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Decision 91-09-069 September 25, 1991

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of SOUTHERN CALIFORNIA GAS COMPANY to revise its rates under the Consolidated Adjustment Mechanism.

Application 86-09-030
(Filed October 10, 1986)

ORIGINAL

OPINION

I. Summary

In Application (A.) 86-09-030, Southern California Gas Company (SoCalGas) sought a finding that its gas supply operations from July 1, 1985 through June 30, 1986 were reasonable.[1] One of the expenses under review was that incurred by SoCalGas to terminate its contract with Getty Synthetic Fuels Energy, Inc. (GSF Energy). In Decision (D.) 90-02-044, the Commission determined that SoCalGas' operations during the review period were reasonable but reserved SoCalGas' payments under the GSF Energy contract for subsequent proceedings. This decision resolves the reasonableness of SoCalGas' payments pursuant to its contract with GSF Energy.

In April of 1986, SoCalGas paid GSF Energy $7,396,514 to terminate a contract under which SoCalGas was required to purchase natural gas produced by GSF Energy's Monterey Park landfill. The Commission's Division of Ratepayer Advocates (DRA) sought disallowance of that payment. According to DRA, SoCalGas had no obligation to purchase the gas because it did not meet minimum

1 The costs of operations were booked to SoCalGas' Consolidated Adjustment Mechanism (CAM) account. This balancing account recorded utility expenditures that were subject to the CPUC's prudency review. After the prudency review, the CAM balancing account was adjusted and rates were changed to carry out the CPUC's findings.

quality standards and, therefore, was not "marketable." DRA also claimed that SoCalGas should not have signed a contract that guaranteed the producer a 19% rate of return, regardless of volumes actually delivered to the buyer.

SoCalGas and DRA have now proposed a settlement of the case in lieu of evidentiary hearing. Under the terms of the settlement, SoCalGas will recover $3,326,514 of the $7,396,514 it paid to terminate its contract. SoCalGas will credit the unrecovered portion of its payment, $4,070,000 to its Core and Noncore Implementation Balancing Accounts.

We have reviewed the materials that would have been introduced as evidence had no settlement been reached. We find that the settlement adequately balances the interests of the ratepayers, the utility, and the Commission in a fair and timely resolution of the dispute. We approve the settlement.

II. Background

A. Procedural History

A prehearing conference on this phase of the proceeding was held on June 13, 1990. Although the direct testimony of SoCalGas and the DRA had been served during the earlier phase of this proceeding, the ALJ directed these parties to serve their testimony upon parties on the service list compiled expressly for this phase. SoCal was ordered to serve its rebuttal testimony on July 31, 1990. Hearings were scheduled to begin on December 3, 1990.

On October 26, 1990, the parties filed a joint motion to suspend the procedural schedule so they could pursue settlement. The motion was granted.

Notice of a public settlement conference pursuant to Rule 51.1(b) of the Commission's Rules of Practice and Procedure (Rules) was appended to the motion to suspend. A copy of a draft settlement agreement was served on all parties on November 6, 1990. The draft was identical on all substantive points with the executed settlement agreement.

The settlement conference was held on November 8, 1990 as noticed. No parties other than SoCalGas and DRA attended this settlement conference. No parties have communicated to SoCalGas, DRA, or the Commission any objection to the settlement or requested any different terms.

On December 5, 1990, the parties filed the "Joint Motion of Southern California Gas Company and Division of Ratepayer Advocates for Approval of Settlement" (Joint Motion). In support of their request for approval of the settlement, SoCalGas and DRA request the Commission to receive in the record the written prepared testimony that each party has distributed to date in this proceeding. The testimony would be received solely for the purpose of considering the settlement. The parties note that they are not stipulating to the truth of the statements made by each other's witnesses, but only to the fact that the testimony is what the witnesses would have said at hearing.

No objections or other responses to the Joint Motion have been received. The testimony of the parties will aid the Commission in determining whether the settlement was reached through arm's-length negotiations in full view of the strengths and weaknesses of each party's positions. The testimony should be admitted on the record. Therefore, the testimony of SoCalGas witness William Owen, dated September 1986 and originally appended to A.86-09-030 when filed in September 1986, is admitted as Exhibit 1. The testimony of DRA witnesses originally served in December 1987 is admitted as Exhibit 2. The rebuttal testimony of SoCal witnesses served on July 31, 1990 is admitted as Exhibit 3.

