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Decision 97-11-030 November 5, 1997

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

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)	ORIGINAL 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 fossil-fuel electric generation plants by the end of 1997. For this interim decision that PG&E requests that (a) the Master Must-Run Agreement (MMRA), in the form filed by the Independent System Operator (ISO) with the Federal Energy Regulatory Commission (FERC) on March 31, 1997, be determined to be sufficient to ensure that plants required for the reliable operation of the transmission system remain available and operational, pursuant to PU Code Section 362, and (b) the proposed form of Operations and Maintenance Agreement, by which PG&E would have the obligation to operate and maintain transferred plants for a period of two years following any transfer, be found reasonable to PG&E, as seller, and the buyer, pursuant to PU Code Section 363(a).

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,[1] issued a

[1] Commissioner Bilas was subsequently co-assigned.

ruling (ACR) to establish a procedural schedule on February 7, 1997. No disputed issues of material fact were presented for the second interim decision, and the matter was submitted on concurrent opening and reply briefs filed on June 16 and 23, 1997, respectively. On June 25, 1997, PG&E amended its application to withdraw its request to sell the Hunters Point Power Plant. In our first interim decision (D.) 97-09-046, we determined that PG&E should be permitted to proceed with the auction while we completed review under the California Environmental Quality Act (D.97-10-058) and considered the issues in this interim opinion. We also granted PG&E's request to withdraw the Hunter's Point Plant from first PG&E's auction. In a final decision, we will consider whether to permit transfer of the plants to the successful bidder, based on the auction results.

Description of the Issues for this Interim Opinion

PG&E wishes to offer for sale three electric generation plants pursuant to PU Section 851: Morro Bay Power Plant, Moss Landing Power Plant, and Oakland Power Plant. 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." In our first interim decision, we determined that the Morro Bay Power Plant will be needed neither for local voltage support nor to meet applicable planning reserve criteria, but that the Moss Landing Power Plant and the Oakland Power Plant are needed to maintain the reliability of the electric supply.[2] PG&E proposes to ensure that these two "must-run" plants remain available and operational by requiring, as a condition of sale, that the purchaser of each plant enter into an MMRA with the ISO. The question thus presented is whether the means proposed ensure that "facilities

[2] In making this determination, we recognize that the ISO will ultimately determine which units are needed as must-run units for the reliability of the transmission system.

needed to maintain the reliability of the electric supply remain available and operational, consistent with maintaining open competition." (PU Code § 362.) In our first interim decision, we determined that until the outcome of the auction was known, it would not be possible to determine whether the MMRA would be consistent with "avoiding an overconcentration of market power," which is another test in PU Code Section 362, because we would need to know what other generation assets the buyer controlled.

PU Code Section 363(a) requires that we impose as a condition of sale on the three plants that the selling utility contract with the purchaser of the facility for the selling utility, an affiliate, or a successor corporation to operate and maintain the facility for at least two years and that the contracts be reasonable for both the seller and the buyer.

Whether the MMRA Ensures the Continued Availability and Operation of the Two Must-Run Plants Consistent with Maintaining Open Competition

Continued Availability and Operation

Description of the MMRA

The MMRA is a bilateral contract between the owner of an electric generating facility and the ISO that permits the ISO to call upon the facility to deliver electricity into the transmission grid, at the times and in the quantities specified by the ISO, and sets out the respective rights and duties of the ISO and the owner. Its essential features are that it is governed by California law, terminable for convenience by the ISO, but not the owner, on 90 days' notice, and renewable for successive terms at the option of the ISO, and it permits the dispatch and payment obligations to be switched among three different regimes at the option of the ISO or the owner under various circumstances.

The three regimes, referred to as "As Called," "Full Recovery with Credit Back," and "Full Recovery with Dedicated Facility," implement three different levels of market participation by the facility.

The default regime is "As Called." Under this form of MMRA, the ISO has the right to direct that the units of a plant be dispatched on a daily or hourly basis to deliver energy and/or ancillary services (such as spinning reserve or voltage support). The owner has the right to receive payments for operation under ISO dispatch, at rates to be determined by the FERC. The owner must be licensed to operate the facility by the FERC. The owner is free to enter into market transactions for energy or ancillary services at all other times. The owner has the duty to maintain the units and to notify the ISO when they will be out of service for maintenance or have been taken out of service on an unscheduled basis. The ISO has the right to dispatch the units up to a stated level. If the owner is unable to deliver required services, it has the duty to propose mitigation measures, which may include delivery from other units at the plant that are not subject to the MMRA. Payment terms are affected by any failure to deliver required services. Obligations of the parties are limited to an amount to be stated in a schedule to the MMRA. The customary types of representations, warranties, covenants, and indemnities are provided. The obligations are binding upon successor owners.

