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Decision 97-07-056 July 16, 1997

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Southern California Edison Company (U 338-E) for Orders: (1) Approving a Settlement Agreement Between Edison and North American Chemical Company and (2) Authorizing Edison's Recovery in Rates of Payments Made Pursuant to the Settlement Agreement.

ORIGINALApplication 97-02-037
(Filed February 21, 1997)**OPINION**

Southern California Edison Company (Edison) seeks approval of the Settlement Agreement, dated July 12, 1996 (Settlement Agreement) between Edison and North American Chemical Company (NACC), including Amendment No. 2 attached to the Settlement Agreement. The settlement resolves a dispute between NACC and Edison regarding the proper interpretation of certain provisions of the contract (Contract) between them for the sale to Edison of electrical power generated by NACC's cogeneration project. The major point of contention is the price Edison must pay under the Contract for energy deliveries above 12 megawatts (MW). Prior to the settlement, NACC contended that it may sell to Edison, at the minimum Contract price of 5.6¢/kW, all energy generated by NACC's cogeneration project. However, Edison contended that it was obligated to pay the Contract price only for deliveries of energy associated with 12 MW of capacity, the amount of capacity specified in the Contract.

The parties also disputed the maximum amount of power NACC could sell to Edison under the Contract. NACC had informed Edison it intended to make certain modifications to the cogeneration project and associated steam host facilities to enable it to reduce the facilities' electrical demand and to increase generation of electrical power, approximately 45 MW of which would be sold to Edison. Edison contended that the contemplated modifications might constitute a "new" project, whose output would not be covered by the Contract, and also that transmission constraints effectively limit NACC's energy deliveries under the Contract to no more than 20 MW.

Finally, the parties disputed whether NACC could sell power for auxiliary load uses to its neighbor, ACE Cogeneration Company (ACE). NACC argued that it could respond to Edison's position on available transmission by selling its excess generation to ACE to meet ACE's internal service requirements. According to NACC, ACE would then be able to sell the entire electrical power generated by its cogeneration plant to Edison under its Interim Standard Offer No. 4 (ISO4) contract with Edison, without deduction for auxiliary power requirements. Edison responded by pointing out that ACE's ISO4 contract permits it to sell to Edison only the portion of ACE's generation that exceeds ACE's auxiliary load requirements.

After Edison declined to accept NACC's positions on these issues, NACC invoked the dispute resolution provision in the Contract. At the conclusion of the negotiations, the parties agreed to the settlement that is the subject of this application.

The Settlement Agreement, which is subject to final Commission approval, ends several years of controversy between NACC and Edison. It eliminates the uncertainties and costs which would have resulted from litigating the dispute. Under a worst case outcome of the litigation, Edison could have been required to accept as much as 45 MW of generation from NACC at the Contract price for the remaining 18 years of the Contract Term.¹

A. The Contract

On November 23, 1982, Kerr-McGee Chemical Corporation (Kerr-McGee) and Edison executed a 30-year negotiated Parallel Generation Agreement (Contract) for the purchase by Edison of electrical power generated by a cogeneration project (Project) at Kerr-McGee's Trona/Argus manufacturing plant in Trona, California. The Project became operational in April 1983 and began delivering electricity under the Contract at

¹ The terms of the Settlement Agreement and the amount of savings are considered confidential and proprietary and are not subject to public disclosure pursuant to California Public Utilities (PU) Code § 583 and General Order 66-C. The Commission and its staff have reviewed all the confidential material.

that time. It was declared to be in Firm Operation under the Contract in July of that year.

Under the Contract, Edison agreed to pay Kerr-McGee either 94% of Edison's current avoided cost of energy as filed with and approved by the Commission, or the higher of a floor of 5.6¢ per kWh or Edison's system fossil fuel costs. To date, Edison has paid the 5.6¢ per kWh price for all energy sales under the Contract. The Contract initially provided for Kerr-McGee to sell 6 MW of firm "contract capacity and associated energy" to Edison. However, the Contract afforded Kerr-McGee one opportunity to increase contract capacity up to 20 MW. In October 1983, Kerr-McGee exercised this right by increasing its firm capacity to 12 MW. Since then, sales of electricity under the Contract have generally been at the 12 MW level. On March 27, 1989, Kerr-McGee and Edison entered into Amendment No. 1 of the Contract to reflect changes in the standby tariff schedule and contract demand under which Edison provides electrical service to the Project.

