3068.)

Vogeler viewed himself as "reasonably" familar with the standard offers, but that "we delegated people to know the nuts and bolts of contracts." (Tr. 3071.) For himself, Vogeler stated that he had "very little to do with Standard Offers 1 or 2." (Tr. 3113.) With respect to Levine's familiarity with the standard offers, Vogeler responded that it "was not something I felt was really paramount to the negotiations." (Id.) Because Vogeler's instructions were to negotiate a contract below avoided cost, Vogeler "did nothing to encourage Mr. Levine to encourage Getty Oil to sign a standard offer contract." (Tr. 3072.)

On the subject of termination provisions, Vogeler instructed Levine that "if we were going to have a termination provision, that termination provision should recover anything other than as-available payments." (Tr. 3080.) Vogeler did not recall Standard Offer 2 ever being discussed in the negotiations nor his ever asking Getty to consider changing some of the contract terms to take into account the standard offers.

With respect to contract preapproval, Vogeler understood from the Commission staff that if the contract was below avoided cost and negotiated in good faith, it was not desirable to submit it to the staff. Vogeler, however, stated that he was not familiar with Commission directives or decisions on preapproval after the

Commission's resolution on the Procter and Gamble contract. Vogeler thought that it was in a discussion with Kent "where we took a look and said, well, they don't want us to submit the Procter & Gamble contract, we have a sense of what the guidelines are, let's not go through the exercise." (Tr. 3088.)

In September, 1982, Levine's draft of a power purchase agreement was circulated for internal review at Edison. Among other things, the draft included a capacity price of $169/kW/year. At the time, the published value for a firm power contract with delivery starting in 1986 was $147/kW/year.

During the circulation of the agreement, various concerns were raised by other Edison employees. Among them, questions were raised regarding the possibility of the payments' exceeding Edison's avoided costs based on the adopted energy price formula and the difference between the contract's capacity price and published capacity price. On September 23, 1982, the draft was forwarded to Getty.

On February 22, 1983, Edison and Getty filed their prehearing conference statement in 82-AFC-2 (Exhibit 173) before the CEC, and on February 25, 1983, a hearing was held before the CEC on Getty's and Edison's request for certification of the Kern River project. In the prehearing conference statement (Exhibit 173), Edison asserted that a CEC certification decision did not require inquiry into the ownership of the project, fuel supply assumptions for the project, or the use of the power from the project (except as to the need for the power). (Exhibit 173, at pp. 15-16.)

During the February 25 hearing (Exhibit 174), however, Edison did inform the CEC of a planned 50% equity ownership in the Kern River project by the end of 1983. With respect to the parties' planned purchase power contract, Vogeler, on behalf of Edison, merely stated that "there may be some adjustments that would make the final agreement not look like a standard offer that we're all so familiar with here in the CPUC proceedings, but in the big picture the price would not exceed anything authorized by the Commission". (Exhibit 174, at pp. 63-64.) Vogeler also indicated that Edison was not contemplating submitting the contract for this Commission's review, because Edison had "not addressed subjects in our negotiations which make us feel it would be necessary." (Exhibit 174, at p. 65.)

On March 23, 1983, a letter of intent was drafted by Levine and subsequently presented to Getty. The letter covered the following contract terms: energy payments, capacity payments, scheduled maintenance allowances, interconnection, metering, electric system integrity, periods of forced generation, term of agreement, and dedicated capacity changes.

On March 23, 1983, a comparison of the Getty letter of intent and a "standard agreement" was apparently conducted by Edison (Exhibit 13 to Commission Exhibit 99.) While Levine's initials were one of the two sets on the document, he could not recall undertaking this comparison nor could he recall to which "standard agreement" the comparison was made. There is no indication on this document nor did Levine recall that this comparison included an examination of termination or scheduled maintenance terms.

On June 3, 1983, Edison formed the SSEC as a wholly owned subsidiary of Edison. Since the approval of Edison's holding company in January, 1988, SSEC has been part of the Mission Energy Company, an Edison affiliate.

At the time of its formation, the officers of SSEC included the following Edison employees: Glenn Bjorkland, president; Michael Vogeler, vice-president and general manager; and Patricia Neel-Glazier, secretary. While serving in these capacities, Bjorkland, Vogeler, and Neel-Glazier remained on the Edison payroll and in their positions as an Edison vice-president, manager, and attorney, respectively.

SSEC's bylaws, adopted June 22, 1983 (Exhibit 156), included among the officers of the company the president, vice-president, and secretary. Under the bylaws, the duties of the president included "general supervision, direction, and control of the business and officers of the corporation." (Exhibit 156, Article IV, Section 9.) The president also had "the general powers and duties of management usually vested in the office of president and general manager of a corporation". (Id.) In the absence of the president, the vice-president was to have "all the duties of the President." (Id., Section 10.) Both president and vice-president were to have any other powers or duties as prescribed by the board of directors. The secretary's duties centered on providing notice of meetings and keeping the meeting minutes.

On June 25, 1983, Edison and Getty entered a partnership agreement in which SSEC and Getty would each own 50% of the Kern River facility. The partnership was to be managed by a management committee with two representatives from SSEC and two from Getty. The committee was to meet monthly. The company resulting from this partnership was to be called the Kern River Cogeneration Company (KRCC). Neel-Glazier was involved in drafting the partnership agreement which she stated was modelled on a prior Edison partnership agreement which did not involve a QF.

The two SSEC management committee members in KRCC were Vogeler and another Edison employee, Thomas Reed. Reed viewed Vogeler as "the lead of the two of us on the management committee." (Tr. 2727.) Charles Myers served as KRCC's executive director.

All parties involved in KRCC saw no conflict of interest relating to the negotiation of the KRCC contract and the choice of the officers and management of KRCC. In this regard, Charles Myers pointed to Section 12.3 of the partnership agreement (Exhibit 129) which provides:

> "Notwithstanding anything to the contrary in this Agreement, with respect to the negotiation of any contract or enforcement of rights

> arising under any contract between the Partnership and a Partner or the Parent or Affiliate of any Partner, the Partnership will act through the Partner who is not and whose Parent or Affiliate is not or will not be a party to the contract."

According to Charles Myers, this language was interpreted by the partnership to preclude SSEC members of the KRCC management committee from having a vote on the approval of the KRCC purchase power agreement. The non-interested party, Getty in the case of the KRCC agreement, was to make all the decisions for the partnership. Charles Myers viewed Section 12.3 as "there to protect the partnership". (Tr. 2559-2560.) Charles Myers indicated, however, that there was no limitation on SSEC management committee members making suggestions on the contract although he could not recall any being made. Charles Myers, however, did remember Vogeler and Reed being present at meetings when the contract was discussed.

Charles Myers also observed:

> "There was always concern that the negotiations for the parallel generation agreement occurred outside of the management committee. And I believe that is why Mr. Levine rather than Mr. Vogeler took the lead in doing those negotiations to keep a member of the management committee from directly participating in and being a lead representative of Edison during the negotiations..." (Tr. 2563-2564.)

Charles Myers also expressed the opinion that "since KRCC is a general partnership, it is not a regulated company, it is a qualifying facility, its internal documents are not subject to review by DRA." (Tr. 2571.)

With respect to the Edison employees also working for SSEC, Bjorkland testified that as president of Southern Sierra, he performed only "ministerial work that was required in signing documents." (Tr. 2755.) While Bjorkland executed the KRCC agreement for SSEC, he saw no conflicts between his duties as president of SSEC and vice-president of Edison.

Although the SSEC bylaws gave the president the authority to perform supervisorial functions, Bjorkland did not recall performing any on behalf of SSEC and stated that the supervision of Vogeler remained under Kent. Bjorkland stated that SSEC was among the first subsidiaries that Edison created for purposes of a QF joint venture following the issuance of PURPA.

Neel-Glazier confirmed that at the same time she was negotiating the KRCC contract she served as the secretary of SSEC. She, like Bjorkland, saw no conflict in these dual roles since the office of secretary was a nonvoting, administrative function. Her duties were to take minutes, establish meeting times and agendas, and send out correspondence.

Neel-Glazier viewed the management committee members as "by and large not the principal negotiators on the [KRCC] contract." (Tr. 2949.) Neel-Glazier recalled that "Mr. Vogeler did have some input on the contract from Edison, not from KRCC." (Tr. 2949.) According to Neel-Glazier, he would not provide this input at the management committee meetings, but in "reviewing the contract at the office." (Tr. 2950.)

Vogeler indicated that he remained on the SSEC management committee until he left Edison in June, 1984. Vogeler stated that he was never compensated for his work on behalf of SSEC. Reed testified that, while serving on the KRCC management committee, he was directed to act at all times to advance Edison's interests and those of Edison's ratepayers. Reed could not recall any written instructions to that effect.

On July 25, 1983, Edison and Getty executed a Letter of Intent. (Exhibit 14 of Commission Exhibit 99.) The terms embraced by this letter of intent are largely those contained in the final executed agreement discussed previously in this decision. The letter, however, contained several provisions relating to the eventual outcome of the negotiations. One, entitled "Liability," stated: "Neither party shall have any liability to the other party if for any reason there is a failure to consummate a Parallel Generation Agreement." (Exhibit 14 of Commission Exhibit 99, at p. 25.) The second, entitled "Standard Offer Provision" provided:

> "If at any time prior to January 1, 1986 there is a change in the law, whether by statute, administrative regulation or judicial decisions, or any combination thereof, which results in an Edison standard offer, approved by the Commission, which in Getty's sole judgment is more favorable to Getty, then Getty may elect to take that standard offer, and upon execution of the standard offer by both Parties, the Agreement is terminated." (Id., at p. 24.)

It was Levine's understanding that Getty wished the letter of intent "to lock in the pricing terms so that they knew, in effect, what the economics of the project would be." While he acknowledged the existence of the "Standard Offer Provision," Levine "did not feel or believe at that time that Edison would have offered the standard offer to the Kern River Project because it was physically located outside of that service territory and we were not under an obligation to purchase that power." (Tr. 1373.) In addition, it was Levine's opinion that when the parties had been negotiating in good faith for a long time, it was not reasonable "to go back and in a sense make a wholesale change and hand them a totally different document". (Tr. 1427.) It was Levine's understanding of the letter of intent that if Edison failed to have an agreement in place in accordance with the terms of the letter of intent that neither party would be liable.

According to Charles Myers, the provision permitting Getty to elect an Edison standard offer was placed in the letter of intent at Getty's request. Charles Myers stated that it was Getty's intent "to just keep all their options open". (Tr. 2503.) Edison was given no concession for this provision nor was a similar clause considered which would have permitted Edison to use a Standard Offer 4 if it considered it better for its ratepayers. It was Charles Myers interpretation of the partnership agreement that Edison would have had no say as to the type of agreement which would have been signed.

It was also Charles Myers's opinion that a request by Edison to switch to a standard offer would not have been in keeping with the prior 18 months of negotiation. In this regard, Charles Myers stated that Getty "never really seriously considered" a Standard Offer 4 contract. (Tr. 2463.)

Between August and September, 1983, the proposed purchase power agreement was reviewed by Edison. Concerns were expressed in written comments from three Edison employees: Carl Silsbee, J. A. Kelly, and John Bunnell.

The concerns of these individuals focused on the three-tiered energy price structure, the use of a minimum heat rate, reduction in contract capacity based on future table values, the absence of termination provisions for levelized capacity overpayments, the 1000 hr./yr. limitation on use of oil/gas/coal average when neither oil or gas is avoided, the requirement that coal is the only alternate avoided fuel, heat rate floor at odds with the proposed long run standard offer which used periodically updated IERs, and the lack of current economic analysis. In one memo, Bunnell expressed concern about the change from earlier drafts from an energy payment based on 93% and 95% of avoided cost to one based on a 96% discount. This individual stated: "We need to be especially careful of giving even the appearance of a sweetheart deal with our own subsidiary." (Exhibit 25 of Exhibit 88.)

On October 13, 1983, Lowell Orren, an Edison employee, conducted a computer analysis of the KRCC contract. (Exhibit 116.) Assuming a 20-year firm capacity contract, a capacity value of $143/kw-year, and no change in the average heat rate from an assumed value of 10,530 Btu/kWh, the analysis concluded that the contract payments would represent 99.77% of avoided cost over the life of the contract. Orren also observed that he made two conservative assumptions: (1) the variable O&M factor would remain constant at 2 mills per kWh, while the Commission has authorized an escalation in variable O&M, and (2) the line loss factor was given a value of 1.0, even though it would have been reasonable to assume that a line loss factor greater than 1.0 would be approved by the Commission in the future.

Bunnell and Kelly testified that the analysis performed by Orren, who was under Bunnell's supervision, addressed Bunnell's concern about the decrease in the energy payment discount and Kelly's concern about the lack of an economic analysis. Bunnell also testified that at the time of the contract negotiation the standard offer was not considered "the Holy Writ" that it is today. (Tr. 2713.) According to Bunnell, at the time of the KRCC contract negotiations Edison "had been evaluating contracts in their overall risk." Based on that approach, there was "not a quid pro quo for every line change in the contract." (Id.) Bunnell created no documents comparing the nonprice terms of the KRCC contract to Standard Offer 4.

Levine could not recall seeing Orren's analysis at the time it was prepared, but he knew that Edison was forecasting payments under the contract to be 99.8% of avoided cost. Levine also did not recall ever speaking with Orren about his analysis.

Vogeler could not recall seeing Orren's analysis during the negotiation or execution of the KRCC contract. Vogeler indicated that he "didn't particularly care what some analyst in another office said and ran out on his calculator, because I didn't think it was relevant and I still don't." (Tr. 3073.) The only avoided cost analysis performed by Vogeler was the following:

> "I took what I felt was the incremental heat rate of the Edison system, the cost of an oil or gas fuel in dollars per Btu and took the 95

> percent of that, that was the extent of the management type analysis that I did; in other words, it was fundamental principle that if you discounted by 5 percent, you were below avoided cost. That's the extent of the in-house analysis." (Tr. 3077.)

On December 27, 1983, Silsbee wrote a note to files on the subject of a request for sign-off on the KRCC contract received from Ed Myers with a due date of December 28, 1983. According to this note, Silsbee had indicated that the KRCC contract differed from the standard offer in a number of key respects. Among them, Silsbee cited the use of the average heat rate, a three-tiered energy price structure, and a limitation on economy hours. He also indicated that his group (revenue requirements) had had no real opportunity to provide input. Nevertheless, Silsbee indicated: "I recommended signoff, but with the understanding that we were disturbed on the deviation from standard offer contracts." (Exhibit 16 of Exhibit 88.) Levine testified that the revenue requirements department of Edison would be the most knowledgeable about standard offer terms; however, he never spoke to Silsbee about this memo.

During hearings in this proceeding, Silsbee acknowledged his concern over the possibility that unforecasted events could cause contract payments under the draft KRCC contract to deviate from payments under a standard offer. Silsbee did not consider, however, that "these events were so likely to occur that the Contract should not be signed." (Exhibit 148, at p. III-7.)

During the same time period, August, 1983, through December, 1983, certain representations were made by Edison to the Commission staff regarding the KRCC contract. In particular, on August 25, 1983, the Commission's Executive Director wrote Edison indicating that the Commission had been "informed" that Edison would be a substantial participant in the Kern River project. The Executive Director asked for Edison's response to a series of questions attached to the letter. On September 27, 1983, Edison responded. (Exhibit 175.)

In Edison's response, Edison indicated that its participation in the project would be through a wholly owned subsidiary which was a 50% partner of KRCC with Getty. Neither the officers nor management of the subsidiary were identified.

Edison described the essential terms of its purchase power agreement with KRCC as follows: "20 years, 96% avoided cost, negotiated contract, provisions similar to Standard Offer No. 2 firm power." (Exhibit 175, Data Request 8/25/83, Answer No. 2.1.) With respect to the contract's termination provisions, Edison noted that it had the right to terminate the agreement upon ninety days' written notice to KRCC in the event KRCC "failed to make available Contract Capacity throughout the term of the agreement pursuant to the availability provisions". (Id., Question 4.)

Edison was also asked whether officers and employees of Edison would be assigned exclusively to the Kern River project and how records and accounts would be maintained. Edison indicated that a separate, identifiable payroll grouping would be established, through which separate records and accounts of these employees would be maintained.

According to Vogeler, several weeks before the KRCC contract was finalized, he met with members of the Commission staff to discuss "the results of the final negotiation." (Exhibit 152.) Vogeler had no written notes or description of these meetings, nor did he recall the extent of the conversation. Vogeler did recall "flipping through the contract" with a staff member present and discussing "the concept behind the pricing, the 20-year term". (Tr. 3092, 3115.)

Vogeler, however, never left a copy of the contract or earlier drafts with the staff, never met with any Commissioner regarding the contract, and never sought the opinion of either the Commission's technical or legal staff on whether Edison should submit the contract for preapproval. He also never provided the Commission staff with a copy of the partnership agreement due to its confidentiality.

Between August 10, 1983, and December 21, 1983, the KRCC parallel generation agreement was revised seven times. Five of those revisions post-dated the approval of Standard Offer 4 on September 7, 1983. Among the revisions occurring after this date was the addition of Section 5.5 to the KRCC termination clause.

Between December 21, 1983, and January 6, 1984, Edison modified the capacity overpayment formula contained in the KRCC contract. The value in the denominator, intended to reflect the length of the firm contract, was changed from 20 to 12. On January 16, 1984, the purchase power agreement between Edison and Getty was executed by Charles Myers, Executive Director of KRCC, and Bjorkland, VP Edison and President of SSEC.

According to Kent, Edison did not refuse to offer or discuss terms and conditions like those contained in the KRCC contract to any other QF nor did any other QF ask for similar payment provisions. Kent stated, however, that Edison never made known to other QFs what the terms and conditions of the KRCC contract were.

C. Amendments of the KRCC Contract--June 7, 1984 to April 28, 1988

Between January 16, 1984, and the present time, the parallel generation agreement between Edison and KRCC has been amended three times. The first amendment, executed on June 7, 1984, resulted in the deletion of Edison's right to terminate the agreement upon 90 days' written notice for KRCC's failure to make contract capacity available, and KRCC's ability to obviate the notice by making contract capacity available within the 90-day notice period. This change resulted in Section 5.2 of the contract reading as follows:

- Section 5.2: "If KRCC fails to make available Contract Capacity throughout the term of this

> Agreement pursuant to Section 14 (Capacity Purchase and Sale), KRCC shall exercise due diligence to correct the reason for loss of Contract Capacity and Net Energy."

The parties also removed language in Section 5.4 of the termination provisions. In particular the first sentence of Section 5.4 read: "If KRCC fails to provide the required Contract Capacity a new Contract Capacity value shall be established by the Parties upon the basis of demonstrated capacity." In the amendment, the parties removed the language "established by the Parties."

On April 12, 1985, Edison and KRCC executed a second amendment of the parallel generation agreement. Section 13.4 of the agreement was amended to permit KRCC to begin operation on May 1, 1985. Previously, Section 13.4 had provided that the earliest date of operation was June 8, 1985. The agreement was also amended to add a section permitting KRCC to receive full as-available capacity payments for capacity delivered by KRCC to Edison at any time after May 1, 1985, but prior to the availability of the contract capacity. (Exhibit 109, Section 14.4.)

On April 28, 1988, Edison and KRCC executed a third amendment to the parallel generation agreement. According to Section 3.1 of the amendment, the amendment was to be effective retroactively to January 16, 1984. Edison states that the changes undertaken in the third amendment were based upon concerns DRA had expressed during the discovery phase of this proceeding regarding the reasonableness of certain provisions of the KRCC contract. Edison states that in order to "more clearly state the original intent," Edison sought and obtained the third amendment from KRCC. Edison alleges that "(n)o consideration was given to KRCC by Edison for the execution of this amendment because it reflected the original intent of the parties." (Edison Opening Brief, at p. 45, footnote 90.)

The amendment itself alters and adds numerous provisions of the contract relating to scheduled maintenance, contract capacity, qualifying facility definition and warranty, termination, the determination of the contract heat rate, and the period performance factor and the on-peak capacity factor used in the calculation of KRCC's capacity prices. Among other things, these amendments resulted in changing the repayment formula under Section 5.5 from "Contract Capacity x $169/kW x (1-(X/12))" to "Contract Capacity x $169/kW x 1-(X/20))".

In addition, significant changes were made to Section 8.7 of the contract. Originally, this section had required KRCC to perform routine maintenance when it would not adversely affect Edison's system integrity "insofar as it is practicable to do so." The amendment resulted in Section 8.7 becoming a section heading, "Maintenance," original section 8.7 becoming section 8.7.1 and five addition subsections being added. These subsections require KRCC (1) to make a reasonable effort to schedule routine maintenance in non-peak months, (2) limit the number of annual and peak period maintenance hours, (3) permit the accumulation of unused annual maintenance hours with a limit on the amount accumulated and its use "consecutively and only for major overhauls, and (4) the application of those hours only when Edison had been notified to apply the hours to the beginning of the outage until the end.

The value to be given the contract heat rate used in calculating energy payments was also changed. In particular, a new section was added to Appendix B, Section 1 of the agreement to require that this value "shall be based upon oil used in Edison's thermal generating stations.

The formulas used to determine the "period performance factor" and "on-peak capacity factor" used to calculate KRCC's capacity price were also amended. Both factors were also limited to a value no greater than 1.0.

D. Events in 1988 to 1989 Related to the Commission's Review of the KRCC Contract

On February 7, 1989, CSC filed an expedited application for stay of D.89-01-047, issued in this proceeding and reviewed earlier in this decision. The basis of the request was CSC's intention to file an application for rehearing of D.89-01-047 no later than February 10, 1989. In the application for rehearing, CSC intended to clarify ambiguities in the Commission's decision related to the Commission's granting DRA's motion to compel.

On February 21, 1989, hearings on the scope of reasonableness review of the KRCC contract issues commenced. During the second day of hearing on February 22, counsel for DRA stated that, despite the Commission granting DRA's motion to compel documents in D.89-01-047, DRA had yet to receive this information. DRA stated that it had made its first request for this information on February 7, 1989, in a letter addressed to counsel for Edison. Based on responses received from Edison, it was the opinion of DRA's counsel that, while CSC's application for rehearing was pending, Edison did not intend to produce the documents which DRA sought. DRA expressed its concern that Edison's action would prevent DRA from using this information during hearing.

In response to counsel for DRA, the ALJ indicated that the filing of an application for rehearing or stay did not stay a utility's compliance with a Commission order. Further, the ALJ stated that an automatic stay in this case was not possible due to the decision having become effective the date of issuance.

In response, CSC's attorney, also representing KRCC, stated that, in the absence of a Commission decision on the stay or the application for rehearing and a decision by the California Supreme Court on appeal of that order, compliance with D.89-01-047 was not required. Counsel for Edison concurred with CSC and stated: "I do believe that CSC and Getty Energy Company have substantive rights to appeal of the Commission's January 27 decision, and by producing the documents without some degree of protection, Getty and CSC's rights to appeal would be denied." (Tr. at p. 1099.) Counsel for Edison continued: "[W]e are now in a position of being torn between two--the rights of our partner and the potential liabilities we may incur as a result of doing something not in accordance with their desires and our desire to comply with the Commission order." (Tr. at p. 1100.) At the end of the discussion before the ALJ, Edison and CSC/KRCC had made clear that neither party intended to provide the information requested by DRA until the case had been decided by the California Supreme Court.

On February 23, 1989, the ALJ addressed Edison's failure to comply with D.89-01-047. In discussing the issues raised by the parties, the ALJ made three letters exhibits in the proceeding. The letters, two authored by Edison's counsel and one by DRA's counsel, had been written between February 10, 1989, and February 17, 1989, and addressed DRA's desire for the documents which were the subject of DRA's motion to compel. (Exhibits 93, 94, and 95.) In Exhibit 95, Edison had stated that it would provide DRA the requested information but only when D.89-01-047 had become final.

In reviewing this correspondence, the ALJ stated that both by statute (Public Utilities Code, Section 1735) and by rule (Commission Rules of Practice and Procedure, Rule 86) the filing of an application for rehearing did not excuse any party from complying with or obeying any order or Commission decision, except under such terms as the Commission directed. The ALJ noted that D.89-01-047 had unconditionally granted DRA's motion to compel production of certain information filed on March 23, 1988. The ALJ in turn directed Edison to produce all of the information requested by DRA within its control.

Noting that D.89-01-047 did not provide any protective order for any of the items requested by DRA, the ALJ concluded that there would be no confidential treatment of the KRCC management committee minutes and the partnership agreement between KRCC and Southern Sierra Company. The ALJ continued that if these two items were not made available to DRA by the end of the first week of hearings, the ALJ would recommend to the Commission a finding that the utility had failed to meet its burden of proof of showing the reasonableness of the costs associated with the KRCC contract. The ALJ did, however, permit the KRCC management committee minutes and its financial records to be provided to DRA as confidential. To the extent that DRA needed to disclose these documents in the course of hearings, DRA could then request that the confidentiality of the documents be lifted.

On March 10, 1989, at the close of Edison's direct showing on the KRCC contract, the ALJ expressed concern with the inadequacy of Edison's showing on the reasonableness of the KRCC contract. Edison's case had consisted of two witnesses, one who addressed Commission decisions and policy on QFs, and another who had reviewed the KRCC contract and found it to be reasonable. Neither witness had been involved in the negotiation or execution of the original KRCC contract, the creation of SSEC, or the partnership agreement between SSEC and Getty.

