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Decision 97-09-046 September 3, 1997

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

ORIGINAL

Application of Pacific Gas and Electric Company for Authorization to Sell Certain Generating Plants and Related Assets Pursuant to Public Utilities Code Section 851. (U 39 E)	Application 96-11-020 (Filed November 15, 1996)

INTERIM OPINION

Summary

Pacific Gas and Electric Company (PG&E) requests authority, pursuant to Public Utilities (PU) Code Section 851, to auction and sell three[1] fossil-fuel electric generation plants by the end of 1997.

In this first interim decision PG&E requests that (a) the proposed sale of the plants be found in the public interest; (b) the proposed sale process be approved; (c) the proposed sale process be found to determine the fair market value of the plants absent some significant irregularity; and (d) the proposed accounting and ratemaking treatment of the sales be approved.

For the next phase, in a second interim decision, PG&E requests that we decide whether the agreements between PG&E and the buyers for operation and maintenance

[1] PG&E had originally proposed to sell four plants (Hunters Point, Oakland, Moss Landing, and Morro Bay), but amended its application on June 25, 1997, after the matter had been submitted, to withdraw its request for the Hunters Point Plant, which it "will be including .. in the application it will file in the next several months for authorization to sell its remaining power plants in the Bay Area – the Contra Cost [sic], Pittsburg and Potrero Power Plants" (according to PG&E's amendment). Parties were permitted to file comments on the effect of the amendment. One effect of that amendment was to remove the only disputed issues of material fact, which concerned whether the Hunters Point Plant was needed for system reliability. As a result, the proposed decision of the assigned administrative law judge (ALJ) is not currently required for purposes of PU Code Section 311(d). The ALJ's proposed decision on the original application, from which these disputed issue of material fact arose, was served on all parties on May 23, 1997.

of the plants should be approved and whether the proposed form of agreement for certain of the plants between the buyers and the Independent System Operator (ISO) should be approved.

For the third and final phase, in a final decision, PG&E requests that we approve the sale if we determine that the auction was conducted in accordance with the approved auction procedure.

We will permit PG&E to commence an auction of the plants, which will be subject to our final review and approval upon review of definitive agreements following the auction. However, PG&E may not accept final bids until we have approved a mitigated negative declaration[2] and the Federal Energy Regulatory Commission (FERC) has approved the form of agreement with the ISO.

Procedural Background

PG&E filed its application on November 15, 1996. Notice appeared in the Daily Calendar on November 19, 1996. Prehearing conferences were held on December 19, 1996 and January 13, 1997. President Conlon, as the assigned Commissioner,[3] issued a ruling (ACR) to establish a procedural schedule on February 7, 1997. An evidentiary hearing was held on March 31, 1997 (concerning an issue that had been raised only with respect to the Hunters Point Plant), and the matter was submitted on concurrent opening and reply briefs filed on April 16 and 23, 1997, respectively.

The Southeast Alliance for Environmental Justice (SAEJ) moved to modify the ACR to require an environmental impact report under the California Environmental Quality Act (CEQA) to be completed before we act on any aspect of PG&E's request, insofar as it affects the Hunters Point Plant. PG&E opposed SAEJ's motion, and the City and County of San Francisco (CCSF) supported the motion. The withdrawal of the request for authority to auction the Hunters Point Plant renders the motion moot in this

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[2] This is expected to occur after September 25, 1997.
[3] Commissioner Bilas was subsequently co-assigned.

proceeding. In any event, on August 25,1997, the Commission issued a mitigated negative declaration for comment.

Description of the Application

PG&E wishes to offer for sale three electric generation plants: Morro Bay Power Plant, Moss Landing Power Plant, and Oakland Power Plant. That wish is consistent with our Decision (D.) 95-12-063, as modified by D.96-01-009, in which we required PG&E to submit a plan to voluntarily divest itself of at least 50% of its fossil generating assets. (*Order Instituting Rulemaking/Investigation on the Commission's Own Proposed Policies Governing Restructuring California's Electric Services Industry and Reforming Regulation*, mimeo. at 223.) The three plants have a combined generating capacity of 3,632 megawatts (MW), which is approximately 45% of PG&E's fossil generation capacity. PG&E proposes to retain ownership of, and reserve easements for, the transmission facilities and lines from each of the power plants. It proposes to transfer the real and personal property (including spare parts) presently used for the operation of the plants.