On November 30, 1990, Kerr-McGee assigned its interest in the Contract to NACC, which also became the owner of another cogeneration system nearby, known as the "Westend" facility. The Westend facility is not at issue in this proceeding. On July 12, 1996, NACC entered into an agreement with General Electric Capital Corporation and General Foods Credit Investing No. 3 Corporation (jointly, General) for the sale and leaseback of the Project that is the subject of this application. Although General owns the facility, NACC is still the "Seller" under the Contract.

B. The Facility

Kerr-McGee originally built a cogeneration system, referred to as the "Trona" system, to serve the electrical load of its mineral processing plant located on a dry lake bed in Trona, California, in the Mojave Desert. Later, during an expansion, Kerr-McGee added another system immediately adjacent to the Trona system, which second system is referred to as the "Argus" system. Together, the Trona/Argus cogeneration systems constitute the Project. (The Project and the mineral processing plant which serves as the Project's steam host are jointly referred to as the "Facility.")

C. The ACE Facility and Its ISO4 Facility

ACE owns a 108 MW coal-fired cogeneration project. Pursuant to an ISO4 contract, ACE currently sells to Edison the electric power generated by its cogeneration system that is net of ACE's own internal requirements. ACE's project is adjacent to the Facility, and sells process steam to NACC on an intermittent basis. The ACE facility was originally developed by NACC's predecessor, Kerr-McGee, as part of an expansion project. In April 1988, ACE purchased and completed the ACE cogeneration project.

D. Transmission System

The Facility is connected to Edison's electric system for the purpose of both delivering power under the Contract and receiving standby electric service from Edison when the Project is not generating power. Deliveries of power both to and from the Facility are made via a 33 kilovolt (kV) overhead distribution line, known as the "Hackman" line, which runs from Edison's Searles substation, located about five miles west of the Facility. The Hackman line, which also serves Edison customers in addition to NACC, is connected at Searles substation by means of a 25 megavolt amperege (MVA) Edison-owned transformer that steps up voltage from 33 kV to 115 kV, for delivery via Edison's 115 kV Searles/Inyokern transmission line. The latter line runs approximately 28 miles west to feed into Edison's Inyokern Substation, which is an integral part of Edison's Inyokern/Kramer /Lugo area 230 kV transmission system, located east of the Sierra Nevada mountain range.

At the time Edison and NACC entered into the Settlement Agreement, potential technical constraints existed on Edison ability to accept power from the facility. Limitations at Searles substation restricted maximum deliveries from NACC to 20 MW. Moreover, Edison's transmission system south of Inyokern Substation was limited to approximately 20 MW of additional capacity.

E. The Issues in Dispute

The dispute between Edison and NACC arose in approximately mid-1993, during discussions concerning NACC's plans to modify its Facility to enable it to sell

Edison up to as much as 45 MW of energy rather than the 12 MW it had typically sold prior to 1993.

The primary issue in dispute was whether the Contract obligated Edison to pay the Contract price for energy deliveries above 12 MW. NACC contended that the Contract obligated Edison to pay NACC the Contract price for all energy generated by its Project, including that resulting from the modification of the Facility. NACC based its contention upon § 11.2 of the Contract, which states that "Edison hereby agrees to purchase from [NACC] all Energy delivered by [NACC] to Edison hereunder," and §§ 2.1 and 4.12, which describe the Project as a 62.5 MW project. According to NACC, the reference in § 11.2 to "all energy" refers to any energy generated by the 62.5 MW Project.

Edison contended that it was obligated to pay the Contract price only for the energy associated with the 12 MW of capacity specified in § 2.12 of the Contract as subsequently increased pursuant to Appendix A; i.e., 12 MW of energy. It further contended that the word "hereunder" in § 11.2 refers to the limitation to "12 MW" of associated energy.

Edison further contended that, even if it were determined that the Contract does not limit NACC's energy deliveries to 12 MW, such deliveries should still be limited to 20 MW. Edison based this contention principally upon ¶ B.4 of Appendix A of the Contract, which allowed Kerr-McGee a one-time opportunity to increase Contract capacity from 6 MW to no more than 20 MW. Edison also cited to the transmission constraints and to contemporaneous correspondence that established, in Edison's view, that the parties intended a 20 MW upper limit on the amount of capacity and associated energy sold to Edison.

