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Decision 97-11-017 November 5, 1997

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of Southern California Edison Company (U 338-E) To Adopt The Performance Based Ratemaking and Incentive Based Ratemaking Mechanisms Specified in D.95-12-063, as Modified by D.96-01-009, and Related Changes.	Application 96-07-009 (Filed July 15, 1996)
Application Of Pacific Gas and Electric Company To Adopt Performance-Based Ratemaking (PBR) For Generation And To Change Electric Revenue Requirements Subject To PBR, Effective January 1, 1998. (Electric) (U 39 E)	Application 96-07-018 (Filed July 15, 1996)

OPINION ON SOUTHERN CALIFORNIA EDISON COMPANY'S CONTINGENCY PROPOSAL FOR COST RECOVERY FOR GAS-FIRED GENERATION

Summary

The Commission determines that the proposal of Southern California Edison Company (Edison) for approval of a contingency cost recovery plan that would remain in effect while divestiture of its non-must-run gas-fired generating plants is pending is not permitted under governing statutes. The proposal is dismissed, since the Commission does not have authority to approve it.

Summary of Edison's Proposal

Edison has proposed an interim cost recovery mechanism for the operation of certain of its gas-fired generating units after January 1, 1998. The mechanism is proposed on a contingency basis only, as Edison plans to divest all of its gas-fired

generation units by January 1, 1998.[1] The proposal does not involve must-run generating units, i.e., those that will be designated by the Independent System Operator (ISO) as needed for its reliability purposes.

Edison asserts that timely divestiture of its gas-fired units by January 1, 1998 is threatened due to circumstances beyond its control. The first is a decision by the ISO to base the identification of must-run generation upon an independent consultant study rather than studies previously conducted by utilities. The other circumstance is a delay in Edison's divestiture application associated with the environmental review process required by the California Environmental Quality Act. Edison contends that neither Assembly Bill (AB) 1890 (Stats. 1996, Ch. 854) nor the Commission's "Preferred Policy Decision" for electric restructuring (Decision (D.) 95-12-063, as modified by D.96-01-009) contemplated these delays in divestiture.

Edison believes there is a possibility that it may be strongly encouraged or even required to operate its non-must-run plants after January 1, 1998 and until divestiture is completed. According to Edison, such a "utility-like" obligation could be created either by order of the Federal Energy Regulatory Commission (FERC) as a market power mitigation measure, or by order of this Commission to address reliability concerns expressed in Section 363 or to support asset sale value.[2] Edison contends that being subjected to such an obligation is inconsistent with cost recovery through market revenues alone. It therefore proposes interim cost recovery through memorandum account recording of Power Exchange (PX)and ISO contract revenues and operation and maintenance (O&M) and fuel costs associated with the operation of these non-must-run plants. The mechanism would be implemented January 1, 1998 if divestiture

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[1] Edison has filed Application (A.) 96-11-046 for authority to divest these plants.

[2] All section references are to the Public Utilities Code.

is not completed by then, and would remain in effect until divestiture of non-must-run generation is completed. Edison describes the proposed mechanism as follows:

> "Specifically, Edison would record the O&M and fuel costs of continuing to operate the non-must-run gas-fired plants pending divestiture. These plants would be eligible to sell energy and ancillary services to the PX and ISO. When doing so, they would be subject to Edison's proposed market power mitigation mechanism at the FERC, which would require that revenues from such sales cannot be less than recorded variable costs over a rolling two-week period. To the extent Edison successfully sells energy and ancillary services under the new market structure, Edison would record these revenues along with the actual O&M and fuel costs of continued operation into a memorandum account. This would not affect the method for calculating ongoing recovery of costs in CTC [competition transition charge] that Edison has proposed in its testimony in the CTC proceeding, nor would it result in any double counting. When a generation plant is ultimately divested, the contents of the memorandum account would be either deducted from or added to the sales prices, depending on whether there were cumulative net costs or net benefits from operations, and accordingly credited to either shareholders or customers respectively." *Generation Performance Based Ratemaking Testimony*, June 11, 1997, pp. 72-73.