As shown on the aerial photographs contained in its Addendum No. 3 to Application filed March 31, 1997, PG&E is not offering for sale two tracts in the vicinity of its Morro Bay Plant, which are separated from the plant by a divided highway, portions of which tracts are occupied by or adjacent to transmission lines. PG&E is not offering for sale a small outlying tract near the Moss Landing Plant that appears to be associated with transmission facilities. PG&E is offering all of its real property at the Oakland Power Plant. The portions of the Morro Bay and Moss Landing Plants that PG&E is retaining appear from inspection of the photographs to be more closely associated with transmission than generation facilities, and no party has raised any issue with respect to the precise property boundaries to be conveyed.

The real property will be conveyed subject to scheduled leases, licenses and permits. PG&E will include scheduled permits for each plant for equipment/facilities operation, steam boilers, pressure vessels, environmental clearances, and building and land use permits. For each plant, the tangible personal property not specifically

excluded will include all telephones and fax machines, computers, printers and related equipment, trailers and cargo containers, certain non-passenger vehicles dedicated exclusively to the plant, all office furniture and office supplies, all tools, including lathes, welding machines, shapers, milling machines, drill presses, grinders, power saws, hydraulic presses, pipe threading machines, sand blast equipment, hand trucks, dollies, testing equipment, and potable pumps, all documents related to the plant, including books, records, procedures, drawings, reports and operating data, all supplies including chemicals used for maintenance, cleaning, chlorination, water purification and chemical analysis, lube oils, and any other substance contained in tanks or other containers located on site, and all warehouse inventory. Certain software will be licensed to the buyer. For Moss Landing and Morro Bay, PG&E will transfer its shares in a mutual water company.

PG&E will assign scheduled contracts for services for each of the plants.

PG&E will not transfer personnel and employment records of PG&E personnel, employee-owned personal property, scheduled pipelines and equipment, rental equipment, certain communications systems and equipment, software and computer programs and licenses, emission reduction credits, intellectual property, insurance policies and claims, passenger vehicles or other vehicles not dedicated to plant use, environmental remediation equipment, or customer information and documents not directly and specifically relating to the plants.

On the advice of its investment banker, Morgan Stanley & Co. Incorporated, PG&E plans to sell the three plants by a competitive open auction bid process in two stages.

In the first stage, PG&E would widely advertise the sale of the plants, provide a detailed information package to each interested potential bidder, and solicit statements of interest and qualification from potential bidders. Bidders would be allowed to bid on the plants in any combination. Based on PG&E's assessment of each bidder's financial and operational qualifications and indicated bid amount, it would identify five to ten bidders for each plant for a final, binding bid process. (PG&E initially proposed that although the bid is non-binding, final bidders are required to explain and justify any

decrease in the final bid on the basis of specific information learned during the second phase of the auction based on site inspections, for example, that was not available during the first stage and could not, in the exercise of due diligence have been available to the bidder during the first stage. If PG&E could reject bids that it determined were lower than the first-stage bid without good reason. Our approval of PG&E's accepting preliminary bids is contingent upon removing this feature, to make such bids truly nonbinding.)

During the second stage of the auction, bidders would have opportunity for further due diligence and could anonymously propose changes to the form of purchase and sale agreement. Such changes might include, for example, adjustments to the exact property boundaries of the plant sites. PG&E would independently consider the proposed changes without negotiation with the proposing bidders, and issue a final form of purchase and sale agreement approximately two weeks before final bids were due. Subject to PG&E's reservation of the rights to reject all bids, if none is acceptable, and to retain the plants, if any reviewing agency imposes unacceptable conditions to the transfer, PG&E would sell each plant to the highest bidder, subject to our final approval.

Applicable Legal Standards

Section 851

No public utility may transfer its property that is necessary or useful in the performance of its duties to the public without first having secured the Commission's authorization. (PU Code § 851.) The plants are presently used to generate electricity for delivery to PG&E's system. Therefore, the plants are presently useful in the performance of PG&E's duty as a public utility, and PU Code Section 851 applies. Because we are asked to approve the sale this year, we need not consider whether the plants might or might not continue to be useful or necessary following implementation of the Power Exchange (PX) and ISO next year. Furthermore, we express no opinion about the future disposition, if any, of unsold generation-related assets (such as emissions reduction credits), which will be subject to future Section 851 applications in

connection with any transfer. With respect to all generation-related property associated with the plants that PG&E proposes to exclude from the auction, we will require that PG&E either file an application to sell all such property pursuant to PU Code Section 851 or file an application to retain the property, pursuant to PU Code Section 377 (including appropriate evidence of market valuation). We encourage PG&E to sell as much of its property related to the plants as possible.