In particular, the ALJ noted that Edison had not presented direct testimony on a number of issues which, according to Commission orders in effect since 1982, would have been important to the determination of the reasonableness of a nonstandard purchase power agreement with a utility QF affiliate. As part of these comments, the ALJ reminded Edison, as the Commission most recently had in D.89-01-047, that it was the utility's, not DRA's, obligation to demonstrate that its actions were reasonable through clear and convincing evidence.

On March 23, 1989, DRA moved to postpone rebuttal hearings on traditional ECAC issues, and use the hearing days set aside for this purpose to consider testimony on the KRCC contract.

In making this request, DRA noted that on March 16, 1989, Edison had served its rebuttal testimony. DRA stated that this testimony included over 150 pages of prepared testimony sponsored by 22 witnesses. Of the 22 witnesses involved, 18 were to sponsor testimony on the KRCC contract.

On March 27, 1989, an assigned Commissioner's ruling was issued. This ruling reviewed both the record and the ALJ's comments at the conclusion of Edison's direct showing in this case, as well as DRA's request of March 23, 1989. The ruling granted DRA's request to postpone hearings on the traditional ECAC reasonableness review issues. The Commissioner made clear, however, that his consideration of DRA's request did not mean that the testimony being presented by Edison was in fact rebuttal, that it was not subject to motions to strike, or that the Commission condoned Edison's approach in this case. The assigned Commissioner's ruling states that the Commission was in fact quite concerned with Edison's decision to follow an approach that was wasteful of valuable Commission resources, including staff and hearing time.

In the ruling, the assigned Commissioner advised Edison that any future relief requested by the utility would be required to be supported by a complete affirmative showing by which Edison met or attempted to meet its burden of proof. Rebuttal would be heard only to the extent that Edison had met this burden and to the extent that it was directly responsive to testimony filed by DRA or other interested parties. In particular, the assigned Commissioner's ruling advised Edison to correct its practices in its next ECAC reasonableness filing in which many of the same issues related to nonstandard QF contracts would be considered.

By D.89-04-088, dated April 26, 1989, the Commission denied the applications for rehearing filed by CSC and Getty on February 14, 1989. The order notes that the items in question had been produced; however, the applications would have been denied even if this information had not been forthcoming. Denial would have resulted because neither application made a case for the clarification which the applicants had nominally requested.

VI. Reasonableness of the KRCC Contract

In this section, we will examine the positions of Edison, KRCC, DRA, and TURN on the reasonableness of the KRCC contract and Edison's actions related to it, including the existence of any self-dealing. This summary will be followed by our discussion and resolution of the issues presented in this case.

A. Parties' Positions

Previously in this order, we noted that the reasonableness of the KRCC contract is to be measured by the facts and conditions that were known or should have been known to Edison at the time of the contract's negotiation and execution. Edison, KRCC, and DRA accept this basic principle. Depending on the party's viewpoint, however, the emphasis or interpretation given to the applicable laws, policies, and events varies greatly between Edison and KRCC, on the one hand, and DRA and TURN, on the other. The parties also differ significantly on whether the contract terms provided risks or benefits for Edison's ratepayers and whether Edison engaged in self-dealing in its negotiation and execution of the contract.

While most of Edison's testimony in this proceeding was presented as a response to DRA's report, we will nevertheless examine Edison's position first. Edison was permitted to place into evidence its rebuttal testimony and may use the entirety of the record to argue the reasonableness of its acts. This circumstance, however, does not preclude our consideration of DRA's concerns regarding Edison's approach to presenting its case.

1. Edison

Edison characterizes the standard of review and the issue involved in this case as follows:

> "It is Edison's position that the same standard of review applies to a utility's decision to enter into a QF contract as that used in the review by this Commission of any other decision made by utility management. Under that

> standard, the relevant question is whether the utility's management acted reasonably, taking into account all of the information management considered or should have considered when its decision was made. [Cites, D.87-06-021, pp. 19-20; D.86-10-069, p. 31.] The precise question to be answered in this proceeding is not whether Edison should have negotiated and executed the KRCC Contract. It is, instead, whether Edison's decision to execute the Contract falls with a spectrum or 'bandwidth' of possible business decisions, any one of which prudent utility managers could reasonably have made under the circumstances, taking into account all of the circumstances -- regulatory, economic and other -- that existed when those decisions were made." (Edison Opening Brief, at pp. 38-39; emphasis original.)

Edison does not agree that the reasonableness of the contract should be judged "solely" on the basis of its comparability to Standard Offer 4, Energy Option 3, and "whether the two contracts are equally beneficial to the Company and its ratepayers." (Edison Opening Brief, at p. 39.) According to Edison, even assuming that "a standard offer contract represents the optimum QF contract, it has long been settled that a utility is not limited to choosing the optimum solution when it makes a business decision." (Edison Reply Brief, at p. 42.)

Edison's view of the issue presented in this case centers on one critical piece of evidence. Specifically, Edison asserts that the record in this case demonstrates that at the time of the KRCC contract's execution, Edison had no choice between the KRCC contract and a Standard Offer 4 contract because Getty would not have accepted the latter. Under this circumstance, "Edison's choice was between the KRCC contract and no contract at all, and it is the prudency of that decision that is before the Commission for review." (Edison Opening Brief, at pp. 39-40; emphasis deleted.)

Applying its standard of review to this issue, Edison states that the following circumstances justified its negotiation and execution of the KRCC contract: (1) a perceived need for additional baseload capacity, (2) federal and state regulatory policies requiring utilities to purchase electric power from cogenerators, (3) encouragement by this Commission for Edison to develop a pioneering enhanced oil recovery cogeneration resource in Kern County, (4) arm's length negotiations in which Edison employees represented only ratepayers' interests, and (5) the prudency of agreeing to a nonstandard contract. In addition, Edison asserts that its management structure and review process ensured that its ratepayers' interests were fully protected throughout the negotiation and execution of the contract.

In support of its position, Edison states that between 1981 and January 16, 1984, the utility reasonably projected a need for and was actively pursuing the acquisition of additional baseload capacity. According to Edison, when the KRCC contract was executed in January, 1984, the capacity which the project provided was "the single most significant accomplishment" toward meeting Edison's goal, announced in October 1980, of bringing 1,900 MW of renewable and alternative generation resources on line by 1990. (Edison's Opening Brief, at p. 25.) Edison found that the response of other QF technologies left considerable doubt as to whether Edison could meet its goal.

Edison also lists the many merits of the Kern River EOR facility. Specifically, Edison notes that the project represented the first major enhanced oil recovery cogeneration facility to be brought on line in California and demonstrated the feasibility of large-scale EOR cogeneration in California.

The interest of state and federal government in the development of alternative resources and the resulting regulatory pressure are other major reason cited by Edison for its policy of pursuing QF cogeneration contracts during this period. In particular, Edison states that its decision to pursue an agreement with Getty for the Kern River project was "due in no small part to the dedication of then CPUC Commissioner Claire Dedrick to the development of that project." (Edison Opening Brief, at p. 27.) Edison states that former Commissioner Dedrick acted to expedite cogeneration projects and encouraged California electric utilities in this effort.

In terms of "regulatory pressure," Edison cites PURPA, the resulting FERC regulations, and decisions by this Commission and the CEC as encouraging QF development generally and cogeneration in particular. This "regulatory pressure" also consisted of the $8 million penalty assessed against Edison in its test year 1983 general rate case. Edison states that its goal in negotiating and executing the KRCC contract "was to reach an agreement that would assure Edison a 20-year firm supply of baseload capacity and energy at prices at or below Edison's full avoided cost, while satisfying, in part, Edison's obligations under the then-current federal and state energy policies that strongly favored the development of R/A (renewable and alternative generation) energy sources." (Edison Opening Brief at p. 28.)

Edison believes that the negotiation of the KRCC contract was "at arm's length between Edison employees, bargaining on behalf of Edison and its ratepayers, and Getty employees, bargaining first on behalf of Getty Oil Company and its subsidiary, Getty Energy Company, and later on behalf of KRCC after that partnership was formed." (Edison Opening Brief at p. 30.) Edison further states that Edison employees negotiated without regard to the fact that an Edison subsidiary would have a 50% ownership interest in KRCC. Edison notes that both companies took steps to avoid even the appearance of favoritism by designating Getty to represent KRCC in negotiating the KRCC contract with Edison.

Edison states that, while it may now seem that there was an "appearance" of an opportunity for favoritism by Edison, the reality was to the contrary. In support of this statement, Edison cites the instructions by Bjorkland to "Edison personnel responsible for negotiating contracts with affiliates" that their obligation was to protect Edison's ratepayers, to provide no special consideration for affiliates, and to be more protective of ratepayers' interests in affiliate transactions. (Edison Opening Brief, at pp. 30-31.)

Edison also asserts that its decision to agree to a nonstandard contract was prudent. In this regard, Edison states that the Commission had directed the utilities to negotiate nonstandard contracts in good faith at the QF's request, and that such contracts could contain floors or levelized payments if the QF were interested.

According to Edison, the negotiated contract was necessitated by the following factors: (1) the absence of a Commission-approved standard offer when the negotiation process began in early 1981, and (2) the "virtual" completion of the drafting of the KRCC contract by the time the Commission approved Standard Offer 4. With respect to this second point, Edison states that it had already signed a letter of intent which fixed the principal economic terms of the contract as of July 25, 1983. Further, Edison indicates that it was convinced that Getty would not have agreed at that point "to abandon the parties' lengthy negotiations in favor of considering the execution of an SO4 contract." (Edison Opening Brief, at pp. 32-33.) Edison was also convinced that Getty would not sign a contract that did not contain the energy price certainty and in turn the energy price formula demanded by Getty.

Edison places greatest emphasis on its inability to leave the bargaining table without risking a bad faith claim. Specifically, Edison argues:

> "Moreover, Edison could not have threatened to leave the bargaining table if Getty refused to discuss an SO4 contract. The Commission had ruled that any QF could choose to have a negotiated contract and that, if it did, the utility was obligated to negotiate with the QF

> in good faith, using its management expertise and judgment, in an effort to reach agreement. (Edison Opening Brief, at p. 35.)

In Edison's opinion, the requirement of good faith negotiations coupled with its $8 million general rate case penalty for failure to offer full avoided cost payments in nonstandard QF contracts would have made it imprudent for Edison not to have continued to negotiate a nonstandard contract with Getty after Standard Offer 4 was approved.

For these reasons, Edison states that its negotiators continued to work from late July 1983 to January 16, 1984, toward obtaining a firm 20-year nonstandard power purchase agreement with Getty. Based on the economic analysis performed by Lowell Orren, Edison determined that "the KRCC contract would fully protect ratepayers' interests and would be better for ratepayers than the Commission's approved SO4." (Edison Opening Brief at pp. 36 - 37.) Edison states that in recommending that the agreement be signed, the agreement represented the most favorable contract for Edison's ratepayers that could be negotiated with Getty.

Edison rejects any assertion that it intentionally favored KRCC and that Edison's negotiators and their supervisors failed to do their jobs. According to Edison, any reliance on Levine's "scant attention" to Edison's standard offers ignores the testimony of his superiors (Vogeler and Kent). Edison states that these managers were fully aware of Commission decisions, policies, and standard offers and took them into account in reviewing the KRCC contract." In Edison's view the knowledge of these supervisors and others who reviewed the contract at Edison "both protected ratepayers and assured that the KRCC Contract would not be inconsistent with the Commission's standards." (Edison Reply Brief, at p. 36.)

It is Edison's opinion that with the choice being the negotiated KRCC contract or no contract at all, the latter choice would have been imprudent. In support of this conclusion, Edison cites (1) the Commission's strong commitment to alternative energy, specifically the large EOR cogeneration facilities in Kern County, (2) the $8 million general rate case penalty, (3) the requirement to negotiate in good faith with QFs desiring a nonstandard contract, and (4) Edison's projection that the KRCC contract would be more beneficial to Edison's ratepayers than a Standard Offer 4. (Edison Reply Brief, at p. 45.)

With respect to the specific contract terms, Edison states that, at the time of signing the KRCC contract, it "reasonably appeared" to Edison that "(1) KRCC would deliver firm capacity to Edison for the 20-year term at a price at or below Edison's posted avoided cost; (2) the capacity and energy pricing terms and the nonprice terms of the KRCC Contract, taken as a whole, were below Edison's avoided cost, were beneficial to ratepayers, and were better than those then available under an SO4 contract; and (3) the risks to ratepayers under the KRCC Contract, if any were less than those under an SO4 contract." (Edison Opening Brief, at pp. 40 - 41.)

It is Edison's position that the KRCC project is a firm capacity resource, not an as-available resource. Edison reaches this conclusion based on the following:

(1) The economic incentives of both parties to perform under the KRCC contract and the technical realities of the Kern River EOR project.

(2) The contract requirement that KRCC make "every reasonable effort" to limit outages during on-peak and mid-peak periods to unscheduled failure of equipment directly related to electrical generation.

(3) The prospective economic viability of KRCC making it highly improbable when the contract was executed that KRCC would ever wish to terminate its performance, or be able to show its performance was

unprofitable after its debt was retired or decreased.

(4) Edison's declining to accept deliveries being an event over which Edison had complete control.

Edison states, however, that "to avoid any concern by the Commission" with respect to the scheduled maintenance or termination provisions these terms were amended by the Third Amendment to the KRCC contract executed in April, 1988. Edison notes that no consideration was given to KRCC by Edison for the execution of this amendment "because it reflected the original intent of the parties." (Edison Opening Brief, at p. 45, footnote 90.)

Edison also dismisses the contention that no fee was required to be paid in the event of termination after 12 years and that if KRCC ceased performance during the fourth through twelfth years, the termination fee was less than the fee under a Standard Offer 4 contract. Edison finds the criticism unjustified because (1) the Third Amendment extended the repayment period for the full 20-year life of the Contract, and (2) the KRCC termination fee formula would have resulted in higher payments than under a Standard Offer 4 contract if KRCC had terminated performance during the 1985, 1986, and 1987 record periods.

To remove any possible concern regarding this provision, Edison renews its commitment "to protect its ratepayers in the unlikely event that KRCC does terminate its performance." (Edison Opening Brief, at p. 48.) Edison states that it has accomplished this result by agreeing, through the testimony of its witness Barrett, to indemnify its ratepayers to the same extent that ratepayers would be protected under a Standard Offer 4. According to Edison, SSEC has indemnified Edison against the cost of such protection.

It is also Edison's opinion that any criticism of KRCC's right to increase contract capacity ignores the facts which existed at the time the KRCC contract was executed. Edison believes that this provision was reasonable as it met an early 1990's resource need and satisfied an operational requirement of the EOR project.

Edison states that its decisions regarding the capacity price of $143/kW-year under the KRCC contract were reasonable. Specifically, Edison asserts that the decision to base the contract term on the 1986 capacity payment was appropriate due to the then-anticipated date of firm operation. Edison also states that it reasonably believed that Getty would not agree to accept a capacity price of $132/kW-year based on earlier operation. When KRCC commenced operation in August, 1985, Edison states that it could not have prevented this elected start-up date and it was then compelled under the language of the contract to pay KRCC a capacity price of $143/kW-year.

With respect to the KRCC contract energy prices, Edison states that, at the time of contract execution, Edison believed that energy costs under the contract would be lower, on a cumulative basis over the life of the contract, than Edison's posted avoided energy costs. Edison reached this conclusion based on the following considerations:

(1) The contract heat rate ensures that energy payments will not exceed Edison's avoided cost of energy.

(2) The KRCC contract energy price formula includes a 4% discount factor for the purpose of reducing energy prices below Edison's avoided energy cost when oil or gas is Edison's marginal fuel.

(3) The KRCC contract energy price formula includes a provision to better approximate avoided energy cost during periods when neither oil nor gas is Edison's marginal fuel;

(4) The heat rate floor and ceiling responds to Getty's insistence on energy price projection;

(5) The reasonable projection that KRCC contract energy prices would be below Standard Offer 4 energy prices.

(6) Getty's insistence on energy price certainty made it reasonable to extend the KRCC energy price for the life of the contract, seven years longer than the forecasted IER under a Standard Offer 4 contract signed on the same day.

Edison states that its decision not to seek preapproval of the KRCC contract by the Commission was also reasonable. In support of its position, Edison cites Resolution E-1938, in which the Commission rejected the advice letter filing of the Procter & Gamble contract, and D.82-01-103. Edison interprets the language of D.82-01-103 as follows: "[T]he Commission made it clear that advance approval was to be requested <u>only in special and limited situations</u>." (Edison Opening Brief, at pp. 74-75; emphasis original.) Edison states that it did not believe in January 1984 or now that there were any significant questions regarding the prudence of the KRCC contract.

Edison further claims that it did keep the Commission staff informed of developments regarding the KRCC contract. Edison notes that no staff member ever advised Vogeler that it was necessary to submit for advance approval contracts which were expected to be below avoided costs.

On the issue of favoritism toward affiliated QFs, Edison asserts that "DRA has the burden of supporting its recommendations for remedial action with evidence that the utility has engaged in conduct which warrants such action by the Commission." (Edison Opening Brief, at p. 52.) Edison states that the evidence cited by DRA in support of its claims of discriminatory treatment by Edison of affiliated QFs in late 1984 and 1985 actually supports Edison's position that it dealt fairly with all QFs. Specifically, Edison contends that its signing affiliate contracts while requesting suspension of Standard Offer 4 occurred almost a year after the KRCC contract was executed and has no relevance to this proceeding. Edison also states that, if favoritism was intended, Edison should not have revealed its capacity concerns to the Commission prior to signing any other affiliate contract. Edison notes that it signed many standard offers prior to Standard Offer 4 being suspended in April, 1985.

Although not addressed in its opening brief, in its reply brief Edison discusses at great length the propriety of its initial showing on the KRCC contract and concludes that no sanctions should be imposed for the approach it chose. In this regard, Edison asserts that its initial showing on the reasonableness of the KRCC contract complied fully with the Commission's requirements as reflected by "the Commission's unquestioning acceptance of earlier Edison filings in respect of QF contracts." (Edison Reply Brief, at p. 62.)

In Edison's view, its direct showing went far beyond Edison's prior ECAC direct showings and beyond the showing that Public Staff Division (PSD), the predecessor of DRA, had requested. According to Edison, its opinion on the appropriate review of QF nonstandard contracts was shaped by Commission ECAC decisions issued prior to the 1985 record period and the Edison and staff testimony filed in those earlier proceedings.

Edison also states that it timely provided all documents DRA requested related to the KRCC contract except three categories of items which Edison withheld only pending a determination by the Commission of their discoverability. According to Edison, its production of these documents was withheld after the Commission's determination was made in D.89-01-047 only because the confidentiality sought by CSC/Getty could not otherwise be protected pending an appeal. Edison states that it was required to accede to Getty's position because "Getty, as the controlling partner of KRCC with respect to matters relating to Edison, did not want to provide the financial statements of KRCC and had instructed Edison not to do so." (Edison Reply Brief, at p. 95.)

Additionally, it is Edison's opinion that the statements of the ALJ during hearings and in the assigned Commissioner's ruling regarding Edison's initial showing were unwarranted based on Edison's prior ECAC showings and the absence of any objections to its filing by PSD or DRA. Similarly, Edison takes exception to D.89-01-047. According to Edison, a review of D.82-01-103 could have led reasonable persons to differ on whether the utility was expected to make an affirmative showing regarding the negotiation of nonstandard QF contracts in an ECAC proceeding.

2. KRCC

It is KRCC's position that the Commission's review of the KRCC contract should be guided by an analysis of whether the agreement is the "economic equivalent" of the standard offer. KRCC also asks the Commission to consider its active promotion of cogeneration projects and its penalty of Edison as reasons supporting Edison's involvement in the Kern River project. In KRCC's view, the Kern River project represented a "preferred project" because it provided a wide range of desired benefits which its size served to enhance. KRCC states that the "partnership interest in the project by an Edison subsidiary was not perceived as 'unusual' since federal law and Commission regulation had authorized this type of ownership structure." (KRCC Opening Brief, at p. 13.)

KRCC believes, however, that, in addition to the Commission's orders, principles of California contract law must be taken into account in the Commission's review of the KRCC contract. These principles, according to KRCC, require that DRA establish that some harm resulted from the challenged act or contract term before the challenge is "actionable", and that the challenge be based on material and substantial claims. In KRCC's view, "absent a showing of harm to Edison's ratepayers, Edison's posture during the negotiations should be of little concern to the Commission." (KRCC Reply Brief, at p. 14.)

With respect to self-dealing, KRCC states that this case is not a forum for DRA to revive its argument regarding self-dealing which was made and rejected in Edison's holding company application. KRCC concludes that there is no demonstrable harm to ratepayers even if self-dealing took place.

On the issue of the prudency of the negotiations, KRCC asserts that Levine's level of sophistication in contract negotiations is not significant since he was "not principally (or solely) responsible for negotiating the KRCC contract." (KRCC Reply Brief, at p. 12.) KRCC also points out that the concerns of Edison employees regarding the KRCC contract were disspelled prior to its execution. KRCC shares Edison's view that Edison could not have abandoned the negotiations or the contract.

With respect to the specific contract terms, KRCC believes that there are ratepayer benefits presented by the KRCC contract which render it more advantageous than the standard offer. These benefits include the following:

1. Energy price savings realized during the record period related to the operation of the energy payment provisions in the KRCC contract.

2. The absence in the KRCC contract of a provision requiring Edison to continue for 90 days to pay for capacity that KRCC fails to produce in an uncontrollable force situation.

3. The requirement that additional dedicated capacity has to meet the same Performance Factor as firm capacity.

4. KRCC's receipt of payments for capacity at the contract rate of delivery.

5. The lack of a probationary period to meet firm capacity and the obligation to make every "reasonable effort" to provide full capacity "during all operating periods."

6. The requirement that KRCC provide insurance at levels five times that of the standard offer.

7. KRCC's contractual right to increase contract capacity.

With respect to the contract's termination provisions, it is KRCC's view that KRCC's termination rights do not diminish its obligation to provide firm power for the full term of the agreement. In this regard, KRCC views its termination provisions as much more restrictive than a standard offer.

In particular, KRCC states that Section 5.5 of the KRCC contracts provides that KRCC may terminate the agreement upon 90 days notice only after the retirement or defeasance of any and all debt obligation of KRCC and if, in KRCC's opinion, its performance becomes unprofitable at any time. Since the original KRCC debt carried a 12-year finance period, KRCC states that the contract could not be terminated at all under the first condition precedent of this section until after 1997. KRCC states that, in the absence of an assessment of the likelihood of a termination occurring under these conditions, "no meaningful judgment could be rendered concerning the 'firm' nature of the 20 year KRCC commitment." (KRCC Opening Brief, at p. 22.)

KRCC concurs with Edison that the risk of unprofitability once the project was on line and operational was essentially non-existent. KRCC asserts that the KRCC agreement "contains a complex balance of economic incentives to assure the long term, firm nature of the agreement." (KRCC Opening Brief, at p. 25.)

In KRCC's view, differences between the standard offer and the KRCC contract relative to penalty or recapture costs do not diminish KRCC's obligation to provide firm power for the full

20-year term of the agreement. KRCC states that the amount of the termination fee is particularly irrelevant if the conditions precedent to termination are unlikely to be met. Further, KRCC asserts that "in the first three years of the project operation, when the risk of project failures is the greatest, the KRCC termination fee was actually higher and more onerous than the Standard Offer." (KRCC Opening Brief, at p. 26.)

KRCC states that there is no foundation to the assertion that KRCC's option to terminate under Section 5.3 could be triggered by an immaterial Edison breach. According to KRCC, a one-hour Edison refusal to accept deliveries would amount to only an immaterial breach and would not justify the exercise of termination rights.

KRCC also rejects any argument that the agreement's provision for $143/kW-year is unreasonable. According to KRCC, the reasonableness of this provision is supported by conditions at the time of negotiation and the fact that a capacity payment is not bound by the standard offer table in order to be deemed reasonable. In particular, KRCC cites Edison's need for baseload resources, the increasing price of power, and the Commission's continuing scrutiny of Edison's failure to bring on-line cogeneration resources as active factors in establishing the negotiated price for the KRCC capacity. KRCC notes that it also agreed to a much more confining schedule than that available to a standard offer developer as an exchange for the negotiated capacity price.

With respect to energy prices, KRCC argues that the heat rate floor is not too high, and that a comparison of the KRCC heat rate floor with Standard Offer 4 energy payments is inappropriate. In support of this point, KRCC cites the differences between the two energy price formulas in Standard Offer 4 and the KRCC contract. KRCC also believes that the provision of the KRCC heat rate floor and ceiling for the entire term of the contract provides added certainty over the standard offer IERs which terminate in 1998. This added certainty for KRCC "carries significant benefits for ratepayers." (KRCC Opening Brief, at p. 37.) For this certainty, KRCC states that it specifically traded away its right to receive payments at the full avoided costs of energy.

KRCC rejects any claim that it is unrestricted in its ability to schedule maintenance during on-peak periods. In particular, KRCC refers to Section 12.1 of the KRCC agreement requiring each party to make "every reasonable effort" to limit the outages during on-peak and mid-peak periods to unscheduled failures.

It is also KRCC's opinion that reliance in this proceeding on the third amendment of the KRCC contract is appropriate. According to KRCC, the third amendment eliminates the majority of the concerns relating to the differences between the KRCC agreement and the standard offer. In KRCC's view the amendment represents an express statement of the parties' intent in construing the original contract terms.