Procedural Background

At a prehearing conference held on June 23, 1997, several parties took the position that the Commission has no authority to approve Edison's contingency proposal. A *Joint Ruling of Assigned Commissioner and Administrative Law Judge* dated June 25, 1997 provided for briefing on the threshold legal question of whether AB 1890, including especially Section 367(c), permits or precludes the mechanism. Opening briefs were filed by Edison and jointly by the Energy Producers and Users Coalition, the Cogeneration Association of California, the California Cogeneration Council, the California Farm Bureau Federation, the California Industrial Users, the California Large Energy Consumers Association, the California Manufacturers Association, the Independent Energy Producers Association, and the Office of Ratepayer Advocates

(ORA) (collectively, Joint Parties). Replies were filed by Edison, Pacific Gas and Electric Company (PG&E), the Joint Parties, ORA, and James Weil.[3]

Discussion

Policy arguments pertaining to Edison's contingency proposal are not directly at issue. The immediate question is whether the proposed mechanism is allowed under AB 1890. As explained below, we conclude that it is not allowed, and the Commission does not have authority to approve the plan.

Applicability of Section 367(c)

Section 367 establishes a Commission duty to identify and determine the uneconomic costs of generation-related assets and obligations which will be recovered from all ratepayers on a nonbypassable basis. With respect to utility-owned fossil generation, Section 367(c) provides that these uneconomic costs shall be limited to the uneconomic portion of the net book value of the capital investment as of January 1, 1998, and appropriate capital addition costs incurred after December 20, 1995. Section 367(c) further provides that:

> "All 'going forward costs' of fossil plant operation, including operation and maintenance, administrative and general, fuel and fuel transportation costs, shall be recovered solely from independent Power Exchange Revenues or from contracts with the Independent System Operator...."[4]

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[3] Although it supports the legal arguments made in the Joint Parties' reply brief, ORA filed a separate reply brief to address Edison's contention that delays in divestiture of its plants are due solely to events beyond Edison's control.

[4] There are two statutory exceptions to this limitation on cost recovery. The first pertains to the operation of plants or units deemed needed for reactive power/voltage support by the ISO. The second pertains to certain costs of fuel and fuel transportation contracts that were executed as of December 20, 1995 by an electrical corporation that served at least four million customers and was also a gas corporation that served fewer than four thousand customers as of that date (i.e., Edison).

The central dispute is whether the limitation on recovery of going forward costs in Section 367(c) applies to the operation of non-must-run plants for which Edison seeks cost recovery. Edison acknowledges that going forward costs may not be recovered through a competition transition charge (CTC). However, Edison takes the position that the purpose of Section 367 is to delineate the categories of generation costs that are and are not eligible for recovery through a CTC. Edison argues that the Commission is not precluded from approving an alternative cost recovery mechanism that does not involve cost recovery through a CTC.

The language in Section 367(c) quoted above is unambiguous. The fact that it is contained within a code section which provides for determination of uneconomic generation costs that may be recovered from ratepayers does not change its meaning or effect. With exceptions which are not at issue in this analysis, the utility's *sole* permissible sources of cost recovery for *all* going forward costs of its fossil plants, including gas-fired plants, are ISO contracts and the PX. The Legislature has precluded guaranteed recovery of going forward costs from ratepayers.

Scope of Going Forward Costs

Edison argues that the fuel and O&M costs associated with the required or strongly-encouraged operation of non-must-run plants are not going forward costs but are, instead, the costs of delayed divestiture. Therefore, in Edison's opinion, the limitation on recovery of going forward costs is inapplicable to its proposal.