Section 362

In proceedings pursuant to Section 851, we must ensure that "facilities needed to maintain the reliability of the electric supply remain available and operational, consistent with maintaining open competition and avoiding an overconcentration of market power." (PU Code § 362.) "In order to determine whether a facility needs to remain available and operational, the [C]ommission shall utilize standards that are no less stringent that [sic] the Western Systems Coordinating Council and North American Electric Reliability Counsel standards for planning reserve criteria." (*Id.*) The parties refer to such facilities as "must-run."

One of our main concerns in reviewing the sale of the plants is market power. In addition to the dimension of locational market power, which is encompassed by "maintaining open competition," we are also greatly concerned that the sale promote increased competition in the entire wholesale and retail energy market, which is partially encompassed by "avoiding an overconcentration of market power." In the second interim opinion, we will focus on the role of the agreements with the ISO in maintaining open competition. When we know the results of the auction, we will be in a position to determine whether the outcome raises any overconcentration issue or other market power issue.

We caution all bidders that in making our final determination, we will not approve any sale that merely changes the identity of the possessor of market power from PG&E to another entity.

Section 377

PU Code Section 377 provides that we "shall continue to regulate the nonnuclear generation assets owned by any public utility prior to January 1, 1997, that are subject to [C]ommission regulation until those assets have been subject to market valuation in accordance with procedures established by the [C]ommission."

CEQA

CEQA applies to discretionary approvals of activities that may cause a direct physical change in the environment or a reasonably foreseeable indirect physical change in the environment and that are undertaken by a person who receives contracts, grants, subsidies, loans, or other forms of assistance from one or more public agencies or the issuance of a lease, permit, or other entitlement for use. (Public Resources (PR) Code § 21065.) Such activities are termed "projects."

Because a purported transfer of utility property that is useful or necessary to the performance of the utility's duties requires our prior approval pursuant to PU Code Section 851, our approval is an "entitlement for use."

On August 25, 1997, the Commission's Energy Division issued a notice of the Commission's intent to issue a mitigated negative declaration. Comments will be received by September 25, 1997, at which time it will be possible to know if all of the potential adverse environmental effects of the transfer of the plants can be avoided or reduced to a non-significant level by imposing appropriate conditions on the transfer. It would be inappropriate for PG&E to accept final bids until the specific environmental mitigation measures that may be required are known and approved by a decision of

this Commission, because the resulting uncertainty would have a natural tendency to depress bid prices.

We will deny SAEJ's motion to prepare an EIR without prejudice, as moot.

Effect on Reliability of the Electric Supply

PG&E presented evidence, that no party disputes, to show that the Morro Bay Power Plant will be needed neither for local voltage support nor to meet applicable planning reserve criteria. It is also undisputed that the Moss Landing Power Plant and the Oakland Power Plant are needed to maintain the reliability of the electric supply.

We will take up the means by which the Oakland Plant and the Moss Landing Plant are to be ensured to remain available and operational in our second interim opinion consistent with maintaining open competition, and we will decide in our final opinion whether doing so is consistent with avoiding an overconcentration of market power. No transfer of the plants can take place until we have concluded that the proposed condition of sale that would make the two must-run plants subject to a contract with the ISO is adequate to ensure that such plants remain available and operational in a way that is consistent with market power issues.

The Office of Ratepayer Advocates (ORA) suggests that we permit the auction of the Morro Bay Plant to proceed as soon as CEQA review permits, but to delay auction of the other plants until the FERC has finally approved the form of agreement with the ISO. This is a sound recommendation because it will reduce uncertainty for the buyers as to the exact obligations that will be imposed for the must-run plants. In light of PG&E's plans to conduct a single auction for the purpose of maximizing bidder interest, however, we will not permit PG&E to accept final bids until the FERC has approved the form of agreement with the ISO.[5]

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[5] We recognize that in light of the current status of proceedings before the FERC, a substantial delay in the bidding may result from this restriction.

Whether the Proposed Sale Process Should be Approved

Non-price Issues

CCSF criticizes the proposed auction process because it does not allow consideration of non-price issues. CCSF suggests that "the Commission should require PG&E to incorporate into its auction process solicitation of information on non-price issues from bidders, and an opportunity to review and consider such information in selecting a winner." Specifically, CCSF wants to have a proposed purchaser's plans for a plant, and the economic and environmental consequences of those plans, taken into account CCSF cites *In re application of Pacific Greyhound Lines, Inc.* 52 CPUC 2 (1952) and *In re application of Marion Lee (Pacific Paging Co.)* 65 CPUC 635 (1966). However, those cases have no application when the prospective transferee will not be operating the plants as a public utility. Otherwise, we should find ourselves engaged, for example, in weighing whether PG&E should be permitted to transfer surplus real property interests in fee simple to one non-utility use, such as a drugstore, rather than another non-utility use, such as a tax preparation service. (*See In re application of Pacific Gas and Electric Co. (Berkeley Land Co.)* D.97-05-028.) CCSF's suggestion that we should require non-price factors will be adequately addressed in our second interim and final opinions, when we take up reliability issues and the issues of competition, market power, and the environment, respectively.

