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Decision 97-07-064 July 16, 1997

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

ORIGINAL

Application of San Diego Gas & Electric Company to Establish an Experimental Performance-Based Ratemaking Mechanism. (U 902-M)	Application 92-10-017 (Filed October 16, 1992; Petition for Modification filed May 24, 1996)

OPINION ON PETITION FOR MODIFICATION

1. Summary

The May 24, 1996 petition by San Diego Gas & Electric Company (SDG&E) for modification of Decision (D.) 93-06-092 is granted. The Generation and Dispatch (G&D) performance-based ratemaking (PBR) mechanism approved by D.93-06-092 is continued in effect until no later than January 1, 1998, when SDG&E begins purchasing energy from the Power Exchange (PX) in accordance with D.95-12-063, as modified by D.96-01-009 (the Preferred Policy Decision). The G&D Mechanism may be terminated sooner by order in Application (A.) 96-10-022, SDG&E's current Energy Cost Adjustment Clause (ECAC) proceeding.

To the extent that expenses for Qualifying Facilities (QFs) are passed through to ratepayers on a dollar-for-dollar basis, and SDG&E's administration of QF contracts is not subject to a PBR mechanism, the Commission confirms that traditional regulatory mechanisms apply to this limited area of SDG&E's operations until an incentive-based approach can be developed. Accordingly, for the time being, SDG&E's administration of QF contract terms and conditions is subject to reasonableness review.

Phase 1 of A.92-10-017 is closed by this decision. The proceeding remains open pending disposition of Phase 2, in which SDG&E's base rate PBR mechanism is under review.

2. Background

D.93-06-092, issued on June 23, 1993 in Phase 1 of this proceeding, approved two experimental PBR mechanisms, one applicable to SDG&E's natural gas procurement activity and the other to its electric G&D operations. Both mechanisms were adopted for two-year terms that began with their implementation on August 1, 1993.

Issued in response to an earlier petition by SDG&E, D.95-04-051 extended the terms of the Gas Procurement and G&D mechanisms until at least July 31, 1996. D.95-04-051 further provided that if SDG&E filed a request for permanent or replacement PBR mechanisms within 90 days after the latest of evaluation reports ordered by D.93-06-092, the experimental mechanisms would remain place until the Commission issued a decision on the merits of such permanent mechanisms. On February 29, 1996 the Commission Advisory and Compliance Division (CACD),[1] through its contractor Vantage Consulting, Inc., issued its evaluation report on the first two years of operation of the Gas Procurement and the G&D mechanisms. The report was filed in this docket on March 4, 1996, and the 90-day period specified in D.95-04-051 began on that date. SDG&E timely filed its petition to extend the G&D mechanism on May 24, 1996.[2]

By this petition SDG&E seeks to modify the G&D mechanism and to extend its term through January 1, 1998 or until SDG&E begins purchasing all energy from the PX. SDG&E also proposes to continue monitoring and evaluation requirements similar to those that were applicable to the first two years of the experiment.

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[1] CACD's responsibilities have now been transferred to a new staff division, the Energy Division.

[2] SDG&E also timely filed a petition to extend the term of the Gas Procurement mechanism. That petition was granted by D.97-02-012.

The Office of Ratepayer Advocates (ORA) filed a response in opposition to SDG&E's petition.[3] ORA contends that the petition is in contravention of D.93-06-092 and D.95-04-051 because it lacks a formal evaluation of the experiment's outcome and because major concerns raised by ORA in its evaluation were not addressed by SDG&E.

A prehearing conference was held on September 5, 1996. No issues requiring evidentiary hearings were identified. The Administrative Law Judge (ALJ) established a comment process providing for opening comments by ORA in which ORA would put forth concrete proposals regarding payments to QFs, off-system sales, and the G&D sharing mechanism. Thereafter, other parties would file responses; and all parties would reply to the responses. SDG&E filed the only response to ORA's comments. ORA filed the only reply to SDG&E's response.

By ruling issued on October 8, 1996, the ALJ provided parties an opportunity to address in their responsive and reply comments the impacts of Assembly Bill (AB) 1890 (Stats. 1996, Ch. 854), if any, on this matter.