B. Facts

1. The SoCalGas - GSF Contract

On July 14, 1978, the predecessors in interest to SoCalGas and GSF Energy signed a contract obligating SoCalGas to buy natural gas from a landfill in Monterey Park, California (Contract). SoCalGas' obligation to buy was coterminous with the productive life of the landfill. SoCal purchased gas under the Contract until February 1986.

Under the Contract's minimum gas quality requirements, the buyer could refuse to accept any gas that did not meet specified pipeline quality standards, had a heating value of less than 1,000 British Thermal Units (BTUs) per cubic foot, or "contain(ed) contaminants which ma(d)e the gas unmarketable; provided, however, that the Buyer shall use its best efforts to accept gas tendered hereunder that has a heating value of less than 1,000 BTU's per cubic foot but not less than 970 BTU's per cubic foot." The buyer's acceptance of gas which did not meet the quality standards did not invalidate the buyer's continuing right of refusal.

In June of 1981, SoCalGas asked a consultant to analyze the gas received from the Monterey Park landfill. The results showed the presence of chlorinated and aromatic hydrocarbons. SoCalGas continued to purchase the gas.

Based on spot tests begun in August 1982, SoCalGas confirmed South Coast Air Quality Management District (SCAQMD) reports that the landfill gas contained vinyl chloride and other chlorinated hydrocarbon compounds. SoCalGas continued to test the gas. The heating value of the delivered gas at times fell below the 970 BTU/CF minimum. SoCalGas continued to accept the gas into its system until May 5, 1986.

Although the parties had expected the landfill to produce 3 to 6 million cubic feet per day (MMcf/d), the actual maximum production in any given month was only 1.3 MMcf/d. The Contract allowed the seller to deliver as little as .025 MMcf/d, less than 1% of the production SoCalGas anticipated from the landfill.

The Contract guaranteed the seller a 19% after-tax return on equity invested in the gas operation beginning on January 1, 1984. No Contract term limited the size of rate base or, consequently, the cost of gas. Because of lower than expected gas production, the Contract price of landfill gas rose to $12.76 per thousand cubic feet (MCF) in 1984. If GSF Energy had sold the minimum quantity required under the Contract when the 19% rate of return obligation became effective, SoCalGas would have been obligated to pay as much as $600/MCF.

In fact, SoCalGas and GSF Energy agreed that beginning in 1984, instead of adhering to the Contract terms, SoCalGas should pay what it had paid in 1983, escalated at the GNP - Implicit Price Deflator Index. The resultant price was $3.30/MCF. The escalated price was to remain in effect until negotiations over an alternate pricing provision were completed.

No agreement on price was reached. In February of 1986, the parties decided to terminate the Contract if SoCalGas would pay GSF Energy $7 million.

2. <u>The SoCalGas - GSF Termination Agreement</u>

In April of 1986, SoCalGas made a lump sum payment of $7.4 million to GSF Energy to terminate the Contract. SoCalGas agreed to pay GSF $7 million in exchange for GSF Energy's release of SoCalGas' obligation to purchase gas under the Contract. The additional $398,000 represents the difference between the payments SoCalGas made at $3.30/MCF, and payments SoCalGas would have made at the price escalated by the GNP Index for gas purchased while negotiations were pending.

C. Testimony of the Parties

1. SoCalGas' Testimony

SoCalGas' witnesses claimed that the Contract was reasonable because the project had the potential to provide renewable local supplies of increasingly scarce natural gas and would make 4 to 6 MMcf/d of gas immediately available to Southern California customers.

SoCalGas stressed that the 19% return on equity contract term provided the incentive for GSF Energy to invest in a risky R&D project. According to SoCalGas, it feared that escalation of a 1979 price for gas at the GNP Index created the potential of uncontrollably high gas prices; it chose instead a price that would enable GSF Energy to earn a 19% return on rate base beginning in the sixth year of the Contract; it believed the 19% rate of return was reasonable because that was the rate being earned by comparable firms during the 1978-1980 period.

SoCalGas interprets its "best efforts" obligation under the Contract to require it to take landfill gas, even though its heat content fell below the contract minimum 17% of the time between January 1982 and May 1986, because the gas did not disrupt SoCalGas' operations.

According to SoCalGas, the termination agreement was reasonable because the supply of natural gas unexpectedly increased, leading to lower gas prices, while low production by the landfill resulted in a unit cost of $12.76/MCF for landfill gas. Early termination of the Contract resulted in a saving of $18 million that would otherwise have been paid under the gas purchase contract from 1985 through 1990.