This argument cannot be upheld. The above-quoted portion of Section 367(c) makes no distinctions in cost categories that depend upon the status of asset divestiture. Edison proposes a mechanism for recovering O&M and fuel costs. These costs are specifically included among the categories of going forward costs listed in Section 367(c) for which the Legislature limited cost recovery to two possible sources. The status of the market valuation and divestiture process, whether the Legislature

foresaw the possibility of delays in divestiture, and whether the utility is blameless for any such delays, have no bearing on this requirement.[5]

We find no basis for the claim that delays in Edison's divestiture plans transform the O&M and fuel costs incurred by operating non-must-run plants into something other than going forward costs.

Effect of Section 390

Section 390 provides for state regulation of energy prices paid by electric utilities to nonutility power generators. At first, short-run avoided cost energy payments will be based upon a gas price indexing methodology. Once two requirements in Section 390(c) are fulfilled, energy payments must be based upon the PX clearing price. The first requirement is that the Commission must determine that the PX is functioning properly. The second requirement is as follows:

> "either (2) the fossil-fired generation units owned, directly or indirectly, by the public utility electrical corporation are authorized to charge market-based rates and the 'going forward' costs of those units are being recovered solely through the clearing prices paid by the independent Power Exchange or from contracts with the Independent System Operator, whether those contracts are market-based or based on operating costs for particular utility-owned power plant units and at particular times when reactive power/voltage support is not yet procurable at market-based rates at locations where it is needed, and are not being recovered directly or indirectly through any other source, or (3) the public utility electrical corporation has divested 90 percent of its gas-fired generation facilities that were operated to meet load in 1994 and 1995."

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[5] Even if it were relevant, the claim that the Legislature (or this Commission) did not anticipate the possibility that divestiture of all gas-fired generation assets would not be completed by January 1, 1998 is not supported by the facts, as ORA has demonstrated. Edison filed its Section 851 divestiture application in November 1996, *after* AB 1890 was enacted. AB 1890 addressed divestiture in certain respects but it did not mandate divestiture of all gas-fired plants by January 1, 1998. It is more reasonable to conclude that the Legislature expected that utilities might continue to own at least a portion of their gas-fired generation for some time after January 1, 1998.

Edison contends that Section 367(c) must be read in light of, and harmonized with, Section 390(c) because both sections use the concept of going forward costs. Edison believes that Section 390(c) expressly recognizes that a utility might not be recovering going forward costs solely from the PX or ISO contracts even though the PX may be functioning properly. Edison argues that if Section 367(c) prohibited recovery of going forward costs from any source other than the PX or ISO contracts, Section 390(c) would have simply provided that energy payments would be set at the PX clearing price as soon as the Commission finds that the PX is functioning properly. There would be no reason for a finding that the utility is recovering all going forward costs solely from the PX or ISO contracts. Finally, Edison contends that the alternative test, which provides for PX-based energy payments if the PX is found to be functioning properly and the utility has divested 90% of its gas-fired generation capacity, would be rendered meaningless if there can never be a circumstance in which the PX is operating and the utility is recovering its going forward costs from any source other than the PX and ISO contracts.

As the Joint Parties note, the Section 390(c) criterion which addresses going forward costs applies to both must-run and non-must-run plants. Section 390(c) necessarily considers more than PX and ISO contract cost recovery alone. It also considers CTC recovery of going forward costs for must-run units. Also, in considering scenarios in which going forward costs are not recovered from PX and ISO contract revenues, Section 390(c) takes into account Section 367(c)(2), which deals with recovery of certain fuel and fuel transportation contract costs. Thus, while it is true that Section 390(c) contemplates recovery of going forward costs through means other than the PX or ISO contracts, those alternatives relate solely to must-run units and certain fuel and fuel transportation contract costs.

Section 367(c) addresses utility cost recovery, while Section 390 addresses energy payments to non-utility generators. We find no need to interpret the clear language of Section 367(c) so that it is "harmonized" it with Section 390 in the manner proposed by Edison. Even if Section 390 contemplated the possibility that a utility could be operating a non-must-run plant without recovering its O&M and fuel costs solely from

the market, Edison cites, and we know of, no principle of statutory construction which requires the strained interpretation of Section 367(c) we are asked to approve.