3. Discussion

3.1. Preliminary Matters

The issues before the Commission are whether to continue SDG&E's G&D PBR mechanism in effect until January 1, 1998 as proposed by SDG&E; whether to adopt the noncontroversial modifications proposed by SDG&E; whether to adopt ORA's proposed modifications regarding the sharing mechanism, QF payments, and off-system sales; and whether and how AB 1890 impacts the G&D mechanism.

As ORA notes, our earlier decisions in Phase 1 of this proceeding provided that we would undertake a more comprehensive formal evaluation of the G&D experiment than anticipated by SDG&E in its petition. We originally envisioned such a comprehensive evaluation as being a prerequisite to adoption of a permanent G&D mechanism. Since we issued those decisions, however, electric industry

[3] During the pendency of this matter, The Division of Ratepayer Advocates (DRA) was replaced by ORA. For purposes of this decision, references to ORA include DRA.

restructuring, and specifically our issuance of the Preferred Policy Decision and the subsequent enactment of AB 1890, have supplanted the need for a permanent G&D mechanism. In addition, we are addressing ORA's major areas of concern in this decision. We conclude that the actions we take today do not require a more comprehensive formal review of the G&D experiment.

By this decision we provide for disposition of the G&D experiment, and we have already provided for disposition of the Gas Procurement experiment in D.97-02-012. Phase 1 of this proceeding is therefore concluded. A.92-10-017 remains open pending disposition of Phase 2, which addresses SDG&E's base rate PBR mechanism.

3.2. Extension of the Term of the G&D Mechanism

The Preferred Policy Decision provided (at p. 87 mimeo.) for continuation of existing PBR programs, including specifically SDG&E's base rate and G&D mechanisms, until transition to the restructured electric industry has taken place.[4] There is no proposal to continue SDG&E's G&D mechanism in effect once the PX is operating and SDG&E commences purchasing energy from the PX. The question raised by this petition is whether we should terminate the experiment at this time and require a traditional ECAC proceeding covering the interim period between now and the startup of the restructured industry.

The monitoring and evaluation reports submitted pursuant to D.93-06-092 reveal several issues associated with the G&D mechanism (generally, those raised by ORA in response to SDG&E's petition), but they provide no basis for terminating the mechanism at this time. To the contrary, the evaluation reports support continuation of the mechanism. For example, ORA's first-year report concluded that the G&D mechanism "...appears to be a relatively effective but complicated mechanism..." and

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[4] Continuing the PBR programs in place "as approved" includes continuing in effect the various components of those programs, such as monitoring, evaluating, and modifying the programs as necessary. Notwithstanding SDG&E's suggestions to the contrary, neither the Preferred Policy nor D.96-03-022 changed the essential experimental nature of these programs.

that "...absent a simpler mechanism, G&D is a good alternative to the traditional ECAC mechanism at this time." (*Monitoring and Evaluation Report on San Diego Gas and Electric Company's Performance Based Ratemaking, Generation and Dispatch*, January 18, 1995, p. 2-1.)

We continue to believe that the G&D experimental program represents an improvement relative to historical regulatory techniques. We will authorize SDG&E to continue the mechanism in effect until January 1, 1998.

SDG&E has filed a motion to withdraw its current ECAC application (A.96-10-022). Attached to the motion is a December 18, 1996 Memorandum of Understanding (MOU) between SDG&E and ORA which provides, among other things, for elimination of the ECAC mechanism, the Electric Revenue Adjustment Mechanism, and the G&D Mechanism. Accordingly, while today's order continues the G&D Mechanism in effect until January 1, 1998, the Commission may provide for earlier termination by order in A.96-10-022.

SDG&E proposes that the G&D mechanism be continued through January 1, 1998 *or* until it begins purchasing all energy from the PX/Independent System Operator. Since AB 1890 confirms the January 1, 1998 commencement date for the major elements of electric industry restructuring, and our implementation proceedings are going forward as scheduled, we see no reason to leave the termination date open-ended as requested.

We approve SDG&E's proposal to continue the monitoring and evaluation requirements that were adopted in D.93-06-092. Because we are closing Phase 1 of this proceeding, we will direct SDG&E to submit evaluation reports in the distribution PBR proceeding which SDG&E will file later this year pursuant to D.97-04-067.