2. DRA's Testimony

According to DRA, the landfill gas did not meet the quality standards of the contract; the gas exposed customers and facilities to environmentally hazardous substances, such as vinyl chloride and nitrogen, which made the gas "unmarketable"; since the gas was unmarketable, SoCalGas was relieved of its obligation to take the gas. DRA argues that SoCalGas owed GSF Energy no consideration when it decided to terminate the Contract.

DRA also believes that by imprudently purchasing the landfill gas, SoCalGas displaced purchases of less-expensive gas.

DRA claims that the Contract provided ratepayers almost no benefits while exposing them to the risk of great economic cost. According to DRA, the Contract was unreasonable because it contained the following features: (1) a guaranteed 19% after-tax return on investment using full cost-of-service treatment, (2) no limit on the costs that could be allocated to the seller's rate base, and (3) a minimum production level so low that there was no ratepayer protection against an exhorbitant price per MCF of gas.

Thus, DRA recommends the disallowance of $7,396,514 which SoCalGas paid the producer to terminate the Contract and $358,169 which SoCalGas paid under the Contract in excess of the cost of alternative gas.

III. Terms of Settlement

The "Settlement and Agreement" (Settlement) executed by the parties is intended to constitute a complete and final resolution of the matters in dispute in this proceeding related to the purchases of gas from the Monterey Park landfill and the termination of SoCalGas' Contract with GSF Energy.

Under the Settlement, within 30 days of a final Commission order approving the Settlement, SoCalGas is to credit to its Core Implementation Balancing Account and its Noncore Implementation Account amounts to be calculated as follows: the sum of $4,070,000, plus interest from April 1986 to the date the credits are made to those accounts, allocated to the two accounts in the same proportion as the CAM balancing account as of April 30, 1988, was allocated by the Commission between core and noncore customer classes.

The Settlement proposes that with the exception of the above credit to ratepayers, SoCalGas will be allowed to recover in rates all amounts already booked to the CAM account in the 1985/1986 reasonableness review period and in previous review periods with respect to the Contract.

IV. Discussion

A. Standard of Review for Settlements

"The Commission will not approve stipulations or settlements, whether contested or uncontested, unless the stipulation or settlement is reasonable in light of the whole record, consistent with law, and in the public interest." (Rule 51.1(e).)

The Commission has also reviewed settlements on the same grounds as those employed by federal courts in their review of class action settlements. The Commission will balance various factors which may include the following: the strength of the applicant's case; the risk, expense, complexity, and likely duration of further litigation; the amount offered in settlement; the extent to which discovery has been completed so that the opposing parties can gauge the strength and weakness of all parties; the stage of the proceedings; the experience and views of counsel; the presence of a governmental participant; and the reaction of the class members to the proposed settlement.[2] In

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2 See, e.g., D.88-12-083, re: Application of Pacific Gas and Electric Company to include costs of Diablo Canyon Nuclear Power Plant in rate base (30 CPUC 2d 189, 222), citing Officers for

(Footnote continues on next page)

summary, the Commission has stated, "The most important element in determining the fairness of a settlement is the relationship of the amount agreed upon to the risk of obtaining the desired result." (30 CPUC 2d, 189, 267.)

B. Reasonableness of SoCalGas - DRA Settlement

The applicant has legal and equitable arguments in support of its claim. SoCalGas did obligate itself to GSF Energy under the Contract. It may be true that the energy market in the late 1970's required a novel shift of investment risk from seller to buyer. Like other investors in experimental energy technologies, GSF Energy was encouraged to undertake a risky venture by the promise of a relatively high rate of return. These factors must be weighed against the possibility that SoCalGas may have been imprudent for failing to recognize the potential for exhorbitant gas prices that could result from the interplay of low production levels and the Contract's guaranteed 19% return on equity.

Overshadowing these extremely risky contract terms is DRA's argument that SoCalGas had no obligation to purchase the gas because its vinyl chloride content may have rendered the gas otherwise "unmarketable." The determination of whether SoCalGas was prudent in signing such a novel contract and whether SoCalGas had any obligation to continue its purchases would have entailed complex and protracted litigation. The resolution of the question of marketability could have spelled a complete victory for one

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(Footnote continued from previous page) Justice v. Civil Service Com'n, etc. (9th Cir. 1982) 688 F.2d 615, 625.

party or the other; thus, the risk to each party of litigation was high.

Approximately four years have passed since the execution of the termination agreement and the filing of the application. During this time, the parties have conducted discovery, served their prepared testimony on each other, and reviewed the rebuttal testimony of SoCalGas. The Settlement was filed after the parties had more than adequate opportunity to discover the facts and assess the strengths and weaknesses of each other's positions.