First-stage Site Visits

ORA asks us to require PG&E to permit prospective bidders to visit plant sites in the first stage of the auction, instead of waiting until the number of potential bidders has been reduced for the second stage. PG&E opposes site visits from the larger group of potentially qualified bidders in the first stage. PG&E believes that coordinating and conducting visits for approximately 40 bidders would require a great deal of time and effort and would disrupt plant operations. In addition, PG&E is concerned that an open house at each plant would lead to the bidders discovering each other's identities. Apparently, the evil that results from this more complete knowledge is that bidders

would be less likely to bid aggressively if they know the competition than if they must assume that competition will be much more vigorous.

Neither argument is very convincing. A walk-through of the site is no substitute for due diligence and the thorough site visit that a prudent buyer would insist upon prior to making a final bid. Nor is the notion that avoiding a site visit will keep potential bidders in the dark worthy of much more credit. It is a minor point, however, and we will not require first-stage site visits.

Minimum Bids/Absolute Auction

ORA suggests that PG&E be required to sell to the highest bidder unless all bids are far below a sealed minimum bid based upon some estimate of market value. AES Pacific, Inc. (AES) also recommends that a minimum bid should be required. PG&E opposes both the requirement for a minimum bid and for an absolute auction. The auction serves a purpose apart from reducing PG&E's market power through divestiture (to whatever extent it does reduce PG&E's market power). That purpose is a market valuation of the plants. A properly conducted auction that results in a completed sale will determine market value in the most direct manner possible. (At a minimum, properly conducted auction would be one in which the property to be sold has been actively exposed to potential buyers, the qualified buyers have been given equal access to relevant information about the property, all buyers are bidding on the basis of the same transaction documents, and the procedures for receiving bids are known in advance to all participants. In short, it is a fair process in which all potential buyers vie in competition. That competition gives assurance that the price arrived at is an objective one.) A minimum bid, by contrast, would represent merely an estimate of market value. In the absence of evidence that bidding at the auction as designed will necessarily be too thin to determine market value, we will not require a minimum bid. PG&E's retention of the right to reject bids in the event of irregularities in the auction process and our own final review provide adequate assurance that plants will not be divested as a result of an auction process that failed to produce serious bids.

Nor will we require an absolute auction. (PU Code § 377.) In view of PG&E's statements that it to sell substantially all of it fossil-fuel generation business within its existing service territory, we would be surprised if PG&E attempted to retain any of the plants for which it had received bona fide bids. Therefore, should PG&E elect to retain any plant, the results of the auction may be evidence of, but shall not determine, the valuation, and we shall determine the fair market value of such plants by other means for purposes of our determination under PU Code Section 377. An auction conducted for a purpose other than a sale could have its integrity compromised in ways that we cannot foresee before seeing the results of the auction. However, we will not convert our request for voluntary divestiture in D.95-12-063 into a mandatory requirement by requiring an absolute auction. If PG&E elects to retain one or more of the plants following the auction, it will have to show that it would be in the public interest to permit it to do so.

Real Property Covenant

ORA opposes PG&E's proposed real property covenant that would restrict the use of the plant site to uses other than permanent or temporary lodging, hospitals or other health-care facilities, schools, day-care centers for children, parks, playgrounds or other recreational uses or any uses that would require more extensive or additional remediation of any existing environmental contamination at the plants or could enhance the risk of human exposure to certain hazardous substances. The covenant would have the effect of restricting future uses of the plant to low-occupancy commercial and industrial uses.

PG&E's purpose in requiring this covenant is to limit potential cost to ratepayers for environmental indemnification. Although PG&E will be conducting environmental remediation at the sites, it is not feasible to entirely eliminate all possibility of remaining environmental contamination. For example, remediation might result in reducing the concentration of a particular contaminant to 1 part per million in the groundwater, which could be considered a non-hazardous level under existing regulation. New studies might result in that non-hazardous level being reduced by a

factor of 1,000, to 1 part per billion. For that reason, it is prudent to avoid future land uses that pose more risk of human exposure through the use of real property covenants.

Under applicable state and federal law, current and past property owners are jointly and severally liable for environmental contamination. In any real property transfer, therefore, parties have to deal with the issue of mutual indemnification because the possibility of existing and future contamination cannot be totally eliminated. From the seller's perspective, it makes sense to assume the obligation to indemnify the buyer for contamination prior to the closing in exchange for an indemnification from the buyer for contamination after the closing.