3.3. Noncontroversial Modifications

SDG&E's petition offers several prospective modifications to the G&D mechanism. SDG&E represents that these modifications were addressed in discussions with ORA. However, if the Commission deems these modifications unnecessary, SDG&E requests that the G&D mechanism be continued in effect without change for the

proposed extension period. The proposed modifications include changing the G&D dispatch price to utilize the Part A Index gas price from the Gas Procurement mechanism; providing that SDG&E will negotiate only the best short-term firm capacity offers within each calendar year; providing that SDG&E will furnish updated and relevant information in ECAC proceedings; providing for true-ups of forecasting errors that occur repeatedly; including miscellaneous firm purchases in the ECAC forecast; updating capacity as well as heat rates in ECAC forecasts following plant overhauls; and continuing audits on an annual basis.

Several of these suggested program modifications are based on continuation of the modified ECAC proceedings that we have pursued for SDG&E since adoption of the G&D experiment. However, there have been no hearings in SDG&E's current ECAC proceeding, and, as noted earlier, SDG&E has filed a motion for authority to withdraw the application. Also, elimination of the forecast phase of ECAC proceedings generally is under consideration at this time. (See, e.g., the Energy Division report, *Energy Division Recommendations on Streamlining Issues*, April 30, 1997.) We find that modifications that would involve continued ECAC proceedings may be unwarranted. Moreover, since the G&D mechanism is scheduled to be terminated at the end of this year, we do not find these proposed modifications are necessary at this time.

3.4. Revenue Sharing

ORA proposes to modify the revenue sharing component of the G&D mechanism, which compares actual fuel and purchased power costs to a performance benchmark. SDG&E opposes this proposal, preferring to keep the current sharing proportions in effect.

The benchmark uses the ECAC forecast of those costs as adjusted for certain variables. If SDG&E's performance (as measured by actual costs) during the 12 months covered by the forecast falls within 6% of the benchmark, additional costs or savings relative to the benchmark are shared between ratepayers and utility shareholders. To the extent that actual costs fall outside of the plus-or-minus 6% range, there is no sharing; ratepayers receive 100% of any savings and are responsible for 100%

of any costs beyond this sharing range. In addition, a reasonableness review is triggered when actual costs fall outside of the sharing range. The allocation of savings and additional costs within the sharing range is as follows:

- If SDG&E's actual costs exceed the benchmark by 1% or less, ratepayers pay 70 % of the additional cost and shareholders pay 30%.
- If SDG&E's actual costs fall below the benchmark by 1% or less, ratepayers receive 70% of the savings and shareholders receive 30%.
- If SDG&E's actual costs exceed the benchmark by more than 1% but less than 6%, the additional costs in excess of 1% are shared equally between ratepayers and shareholders.
- If SDG&E's actual costs fall below the benchmark by more than 1% but less than 6%, the savings in excess of 1% are shared equally between ratepayers and shareholders.

Based on experience with the operation of the G&D experiment, ORA concludes that the sharing mechanism is biased in favor of shareholders because they face little downside risk yet enjoy a strong potential for gains. ORA's principal concern involves short-term firm contracts, the costs of which are included in the G&D benchmark forecast. According to ORA, bids are binding on suppliers, so SDG&E has no risk of increased costs, yet SDG&E may benefit substantially by negotiating better terms than those in the original binding offer. ORA suggests that the savings from such negotiations are not true savings.

ORA contends that in the first two years of the G&D mechanism, "actual net ratepayer savings" were minimal compared to G&D benchmark savings. Based on its estimates, ORA asserts that the total reward added to ratepayer bills based on benchmark savings was approximately $5 million, and that the ratepayers' share of actual savings was approximately $5.5 million. According to ORA, this left ratepayers with a net gain of "close to nil." To resolve this asserted inequity, ORA believes that the sharing component of the G&D mechanism should be modified by extending the 70%/30% sharing ratio throughout the plus-or-minus 6% sharing band. ORA contends that this will provide a more balanced sharing of risks between ratepayers and shareholders.