KRCC rejects DRA's argument that because these terms were in effect during the record period harm could have occurred. KRCC believes this argument has no weight because no harm did occur.

Finally, KRCC does not believe that Edison's decision not to seek preapproval of the contract was unreasonable. According to KRCC, "[w]hile a pre-approval process was adopted by the Commission . . ., the process was explicitly left at the option of the utility" and was to be used "sparingly." (KRCC Opening Brief, at p. 12.) Like Edison, KRCC also emphasizes that Commission staff members were informed of "features of the project development" and gave no indication that preapproval was necessary.

3. DRA

While DRA does not disagree with Edison's general presentation of the history of Commission decisions and policies, it is DRA's position that Edison's actions in negotiating and executing the KRCC contract failed to adhere to those policies. DRA asserts that the criteria established in D.82-01-103 related to nonstandard agreements, preapproval, and scrutiny of utility/QF affiliations are applicable to ECAC reasonableness reviews of QF nonstandard contracts.

In DRA's opinion Edison mischaracterizes state and federal energy policies as excusing Edison from negotiating and executing a contract which fully protected its ratepayers' interest. Contrary to Edison's suggestion, DRA states that the Commission never indicated that Edison was to put its responsibility to encourage the development of QF power before its responsibility to its ratepayers.

DRA is also concerned that KRCC has misunderstood and misapplied the law in this case. DRA has no quarrel with the idea that a disallowance must be based on demonstrable harm. It is DRA's view, in contrast to that expressed by KRCC, however, that the record in this case demonstrates that the KRCC contract was costlier and riskier for ratepayers than a comparable standard offer contract.

Additionally, DRA finds KRCC's reliance on civil court cases involving contract rescissions to be valueless to the issues now before the Commission. According to DRA, this proceeding is not an action by either party to the contract for either rescission or contract damages, but is one intended to protect Edison's ratepayers, who were not parties to the contract, from Edison's lack of prudency in executing this contract.

DRA rejects KRCC and Edison's assertions that the Commission is foreclosed from taking any action on the KRCC contract because no harm resulted in the form of a contract termination or capacity reduction to Edison's ratepayers during the record period. DRA believes that this approach mischaracterizes the nature of contractual obligations, costs, and risks. According to DRA, utilities negotiate electricity purchase contracts on either as-available or firm capacity bases. DRA states that an as-available QF is not obligated to supply electricity to the utility, while a firm capacity QF is required to provide electricity to the utility over a specified period, and if the QF fails to do so, the utility can impose contractual remedies. It is DRA's position that in this case Edison improperly agreed to pay KRCC for firm capacity based on a contract whose terms actually provided for the purchase of as-available electricity.

DRA states that its position regarding the impropriety of such a transaction is no less valid because events which could have caused contract termination failed to occur during the record period. In DRA's view, utilities pay for the contractual right to receive firm capacity and that this assurance, which is not present under an as-available contract, has great value to the utility, even if the utility does not later take the power. DRA states that the difference in expectations causes the difference in pricing between firm and as-available electricity.

With respect to the KRCC contract's negotiation by Edison, it is DRA's view, that Edison drafted the KRCC contract without regard for the Commission's standards. In particular, DRA states that Levine, Edison's chief negotiator for the KRCC contract, did not know about Commission standards and guidelines and was unfamiliar with standard offer contracts used as the measuring stick for nonstandard contracts. DRA contends that Levine's superiors failed to adequately supervise or instruct him in his negotiation efforts, and failed, like other involved Edison personnel, to do their own jobs properly with respect to the KRCC contract. The result, in DRA's view, is a contract that includes no consideration of Commission standards, creates greater risks and costs for Edison's ratepayers, and favors an Edison QF affiliate over other QFs.

DRA points out that the only guideline Levine received was to negotiate a contract at or below Edison's avoided cost.

According to DRA, this emphasis on avoided cost alone disregards important Commission directives governing non-price terms and the risks which could be created by such terms. DRA notes that there is no evidence that anyone at Edison ever considered or evaluated the KRCC non-price clauses in light of the risks of those terms for Edison's ratepayers.

DRA believes that the goals of Levine's supervisor, Vogeler, were confused. Specifically, DRA notes that Vogeler, instructed to negotiate a contract below avoided cost, was unfamiliar with and did not care about the only economic analysis performed by Edison which projected contract payments at 99.77% of avoided cost.

In DRA's view, Edison management never fully addressed nor corrected many of the problems raised by Silsbee and other Edison personnel. DRA cites Silsbee's December 1983 memo as reflecting that responsible Edison personnel were not given "a real opportunity to provide input." (Exhibit 16 to Commission Exhibit 88.)

It is DRA's position that these same facts demonstrate favoritism by Edison toward its QF affiliates. In this regard, DRA notes that the KRCC contract terms were never included in contracts with Edison's nonaffiliated QFs nor was there any evidence that Edison offered such terms to nonaffiliated QFs.

According to DRA, the record also reflects favoritism by Edison towards its QF affiliates in actions taken before the Commission. In particular, DRA argues that Edison signed nonstandard contracts with its affiliates for significant amounts of electricity then requested the Commission to suspend its standard offers in November 1984 due to the potential for overcapacity on Edison's system. This action, in DRA's view, denied nonaffiliated QFs, without the benefit of inside information, the opportunity to compete in the utility's QF program.

It is DRA's view that an unavoidable conflict of interest exists when a utility buys electricity from itself. In this case, DRA believes that Edison greatly increased its conflict of interest by employing the same Edison personnel responsible for the KRCC contract as officers and directors of KRCC or SSEC. In this regard, DRA cites the dual roles served by Bjorklund, Vogeler, Reed, and Neel-Glazier. DRA notes that corporate officers are fiduciaries of the corporation with a duty to maximize profits. In DRA's opinion, an officer or director charged with the duty of maximizing the seller's profits cannot also protect the buyer's ratepayers.

DRA rejects Edison's assertion that no actual conflict arose because its employees were instructed to act solely on behalf of Edison's ratepayers. In this regard, DRA cites the testimony of its witness Kinosian: "'I don't see how it would be possible for someone who knew the bargaining position of both sides to be able to go into a negotiation and forget everything it knows about what the other party's bargaining position is.'" (DRA Reply Brief, at p. 87; citing Tr. at p. 1948.)

DRA refutes Edison's assertions that the penalty imposed in Edison's general rate case and its duty to negotiate in good faith justified entering a contract that exceeded avoided cost and was riskier to ratepayers than the standard offer. DRA asserts that in the interval between the date the Commission issued the penalty (December 13, 1982) and the date Edison executed the KRCC contract (January 6, 1984), Edison executed contracts for over 3,300 MW of QF capacity. Under these circumstances, DRA argues that execution of the KRCC contract at above avoided cost and with unreasonable risks for its ratepayers was hardly essential to meeting Edison's goal of having 2,241 MW of QF capacity under contract by the end of 1984. In addition, DRA argues that the mandate to negotiate in good faith with QFs did not change Edison's continuing duty to ensure that any negotiated contracts were at reasonable cost to the ratepayers.

DRA contends that the record fails to support Edison and KRCC's assertion that they were "locked into" the nonstandard agreement at the time Standard Offer 4 was adopted by the July 1983 letter of intent. In particular, DRA notes: (1) Edison was under no obligation to execute the nonstandard agreement, (2) Edison ignored the Commission's standard offers before the letter of intent was executed, and (3) Edison's and KRCC's own actions with respect to the KRCC contract and other contracts are inconsistent with their claim of being "locked into" a contract by July 1983.

Specifically, DRA notes that the letter of intent expressly provided that neither Edison nor KRCC was obligated to consummate a nonstandard agreement or a cogeneration project. DRA asserts that standard offer guidance was also available before the letter of intent in the form of Edison's Standard Offer 2 which became effective on February 14, 1983. DRA notes that Edison has never attempted to explain why it did not use Standard Offer 2 as a guide during the KRCC negotiations.

It is DRA's opinion that Edison's own actions contradict its claim that the contract terms were set by July 1983. DRA notes the seven revisions to the agreement occurring after the letter of intent, with five being drafted after Standard Offer 4 was adopted. DRA states that these revisions pertained to contractual terms no less important than those Edison contends were locked in place by July 1983.

In DRA's view, the standard offers were too important not to consider no matter how far negotiations had progressed. DRA argues that since early 1982 the Commission had made clear that utilities must gauge the reasonableness of proposed nonstandard contracts against the standard offers.

DRA believes that Edison had reasonable alternatives to executing the KRCC contract. These alternatives, according to DRA, included a nonstandard contract equivalent to a standard offer in terms of price and risk. DRA states that its objection to the KRCC contract is not that Edison negotiated a nonstandard contract instead of a standard offer, but rather that Edison executed a nonstandard contract which exceeded avoided costs, both in terms of actual payments and in terms of the allocation of risk between the QF and Edison's ratepayers.

According to DRA, there is no evidence that Edison's choice was between the KRCC contract or no contract. DRA notes that Getty's principle focus was on obtaining energy price provisions which decreased the risk of forecast changes impacting the Standard Offer 4 energy payments. It is DRA's position that KRCC's insistence on this term, however, did not mean that KRCC would have refused a contract which contained this energy price certainty, but also contained other terms equivalent to the standard offers.

Additionally, DRA states that no evidence exists of Edison even attempting to negotiate commensurate ratepayer benefits in exchange for giving KRCC added energy price certainty or assuming any other risk under the contract. According to DRA, there is also no evidence that KRCC would have rejected terms equivalent to the standard offers since Edison had never suggested them. In this regard, DRA points to the fact that KRCC willingly, and without consideration, accepted Edison's proposed third amendment which aligned the language of the KRCC agreement more closely with the standard offer.

DRA believes, however, that if at the time of contract signing the choice had been between the KRCC contract and no contract, no contract would have been preferable. DRA notes that Edison was never obligated to execute an unreasonable nonstandard contract. In DRA's view, the Commission's encouragement of QF development never altered, but in fact reinforced, Edison's duty to sign reasonable nonstandard QF contracts.

At the heart of DRA's argument of Edison imprudency is DRA's view that the KRCC contract exceeds avoided cost and is riskier than a firm capacity standard offer. The starting point for DRA's analysis is a comparison of the nonstandard contract to the appropriate standard offer. DRA states that the Commission's guidelines for evaluating the nonstandard contract require the Commission to explore the differences between the contract and the standard offer, identify all gains and costs for ratepayers, demonstrate why ratepayers should either be indifferent to or prefer the standard contract, and more closely scrutinize the contract if it involves a utility QF affiliate.

In its review, DRA states that it compared the KRCC contract to Standard Offer 4, Payment Option 3, the contract for long-term power purchases. DRA states that such a comparison was appropriate since both this offer and the KRCC contract include fixed, levelized capacity payments and energy payments tied to a fixed heat rate. Because Standard Offer 4 was in place prior to the execution of the KRCC contract, DRA asserts that Edison knew or should have known of this Commission standard for long-term power purchase contracts.

For DRA, this comparison revealed that the following terms created risks for Edison's ratepayers greater than the standard offer: capacity payments higher than a standard offer, incremental energy rates higher than a standard offer, termination provisions which allow KRCC to unilaterally cancel the 20-year contract on 90 days' notice or to unilaterally cancel if Edison commits a minor breach, provisions which allow KRCC to keep all capacity overpayments if KRCC cancels after 12 years, and the absence of a limit on scheduled maintenance during peak periods. DRA states that there is no evidence that Edison requested or received concessions on behalf of its ratepayers in return for these generous contract terms.

In particular, DRA notes that under Standard Offer 4, a QF could receive $143/kW-year for 20 years if it began firm operations in 1986 and agreed to provide firm capacity for 20 years, subject to specific early termination penalties. DRA states that if the QF terminates before the 20 years are up, the QF must repay with interest the overpayments it received by having a levelized price based on a 20-year contract.

In contrast, DRA notes and finds unreasonable the provisions of the KRCC contract requiring firm capacity payments of $143/kW-year, while permitting operations to begin in 1985. DRA states that KRCC's operation in 1985 was anticipated and did in fact occur.

DRA rejects the argument that such terms were necessary to permit KRCC to obtain federal tax benefits. DRA observes that the development of the levelized, firm capacity price table was based on maintaining costs equal to avoided cost to the utility over the contract term, not on what tax benefits might be realized by the seller.

DRA also disputes Edison's rationale for paying KRCC $143/kW-year because it was compelled by the language of the contract. DRA rejects any implication that "the Commission must find any payment made by Edison under this or any contract to be reasonable simply because Edison agreed to pay it". (DRA Reply Brief, at p. 3.)

DRA finds a further problem with the capacity price. Specifically, the KRCC termination repayment provision clause corresponds to the termination provisions of a 12-year, not a 20-year, Standard Offer 4. DRA notes that under Standard Offer 4, a QF must repay capacity overpayments with interest if it terminates any time during the term of its contract. In contrast, DRA states that if KRCC terminates after 12 years it may keep all capacity overpayments and that the amount to be repaid during the third through twelfth years is substantially less than under

Standard Offer 4. Under a 12-year Standard Offer 4, a QF beginning firm operation in 1985 would receive a capacity payment of $114/kW-year. DRA notes also that the KRCC contract allows KRCC to unilaterally cancel the 20-year contract on 90 days' notice, and contains no limit on the number of peak hours of scheduled maintenance during the peak months.

DRA notes that, under Standard Offer 4, a QF may reduce the contract capacity only upon proper notice to Edison, and upon repayment of capacity overpayments. Five-years' notice is required for a project the size of the Kern River project. If the QF fails to provide the proper notice, which is tailored to the size of the project, it must pay the utility any overpayments plus a penalty equal to the value of the reduced capacity for the period of the deficient notice. In contrast, DRA emphasizes that the KRCC contract permits the QF to terminate the contract at any time after retiring its debt obligations, without penalty, if in KRCC's opinion its performance becomes unprofitable at any time and it has provided 90 days' notice.

Additionally, DRA notes that the standard offer requires a 30-hour limit on scheduled maintenance during peak months. Citing D.82-12-120, at page 58, DRA states that the purpose of the 30-hour cap during peak months is to ensure "appropriate timing (of scheduled maintenance) to avoid periods of greatest demand on the utility system." DRA notes that firm capacity payments are premised on the availability of QFs during these periods of greatest demand.

In contrast, DRA states that the KRCC contract does not contain a cap on scheduled maintenance during peak months. DRA also takes exception to KRCC being permitted to schedule maintenance during peak months if it is not practicable to do it at another time. DRA states that under Standard Offer 4 the scheduling of major overhauls during peak months is prohibited altogether.

To DRA, the result of these provisions in the KRCC contract is to place risks on the ratepayer which are equivalent to an as-available, as opposed to a firm capacity, contract. In DRA's view, if the contract permits a QF to terminate at its own discretion without penalty and imposes no significant restrictions on when that capacity is to be delivered, then the contract is by definition not a firm capacity contract and the QF is not entitled to firm capacity prices. Under these circumstances, DRA believes that Edison should only recover the amount it would have paid for as-available capacity from KRCC.

DRA rejects Edison's and KRCC's arguments that the KRCC contract is a 20-year, firm capacity contract because the parties intended it to be one. DRA believes that Edison has improperly focused on the probability of a QF acting on its contract rights, rather than on the actual existence of these rights or terms. In DRA's opinion, the Commission has not made the focus of review on the likelihood of a QF taking an action permitted under the contract, but the comparability of the actual contract terms with the standard offer. DRA notes that in developing its standard offer contracts the Commission had relied on contractual protection, rather than on factors outside of the contract, to ensure a particular level of performance under the contract.

DRA notes that in interpreting a contract, the courts look for an expressed intent under an objective standard. According to DRA, "[a]bsent ambiguity, evidence cannot be admitted to show that the parties intended the contract to mean other than what it says. (Witkin, Summary of Contract Law, 9th ed., Sec. 684, p. 617.)" (DRA Opening Brief, at p. 43.) DRA concludes: "Just as courts must look to the plain meaning of the contract to interpret the contract, the Commission must look to the plain language to evaluate the reasonableness of the contract." (Id.)

With respect to Edison's arguments of the unlikelihood of KRCC scheduling maintenance during peak periods, DRA states that

QFs under Standard Offer 4 receive the same price signals discouraging scheduled maintenance during peak months as does KRCC. Nevertheless, DRA notes that the Commission still found it reasonable to impose a 30-hour limit on such maintenance.

DRA notes that Edison has not offered a single rationale for the greater leniency of the termination provisions under the KRCC contract and instead focuses on the improbability of KRCC becoming unprofitable, a prerequisite to termination under the contract. DRA states that there is no evidence that Edison evaluated the risks and probabilities of KRCC invoking its termination rights when deciding to include those terms in the contract, or that it obtained more ratepayer benefits than under a standard offer in exchange for accepting those risks. In DRA's view, the possibility of KRCC terminating the contract is also increased because the contract does not define "performance," "unprofitable," or "at any time."

DRA also takes exception to the energy price methodology used in the KRCC contract. DRA's review indicates that, as compared to the Standard Offer 4, the energy price methodology shifts an unreasonable amount of risk onto the ratepayers without providing commensurate benefits. Although DRA does not recommend a disallowance for energy payments made during the record period, DRA concludes that Edison was imprudent in agreeing to this methodology at the time it executed the KRCC contract.

Among DRA's criticisms of the KRCC energy price methodology is the inclusion of fixed heat rate floors and ceilings throughout the life of the contract, as compared to only 13 years under the Standard Offer 4. As a result of this provision, DRA believes that the KRCC contract imposes a risk on ratepayers that the actual heat rates will be lower than those contained in the contract.

In addition, DRA finds unreasonable the specification in the KRCC energy price provisions that only gas or oil be considered the marginal fuel when calculating the incremental energy rate (IER), except for a maximum of 1,000 off-peak hours. During these off-peak hours, the average of gas, oil, and coal prices will be used if oil or gas is not the marginal fuel. In contrast, DRA notes that Standard Offer 4 uses the actual marginal fuel to calculate the actual IER. In DRA's view, the terms of the KRCC contract protect KRCC from the possibility that oil or gas will not be the marginal fuel by shifting the risk to ratepayers. DRA states that, while Standard Offer 4 allows Edison to refuse (and not pay for) deliveries if accepting the energy would result in the utility incurring higher costs or spilling hydro-energy, the KRCC contract requires Edison to take the power and to pay for it.

The final aspect of the KRCC energy price provisions found unreasonable by DRA is the requirement of basing the heat rate on the average heat rate of Edison's gas and oil units, as compared to the system incremental heat rate (which could include other than gas and oil resources) under Standard Offer 4. It is DRA's position that this provision gives KRCC the added certainty that the energy price paid will more closely correspond to the QF's cost of production since it too is a gas fueled resource. DRA does not find, however, a corresponding ratepayer benefit to this term.

Despite the added risk to ratepayers created by the energy provisions, DRA states that it has not found any overpayments due to these nonstandard provisions during the record period. It is DRA's view, however, that this result is due to ratepayers not being subject in this record period to the added risk of the 20-year KRCC heat rate versus the 13-year Standard Offer 4 heat rate. For this reason, DRA asks that KRCC energy payments be reviewed in future ECAC proceedings when that added risk comes into play, and that any overpayments be disallowed at that time.

DRA finds that the following provisions, asserted by Edison to be superior to Standard Offer 4, either increased risks under the KRCC agreement or do not significantly alter the allocation of costs and risks under the contract. These provisions include: (1) insurance coverage, (2) provisions for changes in contract capacity, (3) three-year deadline for beginning capacity deliveries, (4) no payment for energy deliveries in excess of contract capacity, and (5) no capacity payment during uncontrollable force events.

With respect to insurance coverage, DRA states that the KRCC contract requires both parties to maintain $5 million of comprehensive general liability insurance on the KRCC project. DRA finds this provision to be less beneficial to ratepayers than Standard Offer 4 which requires the QF alone, and not the utility or its ratepayers, to provide insurance coverage for its project.

According to DRA, even if there were no additional costs to adding KRCC as an insured under Edison's policies, this provision of the KRCC contract is very costly to ratepayers in terms of risk. In this regard, DRA states that it is logical to assume that Edison's insurance costs, and thus the ratepayers' costs, would be increased if KRCC were to make claims as an insured under Edison's insurance policies.

DRA also takes exception to the KRCC contract provisions governing changes in capacity. DRA states that the KRCC contract defines "contract capacity" as the total of "minimum contract capacity," which is purchased at the fixed contract price, and "additional contract capacity," which is paid the as-available Standard Offer 1 price. According to DRA, unlike QFs with Standard Offer 4 contracts, KRCC has the unilateral right to increase its minimum contract capacity, and to increase or decrease its additional contract capacity. In DRA's view, while under Standard Offer 4 a QF is paid only as-available prices for deliveries above contract capacity, KRCC may unilaterally decide whether to designate increases in capacity as "minimum" or "additional" in order to maximize the price it will be paid for that capacity. DRA notes that Edison did not have a resource need at that time justifying such a provision.

DRA also disagrees with Edison and KRCC that any ratepayer benefit was gained by imposing a three-year, as opposed to five-year, deadline on the start-up for the KRCC project. According to DRA, Edison fails to explain how a three-year versus a five-year lead time for project development provides any added ratepayer certainty.

Further, it is DRA's opinion that the Standard Offer 4 provisions provide greater incentives to meet development expectations than does the KRCC contract. According to DRA, this circumstance results from a Standard Offer 4 QF being paid only as-available capacity prices for early deliveries in advance of its scheduled firm capacity date. DRA states that, as a result, the ratepayer is certain that it will not pay more for capacity than it is worth.

In contrast, DRA finds that KRCC had an incentive to begin deliveries as early as possible, since its 1986 firm capacity price was guaranteed by contract, rather than ensuring that its expected operation date corresponded to its actual operation date. In DRA's view, this result gave ratepayers less certainty for the purposes of resource planning, not more, than the Standard Offer 4. In this regard, DRA notes that Edison's own resource plans at that time showed that the KRCC capacity would not be needed until 1989, more than five years after the contract was signed. In DRA's view, requiring KRCC to provide capacity before it was needed reduces the value of the capacity.

DRA responds to Edison's assertion that the absence of provisions for payment for deliveries in excess of contract capacity is a benefit of the KRCC contract. DRA agrees that under the Standard Offer 4, the utility is required to pay as-available capacity prices for deliveries in excess of contract capacity. DRA notes that the KRCC contract permits KRCC to unilaterally adjust its contract capacity to capture payments for such deliveries at its own discretion. Therefore, DRA views this "ratepayer benefit" as being provided at KRCC's discretion and is in turn one upon which ratepayers cannot depend.

DRA rejects Edison and KRCC's argument of a ratepayer benefit created by the absence in the KRCC contract of the Standard Offer 4 requirement that the utility make capacity payments to the QF for up to 90 days in the event of an uncontrollable outage. In this regard, DRA states that the uncontrollable forces clause of the KRCC contract does not address payments at all and could be interpreted by KRCC to require Edison to continue making capacity payments indefinitely, unlike a standard offer. DRA is also concerned that, if Edison were to maintain that it was not obligated to make any payments, KRCC could perceive such an action to be a breach of contract by Edison.

With respect to the third amendment of the KRCC agreement, it is DRA's opinion that this amendment does nothing to avoid a finding that Edison unreasonably negotiated and executed the KRCC contract or to avoid a disallowance. In support of this position, DRA notes the third amendment was executed after the period under review here, and therefore has no effect on the costs and risks Edison's ratepayers faced during the record period. It is DRA's view that the third amendment's sole effect is to emphasize that Edison's KRCC negotiations and contract execution were unreasonable during the record period. DRA concludes that in reasonableness reviews costs and risks borne by ratepayers during the record period cannot be altered by events which occur after the record period.

DRA cites the testimony of its witness Robert Kinosian for other shortcomings of the third amendment:

> "'The second point about the Third Amendment is that it is an unacceptable amendment unavailable to other QFs. In this instance, the Third Amendment in effect attempts to convert an as-available contract to a firm

> contract. No Commission decision indicates that utilities may choose to do this, particularly in the absence of compensation to ratepayers (e.g., an appropriate disallowance for receiving as-available electricity at firm prices.)'" (DRA Opening Brief, at p. 70, citing Exhibit 141, at p. 16.)

According to DRA this attempted conversion from an as-available to a firm capacity contract without a disallowance would result in Edison's ratepayers paying for as-available capacity in 1985, 1986, 1987, and part of 1988, at firm capacity prices. DRA also expresses the concern that, given the overcapacity which exists on Edison's system, Edison and KRCC had no right to amend the KRCC contract to provide firm capacity, especially without seeking preapproval from the Commission. DRA also notes that the third amendment does not change many of the unreasonable KRCC contract provisions including the formula for capacity overpayments, a capacity price based on a 1986 start date, and KRCC's right to terminate without penalty upon 90 days' notice.

With respect to Edison's indemnification proposal, DRA notes that the unprofitability of KRCC, a prerequisite to termination, would result in the unprofitability of SSEC, and the indemnification would do nothing to protect the ratepayers from the risk of nonperformance. In addition, DRA finds that, like the third amendment, the indemnification agreement cannot undo the unreasonable risks to which Edison's ratepayers were subjected during the record period.