Apart from the price to be paid for energy deliveries above 12 MW, the parties also disputed the effects of the contemplated modifications to the Facility. According to NACC, the Contract provided that it could sell to Edison all energy generated by its 62.5 MW Project, including increased generation made possible by modifications to the Project which reduced the facility's electrical demand. Edison contended that the modifications might constitute a "new" project whose output would not be covered by

the Contract. Further, Edison again asserted that the transmission constraints effectively limited energy deliveries to 20 MW regardless of whether the reductions in electrical demand created a "new" project. Edison estimated that it would cost NACC approximately \$19 million to pay for transmission upgrades that would be required to permit Edison to purchase more than 20 MW.

NACC and Edison additionally disputed whether NACC could sell additional generation resulting from the proposed reduction in NACC's electrical demand to its neighbor, ACE. NACC contended that it could sell electrical power to ACE for auxiliary load requirements, which in turn would permit ACE to sell the entire output from its congeration project to Edison under an ISO4 Contract providing for energy prices substantially above current avoided cost. Edison contended that the terms of ACE's ISO4 permitted ACE to sell to Edison only generation above ACE's own load requirements, and that Commission precedent did not contemplate such sales between qualifying facilities.

F. Settlement Negotiations and Investigations

In late 1993, NACC invoked the dispute resolution procedures of the Contract. The parties exchanged written statements of their positions, followed several months later by a meeting attended by senior management and staff from both parties. Three consultants, including one attorney, from Strategic Energy, Ltd., an energy consulting firm located in Pennsylvania, also attended on NACC's behalf. During the meeting, the parties discussed in detail the legal and factual bases for their respective contentions. However, it became apparent that no resolution would be possible until the parties had the opportunity to investigate fully certain factual claims.

Specifically, NACC's contemplated modifications raised a concern on Edison's part about whether the changes would result in a "new" Project. Under the Commission's QF contract administration guidelines (see Decision (D.) 88-10-032), modifications to NACC's system, if sufficiently extensive, could result in the Project being characterized as "new" such that its additional output would not qualify as power for which Contract-based prices must be paid. Accordingly, for the better part of

the next year, Edison asked for and received detailed information about the modifications and Edison personnel toured the Facility to inspect the proposed modifications. Based upon its inspection and its review of the written information, Edison concluded that the proposed modifications would not result in a "new" Project. Accordingly, a genuine dispute remained between the parties concerning whether the Contract price applied to increased energy output resulting from the modifications.

At the same time, Edison's contention that transmission constraints effectively limited NACC's energy deliveries to 20 MW appeared to raise concerns on NACC's part. In the following months, Edison provided NACC with information which established the existence of the constraints and also verified the \$19 million cost to upgrade the transmission system.

After the parties concluded their investigations, representatives of the parties' senior management and consultants met to discuss the dispute. This time, with all issues and contentions fully investigated to the parties' satisfaction, the parties were able to reach an agreement in principle. Attorneys and staff for both parties then negotiated the numerous remaining details and put the agreement in writing. The result was the Settlement Agreement and the Amendment that are the subjects of this application.

G. The Settlement Agreement

Edison submits that the proposed Settlement Agreement and Amendment fairly balance all of the pertinent considerations and meet the requirements of Rule 51.1(e). The proposed settlement reflects the relative risks and cost of litigation, fairly and reasonably resolves the disputed issues, and conserves public and private resources, while the settlement amount falls well within the range of possible outcomes had the disputed issues been tried in a lawsuit.

The primary dispute between NACC and Edison involved the proper interpretation of several provisions of the negotiated Contract. In essence, NACC contended that, because the Contract describe the Project as a 62.5 MW cogeneration facility, NACC was entitled to the Contract price for all energy delivered to Edison from

the Project up to that amount. Edison, on the other hand, asserted that the Contract specified the upper limit of permissible energy deliveries for which the Contract price would be paid, namely 12 MW as the energy "associated" with 12 MW of capacity. In deciding to enter into the Settlement Agreement and the Amendment, Edison recognized that, had the dispute proceeded to litigation, the dispute could have been decided in favor of either party. Edison also recognized that if NACC prevailed in any such lawsuit, NACC could have obtained a declaration that it is entitled to receive the Contract price for all energy deliveries from the Project.

In view of the above, the settlement falls well within the range of possible outcomes of litigating the dispute, and represents a substantial benefit to Edison and its customers by eliminating the significant litigation risk, cost, and uncertainty that Edison would have faced in the absence of settlement.