If, as ORA contends, the G&D benchmark reflects the highest possible cost for short-term firm agreements, and SDG&E is able to achieve reduced costs through negotiations with suppliers with no risk of incurring greater-than-forecast costs, then there could be a pro-shareholder bias in the G&D mechanism. Still, we are not persuaded from this limited factual record that the benchmark is significantly biased against ratepayer interests. Among other things, there is some indication that bids from suppliers of firm capacity are not as binding on suppliers as ORA suggests.

Even if the G&D benchmark were biased upwards, it is not clear that the proposed adjustments to the sharing proportions would be the correct remedy for such bias. A properly designed sharing mechanism should not only result in an equitable sharing of savings and additional costs that is consistent with the relative risks undertaken by ratepayers and shareholders; it should also induce utility management actions that benefit the common interests of ratepayers and shareholders. Even if we accepted the proposition that the proposed adjustment is more equitable because it compensates for an upward bias in the benchmark, we also need to consider the incentives that are placed before utility management. Other things being equal, reducing the sharing percentage from 50% to 30% would reduce the management incentive to negotiate more favorable contract terms. It has not been shown to our satisfaction that any disadvantages of reduced incentives that may be associated with ORA's proposal are outweighed by the benefits of its proposal.

ORA has identified a potentially troubling aspect of the G&D mechanism, but it has not demonstrated the depth of any such problem. Nor has ORA demonstrated that its solution is the most appropriate. It may be, for example, that the manner in which the benchmark is established is more problematic than the sharing proportions. If that is the case, the solution should focus on the benchmark.

The current sharing mechanism reflects a balancing of ratepayer and shareholder risks associated with the overall G&D mechanism based on information available to parties and the Commission at the time it was adopted. While we reject any argument that the sharing mechanism should be immune to adjustments because of this one-time balancing of interests, we find insufficient justification for modifying the

sharing percentages. In this respect, we generally agree with the conclusion of Vantage Consulting that "[c]hanging the sharing mechanism, at this time, appears inappropriate without a complete restructuring of the PBR mechanism." (*Final Report, Generation and Dispatch Mechanism, Gas Procurement Mechanism*, February 29, 1996, p. 60.) A major restructuring of the G&D mechanism is not warranted at this time. We will not adopt ORA's proposed modification to the sharing mechanism.

3.5. QF Contract Administration

In approving the G&D PBR experiment, D.93-06-092 eliminated the need for most aspects of traditional ECAC reasonableness reviews. With respect to QF purchases, the Commission eliminated reasonableness reviews regarding QF contract terms (i.e. quantity purchased and costs) because they are subject to standard offers or non-standard contracts that are pre-approved. D.93-06-092 also provided for pre-screening of QF contract amendments through "Reasonableness Assessment Letters." However, it did not provide for scrutiny of the company's administration of QF contract provisions, such as those governing curtailments, dispatchability, limitations on energy deliveries, efficiency standards, avoided energy and capacity postings, performance requirements during summer months, meter accuracy, meter tampering, etc.[5]

SDG&E spends over $100 million annually under QF contracts. ORA contends that SDG&E has little if any accountability concerning this expense because QF costs are trued-up under the G&D mechanism, and because ORA finds there is a disincentive for SDG&E to aggressively administer QF contracts. ORA therefore recommends that SDG&E's QF contract administration be made subject to reasonableness review.

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[5] ORA asserts that D.93-06-092 failed to address QF contract administration over the lifetime of the contracts. We note that, in a sense, the decision "addressed" the subject by stating that "QF contract administration and uranium procurement will not receive scrutiny for reasonableness unless SDG&E's overall ECAC costs deviate substantially from the forecast..." (D.93-06-092, 50 CPUC 2d 185, 198.)

To illustrate the significance of QF contract administration, ORA points out that in the reasonableness phase of A.91-09-059, undertaken at a time when SDG&E was subject to traditional ECAC proceedings, ORA recommended that $10.9 million in penalties and disallowances related to imprudent contract administration be imposed.[6] In a subsequent reasonableness review (A.93-09-049), which also covered a period when SDG&E was subject to traditional ECAC proceedings, it was disclosed that SDG&E overpaid QFs by $200,000 because the utility's Customer Energy Contracts Section applied an incorrect posting. ORA also notes that in the first year of the G&D experiment, actual QF payments were $3.5 million lower than forecast following settlement of a lawsuit with a QF. ORA is concerned that under the G&D mechanism, ratepayer interests are not represented in the resolution of such disputes.