The Full Cost Recovery with Credit Back form of MMRA differs from the As Called form in several respects. Under this form of MMRA, the ISO has the right to direct that the units of a plant be dispatched to deliver energy and/or ancillary services on a real-time basis. The owner is free to enter into market transactions for energy or ancillary services at all other times but 90% of payments received are credited against availability payments. The owner may not submit bids to the Power Exchange (PX) below a stated amount to be determined by the FERC. The ISO has the right to obtain temporary, preliminary, and permanent injunctive relief from any court of competent jurisdiction restraining the owner from committing or continuing a breach of the agreement. In certain circumstances, the ISO has the right to the guarantee of the owner's parent company of owner's obligations. In contrast, the "As Called" form of MMRA pays only when the unit is called upon and allows the unit to supply power into the PX of other markets when not needed by the ISO without crediting back of any profits.

The Full Recovery with Dedicated Facility form of MMRA differs from the Full Cost Recovery with Credit Back form in that the owner is not free to enter into market transactions for energy or ancillary services at any time.

Whether to Defer any Decision until the FERC has Set the Specific Terms and Conditions

On October 30, 1997, the FERC issued its order,[3] approving the MMRA, in substantially the form required by the ISO.

As the Coalition of California Utility Employees (CUE) notes in its brief, it is undisputed that the MMRA before the Commission has material contractual terms in blank, including unit-specific operational requirements and the ISO's payment obligations, among others. Therefore, CUE argues, we cannot determine that the MMRA is fair and reasonable to the prospective purchaser and, in the absence of knowing whether the MMRA is beneficial to the new owner, whether it will be adequately "motivated" to honor its obligations under the MMRA. Thus, CUE takes the position that a contract is no more than a scrap of paper that sovereign parties deign to observe only when it suits their interest.

ORA specifically disassociates itself from the suggestion that we must know how the blank terms will be filled, but CUE is joined by the City and County of San Francisco (CCSF) and the Southeast Alliance for Environmental Justice (SAEJ). CCSF echoes CUE's motivational argument and raises the additional argument that despite an intention to honor obligations under the MMRA, an owner might not obtain sufficient revenues under the MMRA to permit it to do so if the FERC approves price terms that are too low and, in the subsequent bankruptcy, the owner could avoid its obligations under the MMRA.

SAEJ takes the position that until the FERC acts, no MMRA exists, thereby precluding any consideration by this Commission of whether the non-existent contract

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[3] Order Conditionally Authorizing Limited Operation of an Independent System Operator and Power Exchange (FERC Order).

is or is not adequate to its intended purpose. That is sophistry. No contract exists without a counterparty to the ISO, either. Under SAEJ's analysis, we would be precluding from taking up the issue until after the results of the auction were known or even until after the MMRA had been executed, and we reject SAEJ's argument.

The ISO argues that because the FERC has properly exercised its jurisdiction to determine the wholesale rates and terms and conditions of the MMRA, we are totally pre-empted by federal law from taking any role whatsoever in looking at the specifics of the MMRA. PG&E and ORA agree that the substantive issues about the contents of the MMRA are within the exclusive jurisdiction of the FERC, and we should limit our role to ensuring that new owners of the must-run plants execute the MMRA in whatever final form is dictated by the FERC and approve or disapprove sale of the plants with such MMRA.

To unravel this particular knot may require more effort than it is worth, so perhaps it may be cut by carefully looking at our duty under Section 362:

> "In proceedings pursuant to Section ... 851 ..., the [C]ommission shall 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. In order to determine whether the 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 Council standards for planning reserve criteria."

As noted, this is a proceeding pursuant to Section 851, and we have determined which facilities are needed to maintain the reliability of the electric supply. As we noted in our first interim decision, the ISO has on-going responsibility for the efficient use and reliable operation of the transmission grid. (PU Code § 345.) It is to seek the authority required to give it "the ability to secure generating and transmission resources necessary to guarantee achievement of planning and operating reserve criteria no less stringent than those established by the Western Systems Coordinating Council and the North American Electric Reliability Council." (PU Code § 346.)