The amount that the parties have agreed should be recovered from ratepayers is roughly 45% of the amount sought by SoCalGas, or $3.33 million instead of $7.40 million. This appears to be a fair result; it signifies that the parties are in accord that the outcome of litigation is almost as risky for one party as for the other. No parties other than SoCalGas and DRA attended the settlement conference. Given all of these considerations, we conclude that the parties reached their agreement under conditions that are likely to lead to a fair settlement of the case.

Conclusion

The recovery by SoCalGas of approximately 45% of the cost of SoCalGas' purchases pursuant to its contract with Getty is reasonable in light of the risk to either party of prevailing on their respective claims. On this basis, we find that the settlement is in the public interest and should be approved.

Findings of Fact

1. On July 14, 1978, the predecessors in interest of SoCalGas and GSF Energy executed a contract whereby SoCalGas would purchase natural gas produced by GSF Energy at its Monterey Park landfill.

2. In April of 1986, SoCalGas paid $7.4 million to GSF Energy to terminate the Monterey Park landfill contract.

3. SoCalGas sought a finding that its $7.4 million payment to GSF Energy is reasonable and should be recovered from ratepayers.

4. The Commission's Division of Ratepayer Advocates (DRA) recommended that the Commission deny recovery of the $7.4 million termination payment and disallow $358,169 that SoCalGas paid under the contract in excess of the cost of alternate supplies of gas.

5. On October 26, 1990, SoCalGas and DRA circulated a notice of public settlement conference pursuant to Rule 51 of the Commission's Rules of Practice and Procedure.

6. A copy of the proposed SoCalGas-DRA settlement was served on parties to the service list on November 6, 1990. The draft was identical on all substantive points with the executed settlement agreement.

7. The settlement conference was held on November 8, 1990 as noticed. No parties other than SoCalGas and DRA attended the formal settlement conference.

8. On December 5, 1990, the parties filed the "Joint Motion of Southern California Gas Company and Division of Ratepayer Advocates for Approval of Settlement" (Joint Motion).

9. The Commission should receive in the record the written prepared testimony that each party has distributed to date in this proceeding for the purpose of considering the settlement.

10. No objections or other responses to the Joint Motion have been received.

11. The "Settlement and Agreement" executed by the parties constitutes a complete and final resolution of the matters in dispute in this proceeding related to the purchases of gas from the Monterey Park landfill and the termination of SoCalGas' contract with GSF Energy for gas from the landfill.

12. The Settlement and Agreement requires that within 30 days of a final Commission order approving the settlement, SoCalGas shall credit to its Core Implementation Balancing Account and its

Noncore Implementation Account amounts to be calculated as follows: the sum of $4,070,000, plus interest from April 1986 to the date the credits are made to those accounts, allocated to the two accounts in the same proportion as the CAM balancing account as of April 30, 1988 was allocated by the Commission between core and noncore customer classes.

13. The Settlement and Agreement provides that with the exception of the above credit to ratepayers, SoCalGas will be allowed to recover in rates all amounts already booked to the CAM account in the 1985/1986 reasonableness review period and in previous review periods with respect to the GSF Energy Contract.

14. The parties reached their agreement under conditions that are likely to lead to a fair settlement of the case.

15. The recovery by SoCalGas of approximately 45% of the cost of SoCalGas' purchases pursuant to its contract with Getty is reasonable in light of the risk to each party of not prevailing on its claims.

16. This order should be effective today, as there were no responses to the Joint Motion for approval of the Settlement and the amounts in controversy continue to accrue interest.

Conclusion of Law

The Settlement is in the public interest.

ORDER

IT IS ORDERED that:

1. The "Joint Motion of Southern California Gas Company and Division of Ratepayer Advocates for Approval of Settlement" filed on December 5, 1990 is granted.

2. The "Settlement and Agreement" appended to the Joint Motion is approved.

3. Within 30 days of the effective date of this decision, SoCalGas shall credit to its Core Implementation Balancing Account

and its Noncore Implementation Account amounts to be calculated as follows: the sum of $4,070,000, plus interest from April 1986 to the date the credits are made to those accounts, allocated to the two accounts in the same proportion as the CAM balancing account as of April 30, 1988 was allocated by the Commission between core and noncore customer classes.

4. This proceeding is closed.

This order is effective today.

Dated September 25, 1991, at San Francisco, California.

PATRICIA M. ECKERT
President
JOHN B. OHANIAN
DANIEL Wm. FESSLER
NORMAN D. SHUMWAY
Commissioners

I abstain.

/s/ G. MITCHELL WILK
Commissioner

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

NEAL J. SHULMAN, Executive Director