With respect to Edison's decision not to seek preapproval of the agreement, DRA expresses the following view:

> "It is hard to imagine a nonstandard contract more appropriate for advance review than the KRCC contract. The KRCC contract was executed after the Commission had approved the Standard Offer 4, and it clearly deviates significantly from it. The Standard Offer 4 constituted the definitive standard of Commission-approved long-term avoided cost principles at that time. And even if Edison, for unknown reasons,

> believed that the KRCC contract met Commission standards, given the explicit Commission warning that transactions between utilities and their QF affiliates would be subject to great scrutiny, Edison's failure to seek preapproval is nothing less than imprudent." (DRA Opening Brief, at p. 66.)

DRA notes the following statement in D.82-01-103: "[O]nce the Commission has reviewed and expressed its opinion as to the consistency of a contract price and terms with avoided cost principles, utilities should be expected to use these principles to sign similar contracts without review." (D.82-01-103, at p. 104.) DRA states that Edison has not offered any evidence of Commission review or approval of contract terms similar to the majority of those terms which distinguish the KRCC contract from the standard offers.

Finally, DRA argues that Edison failed to present evidence to meet its burden of proof in this proceeding. In this regard, DRA states that a utility must affirmatively prove by clear and convincing evidence the reasonableness of energy expenses, including costs associated with nonstandard QF contracts. Such a showing includes the use of percipient witnesses in support of all elements of its showing and is to be made in its direct case, not in rebuttal. In particular, according to DRA, the utility must demonstrate why a QF nonstandard offer is in the ratepayer's interest.

In DRA's view, Edison failed to comply with these requirements in this proceeding for two reasons: "(1) Edison's direct showing lacked an affirmative reasonableness demonstration of any kind, and (2) Edison's direct and rebuttal testimony established imprudence, not prudence." (DRA Opening Brief, at p. 12.) DRA cites the comments of the ALJ during hearings and the assigned Commissioner's ruling also questioning the adequacy of Edison's showing.

DRA urges the Commission to "strongly acknowledge Edison's failure to meet its burden of proof" due to the "hundreds of millions of dollars" paid by Edison each year to QF affiliates. (Id., at p. 12.) In DRA's opinion, Edison's failure to make an adequate direct reasonableness showing was inexcusable due to Edison's knowledge long before hearings of DRA's decision to contest the reasonableness of the KRCC contract. DRA also states that this failure, along with Edison's refusal to respond to legitimate discovery severely impeded DRA's own reasonableness investigation of the KRCC contract.

4. TURN

TURN's participation in the review of the KRCC contract was limited to the filing of an opening brief. In its brief, TURN expresses its support for DRA's position and its continued opposition to allowing utilities to purchase electricity from their affiliates because of the opportunities for self-dealing. It is TURN's position that the record in this case provides unequivocal evidence of the problems associated with affiliate transactions and demonstrates the wisdom of a prohibition against utility purchases from affiliated QFs.

In particular, TURN concludes that the KRCC contract is unreasonable based on the following: (1) DRA has identified contract terms which increase ratepayers' risk above an equivalent standard offer; (2) an inherent conflict of interest exists because personnel were involved in contract negotiation on behalf of both Edison and KRCC; and (3) Edison's justifications of the KRCC contract are based on hindsight and should be rejected. With respect to its second point, TURN states: "Since no method exists for the Commission to go back and probe the hearts and minds of Edison's personnel during the KRCC negotiations, the decision in this case must be based on an analysis of objective facts and not subjective intent." (TURN Opening Brief, at p. 4.) According to TURN, "[n]o matter how carefully Edison personnel were instructed to further Edison's interests and to be conscious of 'what hat they were wearing', their loyalties were necessarily split because of the positions they occupied with Southern Sierra/KRCC." (Id; emphasis original.)

As an example, TURN points to Neel-Glazier's testimony. It is TURN's opinion, that as an attorney representing Edison, Neel-Glazier had an ethical obligation to vigorously represent her client's interests and as an officer of SSEC she had a fiduciary duty to further the interests of those corporations. This conflict, in TURN's view, is obvious and inescapable irrespective of her subjective intent.

TURN rejects Edison's argument that the contract provisions found objectionable have been modified by the third amendment. According to TURN, "[s]ince the claimed modifications occurred long after contract formation, they are ipso facto irrelevant to the conditions existing at the time of contract formation." (TURN Opening Brief, at p. 6.) TURN also argues that since these modifications did not take place until after the record period they cannot retroactively reduce ratepayers' exposure to risk during that period.

B. Discussion

The focus of this decision is the reasonableness of a single nonstandard purchase power contract between Edison and a QF affiliate, KRCC. Within this seemingly limited subject, however, lie significant issues which touch on almost every aspect of our involvement in QF development since 1979. This result has been triggered by one circumstance--the existence of a nonstandard purchase power agreement between a utility and a QF affiliate under which the principal contractual obligations of the parties are defined very differently than the Commission's standard of QF contract reasonableness--the standard offer. The issues to be decided by the Commission are whether Edison acted prudently in signing the KRCC agreement based upon the facts and conditions which were known or should have been known at the time and whether Edison engaged in self-dealing in its actions related to the contract. The numerous decisions summarized at the beginning of this order provide the framework for our review of this agreement.

Edison has steadfastly maintained throughout this proceeding that it properly concluded that evidence of its negotiation of the KRCC contract or its affiliate relationship with KRCC was not relevant to our review of the agreement. In support of this position, Edison and KRCC had initially argued that this Commission's review of the contract was limited to a comparison of the payment streams between the KRCC agreement and the applicable standard offer. Even in its brief, Edison continues to assert that, until the Commission issued D.89-01-047 in this proceeding, the negotiation of a nonstandard agreement had never been considered in an ECAC reasonableness review. These arguments reflect Edison's and KRCC's basic position that the KRCC agreement should be regarded as being no different than any other nonstandard agreement which Edison signed during this record period or any previous record period.

This approach, however, is not consistent with the reality of this case. The KRCC contract is not just another one of Edison's nonstandard QF agreements. By Edison's own admission, the Kern River project was the first large-scale cogeneration project signed by Edison, the first successful EOR facility in California, the subject of a contract by which all other similar agreements would be measured, and Edison's first major QF affiliation. Further, the terms of the KRCC agreement did not match any prior Edison nonstandard contract or any Commission approved standard offer.[3] While Edison resisted our consideration of its negotiations and partnership with Getty, it was only through a complete understanding of that history that this Commission could properly evaluate the end product -- the KRCC contract.

The regulatory encouragement and pressure to develop QF projects which Edison and KRCC cite as support for the execution of the KRCC contract relate to benefits which Edison's ratepayers might realize from the project itself as distinguished from ratepayer benefits related to the contract's terms. We obviously agree with Edison and KRCC's statements regarding the value of this EOR project. During the early 1980's, we found that alternative resource generation was an appropriate and beneficial way in which to meet then-existing utility resource needs. Our decision to foster the development of QF power was a policy we had endorsed on our own and as a response to state and federal mandates. Our response to legislative requirements included our adoption of the FERC regulation permitting a utility to hold a 50% equity interest in a qualifying facility.

This policy picture, however, did not exist in a vacuum and did not exist without rules and limitations. Edison has cited prior Commission orders stating that a prudent act by a utility is not limited to the optimum act, but includes a spectrum of possible acts consistent with the utility system need, the interest of the utility's ratepayers, and the requirements of governmental agencies of competent jurisdiction. This "spectrum" of possible acts, however, in turn exists within the spectrum of all laws and

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3 The record in this case indicates that Robert Levine used a purchase power agreement Edison had entered with Procter & Gamble as a model for the initial draft of the KRCC agreement. When signed, however, the major terms of the KRCC contract differed significantly from the Procter & Gamble agreement. Further, the Procter & Gamble contract was never reviewed for reasonableness by the Commission due to its conversion to a standard offer.

conditions in effect at the time of the utility action. The utility cannot isolate one or two requirements or conditions as justifying its actions, but must take into consideration all of the applicable laws and facts in reaching a decision.

The failure to pay careful attention to all of these requirements and to weigh all possible alternatives can by itself be a critical flaw in the judgment of a utility manager. The need for such vigilance is heightened when the utility is charged with the particular responsibility of maintaining its ratepayers' indifference to a transaction and ensuring equal treatment of all others who might be parties to similar transactions.

The "spectrum" of conditions which Edison claims as support for its actions included the following: a perceived need by Edison for additional baseload capacity; federal and state policy requiring the purchase of electric power from cogenerators, with particular emphasis on the statements of a single CPUC Commissioner; and Edison's claimed need to accede to the demands of its affiliate's partner as a measure of good faith negotiations. Edison rejects DRA's assessment of the reasonableness of the KRCC contract based on its comparability to Standard Offer 4, Payment Option 3 alone. In its testimony, an Edison witness expressed the view that only now has the standard offer attained the status of a "Holy Writ" requiring a quid pro quo exchange for changes in standard offer terms.

This extremely narrow view by Edison of the laws and policies defining the "bandwidth" of possible business decisions which Edison could have made with respect to the KRCC contract does not take into consideration the entire body of law and conditions existing at the time or the importance of the standard offer. Our previous review of the many Commission decisions issued between 1979 and January 1984 make clear that even in that time frame the standard offer was to serve as the benchmark for all utility purchases from QFs. At its inception the terms of the standard offer were those proposed by the utilities in 1980 set against such rudimentary guidelines as providing for avoided cost pricing. By January, 1982, the overall guidelines for standard and nonstandard offers had been set. By December, 1982, the significant pricing, performance, and termination provisions for purchases of as-available capacity and energy and firm capacity were defined. By October, 1983, long-term pricing and the remaining standard offer terminology was in place with the exception of a few minor provisions. While the Commission intended to promote alternative generation, the development of QF power, even cogeneration, was not to be at any cost.

Our decisions, which were the result of enormous time and manpower commitments by this Commission's staff, California's electric utilities including Edison, and active third parties, also addressed many issues on the operation of the QF program itself. The standard offer was viewed as the heart of a program intended to benefit ratepayers and ensure equal treatment of all QFs. Further, the standard offer was found to be per se reasonable and in turn to form the standard against which the reasonableness of all utility actions related to QF transactions was to be measured.

We found the adequacy of the standard offers to be so complete that uncertainty was expressed regarding even the need for nonstandard offers. The Commission concluded, however, that there might be circumstances where such offers might be required to facilitate QF development. In our early orders, however, those circumstances were viewed very narrowly -- to enhance a QF's financeability or unique technology.

The nonstandard offer, which by definition would deviate from the Commission's approved offer, was never intended to avoid Commission review for reasonableness. To some degree, the choice of this review was left to the utility. Review following the execution of a nonstandard agreement would take place in the utility's ECAC, with unreasonable costs being disallowed. As an alternative, the utility could seek preapproval of the nonstandard contract prior to signing. The latter approach was designed to provide a means by which the utility could be assured of cost recovery and thereby promote the use of such offers when necessary.

The Commission did not encourage preapproval in every instance. Edison has noted that the Commission stated that utilities were to submit only those offers for which the utility had "significant questions." (D.82-01-103, at p. 104.) The Commission, in the following sentence, further defined what the utility could consider a "significant question." Specifically, we found: "Once the Commission has reviewed and expressed its opinion as to the consistency of a contract price and terms with avoided cost principles, utilities should be expected to use these principles to sign similar contracts without review." (Id.; emphasis added.)

Whether by preapproval or ECAC review, however, the focus of the Commission's review of nonstandard agreements was to be the same -- was the nonstandard offer in the ratepayer's interest and would the ratepayer "be indifferent to or prefer the nonstandard contract over the standard contract"? (D.82-01-103, at p. 103.) The Commission, not only in its standard offer decisions, but in its early review of nonstandard agreements brought to the Commission for preapproval, provided the guidelines by which to judge the agreement's reasonableness. While the economic reference point of avoided cost was a critical point of comparison, the overall standard by which the reasonableness of the nonstandard agreement was to be judged was its comparability to the standard offer as a whole.

For each additional risk to which the ratepayer was to be exposed under a nonstandard agreement, a "compensating benefit" was to be provided in return. The analysis to be used in any application for preapproval, and in fact in our decisions on such applications (D.93364, D.82-04-087, D.82-07-021, D.83-05-043), was to include a clear statement of "all the differences between the contract and the standard offer" and an identification of "all gains and costs to ratepayers." (D.82-01-103, at p. 103.) Our decisions on nonstandard offers issued during the negotiation of the KRCC contract make clear that these standards applied to even a single difference between the nonstandard agreement and the standard offer and that even a single difference could be a cause for concern as well as a basis for seeking preapproval. Even if a utility manager decided not to seek advance approval of a QF nonstandard contract, our findings in D.82-01-103 and subsequent decisions reviewing nonstandard contracts provided the regulatory policies each utility manager would be expected to know and follow in the negotiation of each nonstandard contract.

These guidelines had equal applicability to nonstandard agreements between the utility and a QF in which the utility held an equity interest. While Edison is correct that the Commission permitted partial utility ownership by a QF, we intended that this ownership carry with it an enhanced level of responsibility by the utility to ensure that its ratepayers were adequately protected.

In this proceeding, Edison has emphasized that SSEC, Getty's partner in KRCC, is now merely an Edison affiliate, a part of the unregulated subsidiary of Edison's holding company. While this circumstance has been true since 1988, at the time of the negotiation and execution of the KRCC contract and throughout the record period of this proceeding, SSEC was a direct subsidiary of Edison, the regulated utility. In D.82-01-103, the Commission announced that, when a utility chose to participate in the ownership of a QF, the Commission would require greater scrutiny of utility operations. The utility would be permitted to come forward with a proposal for partial ownership of a QF. Such proposals were to be reviewed by the Commission on a "case-by-case basis, with the intent of protecting the interest of both ratepayers and any QFs who might be disadvantaged competitively." (D.82-01-103, at p. 12.)

These findings directly stemmed from our concerns related to the potential for harm to the utility's ratepayors and other QFs which might result from such relationships and tho utility's diversification into unregulated activities. In particular, the Commission cited the need to ensure that such relationships did not produce any anticompetitive effects, incentives to increase the utility's avoided costs, the subsidization by ratepayers of the unregulated business, or the impairment of the financial integrity of the regulated entity. At no point in this proceeding, has Edison suggested that any of the Commission's findings in D.82-01-103 regarding utility ownership of QFs, other than our permitting such arrangements, had any significance in the execution of the KRCC contract or Edison's request to recover costs associated with that contract.

It is against this background that we review Edison's actions in negotiating and executing the KRCC agreement. We do not quarrel with Edison's assertions that the utility's baseload need and government policies in effect at the time of the negotiations, as well as Edison and Getty's own feasibility study, made this project a "good one" for Edison to consider and even actively pursue. From that point forward, however, these arguments do not justify signing an agreement which so radically differed from the standard offer and, in many important ways, exposed Edison's ratepayers to significantly greater risks.

Similarly, we accept that former Commissioner Dedrick's contacts with Edison and this Commission's decision to impose a penalty on Edison for offering QFs prices below avoided costs could have been influential on the decisions made by Edison's management. Yet these circumstances cannot excuse actions taken by that management which ignored decisions of the full Commission that provided specific direction on the negotiation and provisions of nonstandard contracts with QFs and with QF affiliates in particular.

Additionally, we note that Commissioner Dedrick had left her office at this Commission before the issuance of even D.82-01-103. With respect to Edison's rate case penalty, this penalty had been necessitated by Edison's reluctance to sign standard contracts with wind developers at full avoided cost. In particular, we found Edison's pricing policies, including Edison's position that standard offers based on avoided costs were not required nor appropriate, "as evidencing a continuing pattern of disregard for the Commission's avoided cost policy of the past three years." (D.82-12-044, 10 CPUC 2d 155, 258.) Although Edison credits this penalty as contributing to the regulatory pressure on Edison to negotiate the KRCC agreement, the penalty can also be viewed as resulting from an Edison practice of disregard for Commission QF pricing policies.

The record in this case indicates that, with respect to the KRCC contract, Edison's adherence to Commission adopted standard offers or avoided costs principles did not improve significantly after Edison's 1982 general rate case decision. In fact, each member of Edison's personnel involved in negotiating and signing the KRCC contract had a common characteristic. None attached any great importance to the standard offers or the Commission's decisions defining those agreements.

Edison takes exception to DRA's emphasis on the "scant attention" paid by Robert Levine to the standard offers. Looking up the "chain of command," however, the attention paid to these offers by Edison's management was never significantly greater than Levine's, and, for Levine's direct supervisor, Michael Vogeler, "was not something I felt was really paramount to the negotiations." (Tr. 3072.)

Of those responsible for negotiating the KRCC contract, at the bottom of the Edison personnel ladder, but at the top of the negotiating chain, were Levine and Patricia Neel-Glazier. Both individuals admitted to knowing little, if anything, about the Commission's standard offer decisions. As our review above indicates, the absence of knowledge about these decisions also represented an absence of knowledge about the Commission's policies on nonstandard offers and utility/QF affiliation.

As their tool in the KRCC contract negotiations, these two individuals, both essentially novices to QF contracts, used an agreement which had never received Commission approval nor was based on any standard offer. Levine and other Edison personnel cited the Commission's resolution declining to approve the Procter & Gamble contract as precedent for the Commission declining to preapprove purchase power agreements. In fact, the resolution does not stand for this principle at all, but is based instead on the rationale that the resolution process or advice letter filings were not a suitable method for seeking review of purchase power agreements or the utility's avoided costs. The Commission viewed these issues as requiring more in-depth review and hearings not available through advice letter filings.

Edison's position in this regard also ignores the Commission's decision issued three months earlier permitting preapproval of a nonstandard contract between SDG&E and Kelco based upon an application filed by the utility. (D.93364.) The analysis applied to that agreement, including its comparison to SDG&E's "standard contract" and a determination of the resulting risk and benefits for the ratepayers and QF, was the very one adopted by the Commission in D.82-01-103. In fact, in D.82-01-103, the Kelco contract was cited as an example of a nonstandard contract benefitting both ratepayers and the QF.

The "benefit-risk" exchange contemplated by the Commission for nonstandard contracts was apparently understood by Edison's Edward Myers at the outset of the negotiations. Nevertheless, Edison now appears to suggest that the standard offer had little relevance to its negotiations with Getty since these negotiations began when there was no Commission-approved standard offers. While no Commission decision approving specific standard offers had been issued at that time, the utilities had in fact filed initial price offerings based on avoided costs in response to early Commission orders. Further, by the time Levine had circulated his draft of the agreement in October, 1982, the Commission had already issued D.82-01-103 and Edison had filed standard offers in response.

Moving up Edison's personnel ladder, we find individuals whose motivation to successfully sign a contract with a large cogeneration project appeared to cloud their judgment. For Vogeler, the contract represented an opportunity to "get that penalty off our backs." Under these circumstances, the contract, for Vogeler, needed only to meet his definition of being "below avoided cost," without regard to the findings of Edison's own analysts. For Kent and Bjorkland, each concluded that verbal instructions to their employees to act on behalf of Edison's ratepayers were sufficient alone to ensure a contract which they would find reasonable. Bjorkland testified that he was not familiar with the standard offers nor had he directed his management to be familiar with those offers.

Kent, the only one of this group who claimed knowledge of all of the Commission's decisions, appeared to do little to ensure that those decisions were being followed. In fact, based on his interpretation that advance approval of nonstandard offers should be sought "only in special and limited situations" or "unusual cases", he made the decision not to submit the KRCC contract to the Commission for preapproval. (Exhibit 148, at p. I-4, II-12.) These phrases used by Kent do not appear in the Commission's decision, but are in fact Edison's interpretation of that order. Based on this approach, Edison concluded that the KRCC Contract did not involve "an unusual case for which a request for Commission preapproval was appropriate." (Id, at p. I-4.)

In using this logic for not seeking preapproval, we find an inherent inconsistency in Edison's argument. For purposes of justifying Edison's signing the KRCC contract, the Kern River project was the largest, most significant endeavor which Edison had undertaken up to that point in purchasing power from QFs and provided a unique opportunity to provide the first successful EOR project and Edison's first significant QF joint venture. For purposes of presenting the resulting contract to the Commission for its preapproval, however, the project was not an "unusual case" or a "special" situation requiring such action.

We do not find that a brief conversation with a Commission staff member about the contract was the equivalent of the request for preapproval contemplated by D.82-01-103. There is no evidence in this record that the Commission or a member of its staff told Edison that preapproval, as contemplated by D.82-01-103, of this particular contract was unnecessary or unwarranted.

This record reflects that the information provided to this Commission and the CEC regarding the KRCC contract and the ownership relation between KRCC and Edison was extremely limited. In fact, the representations made by Edison to the two Commissions came principally from Michael Vogeler. Based on the record in this proceeding, Vogeler's own appreciation of the impact of all of the KRCC contract terms and understanding of the standard offers appear to have been minimal. We note that Edison in its written summation to the Commission's Executive Director regarding the KRCC contract stressed Edison's ability to terminate the agreement in 90 days. In fact, this term, which might have been significant for Edison's ratepayers and this Commission, was removed by amendment to the agreement six months after its execution.

None of Edison's management decisions or the absence of such decisions has significance, however, if the KRCC contract provided Edison's ratepayers with the economic equivalent of the standard offer. Based on firm capacity payments and bonuses received by KRCC, the parties' statements, and the contract's stated duration of 20 years, the KRCC agreement would be required to be the economic equivalent of a firm capacity standard offer. In D.83-10-093, we specifically found that the "economic balance" represented by the standard offer and required to be maintained in a nonstandard contract was "not limited to the exchange of dollars between the parties." (D.83-10-093, 13 CPUC 2d 84, 124.) In this regard, we found that "(c)hanges in nonprice terms can have very real economic effects on ratepayers and the parties to the contract." (Id.)

We conclude, as DRA has ably demonstrated, that the KRCC contract was not the economic equivalent of a firm capacity standard offer. The terms of this agreement were not designed to ensure a firm capacity commitment, to maintain ratepayer indifference, to shield ratepayers from risks greater than those incurred under a firm capacity standard offer, or to provide ratepayers with significant compensating benefits in exchange for those risks.

The only term for which there is evidence of a "bargained-for exchange" by Edison on behalf of its ratepayers as contemplated by the Commission in D.82-01-103 involved a portion of the energy price formula. In particular, Getty requested energy price certainty in the form of levelized energy payments, a feature which became part of the standard offers in September, 1983. In return, Edison requested a discount on its avoided cost of energy.

Despite Edison's and KRCC's reference to other "benefits" of the KRCC contract, nothing in this record indicates that Edison ever negotiated these "benefits" on behalf of its ratepayers as compensation for, in DRA's words, the "generous" terms given to KRCC. Even Getty's chief negotiator could not recall any specific contract terms "being exchanged one for another in any instance."

(Tr. 2581.) Additionally, we find that the "benefits" cited by Edison and KRCC are not sufficient to serve as compensation to ratepayers for any of the "generous" nonstandard terms.[4]

The benefits realized by Getty and KRCC and the risks incurred by Edison's ratepayers are part of the same list. That list includes: (1) energy prices based on a formula at odds with the standard offers and creating the potential for costs above avoided costs in the later years of the contract, (2) capacity prices in excess of those forecasted for QFs beginning firm operation in 1985, and (3) termination and scheduled maintenance provisions which did not ensure a "firm capacity" commitment by the QF. These latter provisions permitted significant operating decisions to be made unilaterally by the QF and failed to provide, for the term of the contract, the repayment upon termination necessary to make the utility whole and its ratepayers indifferent to the transaction.

With respect to this list, we note that the energy price formula negotiated by Edison and Getty went far beyond the compensation received by Edison's ratepayers in the form of a discount applied to Edison's avoided cost, a discount which over the term of the negotiations continually shrank. For capacity prices, KRCC's beginning operation in mid-August, 1985, could easily have been anticipated by the parties in light of the tax incentives to be realized by KRCC and a construction agreement

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4 We note that our discussion of the need for nonstandard contract terms in D.82-01-103 related to difficulties a QF might encounter financing his project or developing his technology. Nowhere in this record is there any evidence that Getty and Edison ever experienced difficulty financing this project or that particular contract terms were necessary to further this effort, with the possible exception of energy price certainty. Further, one of the things which Edison management had found most attractive about the Kern River project was its "off-the-shelf" technology.

which provided for significant incentives for completion of the project before mid-December 1985. The requirement of a three-year operation deadline for this project, as opposed to the standard offer five-year deadline, was an insignificant concession for higher capacity prices given the state of "readiness" of the project as of the date of contract signing.

Edison and KRCC have argued that Edison's ratepayers were benefitted by the chosen energy price formula because the application of this formula between 1985 and 1987 resulted in KRCC being paid less than Edison's avoided costs. In KRCC's testimony, Exhibit 134, KRCC stated that the difference between these two price streams resulted in "ratepayer energy savings (that) ranged from $24.9 million to $38.6 million for the record period, excluding interest savings." (Exhibit 134, at p. 22.)

The record in this proceeding is clear, however, that this result was neither intended nor forecasted by the parties. Edison had only forecasted that payments under the KRCC contract would be 99.8% of avoided cost. At best such an analysis reflects that Edison had negotiated only an infinitesimally small improvement in cost for its ratepayers over the standard offer. This difference was not sufficient to compensate ratepayers for risks assumed under the contract and was based on an analysis, as explained below, which was flawed due to erroneous assumptions regarding capacity price and termination. In fact, if the proper assumptions had been made the forecast would have revealed a contract price stream well above avoided cost.