Because the ISO will have the ability to secure new generating and transmission resources, because the applicable criteria of the two councils may change, from time to time, because existing plants may become decrepit or obsolete, and because load characteristics evolve over time, our designation of plants as "must-run" cannot be considered permanent. It is, rather, simply complementary to the development of the ISO's ability to secure new generating and transmission resources. The Legislature was concerned that transfer of existing plants whose operation is currently necessary to maintain reliability was done in such a way that those plants would continue operating in that role as long as needed by the ISO, whose job it is to assure reliability of the electric supply going forward by securing the necessary resources.

Aside from dictating the sources of technical criteria that the ISO should apply, the Legislature afforded the ISO great scope in how it would discharge its duties. The Legislature contemplated that the "proposed restructuring of the electricity industry would transfer responsibility for ensuring short- and long-term reliability away from electric utilities and regulatory bodies to the [ISO] and various market based mechanisms." (PU Code § 334.) It is thus clear to us that our role in this area is purely transitional pending the full assumption of its authority by the ISO. In particular, as we noted in our first interim opinion, we cannot dictate to the ISO that it enter into an MMRA for a particular plant and, if so, under what terms and conditions.

Thus, if the ISO determines that any of the two plants that we have determined are needed have more attractive substitutes, it is free, under its authority, to decline to execute an MMRA. (After all, as proposed, the ISO would have the right to terminate any MMRA on 90-days' notice, which is a provision that none of the parties have suggested is unreasonable in light of PU Code Section 362.) Thus, the ISO, subject to the requirements of the FERC, is in the position of having the final say on whether to execute a particular MMRA, regardless of what we may have to say about it.[4]

This division of responsibility renders any question of FERC preemption totally beside the point. If the ISO can decline to enter into an MMRA because it believes the plant is no longer needed, it can also decline to enter into an MMRA because it believes that it has better alternatives to it to accomplish the same purposes. In fact, a plant will be ensured to remain available and operational following the establishment of the PX only if it is either owned by the ISO (which no one contemplates) or it is subject to an MMRA or similar contractual arrangement, and it will only be subject to those MMRA terms and conditions that suit the ISO, within the range permitted by the FERC.

The same consideration renders moot the debate about the blank price terms. If we were to conclude that the MMRA fulfilled its function only if a particular blank were to be filled with the number "20" and the FERC required "10," the ISO would not execute the MMRA and, in that case, the MMRA would definitely not ensure the continued availability of a plant.

A different set of considerations also leads us to conclude that the blank price terms should not detain us. The cash flow from the MMRA is to be set in accordance with the FERC requirements to be fair and reasonable to buyer and seller. Buyers of the plants will bid taking into account either the established prices or will make allowance for any uncertainty that still exists at the time of the auction. In either event, the successful bidder will have factored the expected cash flow into its bid. That bid will be made either from the buyer's equity capital, with other people's money, or with a combination of equity and debt. Thus, the proprietors or creditors, or both, of the successful bidder will have made an assessment of cash flow available from the MMRA

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[4] For this reason, as we noted in our first interim opinion, the condition to the transfer of the plants should be either that the buyer have executed the MMRA and delivered it to the ISO or provide a certificate of the ISO that it waives the MMRA.

as part of their calculation and may be presumed to have accepted the risk that the terms implemented in the MMRA are terms that they will have to observe.

What are the consequences if the successful bidder finds itself dissatisfied with the terms of the MMRA? It can attempt to have those wholesale rates changed by the FERC or it can intentionally default on its obligations under the MMRA. If the FERC adjusts the rates to the satisfaction of the successful bidder, no question arises whether rates are sufficiently motivational to ensure the continued availability and operation of the plant. If the owner intentionally defaults, the ISO looks to the remedies in the MMRA, including its right to obtain specific performance of the contract. In either case, given a legal, valid, and binding contract, there is no need to concern ourselves with the adequacy of price terms.

Consider next the case in which the FERC terms are objectively adequate, but through poor management, bad luck, or misadventure in another business, the owner becomes insolvent, unable to meet its performance obligations under the MMRA, and seeks protection in bankruptcy. In bankruptcy, two major kinds of adjustments can be made: debts can be discharged without full payment and performance obligations can be excused. So long as the bankruptcy estate discharges its performance obligations under the MMRA, the ISO is indifferent to how debts are discharged. In a bankruptcy, the debtor-in-possession or trustee has the option to affirm or avoid contractual obligations, including the MMRA. If the MMRA is affirmed, no issue arises as to the continued availability of the facility. If it is avoided, the issue does arise. It would be avoided, however, only if the cost of performance exceeded the cash flow. That would only occur if the FERC required terms were not objectively adequate (*i.e.*, no reasonable operator would be able to perform under the MMRA).