ORA further asserts that the G&D mechanism in combination with the base rate PBR mechanism provides a disincentive for SDG&E to aggressively manage QF contracts. This is because administrative and legal expenses are base rate expenses. Yet, because of true-ups, SDG&E management actions (or inaction) relative to the administration of QF contracts can affect the amounts paid by ratepayers. ORA reasons that if a QF opposes SDG&E's contract administration efforts, SDG&E has an incentive under the base rate mechanism to minimize administrative and legal expenses even if increasing such expenses could lead to reduced QF payments that in turn benefit ratepayers.

We have sought to identify areas where competition and market discipline can function as regulators; elsewhere, where monopoly utility services remain, we have sought to replace traditional ratemaking approaches with PBR. However, it has never been our intent to simply remove an area of utility cost recovery from any and all regulatory oversight. Although we originally adopted the G&D

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[6] ORA later withdrew its disallowance/penalty recommendation when SDG&E was allowed to refile its showing on the reasonableness of QF operations, and SDG&E committed to correct the problems with QF administration that ORA identified. (D.93-04-037, 49 CPUC 2d 1, 7-8.)

mechanism with the understanding that QF contract administration would not be scrutinized, we are now of the opinion that this is a minor defect in the G&D mechanism which should be corrected.

SDG&E contends that QF contract administration is an insignificant issue. We disagree. While we accept the premise that much of the $100 million in annual QF payments is contractually required pursuant to federal and state regulations governing utility/QF relations, and therefore beyond management control, it does not follow that those ratepayer-paid expenses which management can control or influence should be exempt from any form of regulation, even if dollar amounts involved are relatively small.[7]

ORA asserts that the performance philosophy of the G&D mechanism cannot be extended to QF contracts. We are not prepared to accept this proposition. Indeed, one preferred correction would be to institute an incentive-based approach to QF contract administration. Moreover, as SDG&E points out and as ORA acknowledges, we have repeatedly indicated our desire to eliminate reasonableness reviews wherever possible. We are very reluctant to return to reasonableness reviews even for a small portion of SDG&E's operations and for a limited time, but we have not been presented with an incentive-based proposal. On an interim basis only, we accept ORA's assertion that reinstatement of QF contract administration reasonableness review is the simplest and easiest change that the Commission can make to protect ratepayers.

We note that the SDG&E/ORA MOU provides for termination of the reasonableness review which has been a part of the ECAC mechanism. We will revisit today's provision for applying traditional regulation to QF contract administration when we evaluate the MOU in A.96-10-022.

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[7] As a practical matter, we do not expect parties to litigate reasonableness issues where nominal dollar values are at issue.

In the Preferred Policy Decision we provided (at p. 130) that existing QF contracts will be honored by the remaining distribution utility. Thus, QF contract administration will likely remain an issue when industry restructuring occurs. We intend to consider incentives for SDG&E to effectively administer QF contracts in the distribution PBR application to be filed later this year pursuant to D.97-04-067.

3.6. Off-System Sales

ORA proposes that revenues from all off-system sales be included in the G&D mechanism. Along with this modification, ORA would also remove non-jurisdictional electric revenues from the base rate PBR mechanism and increase base rate revenues by $1.375 million on an annualized basis.

Currently, the benefits of economy energy sales go to ratepayers and the benefits of firm off-system sales above those estimated in general rate cases (and therefore embedded in the base rate PBR mechanism) go to shareholders. ORA believes its recommended approach would simplify regulation by eliminating debates over how sales are to be classified and by avoiding problems of allocating joint and common costs associated with off-system sales.