To avoid the application of hindsight, a reasonableness review of a utility's purchase power agreements, as even Edison has concurred, is <u>not</u> outcome oriented. The fact that the application of the KRCC energy price formula during the record period resulted in lower payments is not relevant to the consideration of what the parties anticipated and intended at the time of the contract's execution. The standard offer energy provisions, approved by the

Commission, were the standard of reasonableness. From this standard, the KRCC energy price formula deviated significantly. The fact that energy payments to KRCC were below Standard Offer 4, Option 3, payments for the record period was the result of happenstance, not design.

Additionally, because the operation of the KRCC energy price formula could produce payments above avoided costs in future record periods, as demonstrated by DRA, the Commission is foreclosed from finding the formula to be beneficial to ratepayers. The discount on avoided cost included in KRCC's energy payments was insufficient compensation for Edison's ratepayers given the risks inherent in the provisions as a whole.

With respect to Edison's avoided cost forecast performed in October 1982, we find this forecast to have been flawed since it erroneously assumed that the KRCC project would be entitled to a 1986 firm capacity price based on a 1986 operation date. In fact, KRCC was only entitled, at most, to a 1985 firm capacity price based on its date of operation, and not the 1986 firm capacity price required under the contract. The result of this contract term was to require capacity payments to above Edison's avoided costs. Further, the analyst failed to consider the impact of the lenient and highly flexible termination provisions on the actual capacity price which should have been paid to KRCC.

While the price provisions adopted for the KRCC agreement are at odds with the standard offers, it is the contract's provisions for termination and maintenance which essentially "recharacterize" the nature of the contractual obligation undertaken by KRCC by failing to ensure a firm power commitment by the QF. It is in these provisions where the most significant departures from the firm capacity standard offers are found especially related to restrictions on and prerequisites to termination and maintenance and provision for repayment to Edison upon termination.

Yet, one set of standard offer terms which were specifically in place well before Edison and Getty's July 1983 letter of intent were the termination provisions for firm capacity contracts adopted in D.82-12-120. No one directly negotiating the KRCC contract on behalf of Edison or supervising that negotiation claimed to have any knowledge of these provisions or to have considered their application in the KRCC contract.

KRCC has argued that California contract law is applicable as a means of limiting any disallowance the Commission might make in this proceeding. We agree with DRA that KRCC's argument misunderstands a Commission reasonableness review. Our standards for this review have been developed to respond to a situation unique to utility regulation; namely, our obligation to protect the utility's ratepayers, who are not privy to the negotiation and execution of a purchase power agreement, but must pay for its costs.

In one way, however, contract law is applicable to this proceeding. Specifically, the parties' intent regarding an <u>ambiguous</u> contract term is evidence of the interpretation to be given that term. Where no ambiguity exists, however, the parties' intent is not relevant and certainly should be given little weight when it differs significantly from the plain meaning of the words used.

In this regard, we find that Edison and KRCC have relied on their intentions as a means of "explaining away" many of the KRCC contract's termination and maintenance provisions which are at odds with those required for a firm power contract. We concur with DRA that the language of the termination and scheduled maintenance provisions in the KRCC contract reduces KRCC's obligations under the agreement, increases ratepayer risks, and undermines the 20-year firm power commitment from KRCC which Edison and KRCC claim was intended.

In D.82-12-120, the Commission made clear that the performance standards and termination provisions adopted for firm capacity QFs had these goals: to ensure that the QF was providing firm capacity and to make the ratepayers whole in the event that the QF failed to provide firm capacity. Commensurate with its obligations beyond those required of an as-available QF, the firm power QF was entitled to earn higher capacity payments and even bonuses to reflect the degree to which the utility could rely on the QF's contribution for resource planning.

The termination and maintenance provisions of the KRCC contract did not achieve the goals which the Commission intended such provisions to meet in a firm power contract. In particular, the agreement contained maintenance and termination provisions without restrictions and repayment provisions comparable to a 20-year firm capacity standard offer. Further, the contract permitted significant operating and termination decisions to be made by the QF alone. The result of these circumstances was a contract which failed to ensure a firm capacity commitment by the QF.

Among other things, the agreement, as signed, contained no limit on scheduled maintenance during peak periods and permitted KRCC to schedule maintenance during peak months upon KRCC's determination that it was not practicable to perform maintenance at another time. The contract's termination provisions contained repayment terms which were not comparable to a 20-year firm power standard offer and gave KRCC "the right" to terminate the agreement upon 90 days' notice to Edison after retiring its debt obligations "if in KRCC's opinion, its performance becomes unprofitable at any time". (Exhibit 109, Section 5.5; emphasis added.) The contract also permitted KRCC to unilaterally cancel the agreement upon 90 days' notice if Edison, unless otherwise excused under the contract, declined to accept delivery "at any time". (Exhibit 109, Section 5.3.)

KRCC and Edison argue that, because KRCC did not terminate the agreement during the record period, Edison's ratepayers were unharmed. As we have indicated, however, the measure of the contract's reasonableness does not depend on what actually occurred, but what the contract terms permitted to occur and the resulting risks to which Edison's ratepayors were exposed at the time of the contract's execution.

With these pricing and contract terms in mind, we turn Edison and KRCC's assertions that the parties were essentially "locked in" to these particular provisions by the July 1983 letter of intent and the requirement that Edison bargain in good faith with Getty. In this regard, Edison justifies many of the nonstandard contract terms on the basis that Getty "insisted upon" their inclusion.

In several of our standard offer decisions, we repeated the requirement that utilities were to bargain in "good faith" with QFs. Our need to address this topic stemmed from utilities refusing to consider any QF requests for changes to the standard offers. Not in any of these orders, however, did the Commission ever state that this requirement of good faith negotiations meant that a term was to be included in a nonstandard offer because the QF "insisted" upon it. The only requirement placed on the utility was to <u>consider</u>, but not necessarily include the term. The decision for inclusion was uniquely a utility management decision to be made in the context of the applicable law.

That law, as we have discussed, required comparability between the standard and negotiated offers and ratepayer indifference to the two transactions. We fully concur with DRA that the standard offers and our decisions relating to them were sufficiently significant that at no point up to the time of contract execution was it appropriate to ignore them.

Further, Edison's choice was never solely between a standard offer and no contract. As DRA has pointed out, Edison had an opportunity to negotiate a contract and respond to Getty's principle concerns related to energy price certainty and contract capacity changes without providing additional terms highly favorable to the QF for which no compensating benefits were obtained for Edison's ratepayers. The fact that Edison felt it had to accede to Getty's demands did not mean that it could or should no longer bargain vigorously for its ratepayers and obtain compensation for these demands. Without these efforts even being made, there can be no assertion that the only choice Edison faced in January 1984 was between the agreement which was signed and no contract at all. We also do not find in this record any evidence of such an ultimatum being given to Edison by Getty.

Finally, if the letter of intent signed by Getty and Edison truly "locked in" the terms of the agreement, we question, as has DRA, (1) the reason for a provision absolving the parties from liability in the event that a contract was not executed, (2) the ability of Getty to switch to a standard offer if desired, and (3) the freedom of the parties to revise the agreement several times after the letter of intent was signed. Among these revisions was the final critical revision shortly before the contract's execution changing the denominator in the termination formula from "20" to "12". We concur with DRA that at the very least this change alone effectively altered KRCC's obligations to provide firm power from 20 to 12 years.

With respect to the impact of the KRCC contract's third amendment, we agree with DRA that this amendment has no relevance to our review of the reasonableness of the KRCC contract at the time of its execution. No matter what retroactive effect was given to this amendment by the parties, the fact remains that the contract terms contained in the amendment did not exist nor were even contemplated at the time of the contract's execution or this record period. Under these circumstances, the amendment certainly could not be included among the conditions "existing at the time" which would have or should have influenced Edison's actions or our perception of the reasonableness of those actions.

As we explain in the following sections dealing with remedies, however, we do not share DRA's view that the parties were precluded from amending their agreement. Our approach instead is to encourage the contract's reformation and to ensure the continuance of a highly beneficial QF project.

Based on the record and the applicable law in this proceeding, we find that Edison and its managers did not act prudently in negotiating or executing the KRCC contract. The actions taken by Edison belie their responsibility to their ratepayers in signing this nonstandard QF contract. The fact of Edison's ownership interest in the project should have heightened Edison's attention to this Commission's decisions and the interests of its ratepayers and other QFs. Instead, we find that Edison was almost uniformly inattentive to the Commission's standards of reasonableness governing purchase power agreements with QFs and the Commission's guidelines for preapproval of nonstandard QF contracts. The result was an agreement which provided increased risks to ratepayers over the standard offers without compensating benefits and was therefore unreasonable.

We further find that DRA has presented a reasonable theory on which to base a disallowance related to this contract. Namely, it is DRA's position that the result of all of the KRCC contract terms was to create an agreement for as-available as opposed to firm capacity. We agree with this conclusion and discuss its application and ramifications for this contract in our following section on remedies.

Although this case has primarily focused on the impact of the KRCC contract on Edison's ratepayers, DRA has also asserted that other QFs were harmed by this agreement. The most significant evidence in this regard was the testimony of Kent that Edison had never refused similar contract terms to other QFs. In fact, however, neither Kent nor apparently anyone else at Edison had ever made known to other QFs that such terms were available.

DRA believes that another instance of favoritism toward Edison's QF affiliates occurred during the end of 1984 when Edison first requested the suspension of its standard offers while still negotiating and eventually signing nonstandard agreements with its affiliates. The record in this proceeding related to these events, however, is not sufficient to conclude in this decision that Edison intended a course of conduct related to these events specifically designed to favor its affiliated QFs over nonaffiliated QFs.

We do not intend, however, to prevent further evidence on this issue being received in Edison's next ECAC reasonableness reviews which will examine other nonstandard contracts signed with Edison affiliates during 1984 and 1985. We will therefore leave open for those proceedings the issue of whether the signing of these other nonstandard contracts favored Edison's affiliates over other QFs.

Consideration of this issue, however, directly raises the issue of Edison's burden of proof in demonstrating the reasonableness of its nonstandard agreements with QF affiliates. It is Edison's position that, while it has the burden of proving the reasonableness of these agreements, DRA has the burden of supporting its recommendations with sufficient evidence.

This latter statement viewed in isolation is no doubt true. DRA, however, cannot effectively make its recommendations unless the utility has first met its burden of proving the reasonableness of its agreement and providing all requested, relevant documents. In this case, Edison had the traditional burden of proving the reasonableness of the nonstandard agreement with KRCC, but also the further burden, once it agreed to own the facility, of showing that no harm was caused to its ratepayers or other QFs by this action. This conclusion is well-supported by D.82-01-103 which sets forth precisely the concerns which the

Commission expects each utility to address when utility ownership of the QF is involved. We have noted previously that in this case Edison has chosen to largely ignore or minimize these requirements of D.82-01-103.

Based on the facts presented in this proceeding, we advise Edison that in its next ECAC reasonableness review, Edison will be expected to demonstrate through clear and convincing evidence that its nonstandard agreement with affiliates resulted in no harm to Edison's ratepayers or nonaffiliated QFs. We find that a statement that no QF was "refused" a nonstandard agreement similar to one with an Edison affiliate, by itself, will not be adequate to meet this requirement given Edison's actions in late 1984 requesting the suspension of its standard offers.

With respect to this proceeding, we conclude that the comments of the ALJ during hearing and the assigned Commissioner in a subsequent ruling were totally appropriate in advising Edison of the weakness of its showing. The many reasons offered by Edison in its reply brief to support its approach do not justify the stark absence of information regarding the negotiation and execution of the KRCC contract or the partnership of SSEC and Getty.

What occurred in prior Edison ECACs has little relevance to the issues which the Commission was required to consider for the first time in this proceeding. Edison's exclusive reliance on its prior ECACs as support for its showing in this case ignores the significant departure of the KRCC agreement from the standard offers, the ownership tie between Edison and KRCC, and the Commission's orders on both standard and nonstandard offers. The record is clear that Edison was well aware almost a year prior to hearings in this proceeding of DRA's concerns with the KRCC agreement. These concerns in fact led Edison to execute a third amendment to the agreement months before hearings took place.

Because the record in this case included all evidence, whether entitled "rebuttal" or "direct," necessary to evaluate the contract, we do not intend to impose a sanction on Edison for its approach in this proceeding. We advise Edison, however, that, with the issuance of this decision, there can no longer be any question regarding the nature and the level of proof required to demonstrate the reasonableness of its nonstandard agreements with affiliates. We also intend to ensure this result by adopting DRA's recommendations for increased reporting requirements related to nonstandard agreements between Edison and its QF affiliates. This recommendation is discussed in the section of this decision dealing with remedies.

The issue of affiliation brings us finally to DRA's concerns with the existence of self-dealing related to the KRCC contract. Based on the record in this proceeding, we find these concerns to be legitimate. Edison and KRCC, similar to their arguments in support of the KRCC agreement, assert again that the absence of any harm related to self-dealing results in a claim which is essentially not actionable.

We reiterate, however, that the Commission's oversight of utility action is not focused on what occurred, but with the risks to which Edison's ratepayers and other QFs were exposed beyond those of a standard offer and beyond those found in non-affiliate QF transactions. The fact that Edison created the <u>potential</u> or even the appearance of a conflict is cause for concern.

In this case, the potential for a serious conflict of interest was present. No matter what instructions were received or actual functions undertaken, Edison personnel had the opportunity to serve and hold simultaneously fiduciary relationships to two very different and conflicting interests. On the one hand, these individuals were to negotiate a contract on behalf of Edison's ratepayers; on the other, as officers of SSEC, each held an obligation to promote the interests of that company.

The evidence in this proceeding does little to reassure us that a conflict of interest was not present and did not result in self dealing. In one respect, Edison asks the Commission to place little emphasis on Levine's lack of knowledge of standard offers because his immediate supervisors within Edison, including Bjorkland and Vogeler, were effectively making the utility's decisions on the negotiations and were familiar with the Commission's standard offer orders. Yet, when referring to Bjorkland's and Vogeler's activities with SSEC and the SSEC management committee, Edison would like us to perceive that neither man was primarily involved in the negotiation of the KRCC contract.

In this regard, we note the testimony of Charles Myers that it was important that the members of the management committee not be the individuals primarily responsible for the negotiations. Yet Vogeler, even without a vote on the approval of the contract for SSEC, seemed to be truly involved on both sides of the bargaining table. The record indicates that he was present at all KRCC management committee meetings at which the contract was discussed and, during the same time period, in his office at Edison, provided advice and direction on the agreement to Edison employees.

The record in this case, as a whole, also reflects a willingness by Edison to act according to the wishes of its affiliate's partner, Getty, on important decisions made contrary even to specific guidance or direction provided by the Commission. These steps not only related to Edison agreeing to terms upon which Getty "insisted" in the KRCC agreement, but also acceding to Getty's wishes to withhold information which Edison had been directly ordered to produce by the Commission. Edison has apparently extended the logic of Getty's control over KRCC management committee decisions involving contracts with the other partner's parent to a control by Getty over decisions made by Edison directly impacting its regulation by this Commission.

It is our sincere hope that no agreement exists in which Edison's actions which are specifically the subject of regulatory oversight are guided or influenced by an unregulated third party. While we do not believe that DRA's proposed wholesale changes in Edison's holding company structure are required as a result of this case, we do believe that the record in this proceeding requires some action to protect Edison's ratepayers and other QFs from any further conflicts of interest or the potential for such conflicts. DRA's proposals and our conclusions in this regard are discussed in our subsequent discussion of remedies.

VII. <u>KRCC Contract Administration</u>

In the case of the administration of the KRCC contract, as well as the remedies for lack of prudency associated with the agreement, the framework for these issues has been set by the recommendations of DRA. In its report (Exhibit 87) DRA cited two incidents occurring after the Kern River project became operational which DRA believes raises issues regarding the contract's administration.

The first incident involved the scheduling of maintenance hours. This episode began with a letter by KRCC to Edison on November 4, 1985, asking that Edison review and revise its computation of KRCC's September 20 to October 20, 1985, on-peak hours. (Exhibit 132.) In Edison's original statement of energy and capacity purchases from KRCC for this time period, Edison had found KRCC to have an on-peak capacity factor of 83.126%. Under the terms of the KRCC contract, the QF is entitled to a bonus payment in each peak month in which the QF provides contract capacity for all on-peak hours and the on-peak capacity factor exceeds 85%.

The question of KRCC's on-peak hours during this period centered on KRCC's plant capacity being reduced for five days due to the loss of a boiler feedwater pump motor. In its November 4, 1985, letter, KRCC stated that Edison had erred in its computation of KRCC's on-peak hours and, as a result, in determining that KRCC was not entitled to a Capacity Bonus Payment for September 20 to October 6, 1985. In particular, KRCC asserted: "The reduction in plant capacity experienced on September 20 was a forced outage, and as such, the second 'on-peak' day of the five-day reduced plant capacity should be considered as maintenance." (Exhibit 132.) The letter, however, also contained the following statement: "The system for reporting scheduled outages as per Terms and Conditions of the Parallel Generation Agreement, has not been followed as it should." (Exhibit 132.)

The contract term referenced in the letter was the requirement of one week's notice for scheduling outages of one day or more. (Exhibit 109, Section 8.4.1.) For the outage in question, KRCC had not provided Edison's Operating Representative with any advance notice. According to a memo from Edison to Getty dated November 15, 1985, Edison's Pardee substation was notified of the outage "but was unable to prove or disprove this claim [of a scheduled outage] based on the substation log." (Exhibit 130.)

A few weeks after the September 29 outage, KRCC again failed to properly schedule maintenance. By letter of November 5, 1985, KRCC asked Edison to consider an outage on October 11 and October 15, 1985, related to the inspection of one of the project's combustion turbines, to be a scheduled outage "although it was not reported as such." (Exhibit 132.) The letter acknowledged that while the KRCC management committee was aware of the inspection, Edison was not advised of this scheduled maintenance in accordance with the terms of the KRCC contract.

In two separate letters from Edison to Charles Myers on November 21, 1985, Edison concluded that for the first outage KRCC was entitled to a scheduled maintenance allowance, and in turn a capacity bonus payment for the period September 20 to October 18, 1985. (Exhibit 130.) Edison paid KRCC a peak month bonus payment of $124,253 for the period September 20 through September 30, 1985.

For the outage occurring in October, Edison concluded that it was "unable to meet [KRCC's] request for additional maintenance hour credits for the payment period of September 20, 1985 to October 18, 1985." (Exhibit 132.) This conclusion was based on KRCC's failing to "notify Edison in advance of the planned outage as required by contract terms." (Id.)

The second incident challenged by DRA involves KRCC's entitlement to certain winter on-peak bonuses. Under the contract, KRCC can qualify for a bonus payment in non-peak months if all the Peak Month bonus requirements have been met for all Peak Months, the on-peak Capacity Factor for each of the year's Peak Months was at least 85%, and the non-peak months' capacity factor exceeds 85%. (Exhibit 109, Appendix B, Section 2; emphasis added.) The contract provides that "[c]urrently, but subject to change with reasonable notice, the peak months for the Edison system are June, July, August, and September." (Exhibit 109, Section 4.20.)

On August 9, 1985, KRCC initially made its contract capacity available to Edison. KRCC's capacity factor was 96.92% for the period August 9, 1985 to August 31, 1985 and 94.49% for the period September 1, 1985 to September 30, 1985. From October 1985 to May 1986, Edison paid KRCC $3,043,084 in non-peak month bonuses even though KRCC did not provide contract capacity in either June or July.

A. Parties' Positions

1. DRA

In its testimony DRA states its position on contract administration as follows:

> "Once a contract has been executed, the facility has been constructed and Edison has begun to purchase power from the facility, the utility is responsible for administering the contract in a reasonable and prudent manner.
>
> Prudent contract administration requires Edison to properly implement the various pricing provisions, monitor and enforce the terms of

> the contract, exercise its rights under these contracts in a timely manner, and execute amendments consistent with Commission guidelines." (Exhibit 87, p. VII-1.)

Based on this standard, DRA believes that Edison's reclassification of KRCC's outage in September 1985 as scheduled maintenance was unreasonable because the reclassification did not conform to the terms of the contract. According to DRA, the essential element of a "scheduled" outage is that it must be scheduled. Further, DRA states that KRCC did not comply with the contract because it failed to supply the one week's advance notice to Edison's Operating Representative as required by the contract. DRA states that the Pardee substation log contained no evidence that KRCC had notified Edison that it intended to schedule any maintenance hours, and KRCC, by its own admission, states that the contract provisions governing the reporting of scheduled outages had not been followed.

DRA also takes issue with Edison's payment to KRCC of non-peak bonuses of $3,043,084. DRA notes that, since KRCC first made its contract capacity available to KRCC on August 9, 1985, KRCC did not achieve an 85% capacity favor for either June or July. In DRA's opinion, this circumstance means that KRCC could not legitimately earn the non-peak bonus because of the contract's requirements that KRCC meet the peak month bonus requirements for all peak months, identified as June, July, August, and September. Under these circumstances, DRA concludes that Edison improperly paid non-peak bonuses which did not meet the requirements of the contract.

2. <u>Edison</u>

In Edison's view, because the KRCC contract is a pay-for-performance contract, the issue of contract administration centers on whether Edison "properly implemented its pricing provisions and monitored, enforced, and exercised Edison's rights under the contract." (Edison Opening Brief, at p. 82.) With respect to the reclassification of the outage, Edison states that this reclassification was appropriate since no harm to ratepayers resulted from it. In particular, Edison asserts that there was no difference in its operation as a result of the technically improper notice. Further, it is Edison's opinion that KRCC acted in good faith in its first attempt to comply with the scheduled maintenance provision of the KRCC contract and did in fact notify Pardee substation of the reduction as soon as it occurred.

Edison also believes that it acted reasonably and in conformance with the Commission's intent in determining that KRCC was entitled to winter non-peak bonus payments. Edison states that, in administering the contract, Edison determined that, for firm operation beginning mid-summer, a QF which operated thereafter at 85% of contract capacity should not be precluded from qualifying for winter bonus payments. Edison acknowledges that the KRCC contract does not address this unique situation, but the definition of peak month under the contract makes clear that as little as one month or as many as four months each year may be designated as peak months. Under these circumstances, it is Edison's opinion that KRCC's operation during the final two months of summer, including Edison's peak month of September, satisfied this contractual requirement.

Edison states that a reasonable interpretation of D.82-12-120 supports Edison's administration of the contract. In particular, Edison asserts that D.82-12-120 provides that the QF must consistently exceed the minimum level of availability of the peaking unit used as a proxy to achieve bonus payments. According to Edison, citing D.82-12-120, at pages 56-57, the utility was left to establish a reasonable method for determining "consistent availability." Edison concludes that KRCC's standard of performance for the two peak months of 1985 justified Edison awarding the QF the winter bonus payments.

3. KRCC

KRCC states that DRA's allegations of impropriety in the administration of the KRCC contract demonstrate a disregard for the evidentiary record and a failure to acknowledge prudent and reasonable contract administration policies. According to KRCC, DRA's challenge to a credit for KRCC's scheduled maintenance is contrary to the contract provisions and unsupported by Edison's factual determination at the time of the outage. In particular, KRCC cites Edison's "in-depth" review which demonstrated that the incident "while not letter perfect" was sufficient to credit KRCC for a maintenance outage. (KRCC Opening Brief, at p. 41.) In KRCC's view, DRA's challenge "exalts form over substance", noting the absence of any harm to Edison's ratepayers in the initial exercise of these provisions by KRCC. (Id.)

Like Edison, KRCC references this Commission's silence on how a utility is to apply bonus payments to QFs that begin commercial operation during the summer on-peak months. According to KRCC, since KRCC contributed greatly to Edison's capability to meet peaking requirements in all months following commercial operation, Edison properly determined that KRCC had met the performance requirements of the bonus payment. KRCC asserts, without cite, that this approach is reasonable "because Edison has uniformly applied it to all Standard Offer and nonstandard contracts." (KRCC Opening Brief, at p. 45.)

B. Discussion

We find that DRA has appropriately brought into question two incidents involving Edison's administration of the KRCC contract. We concur with DRA that effective contract administration requires the utility to ensure compliance with the contract terms. Although we can imagine instances in which it is reasonable for the utility to show a degree of latitude toward a QF's performance under some terms of a purchase power agreement, we expect stricter compliance when the direct result is the payment by the utility of a significant bonus to the QF. The reason for this approach is clear -- Edison's ratepayers directly bear the burden of shouldering the costs of the agreement. It is this Commission's duty to ensure, therefore, that those costs were reasonably incurred.

We do not find that Edison's payment of a capacity bonus to KRCC for its performance between September 20 and October 6, 1985, was reasonable. KRCC admitted that the procedure which it followed to "schedule" maintenance was not the one dictated by the terms of its agreement with Edison. Additionally, there is insufficient evidence that the outage was indeed scheduled maintenance. Finally, based on information available to it at the time, Edison had properly concluded initially that a capacity bonus payment was not warranted. The request by KRCC to Edison to reconsider this decision provided an inadequate basis, even when coupled with Edison's review of the incident, to justify the reclassification of the outage as scheduled maintenance.