The parties' discussions included numerous exchanges of detailed information and a site visit. These informational exchanges and the site visit have given each side ample opportunity to assess the relative strengths and weaknesses of its position, the position of the other party, and the strength of evidence that would likely to be used at trial if the dispute had proceeded to litigation. The dispute is therefore ripe for reasonable compromise.

The settlement will eliminate the risk, expense, and time of civil litigation. The issues involved in the dispute are complex and trial of this dispute would require substantial time and expense. Both sides were represented by counsel experienced in QF matters and/or litigation. Moreover, the Settlement Agreement and the Amendment result from arm's length negotiations between unaffiliated parties without collusion.

H. Range of Possible Outcomes in the Absence of Settlement

Edison believes that the proposed settlement is just and reasonable from the perspective of customers. In analyzing the settlement from this viewpoint, Edison is cognizant that, to be considered reasonable, the settlement must clearly fall within the

range of possible outcomes (D.90-08-046) as well as generally conform with the criteria of Rule 51.1(e).

Had a lawsuit been filed and Edison achieved a complete victory in court on the merits of NACC's claims, Edison would pay nothing to NACC above that which it already pays under the Contract. Had NACC prevailed, however, Edison could have been required to pay more than avoided cost for energy above 12 MW for the remaining life of the Contract (18 years at the time of settlement). Even if NACC had only partially prevailed at trial because a trier of fact determined that the Contract capped energy deliveries at 20 MW, Edison would have been required to pay more than avoided cost for energy above 12 MW and up to 20 MW for the remaining life of the Contract.²

In addition to the foregoing financial considerations, Edison also considered less tangible aspects of the issues in dispute in determining whether to settle. Specifically, Edison thought it likely that the trier of fact in litigation (either a jury or a judge) might be confused by the complex contractual provisions relevant to the conflicting contentions of the parties.

The Commission's Office of Ratepayer Advocates (ORA) has reviewed the application and has not opposed approval.

We will approve the settlement. There was a genuine dispute between the parties regarding the interpretation of the Contract. Both parties engaged in significant investigations of each others' claims and employed outside consultants. The result was the realization that the stakes were high and that settlement was a superior course to follow rather than chancing a trial before a trier of fact who might be less than knowledgeable about a complex subject matter.

² The economic analysis of the settlement is considered confidential and proprietary and is omitted pursuant to PU Code § 583 and General Order 66-C.

Findings of Fact

1. In 1982, Edison and NACC's predecessor entered into a 30-year contract whereby Edison would buy electricity from a cogenerator.
2. In 1993, NACC planned to sell Edison up to 45 MW of energy under the Contract price rather than the 12 MW it had typically sold.
3. Edison contended it was obligated to pay the Contract price for 12 MW of capacity energy. NACC differed.
4. Both parties entered into an extensive investigation of each others' claims.
5. There is a reasonable probability that NACC might have prevailed had the dispute gone to trial.
6. The proposed settlement is reasonable and should be approved.
7. Notice of the application appeared on the Commission's Daily Calendar on March 7, 1997. There are no protests. A public hearing is not necessary.

Conclusions of Law

1. The terms of the July 12, 1996 Settlement Agreement are reasonable.
2. Edison's action in entering into the Settlement Agreement and the Amendment to the Settlement Agreement is reasonable and prudent and Edison should recover in rates all payments to NACC required under the Amendment to the same extent allowed under standard offer QF contracts generally, subject only to Edison's prudent administration of the Contract, as amended by the Amendment.
3. Edison's ratepayers will be adequately served by the Settlement Agreement.
4. The July 12, 1996 Settlement Agreement is approved as executed.
5. The Commission's approval is final and not subject to further reasonableness review, subject only to Edison's prudent administration of the Contract, as amended.

O R D E R

IT IS ORDERED that:

1. The approval sought by Southern California Edison Company (Edison) of the Settlement Agreement dated July 12, 1996, including Amendment No. 2 attached to the Settlement Agreement, between it and North American Chemical Company is granted.
2. Edison is authorized to recover in rates all payments which Edison will make to North American Chemical Company under the Settlement Agreement subject only to Edison's prudent administration of the Contract, as amended.
3. This proceeding is closed.

This order is effective today.

Dated July 16, 1997, at San Francisco, California.

P. GREGORY CONLON
President
JESSIE J. KNIGHT, JR.
HENRY M. DUQUE
JOSIAH L. NEEPER
RICHARD A. BILAS
Commissioners