PG&E will, however, entertain proposals from second-stage bidders to remove this restriction[6] in the event that they are seeking to acquire the plants for redevelopment to non-electrical generation uses.

Whether the Proposed Sale Process will Result in Determining the Fair Market Value of the Plants

Aside from ORA's suggestion that first-stage site visits would be beneficial, which we have decided is not necessary, no party disputes that the proposed sale process, if consummated, will result in determining the fair market value of the plants absent some significant irregularity.

Whether the Proposed Accounting and Ratemaking Treatment Should be Approved

No party disputes PG&E's proposed accounting and ratemaking treatment of the sales. ORA recommends that PG&E's proposed treatment be approved. As described in the application, upon sale the plant in service and plant-related costs[7] will be removed from rate base and the associated accumulated depreciation will be removed from the depreciation reserve. The net book value of the facility (which shall be determined in

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[6] And to make an appropriate adjustment in the environmental indemnity required by PG&E.
[7] These consist of related inventory, tax-related adjustments, and Construction Work in Progress, but not decommissioning, which PG&E proposes to have treated in a separate subaccount for competitive transition charge purposes.

Application (A.) 96-08-001 *et al.*) will be subtracted from sale proceeds after transaction costs and the difference credited or debited to PG&E's proposed CTC Revenue Account, consideration of which is now pending in A.96-08-070. With respect to environmental remediation costs, PG&E will prepare a forecast based on Phase II environmental testing on site and use that forecast to adjust the current decommissioning cost estimate. PG&E will file its estimated environmental remediation costs in a subsequent application and request recovery of those estimated costs. Under PG&E's proposal, the costs authorized to be recovered will not be trued-up to adjust for actual costs. We adopt this ratemaking proposal put forth by PG&E in concept in this decision, but will grant a final approval of it only after PG&E files the actual estimates and provides us with information on who these estimates are derived and what types of contingencies are built into these estimates. Finally, PG&E proposes to retain revenues from the required two-year operations and maintenance contract for each plant, up to its actual costs. PG&E would absorb any deficiency and credit any excess to the CTC Revenue Account.

Findings of Fact

1. PG&E is an electric utility subject to the jurisdiction of the Commission.

2. Morro Bay Power Plant, Moss Landing Power Plant, and Oakland Power Plant are presently used in the performance of PG&E's duties as a public utility.

3. It is reasonable to consider PG&E's application in phases, in light of the proposed auction form of transaction.

4. It is reasonable to permit PG&E commence an auction, but without more certainty as to the environmental mitigation measures that will be required as a condition of transfer and approval of the form of agreement with the ISO by the FERC, it would not be reasonable for PG&E to accept final bids.

5. PG&E has designed an auction process that will, absent significant irregularity, establish the market value of the Morro Bay Power Plant, Moss Landing Power Plant, and Oakland Power Plant upon sale of the plants.

6. No party disputes PG&E's proposed accounting and ratemaking treatment of the sales.

7. The Morro Bay Power Plant will be needed neither for local voltage support nor to meet applicable planning reserve criteria.

8. For purposes of PU Code Section 362, the Moss Landing Power Plant and the Oakland Power Plant are needed to maintain the reliability of the electric supply.

Conclusions of Law

1. The sales of the Morro Bay Power Plant, Moss Landing Power Plant, and Oakland Power Plant are subject to PU Code Section 851.

2. In proceedings pursuant to Section 851, we must ensure that facilities needed to maintain the reliability of the electric supply remain available and operational, consistent with maintaining open competition and avoiding an overconcentration of market power.

3. We should determine whether the Moss Landing Power Plant and the Oakland Power Plant remain available and operational in a subsequent decision, prior to the consummation of any sale of those plants.

4. The sales of the Morro Bay Power Plant, Moss Landing Power Plant, and Oakland Power Plant are consistent with the policies underlying D.95-12-053, as modified by D.96-01-009, and expressed in Assembly Bill (AB) 1890 (1996 Stats. ch. 854).

5. PG&E should be permitted to commence an auction, but should not be permitted to solicit final bids until we have adopted a negative declaration and the FERC has approved the form of agreement with the ISO.

6. The auction and sale of the plants will, absent some significant irregularity, determine the market valuation of the plants for purposes of PU Code Section 377.

7. If the plants are sold, and if PG&E's proposed CTC Revenue Account is approved in A. 96-08-070, PG&E's proposed accounting and ratemaking treatment should be approved; provided, however, that if the CTC Revenue Account is not