Effect of Sections 216(h) and 377

As we noted in D.97-04-042, AB 1890 provides that we have continuing authority for regulation of utility-owned fossil plants in accordance with Sections 216(h) and 377. (D.97-04-042, Conclusion of Law 2, slip op., p. 22.) Edison asserts that this authority provides us with discretion to approve its contingency plan.

Even though we retain jurisdiction and regulatory responsibilities with respect to utility-owned generation assets until those assets have undergone market valuation, and the Commission's authority to regulate generation during the transition to a competitive market is broad, that authority is not unlimited. The Commission may not, based upon its general powers, disregard express legislative direction such as that stated in Section 367(c). (*Pacific Telephone and Telegraph Co. v. Public Utilities Commission* (1965) 62 Cal.2d 634, 653; see *Assembly of the State of California v. Public Utilities Commission* (1995) 12 Cal.4th 87, 103.)

Effect of Sections 330 and 362

Section 330 sets forth legislative findings and declarations which are to be used as guidance in carrying out the electric restructuring statutes. Subdivisions l(1) and l(2) confirm our conclusions that the transition to competition in generation should be accomplished through market valuation mechanisms and that there is a need to assure that market participants are not able to exercise significant market power. Subdivision (t) provides for an orderly and expeditious transition to a competitive generation market. Section 362 requires the Commission, in proceedings brought under Sections 455.5, 851, or 854, to ensure that facilities needed for reliability of electric supply remain available and operational consistent with maintaining competition and avoiding excessive market power concentration.

Edison asserts that these provisions of AB 1890 indicate that, in the context of divestiture to facilitate a competitive generation market, the Legislature did not intend to preclude an interim cost recovery mechanism. We cannot agree. AB 1890 comprises a comprehensive set of legislative findings and declarations and implementing statutes

that reflect a complex balancing of sometimes competing goals and objectives for restructuring of the electric services industry. It is unreasonable to assume that the Legislature failed to implement its preferred balancing of goals and objectives when it drafted Section 367(c). Notwithstanding legislative concerns regarding safety, reliability, market power, etc., precluding a cost recovery mechanism such as that proposed by Edison is exactly what the Legislature intended.

Two-Year O&M Contracts

Section 363 establishes a Commission duty, in Section 851 proceedings involving the sale of utility-owned generation facilities, to require that the selling utility contract with the purchaser for the seller to operate and maintain the facility for at least two years if the new owner chooses to operate the facility. Edison asserts that while the intent of Section 363 is to retain the services of experienced employees to assure a reliable transition in the initial period of new ownership, it will have a strong reason to reduce generating plant staffing if it is unable to recover costs as proposed. Edison further suggests that a new owners' discretion under Section 363 to determine whether it will shut down a plant could be prejudiced by a short-term decision by Edison to radically reduce staffing levels in early 1998. Edison claims these results are inconsistent with legislative intent in Section 363.

As noted earlier, we believe the Legislature carefully weighed safety and reliability concerns embodied in Section 363 when its enacted AB1890. We have no basis for concluding that the Legislature failed to consider these concerns when it enacted Section 367(c).

The Taking Issue

Citing *FPC v. Hope Natural Gas* (1944) 320 U.S. 591, *Brooks-Scanlon Co. v. Railroad Commissioner* (1920) 251 U.S. 396, 399, and *Duquesne Light Co. v. Barasch*, (1989) 488 U.S. 299, 309, Edison argues that if it is required by regulatory mandate to operate generation at a loss, a serious constitutional issue is raised under the Takings Clause of the Fifth Amendment to the United States Constitution and Article I, Section 19 of the California Constitution. Edison further argues that, pursuant to the Ninth Circuit's holding in *Mountain Water Co. v. Montana Dep't. of Public Serv. Regulation* (1990) 919 F.2d

593, failure to permit full recovery, from ratepayers, of all costs incurred under a specific mandate or policy to operate generation would constitute an unlawful taking.