Similarly, we do not find that Edison's payment of winter bonus payments to KRCC following the operation of the facility in August and September, 1985, was reasonable. The explicit terms of the contract limits the payment of non-peak bonuses to instances when the QF performed at an 85% on-peak capacity factor for <u>all</u> peak months. In this case, KRCC operated at this level in only two of the four peak months and therefore did not meet the contract requirements for non-peak bonuses. Despite Edison and KRCC's assertions, we have no evidence in this proceeding that Edison, in administering similar provisions under its standard offers, has in fact provided non-peak bonus payments for meeting bonus requirements in fewer than all of the peak months designated under the contract.

We, therefore, conclude that it is appropriate to disallow the bonus payments to KRCC by Edison related to these two incidents. We note, however, that our adoption of DRA's characterization of the KRCC contract as one for as-available capacity results in a disallowance, discussed in the following section, which incorporates the firm capacity bonuses paid during the record period. No further disallowances is therefore required to reflect Edison's imprudence in administering the KRCC contract.

VIII. Remedies

A. Disallowance

In the previous sections, we have found that Edison acted imprudently in signing the KRCC contract and without regard for the appearance of self-dealing. In this section, we address the parties' positions on the appropriate Commission responses to these actions.

1. Parties' Positions

a. DRA

DRA has recommended a disallowance of $52.23 million for Edison's imprudency related to the KRCC contract. In making this recommendation, DRA reviews specific disallowances related to the contract's 1985 versus 1986 start date, 12-year versus 20-year price, firm capacity payments for increased contract capacity, and as-available versus firm prices.

As explained in the previous sections, it is DRA's position that the KRCC agreement during the record period did not represent a 20-year firm capacity contract with firm operation beginning in 1986. DRA's first three disallowance recommendations, listed below, place a value on separate contract terms which DRA has argued were unreasonable. The final recommendation, which would incorporate all of DRA's recommendations and would require no additional disallowance for the record period, is based on DRA's theory that the KRCC contract represented a contract for as-available, as opposed to firm, capacity.

1. <u>1985 Versus 1986 Start Date</u>. According to DRA, KRCC began operations in 1985 and under Standard Offer 4 would have received \$132/kW-year for firm capacity. In contrast, DRA states that KRCC receives \$143/kW-year. DRA argues that the difference between these two prices of \$5,326,000 in nominal dollars for the record period should be disallowed.

2. <u>12-Year Versus 20-Year Price</u>. DRA states that the \$143/kw-yr and \$132/kw-yr prices stated above are Standard Offer 4 prices for a 20-year firm contract. However, unlike a Standard Offer 4, the KRCC contract allows KRCC to terminate after 12 years without penalty. The Standard Offer 4 price for a 12-year firm contract beginning operations in 1985 is \$114/kw-yr. DRA recommends that a disallowance of \$14,042,317 in nominal dollars for the record period be ordered to reflect the difference in capacity payments to KRCC of \$143/kW-year and \$114/kW-year. DRA notes that this disallowance reflects corrections to include more accurate information provided by Edison regarding the actual payments made to KRCC and changes in the level of contract capacity.

3. <u>Firm Capacity Payments for Increased Contract Capacity</u>. DRA states that KRCC may increase the amount of firm capacity entitled to \$143/kW-year at its sole discretion, unlike Standard Offer 4 QFs who require the utility's consent for such a change. DRA notes that during the record period KRCC increased its firm capacity sales from 170 MW to 195 MW and should receive the short-run avoided capacity price, like a Standard Offer 4 QF would, for this 25 MW change. DRA asks that \$1.2 million in nominal dollars be disallowed representing the difference between the firm and short-run prices for this capacity increase. According to DRA, only \$500,000 needs to be added to the \$14,042,317 noted in the section above to reflect this disallowance.

4. As-Available Versus Firm Prices. In addition to disallowances for the individual contract terms described above, DRA states that a disallowance of $37,455,675 in nominal dollars for the record period should be adopted for the difference between the KRCC contract capacity price and the as-available capacity price in Standard Offer 4. This recommendation reflects revisions to incorporate more accurate information provided by Edison in its rebuttal.

DRA notes that Edison represents that $34,053,506 is the appropriate disallowance if the Commission were to adopt DRA's ultimate recommendation. According to DRA, the difference between this figure and DRA's proposed $37,455,675 is the value of energy deliveries above contract capacity at the as-available capacity price. DRA states that Edison improperly credits this amount against the recommended disallowance since testimony by Edison on the issue of an as-available capacity credit was struck by the ALJ ruling on April 6, 1989. DRA notes, however, that, despite this action by the ALJ, Edison had reflected in a table to Exhibit 148 the value of the as-available capacity in excess of the contract capacity.

As part of its disallowance recommendation, DRA states that all of its disallowance values, presented above in nominal dollars, must be escalated to present day dollars. DRA recommends that the Commission escalate the proposed disallowance by the utility's authorized rate of return. Using this escalation factor, DRA calculates the disallowance incorporating all of its recommendations to be $52.23 million.

DRA believes that basing the interest on the disallowance on the three-month commercial paper normally used in ECACs is inappropriate in this case. DRA reasons that, because this case involves overpayments made by the utility to a subsidiary, the amount overpaid by the utility to its QF affiliate flows back to the utility's stockholders. In DRA's view, the utility has access to this money and may use it in any way it wishes. As a result, DRA asserts that "[a]t the very least, the utility can make a profit with this money equal to its rate of return by, for example, retiring existing utility debt." (DRA Opening Brief, at p. 76.) In DRA's opinion, application of the three-month commercial paper rate to overpayments to a QF affiliate would, therefore, result in the balancing account serving to reward the company.

DRA also examines the issue of the impact, if any, of the record period KRCC energy payments on DRA's recommended disallowance. DRA states that it has shown that the KRCC energy price provisions are unreasonable. Only because no overpayments resulted from the operation of these provisions during the record period, does DRA believe that a disallowance at this time based on these provisions is not appropriate. DRA asks the Commission, however, to find these provisions imprudent and determine the appropriate disallowance in future record periods when the imprudent terms come into play.

It is also DRA's position that the KRCC energy price provisions result in "underpayments" by accident, not by design. According to DRA, it is contrary to the standard of evaluating contract in light of circumstances at the time of contract execution to offset capacity disallowances with energy "underpayments."

Specifically, DRA concludes that even though "Edison <u>now</u> believes particular energy pricing components to be better than those in Standard Offer 4, it is evident that <u>at the time of contract execution</u>, Edison considered and believed that the KRCC energy price terms would be 99.77% of avoided energy cost." (DRA Opening Brief, at p. 51.) DRA further states that there is "no evidence that the .03% forecasted 'discount' was bargained for in exchange for Getty's 'bottom-line negotiating position' of price certainty for the life of the contract. (<u>Id</u>.) In DRA's view, any difference between what Edison predicted with respect to the KRCC energy price provisions and what actually occurred was "a product of accident" and should not be taken into consideration in calculating the appropriate disallowances. (Id.)

DRA also notes that a utility is entitled to recover all of its payments based on reasonable forecasts even if actual costs exceed those forecasts. DRA believes the converse is also true, and that "overpayments associated with terms which were known or should have been known to be unreasonable at the time of contract execution will be disallowed." (DRA Opening Brief, at p. 52.)

Finally, DRA states that its recommendations did not include any suggested modifications to the KRCC contract which would enable Edison to avoid future disallowances during later reasonableness reviews. DRA states that its objections to KRCC's consideration of a retroactive conversion of the contract to a Standard Offer 4 are the same as those voiced with respect to the third amendment of the KRCC agreement. In particular, DRA notes that such changes could not undo the harm to ratepayers occurring in the record period. DRA also believes that it is premature to discuss changes to prevent future disallowances until the Commission rules on the reasonableness of KRCC contract terms in this proceeding.

b. Edison

During this proceeding, it was Edison's view that a disallowance related to the KRCC contract was inappropriate because Edison had been prudent in executing the agreement. Edison asked, however, that if the Commission did adopt DRA's recommendations, certain adjustments be made in the proposed disallowance.

The first adjustment Edison seeks is for the Commission to adopt a three-month commercial paper rate in calculating the interest on the disallowance. Edison states that this position is consistent with current Commission policy for an ECAC disallowance as announced in D.89-02-074. Edison asserts that

DRA's proposal for an interest rate based on Edison's rate of return would require a retroactive change to Edison's ECAC preliminary statement which provides for the use of a three-month commercial paper rate in the recorded operation of the ECAC balancing account. Edison believes that changes to this Commission-approved statement should be made prospectively only.

It is also Edison's contention that DRA's proposal goes beyond the scope of ECAC reasonableness reviews. According to Edison, "[w]hether or not SCEcorp shareholders benefitted from the alleged QF overpayments to KRCC is not germane to this proceeding the purpose of which is to determine if expenses incurred by Edison (an electric utility and subsidiary of SCEcorp) during the defined ECAC Record Period were reasonably incurred." (Edison Opening Brief, at pp. 79-80.) Edison believes that its ratepayers and shareholders will be placed in the same position they would have been, but for the recording of any unreasonably incurred energy expense, if its approach on interest is followed. This approach requires the removal of unreasonably incurred expenses from the ECAC balancing account together with a component for accrued interest using the three-month commerical paper rate. It is Edison's position that DRA's proposed interest rate removes an amount from the ECAC balancing account greater than what was originally recorded.

Edison states that DRA's proposed disallowance is overstated based on a comparison to as-available capacity prices for all capacity delivered to Edison by KRCC. According to Edison, the $3.4 million added by DRA to the disallowance is savings to ratepayers based on KRCC not receiving as-available capacity. Edison views this sum as a benefit to ratepayers received at no cost.

Edison also asserts that DRA's disallowance for increased contract capacity was never explained nor justified. Edison states that DRA did not propose a disallowance until the last day of the hearings, and the $1.2 million figure was not the amount recommended. According to Edison, neither the $1.2 million nor $500,000 has any record support nor is its manner of calculation clear from DRA's discussion. Edison has also corrected the proposed disallowance to ensure that DRA's disallowances for 1985 and 1986 bonus payments for alleged imprudent contract administration should not be double counted with any capacity payment disallowances.

With these corrections, Edison asserts that the proposed disallowance based on a comparison of firm to as-available capacity prices should be $34,053,506. This figure, according to Edison, also accounts for the portion of the payment allocated to Edison's Annual Energy Rate when it was in effect during the Record Periods.

Finally, in determining a disallowance, Edison states that the test of reasonableness "which is not outcome oriented" (Edison Reply Brief, at p. 46; emphasis original) is confused by DRA with the test for a disallowance, which, according to Edison, is outcome oriented. In support of this proposition, Edison cites D.89-02-074 in which the Commission recognized certain benefits of a purchase power contract and credited energy savings realized from those beneficial provisions against a proposed disallowance.

Edison states that it is, therefore, appropriate to apply any energy underpayments resulting from the KRCC contract to capacity overpayments. According to Edison, this approach would result in a reduction of DRA's proposed $52 million disallowance by $47 million. Edison states this number is derived by determining the amount by which as-available energy prices exceeded those actually paid to KRCC ($38 million) and escalating that figure as proposed by DRA.

c. KRCC

KRCC joins Edison in asserting that any calculation of a disallowance related to the KRCC contract should balance the

KRCC energy payments which were below avoided costs against the KRCC capacity payments. According to KRCC: "The determination of a remedy requires that the Commission: (1) determine the 'harm' (or benefit) to ratepayers under the entire KRCC Agreement, by comparing the stream of payments that actually occurred during the record period and, (2) the payment stream under the applicable standard." (KRCC Reply Brief, at p. 17.) KRCC offers no cite or support for this statement.

KRCC asserts that if there is cognizable harm from Edison's actions, the proper remedy is not disallowance but some form of a penalty. While DRA has made clear that abrogation of the KRCC agreement is not sought, Edison has not. Therefore, KRCC asks: "If there is some penalty that the Commission determines Edison should bear in this proceeding it is imperative that the Commission carefully consider the nature of the sanction in light of Edison's comments concerning contract abrogation." (KRCC Opening Brief, at p. 60.) If a disallowance is used, KRCC asks that the Commission specifically direct Edison to maintain the sanctity of the QF contract.

2. <u>Discussion</u>

We have previously found that Edison acted imprudently in the negotiation and execution of the KRCC contract. We have enumerated the many significant contract terms which placed Edison's ratepayers at greater risk than those contained in Standard Offers 2 and 4.

Under these circumstances, a disallowance of certain costs associated with the contract for the record period 1984 through 1987 is appropriate. We find that DRA has identified several approaches which attempt to quantify the unreasonable costs associated with the contract. Based on the significant differences between the KRCC contract and the firm capacity standard offers which required less of KRCC than other firm capacity QFs and provided KRCC the opportunity to receive payments above Edison's avoided costs, we conclude that DRA's assessment of the KRCC contract as in fact an as-available contract is appropriate.

Previously in this decision, we recited our findings regarding firm power (D.82-12-120) and the level of performance required of a QF providing firm capacity. In exchange for providing a firm resource, principally defined by requirements related to performance, termination, and maintenance, the QF was entitled to earn a higher capacity payment. Without that commitment, the QF was to be considered an "as-available" QF and paid commensurately less.

In this case, the termination and maintenance provisions of the KRCC contract served to diminish KRCC's "firm power" commitment. Even if KRCC did not exercise any of its termination or maintenance options under the contract during the record period, our review is based on the contractual commitment of the parties as undertaken at the time of contract execution. Coupled with this reduced commitment are pricing provisions permitting KRCC to be paid above Edison's avoided costs.

We therefore adopt DRA's proposed total disallowance of $37,455,675 in nominal dollars for the three-year record period. We believe that this disallowance, which will be absorbed by Edison's shareholders, properly reflects the impact of Edison's management decisions which did not adequately take into account the interests of its ratepayers as defined by the Commission's decisions and adopted standard offers. Edison makes clear in its arguments that it continues to have unwavering faith in the reasonableness of its actions. This "reasonableness" standard, however, was one developed by Edison, not this Commission, and did not provide sufficient consideration for Edison's ratepayers. Under these circumstances, it is unreasonable to require those ratepayers to bear the costs of Edison's decision-making.

The adopted disallowance does not reflect a reduction for $3.4 million in capacity "savings" asserted by Edison. DRA properly notes that consideration of such savings was not included in the record in this proceeding.

In ordering a disallowance, we must also address three other significant issues. These issues include: (1) the interest to be applied to the disallowance, (2) the impact on the disallowance of any "savings" in KRCC's energy payments, and (3) the impact of the disallowance on the status of the contract.

On the issue of the applicable interest rate, we agree with Edison that in ECAC proceedings the appropriate interest rate to be applied to a disallowance is the three-month commercial paper rate. We find no basis in this record to change this approach or to adopt DRA's proposal. There is no evidence that costs associated with this contract were reflected or used in Edison's balancing account in any way different than those associated with any other purchase power agreement. The application of the three-month commercial paper rate in this proceeding to the adopted disallowance results in an overall disallowance of $48,370,708 for the three-year record period.

Both Edison and KRCC have argued that during this record period the KRCC contract energy payments were below those which KRCC would have received under Standard Offer 4, Energy Payment Option 3. These parties have urged that these "savings" be used to offset any disallowance adopted in this decision.

In our review of Commission reasonableness standards, we have noted that a determination of the reasonableness of an act or contract is not "outcome-oriented." This approach is to avoid the use of hindsight in assessing the prudency of a utility's actions based on conditions existing at the time.

Applying this principle to the instant case, we find that the parties to the KRCC contract did not intend nor forecast that the payments under that agreement would be significantly different than the forecasted avoided costs. Further, we have found that the energy provisions themselves contain terms which, due to their potential for causing harm to ratepayers in the future, render these payment provisions unreasonable. The fact that the energy provisions resulted in lower energy payments in this record period does not, therefore, mean that the same result will occur in future record periods.

It is Edison's position that, while a "reasonableness" review is not "outcome-oriented", a disallowance can take into account the actual operation of the contract's terms. The cases cited by Edison in which offsets on disallowances have been made, however, are distinguishable from this case in one very critical way: the savings applied to those disallowances stemmed from contract provisions which the Commission had found to be beneficial to the utility's ratepayers. In particular, we found in D.89-02-074, upon which Edison has relied, the following:

> "Our consideration of an appropriate disallowance for SDG&E's imprudent actions in relation to the PNM [Public Service Company of New Mexico] contract is tempered by our recognition of the benefits of the contract and the many prudent actions and decisions SDG&E took in its negotiation and evaluation of this contract." (D.89-02-074, at p. 96.)

In this case, we have found that the energy payment formula of the KRCC contract creates risks for Edison's ratepayers for which they have not been adequately compensated. The operation of that provision may also cause Edison to incur unreasonable costs in future record periods. Under these circumstances, despite savings from the operation of the KRCC energy price formula during the 1984 to 1987 record period, we are precluded from applying those savings to offset the adopted disallowance.

KRCC has expressed concern that by disallowing costs associated with the contract, the Commission will in turn jeopardize continued viability of the contract. This result is one which the Commission wishes to avoid to the extent that the unreasonable provisions of the contract are reformed.

At the beginning of this decision, we indicated our continued recognition of the value of alternate resources. One fact which is clear from this record is that the Kern River EOR project is a significant and beneficial cogeneration facility. It is not the Commission's intent by ordering this disallowance to impair or alter the value of that facility to Edison's ratepayers. Instead, we have intended the disallowance adopted by this decision to serve as a regulatory response to actions taken by Edison which were at odds with specific Commission directives and placed Edison's ratepayers at risks greater than those under the standard offer agreements.

We therefore find that this decision should not serve as a basis for abrogation of the contract. We also reject DRA's position that current regulatory and resource conditions limit the parties' ability to reform the contract. In this regard, we conclude that D.85-12-104, involving SDG&E's contract with a former affiliate, provides the best approach for permitting and encouraging the parties to cure deficiencies in nonstandard QF contracts. In D.85-12-104, the Commission did not restrict the reformation of the contract to a standard offer and indicated that the disallowance or basis for disallowance would continue in the future until the parties had "arrive[d] at some different contractual arrangement." (D.85-12-104, 20 CPUC 66, 70.)

We therefore encourage the parties to consider moving in the direction started with the third amendment of the KRCC contract and reform the agreement in keeping with the standard offer terms in effect at the time of its execution. In our discussion below on self-dealing, we also concluded that the standard offer can serve to ensure the propriety of future dealings between Edison and its QF affiliates.

B. Self-Dealing

1. Parties' Positions

a. DRA

According to DRA, the reasonableness of the KRCC contract and the resulting disallowance are not the only important issues in this case. DRA believes that the Commission must also take steps to protect Edison's ratepayers and nonaffiliated QFs from the self-dealing abuses and unfair competition evidenced in this case. It is DRA's position that in response to the record in this case, the Commission must order major changes in Edison's QF program.

DRA believes that the natural conflict of interest which resulted from Edison acting as buyer and seller in the same transaction was increased in this case by Edison negotiating and executing a contract with the same personnel on both sides of the bargaining table. DRA also asserts that Edison has discriminated against nonaffiliated QFs by (1) never offering these QFs contract terms similar to those contained in the KRCC agreement and (2) by signing up great blocks of affiliated QF power and then requesting the suspension of standard offers because of potential overcapacity.

DRA notes that the KRCC contract is the only Edison QF affiliate contract which DRA has reviewed in depth to date. DRA states, however, that Edison has signed significant nonstandard contracts with other QF affiliates, including one modelled after the KRCC contract which will be the subject of review in Edison's 1989 ECAC. (A.89-05-064.) It is DRA's concern that the "KRCC contract may not be the only affiliate contract characterized by high costs, high risks, and favoritism for Edison's QF affiliates." (DRA Opening Brief, at p. 82.)

It remains DRA's concern that "Edison and its QF affiliates will always possess and use their superior inside information which nonaffiliated QFs can never hope to match."

(Edison Opening Brief, at p. 83.) This situation, according to DRA, deprives nonaffiliated QFs a fair chance to compete in the utility's QF program.

The conflict of interest which exists when the utility acts as both buyer and seller of QF energy, in DRA's opinion, also presents too many incentives for the utility to maximize its profits to its shareholders without a similar incentive to minimize costs to its ratepayers. DRA notes that, of the three major California electric utilities, only Edison currently sells electricity to itself.

DRA finds this conflict to be intensified by Edison personnel serving as officers and directors of the affiliate. It is DRA's position that a corporate officer charged with a fiduciary duty to the seller cannot also protect the buyer's ratepayers. In DRA's view, "[i]f Edison insists on self-dealing, it should have separated personnel so that Edison employees with KRCC contract responsibility would not be directors or officers of KRCC or Southern Sierra." (DRA's Opening Brief, at p. 85.) In DRA's view, a verbal instruction to act solely on behalf of Edison's ratepayers given to Edison's personnel, who also served as the affiliate's corporate officers, is not an effective means of justifying or avoiding an obvious conflict of interest.

Based on these circumstances, DRA recommends that the Commission take specific action to prevent future self-dealing abuses by Edison. It is DRA's opinion that, given the ineffectiveness of current regulations to prevent Edison's self-dealing abuses, the only appropriate remedy is for the Commission "to prohibit further Edison purchases from nonaffiliated QFs and to encourage Edison's holding company to divest itself of QF ownership." (DRA Opening Brief, at p. 87.) DRA states that a "never ending series of reasonableness reviews" is an inadequate approach to ensuring propriety in dealings between a utility and its QF affiliate. According to DRA's testimony, "(t)he DRA Staff

is not equipped to monitor and investigate all possible abuses in utility transactions with affiliates and headquarters."
(Exhibit 87, at p. IV-26.)

If this recommendation is not adopted, DRA requests that one of the following alternative recommendations be adopted:

(1) The Commission should request Edison's holding company, SCE Corp., to divest its ownership interest in QFs with which Edison does business. In DRA's view, divestment will prevent self-dealing abuses of all kinds, including those related to the execution and administration of QF agreements.

(2) If divestment cannot be accomplished for any reason, the Commission should adopt DRA's proposed Affiliate Cost Adjustment. This adjustment permits a flow-through to Edison's ratepayers of the profits Edison's QF affiliates earn in excess of Edison's authorized rate of return or, as an alternative, profits in excess of the average return earned by California QFs.

(3) If its other recommendations are rejected, DRA asks the Commission to order that all of Edison's future QF affiliate transactions be limited to standard contracts. DRA notes that the Commission has thoroughly scrutinized the standard contracts and found them fair to ratepayers and all QFs.

With respect to the Affiliate Cost Adjustment, DRA states that it patterned this adjustment after the Western Electric Adjustment which the California Supreme Court ordered the Commission to apply in the City of Los Angeles v. Public Utility Commission, 7 C.3d 331 (1972). In DRA's opinion, if Edison continues to deal with QF affiliates, the Affiliate Cost Adjustment is necessary to ensure that Edison's ratepayers do not pay any excessive costs associated with affiliate nonstandard agreements.

Regarding the impact of the Affiliate Cost Adjustment on avoided cost, DRA agrees that the Commission has no jurisdiction to change the general policy concept of paying avoided costs to QFs. DRA argues, however, that its adjustment is appropriate here because it is a remedy for Edison having paid its QF affiliate more than avoided cost and favoring its QF affiliates over other QFs. According to DRA, PURPA legislation or legislativo history does not prohibit a state Commission from applying a remedial adjustment to correct QF abuses.

As a final recommendation, DRA asks that, to the extent that Edison continues to purchase power from affiliated QFs, increased reporting requirements about such dealings should be imposed. DRA proposes that the utility's exhibit on the reasonableness of QF purchases in its annual ECAC filing should provide the following information for each QF in which Edison or its affiliate has an ownerhsip interest: (1) the percent of ownership, (2) the name of the affiliate, and (3) the date ownership was acquired. DRA also asks that for each individual QF report, Edison provide: (1) kWh production by time period by month, (2) energy and capacity payments by time period by month for firm capacity QFs, (3) on-peak capacity factor by month, (4) capacity bonus payments by month, (5) scheduled downtime by month, (6) unscheduled outages by month with an explanation of the outage cause, and (7) an accounting of steps Edison has taken or considered taking to recover overpayments or damages from its affiliates when they may have breached their contracts, and all other steps taken or considered in administering QF contracts with affiliates.

DRA responds to Edison's claim that DRA's recommendations are inappropriate because current Commission decisions, including the holding company decision and OIR-2 decisions, provide adequate safeguards. DRA states that, while the self-dealing abuses in this case occurred before the holding company decision, the Commission was unaware of these abuses when it issued its decision. DRA is unaware of anything in this record to demonstrate how the holding company decision can protect ratepayers against the type of abuses experienced in this case.

DRA also asserts that Edison has already disregarded guidelines established in OIR 2 and the holding company decision when Edison negotiated the KRCC contract. DRA states that "[a] central theme of the Holding Company decision is that Edison and its unregulated affiliates would provide the Commission and DRA with all the documents and other information from unregulated affiliates." (DRA Opening Brief, at p. 93.) It is DRA's opinion that Edison did not comply with this requirement leaving DRA "to 'painfully dig' for information about KRCC [cite to Tr. 1986], instead of Edison and KRCC supplying the information voluntarily." (Id.) DRA states that it was forced to file motions to compel to receive documents which Edison and KRCC should have supplied without question and which were even refused in the face of a Commission order.

b. Edison

It is Edison's position that the Commission may not lawfully take any of the actions recommended by DRA to prevent or restrict future dealings by Edison with affiliated QFs. Edison also believes that such actions are not appropriate California regulatory policy.