We do not feel that the FERC is likely to badly miss the mark on what terms for the MMRA should be required. Even if we did, moreover, we are in no position to substitute our own judgment for that of an agency with superior jurisdiction over wholesale rates for all the reasons discussed above. Therefore, we look solely to the form of the MMRA.

The form of the MMRA suitably provides for a valid, legal, and binding contract between the ISO and the buyer, enforceable in accordance with its terms. The ability of the ISO to obtain specific performance in the two situations in which it relies upon the plants (the Full Cost Recovery with Credit Back form and the Full Recovery with Dedicated Facility form) and its right to require a corporate parent guarantee from any counterparty that was not the purchaser of the plant (and therefore could be thinly capitalized) are two important safeguards that provide assurance that the ISO will have the rights it requires to keep the plants in operation. The FERC Order did not modify the final form of MMRA to make it legally infirm as a binding contract or remove the right to specific performance. We also observe that the FERC adopted in part this Commission's recommendations concerning additional remedies. (See FERC Order, at 257, 259.)

Maintaining Open Competition

Our obligation pursuant to PU Code Section 362 to ensure the continued availability of the two must-run plants is qualified by the requirement to do so "consistent with open competition." Therefore, it is possible that we could determine that the two must-run plants ought not be subject to the MMRA, if we were to find that to do so were inconsistent with maintaining open competition.[5]

One reason that making the plants subject to the MMRA could be inconsistent with maintaining open competition is that if they were made subject to the Full Recovery with Dedicated Facility form, they would not be selling into the PX or direct access markets. In theory, at least, this could result in a situation in which supply in those markets was too "thin" (that is, the market clearing price would be higher than it

[5] CUE argues that we should not permit the transfer of the plants if we cannot find that the standards in PU Code Section 362 are met. The fallacy in this position is that the plants will become subject to the MMRA even if PG&E retains them, once the PX commences operation. Thus, if the MMRA is not consistent with maintaining open competition, for example, and should not be required for that reason, the only choice open to the Commission to avoid the MMRA is to permit transfer but to omit the MMRA as a condition.

would otherwise be if the plants were bidding). This concern is mitigated by considering that, almost as a matter of definition, plants that are needed for reliability are dispatched out of merit order. That is, they are dispatched even though another plant on the system can produce the same amount of energy at a lower price. If a plant performing a reliability role were highly efficient and likely to be dispatched in merit order in a competitive market, the ISO would be unlikely to place it in the Full Recovery with Dedicated Facility regime. Therefore, taking reliability plants out of the market is unlikely to raise the market clearing price.

CCSF raises the specter of the payments under the MMRA resulting in subsidization of bids into the PX and the direct access market. The issue here is not the fact that the owner under the MMRA will receive payments, which are reasonable wholesale rates as determined by the FERC. Rather, the danger to confront is that the owner will sell into the PX and the direct access market below its actual cost. Although competition is supposed to lower prices, and lower energy prices is one of our principal objectives in restructuring the electric industry, below-cost pricing may harm competition and lead to higher prices in the future. This evil comes about through the practice of "predatory pricing." The parties agree that this is an issue only with respect to the Full Cost Recovery with Credit Back form of MMRA. The California Manufacturers Association (CMA), California Cogeneration Council (CCC), and the Independent Energy Producers Association (IEP) argue that we should not approve the MMRA with this feature.[4]

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[4] CMA, CUE, PG&E, and the California Large Energy Consumers Association filed a joint reply brief referring to a motion adopted by the ISO that contemplates the ISO would reduce the amount of fixed and going forward costs that are recoverable under this feature, after October 31, 1998. For reasons described below, we regard this as a "lesser included power" to the ability of the ISO to terminate on 90 days' notice, and due to the division of responsibility between the Commission and the ISO, it is unnecessary to speculate what changes the ISO may direct in the future.

Predatory pricing is an economic game of beggar thy neighbor. If a participant in the market can depress prices sufficiently for a long enough period, other participants will tire of losing money and withdraw from the market. The reward for the perpetrator is market power, which is the ability to set prices above its cost (including a reasonable return on its investment) of doing business.

The conditions for successful predatory pricing are (1) a source to cover operating losses arising from below-cost pricing during predation; (2) the ability to escape detection, prosecution, and punishment by the antitrust authorities; (3) greater patience than like-minded predators; and (4) post-predation barriers to entry that are sufficiently high to deter new entrants after existing competitors have been driven from the field, for a long enough period to permit recovery of accumulated losses and an additional time to earn sufficient monopoly profits to make the effort worthwhile.