The issue of the proper classification and regulatory treatment of the various categories of sales has been before the Commission before and is one that generally transcends the limited scope of this proposal to extend the G&D mechanism. If the G&D mechanism were to be retained for a longer period, ORA's proposal would further the objective of regulatory simplification. However, as ORA acknowledges, its proposal would be operative only for the remaining term of the G&D mechanism. Adopting this modification in the name of regulatory simplification for only a limited time strikes us as potentially counterproductive. Accordingly, and in light of our policy of avoiding unnecessary changes in the base rate PBR experiment, we will not adopt the proposed change at this time.

3.7. AB 1890

As noted earlier, parties were given an opportunity to address the impacts of AB 1890, if any, on this matter. Among other things, the ALJ ruling asked whether

the Fuel Price Incentive Mechanism (FPIM) authorized by Public Utilities Code Section 397 affected the need for, or appropriate form of, the G&D Mechanism. In response, SDG&E suggested that the FPIM in effect replaced the G&D Mechanism. ORA on the other hand suggested that AB 1890 should not impact the G&D Mechanism for the reminder of its term. ORA points out that despite the rate cap provisions of AB 1890, SDG&E will continue incurring ECAC-related expenses until restructuring is implemented. ORA asserts that PBR or traditional cost of service regulation is necessary to regulate SDG&E's ECAC expenses for the time being.

As noted earlier, the question of continuing the G&D mechanism in light of the enactment of AB 1890 is under consideration in A.96-10-022. In their MOU, SDG&E and ORA have addressed the impact of AB 1890 more comprehensively than in their comments in this proceeding. Accordingly, we will not further consider the issue here.

Findings of Fact

1. Phase 1 issues involving the Gas Procurement mechanism were resolved by D.97-02-012, and Phase 1 issues involving the G&D mechanism are resolved by this decision.

2. It is not clear that any disadvantages of reduced incentives that may be associated with the revised sharing proportions recommended by ORA are outweighed by the potential benefits of such revisions.

3. In considering new approaches to regulation of utility rates, it has never been our intent to simply remove an area of utility cost recovery from oversight of any kind.

4. In the administration of QF contracts and enforcement of their terms, SDG&E has discretion to take actions that can impact QF expenses that are ultimately paid by ratepayers.

5. Whether to continue the G&D mechanism in effect under the provisions of AB 1890 is under consideration in A.96-10-022 pursuant to the SDG&E/ORA MOU.

Conclusions of Law

1. D.93-06-092, as modified, should be further modified to provide for an extension of the experimental G&D mechanism until no later than January 1, 1998. This extension does not preclude or prejudge earlier termination of the mechanism by order in A.96-10-022.

2. The sharing proportions adopted in D.93-06-092 remain reasonable and proper at this time.

3. Until and unless an incentive approach to QF contract administration is developed, or QF expenses are not simply trued up, QF contract administration should be subject to reasonableness review.

4. In light of the limited remaining term of the G&D Mechanism and our policy of avoiding unnecessary changes in the base rate PBR experiment, we will not adopt the proposed change in the treatment of off-system sales at this time.

5. Phase 1 of this proceeding should be concluded.

O R D E R

IT IS ORDERED that:

1. The May 24, 1996 petition by San Diego Gas & Electric Company (SDG&E) for modification of Decision (D.) 93-06-092 is granted as provided herein.

2. The Generation and Dispatch (G&D) mechanism originally adopted by D.93-06-092 and continued in effect by D.95-04-051 will remain in effect until January 1, 1998, subject to earlier termination upon order of the Commission in Application (A.) 96-10-022.

3. In the Distribution Performance-Based Ratemaking (PBR) application to be filed pursuant to D.97-04-067, SDG&E shall include an evaluation report on the fourth year of the G&D mechanism, i.e., the period ending April 30, 1997. In addition, no later than March 30, 1998, SDG&E shall submit a final evaluation report on the G&D mechanism as an updated filing in its distribution PBR proceeding.

4. To the extent that qualifying facilities (QF) payments are passed on to ratepayers through true-ups, and in the absence of an incentive-based mechanism for regulatory oversight of QF contract administration, SDG&E's administration of QF contracts is subject to reasonableness review. Such review shall take place according to existing rate case processing procedures, as those procedures may be modified from time to time. This ordering paragraph may be rescinded by order of the Commission in A.96-10-022.

5. This proceeding remains open for consideration of Phase 2 issues.

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