According to Edison, a prohibition against Edison affiliates having ownership interests of 50% or less in QFs would negate FERC regulations explicitly authorizing such ownership. In Edison's view, the supremacy clause of the United States Constitution prevents a state regulatory agency from negating FERC's authorization of limited utility ownership of QFs.

It is Edison's opinion that Commission adoption of the Affiliate Cost Adjustment proposed by DRA would also negate FERC regulations exempting QFs from regulation as utilities.

Edison asserts that state laws and regulation that attempt to subject QFs to cost-of-service rate regulation are both preempted by PURPA and contrary to FERC's regulations. In Edison's view, DRA's proposed Affiliate Cost Adjustment would impose cost-of-service rate regulation on affiliated QFs that sell power to Edison.

Edison states that the fundamental premise of utility regulation is the authority to regulate rate of return. In order to implement the affiliate cost adjustment, Edison asserts that the Commission would of necessity be required to review both revenues and expenses of KRCC and also determine a reasonable rate of return for its operations. As a result, Edison argues that QFs affiliated with Edison would be subjected to cost-of-service rate regulation which would constitute state action expressly precluded by PURPA and the FERC's regulations.

Edison believes that DRA's recommendations are also contrary to sound California regulatory policy. Edison asserts that DRA's recommendation to prohibit transactions between utilities and unregulated QFs has been rejected in the OIR-2 proceeding and Edison's holding company proceeding. In this regard, Edison cites D.87-05-060 in OIR 2 permitting affiliated QFs to bid in the utility's final Standard Offer 4 auction. In that decision, Edison notes that the Commission found that it could deny rate recovery for expenses which are found to be unreasonable as a result of favoritism shown by a utility to a QF affiliate.

Further, Edison states that in its holding company decision the Commission specifically recognized these OIR 2 safeguards as assuring that ratepayers would be protected in the pricing and purchase of QF-produced electricity. According to Edison, "[t]hose safeguards should be given an opportunity to work before they are, in effect, rescinded by prohibiting Edison from entering any new power purchase agreements with a QF affiliate." (Edison Opening Brief, at p. 102.)

If the Commission should make any determination of favoritism, Edison believes that the disallowance remedy provided in ECAC proceedings will protect ratepayers' interests. Edison rejects any of the alternate recommendations made by DRA.

c. <u>KRCC</u>

According to KRCC, unless some harm can be demonstrated, self-dealing cannot be relied upon to disallow reasonable costs of the KRCC agreement. It is KRCC's position that some resultant cognizable harm must have resulted from the utility's actions for a sanction to be applied.

2. <u>Discussion</u>

We have found that in its actions related to the KRCC contract, Edison repeatedly showed a disregard for the appearance and potential of a conflict of interest. In addition, Edison has acted in several instances, both in its negotiations of the contract and its actions in this proceeding in a manner indicating that its affiliate or the QF affiliate's partner had greater influence over the utility than direct orders of this Commission.

We also find that Edison's negotiation of the KRCC contract reflects the difficulty in ensuring that a transaction between the utility and a QF affiliate is truly "arm's length." In this regard, Edison followed a course of action which was not in keeping with its verbal policy of actively asserting and promoting the interests of its ratepayers.

In reviewing the many recommendations made by DRA to address self-dealing, we find that the most severe proposals are not justified based on the record in this particular case. Strict prohibitions on Edison affiliating with QFs is not consistent with the record of self-dealing which exists in this case. Only inferentially can the Commission conclude that Edison may have considered the interests of its QF affiliate before its ratepayers and other QFs. Similarly, we do not believe that adoption of DRA's proposed affiliate cost adjustment is appropriate at this time.

Our decision not to impose a prohibition on Edison's ownership of QFs, however, does not mean that this Commission is without the jurisdiction or the tools to act on direct and compelling evidence of self-dealing. We remind Edison that its current corporate structure was the direct result of a Commission decision approving the holding company. We can and are prepared to reconsider that decision at any time when facts warrant such a change.

We do not, however, believe that such a change is necessary at this time, and in fact find that the holding company decision (D.88-01-063) provides the safeguards necessary to respond to the record in this case. Specifically, the Commission found that the bidding process adopted in D.87-05-060 provided an adequate safeguard to ensure the propriety of utility and QF affiliate transactions. In reviewing that decision again in this order, we find that the bidding process adopted in that decision specifically involved bids on <u>Standard Offer 4</u> only. It was in this context that the Commission concluded that the utility could accept bids, under certain conditions, from its QF affiliates.

Given this Commission's reliance on that order in approving the holding company and given the facts of this case, we must now consider how best in the future to protect against any potential for self dealing abuse, or potential for confusion in the application of Commission guidelines by utilities.

Several issues need to be discussed as we consider how to regulate contracts between utilities and their affiliates in the future. First, the Commission could limit utilities only to Standard Offer contracts when entering into purchases from non-utility power generators in which the utility has a financial stake. This would remove the Commission from a micromanagement role while still affording the necessary protections for ratepayers.

The advantage to limiting a utility to use of a Standard Offer in dealing with affiliates is the ease of administration and implementation for the utility. It is impractical to require the utility to seek pre-approval of every contract it may enter into with its affiliates. Utilities require flexibility to deal quickly with market conditions and management needs lattitudo to make cost effective decisions without enduring regulatory delay and administrative burden. Therefore we will allow Edison to sign Standard Offer contracts with affiliates without requiring prior Commission approval.

However, the Commission will not limit Edison to Standard Offers alone in future agreements with affiliated non-utility power producers. Limiting Edison to Standard Offers might frustrate the ability of the utility to take advantage of unique alternative energy opportunities which require non-standard contracts. If we do not allow utilities to capture these opportunities it ultimately could be to the detriment of ratepayers and California as a whole.

Further, in the future our currently adopted Standard Offer contract format may change. For example, modifications to the Standard Offers are under review for final Standard Offer 4, in the Biennial Resource Plan Update (Update) proceeding (I.89-07-004). In the future we may move to a bidding system, in which projects with different characteristics in varied locations may have very different prices and contract terms. A standard contract with standard pricing terms and contractual provisions may be difficult to define.

In the event that Edison wishes to sign a non-standard contract for a power purchase from projects in which Edison has an interest, either directly or through affiliates, the contract must be approved by the Commission prior to taking effect. To avoid undue delay in the review of these non-standard contracts, we will review the contracts via an Expedited Application Docket.

In the future, we recognize that as the Commission's policies toward non-utility power producers progresses Standard Offers as we have known them may change or cease to exist. Should the time come where Standard Offer Contracts are no longer available, we will direct Commission staff to prepare new contract rules for all utilities to follow. Those new rules may replace, where appropriate, the rules we adopt today for Edison.

Limiting the transactions between a utility and its affiliate is not new. Specifically, the Commission concluded in D.85-12-104, with respect to SDG&E's dealings with its QF subsidiary, that the "best way to establish an arms-length relationship" was to treat the affiliate like any other similar QF in utility's service area and that the best standard to ensure that equal treatment was the standard offer. (D.85-12-104, 20 CPUC 2d 77, 70.) In light of the issues discussed above, we believe that requiring prior approval of non standard power purchase agreements is an appropriate and logical extension of this policy.

Further, while limiting utility affiliates to standard offers might seem to assure utility ratepayers and other QFs of arm's length transactions, we feel that Edison's actions in this case require the extraordinary actions we decribe above. This Commission is mindful of actions which appear to substitute Commission decision-making for the judgement of utility management and are reluctant to take on such duties. Yet, the appearance of self-dealing described in this case requires us to mandate this pre-approval requirement on Edison's contracting with affiliates.

While the prior approval requirement provides a reasonable means of protecting ratepayers and other QFs in future transactions involving Edison and its affiliates, it is still necessary to address currently existing contracts in which Edison buys power from a QF affiliate. For this reason, we will adopt the reporting requirements recommended by DRA for use in Edison's reasonableness reviews to ensure that DRA and this Commission are provided with sufficient information to properly evaluate Edison QF affiliate nonstandard contracts at issue. We also alert Edison that, consistent with the findings in this decision, any unreasonable costs associated with existing nonstandard contracts between Edison and its QF affiliates are subject to disallowance in future ECAC reasonableness reviews.

Comments to ALJ's Proposed Decision

Initial and reply comments to the proposed decision of the Administrative Law Judge have been received and considered by the Commission in preparing it final order.

Findings of Fact

1. This Commission remains committed to the inclusion of cogeneration and small power production in electric utility resource plans consistent with applicable law and utility resource needs.

2. To the extent that it is carefully integrated into a utility system, a qualifying facility can provide least cost, efficient or renewable electricity generation from facilities which can be less capital intensive, can be quicker to develop, and, to the extent the Commission's adopted rules and safeguards are followed, can expose ratepayers to less risk than traditional utility plant.

3. The utilities' ratepayers are to remain indifferent to the source of the utility's energy supply, whether from the utility itself or from a qualifying facility.

4. A negotiated QF contract is to create no greater risk for ratepayers or inequitites for other QFs than one of the Commission's adopted standard offers.

5. The focus of this decision is on the reasonableness of the negotiation, execution, and administration of a QF nonstandard contract between Edison and the Kern River Cogeneration Company (KRCC) and any instances of self-dealing between Edison and its QF affiliate, the Southern Sierra Energy Company (SSEC).

6. SSEC, an Edison subsidiary during the negotiation and execution of the KRCC contract and the record period of this proceeding, owns a 50% partnership share of KRCC, with the other 50% held by Getty Energy Company (Getty), now part of Texaco Producing, Inc.

7. This case marks the Commission's first review of a nonstandard contract involving one of Edison's QF affiliates.

8. Prior to hearings on the KRCC contract, the issue of the scope of review of this contract in an ECAC proceeding was raised.

9. For transactions between a utility and an affiliated QF, the Commission is obligated to review the negotiations, all contract terms, and the ownership relation between the parties to determine whether the agreement was reasonable and fair to the utility's ratepayers and all QFs.

10. In D.89-01-047, the Commission concluded that information sought by DRA related to the KRCC financial and partnership records was relevant to this proceeding and should be produced by Edison and that DRA's proposed evidence of self-dealing by Edison relative to the KRCC contract was within the scope of the Commission's reasonableness review of that contract.

11. By permitting Edison a great deal of latitude in presenting its case to the Commission in this proceeding, a sufficient record on issues related to the reasonableness of the KRCC contract and any related self-dealing was developed in this proceeding.

12. The "reasonable and prudent act" for both traditional and QF-related utility decisions results from "the exercise of reasonable judgment in light of facts known or which should have been known at the time the decision was made." (D.87-06-021, at p. 19.)

13. The above standard is used to avoid the application of hindsight in reviewing a utility decision for reasonableness.

14. The Commission has applied the following guidelines in determining the reasonableness of a utility decision or act: (1) the act of the utility should comport with what a reasonable manager of sufficient education, training, experienco and skills using the tools and knowledge at his disposal would do when faced with a need to make a decision and act; (2) the Commission has a legitimate concern not only with the outcomes of tho utilities' decisions, but also the process employed to arrive at a particular decision; (3) the reasonable and prudent act is not limited to the optimum act, but includes a spectrum of possible acts consistent with the utility system need, the interest of the ratepayers, and the requirements of governmental agencies of competent jurisdiction; (4) the action taken should logically be expected, at the time the decision is made, to accomplish the desired result at the lowest reasonable cost consistent with good utility practices, and (5) the greater the level of money, risk, and uncertainty involved in a decision, the greater the care the utility must take in reaching that decision.

15. The burden rests heavily upon a utility to prove with clear and convincing evidence, that it is entitled to the requested rate relief and not upon the Commission, its staff, or any interested party to prove the contrary.

16. The regulations and decisions governing utility purchases of QF power in effect at the time are the foundation for the "knowledge" that should have been used by Edison's management in negotiating, executing, and administering the KRCC contract or seeking cost recovery before this Commission.

17. Between 1976 and 1984, state and federal legislation and regulations and Commission decisions were issued governing the purchase of QF power by electric utilities, including Edison.

18. In January, 1982, the Commission issued D.82-01-103 requiring utility filing of standard offers for the purchase of firm and as-available QF power.

19. Electric utility power purchases under the standard offer are *per se* reasonable.

20. D.82-01-103, in addition to providing the basic guidelines for standard offers, provided guidelines for nonstandard QF contracts and QF ownership by utilities; such ownership was permitted under this order and FERC regulations up to a 50% equity interest by the utility.

21. In D.82-01-103, the Commission permitted utilities to submit nonstandard contracts about which the utility had "significant questions" for preapproval; otherwise, the contract was to be reviewed in the utility's ECAC.

22. A request for Commission preapproval of a nonstandard contract requires a clear statement of all differences between the nonstandard contract and the standard offers, an identification of all gains and costs for the utility's ratepayers, and a demonstration why ratepayers should either be indifferent to or prefer the nonstandard contract over the standard contract.

23. Nonstandard contracts are reviewed with scrutiny and skepticism, and the burden is on the utility to demonstrate why the nonstandard offer is in the ratepayers' interest.

24. Nonstandard contract terms, taking into account the associated risks, should not be more than expected avoided costs under the standard offer.

25. Ratepayers are expected in most non-standard offers to accept some technological or market risk for which ratepayers are to be returned compensating benefits.

26. D.82-01-103 requires that a utility submit a nonstandard offer for preapproval for which the utility has "significant questions" regarding the contract's prudency and that, once nonstandard terms have been reviewed by the Commission, the utilities should use the Commission's findings in signing similar contracts without review.

27. A utility's ownership of a QF requires greater scrutiny of utility operations with attention to the impacts on competition, avoided costs, and ratepayers which could result from the utility's diversification into unregulated activities.

28. The Commission's reviews of nonstandard contracts have focused on the differences between the nonstandard contract and the standard offer and the risks and benefits to be realized by ratepayers from those contracts.

29. A firm capacity commitment by a QF is viewed as an increase in the utility's supply of electricity with corresponding performance standards, termination provisions, and sanctions.

30. Firm capacity is provided in predetermined quantities at predetermined times with sufficient legally enforceable guarantees of deliverability to permit the purchasing utility to avoid the construction of a generating unit or the purchase of firm power elsewhere.

31. A QF providing firm capacity avoids costs in addition to those related to as-available power and is entitled to a higher capacity payment to reflect this result.

32. Termination provisions were adopted for firm capacity standard offers to encourage QFs to fulfill their contractual obligations, provide reasonable certainty of the consequences of termination, and make the utility and its ratepayers whole.

33. Firm capacity termination or capacity reduction provisions include requirements related to notice of termination, refunds of capacity overpayments, and replacement costs.

34. QF power is not to be developed at any cost, but rather at reasonable cost to the utility's ratepayers.

35. The Commission has found that the best way to establish an arms-length relationship between a utility and a subsidiary is to treat the subsidiary in the same manner as any other cogenerator in the utility's service territory and that the standard offer

price relationship is the best standard to use to ensure this result.

36. In approving Edison's holding company, the Commission imposed several conditions, including Commission access to holding company and affiliate records, to ensure this Commission's effective regulation of the utility.

37. The Commission has found that the QF bidding process adopted in D.87-05-060 provides an existing safeguard to prevent self-dealing abuses in utility and QF affiliate transactions.

38. D.87-05-060 permitted participation by utility QF affiliates in the bidding for Standard Offer 4 contracts.

39. A utility is not to use its non-regulated activities to hinder the Commission's legitimate inquiry into its regulated activities.

40. The project which is the subject of the KRCC contract is a combustion turbine generator heat recovery steam generator cogeneration facility located at the Kern River Oil Field, near Bakersfield, California.

41. The KRCC contract, as executed in January, 1984, provides for the purchase by Edison from KRCC of 170 MW of minimum contract capacity for 20 years.

42. Provision is made under the KRCC contract for increasing the minimum contract capacity during the term of the contract; the Kern River facility has a maximum capacity of 284 MW.

43. As executed on January 16, 1984, the KRCC contract includes terms governing energy payments, capacity payments, termination, scheduled maintenance, and insurance, among others, which differ from the standard offer.

44. The reasonableness of the KRCC contract is to be measured by the facts and conditions that were known or should have been known to Edison at the time of the contract's negotiation and execution.

45. Depending on the party's viewpoint, the emphasis or interpretation given to the applicable laws, policies, and events affecting the negotiation and execution of the KRCC contract varies greatly between Edison and KRCC, on the one hand, and DRA and TURN, on the other.

46. The Kern River project was the first large-scale cogeneration project signed by Edison, the first successful enhanced oil recovery facility in California, the subject of a contract by which all other similar agreements would be measured, and Edison's first major QF affiliation.

47. The terms of the KRCC agreement did not match any prior Edison nonstandard contract or any Commission approved standard offer.

48. It is only through a complete understanding of the negotiation of the KRCC contract and Edison's partnership with Getty that this Commission could properly evaluate the end product -- the KRCC contract.

49. The regulatory encouragement and pressure to develop QF projects cited by Edison and KRCC as support for the execution of the KRCC contract relate to benefits which Edison's ratepayers might realize from the project itself as distinguished from ratepayer benefits related to the contract's terms.

50. The Commission's policy in the early 1980's to encourage alternative resources did not exist in a vaccum without rules and limitations.

51. The "spectrum" of possible acts available to the prudent utility manager exists within the spectrum of all laws and conditions in effect at the time of the utility action.

52. A utility cannot isolate one or two requirements or conditions as justifying its actions, but must take into consideration all of the applicable laws and facts in reaching a decision.

53. The need for a utility to pay careful attention to all laws and conditions and to weigh all possible alternatives is increased when the utility is charged with the particular responsibility of maintaining its ratepayers' indifference to a transaction and ensuring equal treatment of all others who might be parties to similar transactions.

54. The Commission's decisions issued between 1979 and January, 1984, make clear that the standard offer was to serve as <u>the</u> benchmark for all utility purchases from QFs.

55. By October 1983, the guidelines for all standard offers and nonstandard offers were in place.

56. The standard offer, which is <u>per se</u> reasonable, is the standard against which the reasonableness of all utility actions related to QF transactions is to be measured.

57. The nonstandard offer, which by definition would deviate from the Commission's approved offer, was never intended to avoid Commission review for reasonableness.

58. Whether by preapproval or ECAC review, the focus of the Commission's review of nonstandard agreements was to be the same -- was the nonstandard offer in the ratepayer's interest and would the ratepayer be indifferent to or prefer the nonstandard contract over the standard contract.

59. While the economic reference point of avoided cost is a critical point of comparison between a nonstandard contract and a standard offer, the overall standard by which the reasonableness of the nonstandard agreement is to be judged is its comparability to the standard offer as a whole.

60. For each risk to which the utility's ratepayers are exposed under a nonstandard agreement, a "compensating benefit" is to be provided in return.

61. Even a single difference between a nonstandard agreement and the standard offer can be cause for concern as well as a basis

for a utility manager to seek preapproval by the Commission of the nonstandard agreement.

62. The Commission intended that a utility's partial ownership of a QF would require an enhanced level of responsibility by the utility to ensure that its ratepayers were adequately protected.

63. At the time of the negotiation and execution of the KRCC contract and the record period of this proceeding, SSEC, Getty's partner in KRCC, was a direct subsidiary of Edison.

64. Proposals for utility ownership of QFs were intended to be reviewed by the Commission on a case-by-case basis with the intent of protecting the interest of both ratepayers and any QFs who might be disadvantaged competitively.

65. The Commission has sought to ensure that utility - QF affiliate relationships do not produce any anticompetitive effects, incentives to increase the utility's avoided costs, the subsidization by ratepayers of the unregulated business, or the impairment of the financial integrity of the regulated entity.

66. While Edison's baseload need and government policies in effect at the time of the KRCC negotiations, as well as Edison's and Getty's own feasibility study, made the KRCC project a "good one" for Edison to consider these circumstances did not justify Edison's signing an agreement which radically differed from the standard offer and exposed Edison's ratepayers to significantly greater risks.

67. Contact by a Commissioner whose term expired at the end of 1981 and a rate case penalty imposed on Edison for offering QFs prices below avoided costs cannot excuse actions taken by Edison's management which ignored decisions that were issued by the full Commission after 1981 and provided specific directions on the negotiation and provisions of nonstandard contracts with QFs and QF affiliates in particular.

68. The penalty imposed on Edison in D.82-12-044 can be viewed as resulting from an Edison practice of disregard for Commission QF pricing policies.

69. With respect to the KRCC contract, Edison's adherence to Commission adopted standard offers or avoided cost principles did not improve significantly after Edison's 1982 general rate case decision.

70. None of Edison's personnel involved in negotiating and signing the KRCC contract attached any great importance to the standard offers or the Commission's decisions defining those agreements.

71. The Edison employees principally responsible for the negotiation of the KRCC contract knew little, if anything, about the Commission's standard offer decisions.

72. The absence of knowledge about the Commission's standard offer decisions in turn represents an absence of knowledge of the Commission's policies on nonstandard offers and utility/QF affiliation.

73. The tool used by Edison's negotiators in developing the KRCC contract was an agreement which had never received Commission approval nor was based on any standard offer.

74. The Commission's resolution finding that the Procter & Gamble agreement did not require Commission authorization to become effective was based on the rationale that the resolution process or advice letter filing was not a suitable method for seeking review of purchase power agreements or the utility's avoided costs, issues which required more in-depth review and hearings not available through advice letter filings.

75. Three months prior to the resolution on the Procter & Gamble agreement the Commission had approved a nonstandard contract based upon a utility application.

76. While no Commission decision approving specific standard offers had been issued at the time Edison commenced its negotiation

of the KRCC contract, Edison had filed initial price offerings based on avoided costs in response to early Commission orders.

77. By the time a draft of the KRCC agreement had been circulated in October, 1982, the Commission had issued D.82-01-103, and Edison had filed standard offers in response.

78. A brief conversation with a Commission staff member about the KRCC contract just prior to its being signed was not the equivalent of the request for preapproval contemplated by D.82-01-103.

79. There is no evidence in this record that the Commission or a member of its staff told Edison that preapproval, as contemplated by D.82-12-103, of the KRCC contract was unnecessary or unwarranted.

80. The information provided to this Commission and the CEC regarding the KRCC contract and the ownership relation between Edison and the QF was extremely limited.

81. The "economic balance" represented by the standard offer and required to be maintained in a nonstandard contract was not limited to the exchange of dollars between the parties.

82. The Commission has found that changes in nonprice terms of the standard offer can have very real economic effects on ratepayers and the parties to the contract.

83. The terms of the KRCC agreement were not designed to maintain ratepayer indifference, to shield ratepayers from risks greater than those incurred under the standard offer, or to provide ratepayers with compensating benefits in exchange for those risks.

84. With the exception of a discount on avoided costs used to calculate the KRCC energy payments, none of the "benefits" of the KRCC contract asserted by Edison and KRCC were negotiated on behalf of Edison's ratepayers as compensation for the "generous" contract terms provided KRCC nor were any of these "benefits" sufficient to serve as compensation for those terms.

85. The risks incurred by ratepayers and benefits provided to KRCC and Getty resulting from the KRCC contract include (1) energy prices based on a formula at odds with the standard offers and with the potential for costs above avoided costs in the later years of the contract, (2) capacity prices in excess of those forecasted for QFs beginning firm operation in 1985, and (3) termination and scheduled maintenance provisions which did not ensure a "firm capacity" commitment by the QF.

86. The termination and scheduled maintenance provisions of the KRCC contract permitted significant unilateral operating decisions to be made by the QF and failed to provide, for the term of the contract, the repayment upon termination necessary to make the utility whole and its ratepayers indifferent to the transaction.

87. The energy price formula negotiated by Edison and Getty for the KRCC contract goes far beyond the compensation received by Edison's ratepayers in the form of a discount applied to Edison's avoided cost.

88. The requirement of a three-year operation deadline for the Kern River project, as opposed to the standard offer five-year deadline, was an insignificant concession for higher capacity prices given the state of "readiness" of the project and the construction incentives provided as of the date of the contract's execution.

89. The circumstance that application of the KRCC energy price formula between 1985 and 1987 resulted in KRCC being paid less than Edison's avoided costs was a result that was neither intended nor forecasted by the parties.

90. Edison's forecast of payments under the KRCC contract being 99.8% of avoided cost was not sufficient to compensate ratepayers for risks assumed under the contract and was based on an analysis which was flawed based on erroneous assumptions regarding capacity price and termination.

91. KRCC was only entitled to a 1985 firm capacity price based on its date of operation and not the 1986 firm capacity price required under the contract; this contract term resulted in requiring capacity payments to KRCC above Edison's avoided costs.

92. Given the proper assumptions, Edison's forecast of KRCC contract payments would have revealed a contract price stream well-above Edison's avoided cost.

93. To avoid the application of hindsight, a reasonableness review of a utility's purchase power agreements is not outcome-oriented.

94. The circumstance that the application of the KRCC energy price formula during the record period resulted in lower payments is not relevant to the consideration of what the parties anticipated and intended at the time of the contract's execution.

95. The operation of the KRCC energy price formula could produce payments above avoided costs in future record periods and, as such, this formula cannot be found to be a benefit to ratepayers.

96. The discount on avoided cost included in KRCC's energy payments was insufficient compensation for Edison's ratepayers given the risks inherent in the provisions as a whole.

97. Edison's avoided cost forecast performed in October 1982 was flawed since it erroneously assumed that the KRCC project would be entitled to a 1986 firm capacity price based on a 1986 operation date and since it failed to consider the impact of the lenient and highly flexible termination provisions on the actual capacity price which should have been paid to KRCC.