Edison argues that under the principles of statutory construction established in *Ashwander v. Tennessee Valley Auth.* (1936) 297 U.S. 288, 347, and *Rust v. Sullivan* (1990) 500 U.S. 173, 190-91, interpretations which would require the Commission to address serious constitutional issues should be avoided in favor of interpretations that do not jeopardize the constitutionality of the statute. Edison contends that we should interpret Section 367(c) in a manner which avoids this problem.

In relying upon *Ashwander and Rust*, Edison incorrectly assumes that a reasonable interpretation of Section 367(c) exists which would avoid its asserted constitutional problem. However, for the reasons discussed at length earlier, we find no basis for interpreting the relevant portions of Section 367(c) other than by applying the unambiguous wording of the statute. In any event, Edison has not demonstrated that limiting cost recovery for non-must-run generation operations to PX revenues and ISO contracts necessarily causes an impermissible taking. As we stated in the Preferred Policy Decision,

> "we are not required to guarantee full transition cost recovery. We are required only to design a rate structure the total impact of which provides the utilities with the opportunity to earn a fair return on their investment. (*Duquesne Light Co. v. Barasch* (1989) 488 U.S. 299.)" (D.95-12-063, as modified by D.96-01-009, slip op., p. 123.)

In D.97-02-021, our order modifying and denying rehearing of the Preferred Policy Decision, we considered several taking arguments made by PG&E concerning the restructuring decision's treatment of fossil generation assets. PG&E claimed that a confiscation had occurred because various fossil plant costs would not be recoverable other than through the PX spot price. Referring to Section 367(c), we stated:

> "Thus, AB 1890 controls recovery of the various fossil plant costs, and thus, this Commission need not address the taking issue raised on these same costs in PG&E's application for rehearing of the Preferred Policy Decision. The issue is moot." (D.97-02-021, slip op. p. 31.)

Accordingly, the Commission has already determined that taking issues associated with a requirement that the utility's recovery of fossil plant costs be limited to market revenues are made moot by the enactment of Section 367(c).

In light of the foregoing discussion, and consistent with our holding (in D.97-04-042, slip op., p. 19) that "utilities should have reasonable discretion to shut down plants that are deemed too costly to run and that are not needed for reliability," we agree with PG&E that it would be appropriate to coordinate with FERC to ensure that utilities have the reasonable freedom to shut down non-must-run fossil plants.

Findings of Fact

1. With exceptions which are not at issue, Section 367(c) limits a utility's recovery of the going forward costs of operating its non-must-run fossil generation to revenues from the PX and ISO contracts.

2. O&M and fuel costs that Edison would incur in operating non-must-run gas-fired generating plants are included among the categories of going forward costs listed in Section 367(c), and neither the existence of or status of divestiture plans by Edison has any effect on the categorization of O&M and fuel costs as going forward costs.

3. Edison's proposal provides for recovery of certain of the going forward costs of operating its non-must-run gas-fired generation units from a source other than PX or ISO contract revenues.

Conclusions of Law

1. There is no ambiguity in Section 367(c)'s limitation on going forward cost recovery that warrants an interpretation based upon other provisions of AB 1890 that address safety, reliability, and market power concerns.

2. Edison's proposed interim mechanism for cost recovery for the operation of its non-must-run gas-fired generating plants is not permitted under Section 367(c).

3. The Commission does not have authority to approve Edison's proposal, which should therefore be dismissed with prejudice.

O R D E R

IT IS ORDERED that Southern California Edison Company's request for approval of its contingency cost recovery plan for operation of its non-must-run gas-fired generating plants is dismissed with prejudice.

This order is effective today.

Dated November 5, 1997, at San Francisco, California.

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