98. The KRCC contract's provisions for termination and maintenance "recharacterize" the nature of the contractual obligation asserted by KRCC and Edison by failing to ensure a firm power-commitment by the QF.

99. Despite the existence of standard offer termination provisions prior to Edison's and Getty's letter of intent, the KRCC

contract contained termination and maintenance provisions significantly different from the firm capacity standard offers especially with respect to restrictions on and prerequisites to termination and maintenance and provision for repayment to Edison upon termination.

100. No one directly negotiating the KRCC contract on behalf of Edison or supervising that negotiation claimed to have any knowledge of the firm capacity termination provisions adopted in D.82-12-120 or to have considered their inclusion in the KRCC contract.

101. The Commission's standard for reasonableness reviews have been developed to respond to a situation unique to utility regulation; namely, the Commission's obligation to protect the utility's ratepayers who are not privy to the negotiation and execution of a purchase power agreement, but must pay for its costs.

102. Where no ambiguity exists in a contract term, the parties' intent is not relevant and should be given little weight when it differs significantly from the plain meaning of the words used.

103. The termination and scheduled maintenance provisions of the KRCC contract reduced KRCC's obligations under the agreement as compared to a firm capacity standard offer, permitted significant operating and termination decisions to be made by KRCC alone, increased ratepayer risks, and undermined the 20-year firm power commitment from KRCC which Edison and KRCC claim was intended.

104. The termination and maintenance provisons of the KRCC contract do not achieve the goals which the Commission intended such provisions to meet in a firm power contract.

105. The measure of the KRCC contract' reasonableness does not depend on what actually occurred, including the absence of any termination during the record period, but on what the contract

terms permitted to occur and the resulting risks to which Edison's ratepayers were exposed at the time of the contract's execution.

106. The requirement of good faith negotiations related to QF power purchase agreements does not mean that a term is to be included in a nonstandard offer because the QF "insisted" upon it, but rather that the utility is to consider, but not necessarily include, the term.

107. The decision to include a term in nonstandard agreement is a utility management decision to be made in the context of the applicable law.

108. The standard offers and the Commission's decisions relating to them were sufficiently significant that at no point up to the time of the execution of the KRCC contract was it appropriate to ignore them.

109. The record in this case does not support Edison's argument that Edison's choice was solely between a standard offer and no contract since Edison had an opportunity to negotiate a contract and respond to Getty's principle concerns related to energy price certainty and contract capacity changes without providing additional terms highly favorable to the QF for which no compensating benefits were received by Edison's ratepayers.

110. The assertion that Edison and Getty were "locked into" the principle contract terms by a July 1983 letter of intent is undermined by (1) a provision in that letter absolving the parties from liability in the event that a contract was not executed, (2) the ability of Getty to switch to a standard offer if desired, and (3) the freedom of the parties to revise the agreement several times after the letter of intent was signed, including a critical revision changing the denominator in the termination formula from "20" to "12."

111. The third amendment of the KRCC contract has no relevance to our review of the reasonableness of the KRCC contract at the time of its execution since the contract terms contained in the

amendment did not exist nor were even contemplated at the time of the contract's execution or this record period.

112. The result of all of the KRCC contract terms was to create an agreement for as-available as opposed to firm capacity.

113. The record in this proceeding is not sufficient to conclude in this decision that Edison intended a course of conduct related to events occurring in late 1984 which would have favored its affiliated QFs over non-affiliated QFs.

114. Further evidence on the issue of Edison's treatment of affiliated versus non-affiliated QFs can be received in Edison's future ECAC reasonableness reviews which will examine the nonstandard contracts signed with Edison affiliates during the late 1984 through early 1985 time period.

115. DRA cannot effectively make its recommendations unless the utility has first met its burden of proving the reasonableness of its agreement and providing all requested, relevant documents.

116. Edison has the burden of demonstrating through clear and convincing evidence that its nonstandard agreements with affiliates were reasonable and resulted in no harm to Edison's ratepayers or nonaffiliated QFs.

117. A statement that no QF was "refused" a nonstandard agreement similar to one with an Edison affiliate, by itself, is not adequate to meet Edison's burden of proof recited in the finding above given Edison's actions in late 1984 requesting the suspension of its standard offers.

118. Comments by the ALJ during hearing and the assigned Commissioner in a subsequent ruling appropriately advised Edison of the weakness of its showing in this proceeding.

119. Prior Edison ECAC reasonableness reviews had little relevance to the issues which the Commission was required to consider for the first time in this proceeding including the significant departure of the KRCC agreement from the standard offers and the ownership tie between Edison and KRCC.

120. Edison was aware almost a year prior to hearings in this proceeding of DRA's concerns with the KRCC agreement.

121. During the negotiation and execution of the KRCC agreement, Edison's personnel had the opportunity to serve and hold fiduciary relationships to two conflicting interests -- Edison's ratepayers and SSEC.

122. As a member of the KRCC management committee and as the manager in charge of Edison's negotiation of the KRCC contract, one Edison employee had the opportunity to be involved on both sides of the bargaining table related to the negotiation of the KRCC contract.

123. Edison has demonstrated a willingness to act according to the wishes of its affiliate's partner, Getty, in making important decisions contrary to specific guidance or direction provided by this Commission.

124. The potential or appearance of a conflict of interest requires a Commission response to protect the utility's ratepayers and other QFs from any further conflicts of interest or the potential of such conflicts.

125. To ensure that the utility's ratepayers pay for costs reasonably incurred under a purchase power agreement, effective contract administration requires the utility to ensure compliance with the contract terms with stricter compliance being required when the direct result is the payment by the utility of a significant bonus to the QF.

126. Edison's payment of a capacity bonus to KRCC for its performance between September 20 and October 6, 1986, was contrary to the terms of the KRCC agreement and was not reasonable.

127. Edison's payment of winter bonus payments to KRCC following the operation of the facility in August and September, 1985, was contrary to the terms of the KRCC agreement and was not reasonable.

128. No evidence exists in this proceeding that Edison, in administering standard offer winter bonus provisions similar to those contained in the KRCC agreement, has provided non-peak bonus payments for meeting bonus requirements in fewer than all of the peak months designated under the contract.

129. Edison's acts of imprudency in the negotiation, execution, and administration of the KRCC agreement requires a disallowance of certain costs associated with the contract for the record period 1984 through 1987.

130. Based on the significant differences between the KRCC contract and the firm capacity standard offers which resulted in requiring less of KRCC than other firm capacity QFs and provided KRCC the opportunity to receive payments above Edison's avoided costs, the KRCC contract can be considered to be in fact an as-available contract.

131. DRA's proposed total disallowance of $37,455,675 in nominal dollars for the three-year record period is appropriately based on the difference between the KRCC contract capacity price and the as-available capacity price in Standard Offer 4 and incorporates all other appropriate bases for disallowance in this proceeding.

132. DRA's proposed disallowance properly reflects the impact of Edison's management decisions related to the KRCC contract which did not adequately take into account the interests of its ratepayers as defined by the Commission's decisions and adopted standard offers.

133. DRA's proposed disallowance properly does not include capacity "savings" asserted by Edison which were not part of the record in this proceeding.

134. In ECAC proceedings, the appropriate interest rate to be applied to a disallowance is the three-month commercial paper rate.

135. There is no evidence in this proceeding that costs associated with the KRCC contract were reflected or used in

Edison's balancing account in any way different than those associated with any other purchase power agreement and would therefore require the application of an interest rate different than the three-month commercial paper rate.

136. The application of the three-month commercial paper rate in this proceeding to the adopted disallowance results in an overall disallowance of $48,370,708 for the three-year record period.

137. Given the absence of any intent or forecast by the parties to the KRCC contract that payments under the agreement would be significantly different than forecasted avoided costs and the potential for harm to Edison's ratepayers from the operation of the KRCC energy price provisions in future record periods, energy cost "savings" occurring during this record period cannot be used to offset the disallowance adopted in this decision.

138. The disallowance adopted in this decision is not intended to impair or alter the value of the Kern River project to Edison's ratepayers, and is, instead, required to serve as a regulatory response to actions taken by Edison which were at odds with specific Commission directives and subjected Edison's ratepayers to risks greater than those under the standard offer agreements.

139. The disallowance adopted by this decision is not a basis for abrogation of the KRCC contract.

140. Current regulatory and resource conditions do not limit the parties ability to reform the existing KRCC contract.

141. In its actions related to the KRCC contract, Edison repeatedly showed a disregard for the appearance of a conflict of interest.

142. Edison's negotiation of the KRCC contract reflects the difficulty in ensuring that a transaction between a utility and a QF affiliate is truly "arm's length."

143. In negotiating the KRCC agreement, Edison followed a course of action which was not in keeping with its verbal policy of actively asserting and promoting the interests of its ratepayers.

144. Strict prohibitions on Edison affiliating with QFs or adoption of DRA's proposed affiliate cost adjustmont at this time are not consistent with the record of self-dealing which exists in this case.

145. By inference, it appears that Edison may have considered the interests of its QF affiliate before its ratepayers and other QFs.

146. Although the Commission has the authority to reconsider Edison's holding company decision based on evidence of self-dealing abuses, changes in that order are not necessary at this time.

147. The holding company decision (D.88-01-063) provides the safeguards necessary to respond to the record in this case.

148. Given the Commission's reliance in D.88-01-063 on the safeguard on Edison/QF affiliate transactions provided by the Standard Offer 4 bidding process adopted in D.87-05-060, it is appropriate to limit any future transactions between Edison and its affiliates to the standard offers.

149. The Commission has previously relied on the standard offer to ensure arm's length transactions between a utility and its QF subsidiary.

150. The standard offer, which the Commission has found to be per se reasonable, assures the parties, the utility's ratepayers, and other QFs of an arm's length transaction which will be in the interests of the utility's ratepayers and fair to all QFs.

151. Where a standard offer is not practicable, prior commission approval of non-standard contracts between utilities and affiliated QFS will assure a utilities' ratepayers and other QFS of equitable transactions between parties.

152. The reporting requirements proposed by DRA for future Edison ECAC reasonableness reviews are necessary to ensure that DRA

and this Commission are provided with sufficient information to properly evaluate Edison QF affiliate nonstandard contracts at issue.

153. Consistent with the findings of this case, unreasonable costs associated with existing nonstandard contracts between Edison and its QF affiliates are subject to disallowance in future ECAC reasonableness reviews.

Conclusions of Law

1. The "reasonable and prudent act" for both traditional and QF-related utility decisions should result from the exercise of reasonable judgment in light of facts known or which should have been known at the time the decision was made.

2. To avoid the application of hindsight, the Commission's reasonableness review of a utility's purchase power agreements should not be outcome oriented.

3. A negotiated QF contract should create no greater risk for ratepayers nor inequities for other QFs than one of the Commission's adopted standard offers and should maintain ratepayer indifference to the source of the utility's energy supply.

4. Edison had the burden to demonstrate why the KRCC contract was in its ratepayers' interest, and the Commission is required to review such an agreement with scrutiny and skepticism.

5. The Commissions should apply greater scrutiny of utility operations when utility ownership of a QF is involved to ensure that the relationship does not have a negative impact on competition, avoided costs, or the utility's ratepayers.

6. The Commission's review of nonstandard contracts focuses on the differences between the nonstandard contract and the standard offer and the risks and benefits to be realized by ratepayers from the nonstandard contract.

7. A firm capacity commitment by a QF requires corresponding performance standards, termination provisions, and sanctions.

8. QF power should not be developed at any cost, but rather at reasonable cost to the utility's ratepayers.

9. A utility should not use its non-regulated activities to hinder the Commission's legitimate inquiry into its regulated activities.

10. The reasonableness of the KRCC contract should be measured by the facts and conditions that were known or should have been known to Edison at the time of the contract's negotiation and execution.

11. The standard offer is the standard against which the reasonableness of all utility actions related to QF transactions is to be measured.

12. For each risk to which the utility's ratepayers are exposed under a nonstandard agreement, a compensating benefit should be provided in return.

13. A utility's partial ownership of a QF should require an enhanced level of responsibility by the utility to ensure that its ratepayers are adequately protected.

14. The principle terms of the KRCC contract differed significantly from the terms of the firm capacity standard offers and exposed Edison's ratepayers to risks greater than those related to the standard offers.

15. In negotiating and executing the KRCC contract and deciding not to seek Commission preapproval of the agreement, Edison showed a disregard for applicable Commission decisions and standard offers.

16. The "economic balance" represented by the standard offer and required to be maintained in a nonstandard contract is not limited to the exchange of dollars between the parties and can be impacted by changes in nonprice terms.

17. At the time of its execution, the KRCC contract terms did not result in maintaining ratepayer indifference, did not shield ratepayers from risks greater than those incurred under the

standard offer, and did not provide ratepayers with compensating benefits in exchange for those risks.

18. At the time its execution, the KRCC contract's provisions for termination and maintenance resulted in diminishing the commitment otherwise required of a firm power QF under the standard offers and increased ratepayer risks and were not reasonable.

19. The energy and capacity price provisions of the KRCC contract, to the extent that they differ from the applicable standard offer and create greater risks for Edison's ratepayers, are not reasonable.

20. The KRCC contract was not the economic equivalent of a firm capacity standard offer.

21. The KRCC contract terms result in the agreement being one for as-available as opposed to firm capacity.

22. Edison and its managers did not act prudently in negotiating or executing the KRCC contract.

23. Edison's negotiation of the KRCC contract resulted in an agreement which provided increased risks to ratepayers over the standard offers without compensating benefits and was therefore unreasonable.

24. Because the record in this case eventually included the evidence necessary to evaluate the contract, no sanction should be imposed on Edison at this time for its showing in this proceeding.

25. Edison has the burden of demonstrating through clear and convincing evidence that its nonstandard agreements with affiliates were reasonable and resulted in no harm to Edison's ratepayers or nonaffiliated QFs.

26. With the issuance of this decision, there should be no question regarding the nature and the level of proof required by Edison to demonstrate the reasonableness of its nonstandard agreements with both affiliates and nonaffiliates.

27. Further evidence on the issue of Edison's treatment of affiliated and nonaffiliated QFs should be received in Edison's

future ECAC reasonableness reviews which will examine the nonstandard contracts signed with Edison affiliates during 1984 and 1985.

28. Edison showed a disregard for the potential and appearance of a serious conflict of interest related to its ownership interest in KRCC and its negotiation of the KRCC contract.

29. Edison has shown a willingness to act according to the wishes of its affiliate's partner, Getty, in making important decisions contrary to specific guidance and direction by this Commission.

30. The Commission should respond to the potential or appearance of a conflict of interest to protect the utility's ratepayers and other QFs from any further conflicts of interest or the potential of such conflicts.

31. Effective contract administration requires the utility to ensure compliance with the contract terms.

32. It would be appropriate to disallow bonus payments to KRCC related to KRCC's performance in the summer and fall of 1985 to the extent that these bonus payments are not otherwise incorporated in the overall disallowance authorized by this decision.

33. The Commission should disallow certain costs associated with the KRCC contract for the record period related to Edison's imprudency in negotiating, executing, and administering the contract.

34. A total disallowance of $48,370,708 for the three-year record period should be adopted to reflect the difference between firm capacity payments made to KRCC during the record period and as-available capacity payments under Standard Offer 4 to which KRCC was in fact entitled.

35. The total disallowance adopted by the Commission properly includes interest calculated at the three-month commercial paper rate.

36. Energy cost "savings" resulting from payments made to KRCC during the record period under energy price provisions which have been found to be unreasonable should not be used to offset the disallowanced adopted in this decision.

37. The disallowance adopted by this decision should not be used as a basis to abrogate the KRCC contract.

38. The parties should be permitted to reform the KRCC contract in keeping with the findings of this decision.

39. Use of the standard offer in transactions between the utility and its QF affiliate ensures an arm's length transaction which is in the interests of the utility's ratepayers and fair to all QFs.

40. Edison should be directed to limit all future purchase power agreements with its affiliates to the available Standard Offers or to receive prior commission approval of any non-standard contract before any non-standard contract terms shall become effective.

41. The reporting requirements for Edison/QF affiliate transactions proposed by DRA for future Edison ECAC reasonableness reviews should be adopted.

42. Unreasonable costs associated with existing nonstandard contracts between Edison and its QF affiliates should be subject to disallowance in future ECAC reasonableness reviews.

43. To ensure a prompt adjustment to Edison's ECAC balancing account, this order should be made effective the date of issuance.

<u>O R D E R</u>

IT IS ORDERED that:

1. Southern California Edison Company (Edison) shall reduce its Energy Cost Adjustment Clause (ECAC) account to reflect a total disallowance, including interest calculated at the three-month commercial paper rate, of $48,370,708 of the costs unreasonably incurred by Edison during the record period from December 1, 1984, through November 30, 1987, related to the purchase power agreement between Edison and the Kern River Cogeneration Company (KRCC).

2. Edison shall limit all future purchase power agreements between itself and its qualifying facility affiliates to the Commission's adopted Standard Offers in effect at the time of contract signing and to which the QF is entitled pursuant to any applicable bidding requirements. In the event that Edison shall negotiate a non-standard contract with its affiliate, Edison must receive prior commission approval of that contract before the contract terms shall become effective.

3. The disallowance adopted in this decision shall not serve as a basis for abrogation of the KRCC contract.

4. Edison's exhibit on the reasonableness of QF purchases made in all future annual ECAC filings shall provide the following information for each QF in which Edison or its affiliate has an ownership interest: (1) the percent of ownership, (2) the name of the affiliate, and (3) the date ownership was acquired. Each individual QF report shall include the following: (1) kWh production by time period by month, (2) energy and capacity payments by time period by month for firm capacity QFs, (3) on-peak capacity factor by month, (4) capacity bonus payments by month, (5) scheduled downtime by month, (6) unscheduled outages by month with an explanation of the outage cause, and (7) an accounting of steps Edison has taken or considered taking to recover overpayments or damages from its affiliates when they may have breached their

contracts, and all other steps taken or considered in administering QF contracts with affiliates.

5. Further evidence on the issue of Edison's treatment of affiliated and nonaffiliated QFs shall be received in Edison's future ECAC reasonableness reviews related to nonstandard contracts signed by Edison with its affiliates in 1984 and 1985.

This order becomes effective 30 days from today.

Dated September 25, 1990, at San Francisco, California.

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

Commissioner John B. Ohanian, being necessarily absent, did not participate.

I will file a written concurrence.

/s/ STANLEY W. HULETT
Commissioner

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

NEAL J. SHULMAN, Executive Director

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LIST OF APPEARANCES

Applicant: Bruce A. Reed, Frank J. Cooley, Richard K. Durant, Carol B. Henningson, Michael Gonzales, and Julie A. Miller, John R. McDonough, Attorneys at Law, for Southern California Edison Company.

Interested Parties: Lindsay, Hart, Neil & Weigler, by Michael Alcantar and Paul J. Kaufman, Attorneys at Law, for Cogenerators of Southern California; Barbara Barkovich, for CLECA, California Steel Producers Group; Jackson, Tufts, Cole & Black, by Allan Thompson, William Booth, and Evelyn K. McCormish, Attorneys at Law, for CLECA; Morrison & Foerster, by Jerry R. Bloom, Attorney at Law, for California Cogeneration Council; R. H. Berby, for CLECA; Matthew Brady and Dian M. Grueneich, Attorneys at Law, for California Department of General Services; Deborah Bosch, for Energy Modeling Forum; David Branchcomb, for Henwood & Associates, Inc.; McCracken, Byers & Martin, by David J. Byers, Attorney at Law, and Reed V. Schmidt, for California Street Light Association; Bryan Cope, for Sierra Energy and Risk Assessment, Inc.; Brobeck, Phleger & Harrison, by Gordon E. Davis, Attorney at Law, for California Manufacturers Association; Sam DeFrawi, for Naval Facilities Engineering Command; Karen Edson, for KKE & Associates; Mike Florio, Attorney at Law, for TURN; Steven Geringer, Attorney at Law, for California Farm Bureau Federation; Cynthia Hall, Attorney at Law, for Department of the Navy; Biddle & Hamilton, by Richard L. Hamilton, Attorney at Law, for Western Mobile Home Association; Jan Hamrin and Jan Smutny-Jones, for Independent Energy Producers; William Marcus, for JBS Energy, Inc.; Graham & James, by Robert C. Lopardo and Martin A. Mattes, Attorneys at Law, for California Hotel and Motel Association; A. Kirk McKenzie and Antonia Radillo, Attorneys at Law, for California Energy Commission; John D. Quinley, for Cogeneration Service Bureau; Thomas D. Clarke, Jeffrey E. Jackson, and Lisa T. Horwitz, Attorneys at Law, and Roy M. Rawlings, for Southern California Gas Company; Donald G. Salow, for Association of California Water Agencies; Donald W. Schoenbeck, for Cogenerators of Southern California; Gary Simon and Steve Harris, for El Paso Natural Gas; Clark Smith, for Transwestern Pipeline Company; James D. Squeri, for California Building Industry Association; Downey, Brand, Seymour & Rohwer, by Philip A. Stohr and Christopher T. Ellison, Attorneys at Law,

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for Industrial Users; Michael R. Weinstein and Thomas G. Hankley, Attorneys at Law, for San Diego Gas & Electric Company; Harry K. Winters, for University of California; Bill Dixon, Bernie Garcia, and John Chabot, for Utility Workers Union of America; Lawrence E. DeSimone, for Energy Management Associates, Inc.; Norman Furuta, Attorney at Law, for Federal Executive Agencies; and Harvey Mark Eder, for Public Solar Power Coalition and himself; Baker G. Clay, for the City of Vernon, Paul Crost and Glenn Rothner, Attorneys at Law, for IBEW, Local 47 and WWUA, Local 246; Rae Sanborn and Willie Stewart, for Local Union 47 and IBEW; Wayne Meeks, Kathi Robertson, and Victor Scocci, for Simpson Paper Company; Ray R. Coulter, for Winter, Ltd.; and Graham & James, by Norman Pederson, Attorney at Law, Kathryn L. Stein, Robert Weisenmiller, and Joseph G. Meyer, for themselves.

Division of Ratepayer Advocates: Robert C. Cagen and Hallie Yacknin, Attorneys at Law, Bill Y. Lee, and Meg Gottstein.

Commission Advisory and Compliance Division: Frank Crua.

(END OF APPENDIX A)

A.88-02-016
D.90-09-088

STANLEY W. HULETT, Commissioner, concurring:

Today the Commission closes a lengthy and litigious chapter in its ten year effort to implement tho directives of the Public Utility Regulatory Policies Act of 1978. This decision is not just another reasonableness review case or even a utility affiliate case but is fundamentally part of our long line of decisions dealing with implementing PURPA and spurring the development of Qualifying Facilities in California. From my perspective as the assigned Commissioner for both this reasonableness review and many of the Commission's significant efforts on establishing and developing our policies toward independent power producers I feel compelled to add my comment's on this decision. Although Commissioner Ohanian is necessarily absent today and thus unable to vote on this decision, he and I have discussed this decision at length. These comments reflect both of our views.

I generally concur with today's decision. The decision's discussion of Edison's behavior in negotiating this non-standard agreement is almost frightening. While I do not believe that Edison's actions were part of a purposeful strategy to maximize shareholder returns from this contract, they must be held accountable for the ratepayer exposure caused by those actions. California's investor-owned utilities have, at this Commission's discretion, been given the freedom to invest in non-utility energy suppliers for a number of years.

In every decision establishing and preserving this privilege, however, Commissions have taken pains to make clear that ratepayers would not be allowed to be exposed to excessive or unreasonable costs by the allowance of these investments. I strongly agree with these standards and am more than willing to exercise remedies, on the ratepayer's behalf, when utility transgressions in affiliate relationships are demonstrated. I share this decision's finding, based on the voluminous record presented in this reasonableness review, that unreasonable behavior has taken place.

I dissent, however, with the remedies established in this decision for Edison's action. I believe the disallowance contained in this decision is excessive and unreasonable. DRA demonstrated during the hearings that the KRCC energy price formula could produce payments to KRCC above avoided costs in future record periods. While this possibility may reflect poorly on Edison's ability to construct an energy price formula that guarantees benefits to ratepayers over its life, it does not necessarily make those terms unreasonable. While the methodology does not conform to the methodology used in standard offers, it clearly did not harm ratepayers during the record period and, in fact, provided some benefits to offset some of the more onerous provisions in the contract.

I do not believe that the evidence presented in this proceeding on the energy methodology conclusively demonstrated its unreasonableness. Further, refusing to recognize the benefits of a methodology because it differs from standard offer methodologies, the essential basis used for refusing to apply a credit in this decision, is troubling. Such reasoning could erode the value of nonstandard offers by penalizing contracts which differ excessively from standard contracts. I am concerned over the precedent this may set for future non-standard contracts. If this is the signal we intend to give, we might just as well consider eliminating the option of nonstandard contracts. I believe this is the signal we are sending with today's decision and it is that signal with which I disagree.

I believe an appropriate disallowance should take into account the lower energy costs enjoyed by the ratepayers from

A.88-02-016
D.90-09-088

this contract. These benefits, equal to $24,253,036, should be used to offset the capacity disallowance determined in the decision. This would result in a total disallowance, after applying the appropriate interest rates, of $16,988,856. This disallowance is not an insubstantial sum, and it would send the appropriate signal to Edison of our displeasure with their actions in formulating this contract.

/s/ Stanley W. Hulett

Stanley W. Hulett, Commissioner

San Francisco, California
September 25, 1990