Thus, while it is undisputed that payments under the MMRA might be sufficient to provide a source to cover operating losses (although not necessary, since any source of funds will do), the MMRA does nothing to establish the other conditions needed for successful predatory pricing, and no party offered any evidence that those other conditions do, or could, exist in the coming marketplace for energy.

SAEJ offered a slightly different variant, which is that the MMRA will provide sufficient "financial security" to permit the owner confidently to make improvements to the plant. We do not think that a contract terminable without cause upon 90 days' notice is sufficient "financial security" to raise any real issue with respect to open competition.

Avoiding an Overconcentration of Market Power

Our obligation pursuant to PU Code Section 362 to ensure the continued availability of the two must-run plants is also qualified by the requirement to do so "consistent with ... avoiding an overconcentration of market power." Therefore, it is possible that we could determine that the two must-run plants ought not be subject to the MMRA, if we were to find that to do so would conflict with avoiding an overconcentration of market power.

What market power arises from owning any one or more of the plants subject to the MMRA, compared to owning any one or more of the plants not subject to the MMRA, is unknown. To start, the relevant market, the PX and direct access, does not yet exist, and the number of distinct market actors is unknown. Therefore, it is premature to attempt an analysis of horizontal market power until we at least know in how many hands the plants come to rest. As we stated in our first interim opinion, we will require disclosure by the successful bidder of other generation assets in California[7] held by it or related entities.

Reasonableness of the Proposed Operations and Maintenance Agreement

Whether to Wait to Consider the O&M Agreement

ORA recommends that the Commission find the proposed form of operations and maintenance agreement (O&M Agreement)[8] reasonable, but defer doing so until review of the agreement in its final form, following changes that PG&E may make in response to proposals by bidders during the second stage of the auction. We will want to permit parties, for our final decision, to raise any issues in connection with material changes to the form of O&M Agreement, but we are prepared to deal with its merits as it now stands.

Whether O&M Agreement Should be Negotiated

PU Code Section 363(a) requires a buyer to contract with PG&E for plant operation and maintenance for at least the first two years following any transfer. AES Pacific, Inc., (AES) argues that bargaining over the O&M Agreement is, therefore, likely to be one-sided, in favor of PG&E. AES asks that the Commission give the buyer right to obtain our intervention in the event the parties fail to negotiate a mutually

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[7] Due to the nature of the California energy market, which imports large quantities of energy from a vast interstate and North American market, it is the locational market power aspects that concern us.

[8] PG&E filed the O&M Agreement as Addendum No. 4 to its application.

satisfactory final O&M Agreement. On first glance, this is an appealing suggestion. However, it is inappropriate in the context of an auction.

While it is true that PG&E is the exclusive provider of services necessary to operate the plant over the first two years, it is also true that every bidder will know in advance the terms and conditions of the O&M Agreement and be able, unilaterally, to adjust its bid price accordingly. Thus, the process by which issues associated with the O&M Agreement are resolved is different from a negotiated asset sale, in which buyer and seller negotiate price, covenants, representations and warranties, indemnities, and collateral agreements as part of a single package. In that context, PG&E would be able to offer concessions on the O&M Agreement in exchange for a higher purchase price for the plant. If we required the parties to negotiate the O&M Agreement after the leading price terms for the sale of the plants had been set, we would be ignoring the fact that PG&E is legally obligated to provide these services, whether it desires this role or not. Putting PG&E in the position in which it had nothing to gain from a negotiation, and stood to incur additional costs or risk exposure, is fundamentally unfair. Instead, we examine the O&M Agreement as if it were a utility service.

Description of the O&M Agreement

The O&M Agreement is a bilateral contract between the owner of a plant and PG&E. It is governed by California law. Its term is two years from the date of purchase, but the owner may terminate before then by taking units out of service upon prior written notice. PG&E is obligated to provide personnel required to operate and maintain the plant,[9] and the owner is prohibited from obtaining personnel from any other source, including its own employees, even if PG&E is unable to satisfy the owner's requirements for personnel under the O&M Agreement. The owner is obligated to pay PG&E in accordance with scheduled rates for specified personnel. PG&E is to observe the dispatch instructions of the owner, or the ISO under an MMRA,

[9] Other than security and janitorial personnel and personnel to perform certain major overhauls.

if different. Various covenants, representations and warranties, and indemnities are provided.

AES Criticisms of the O&M Agreement

Remedies

AES believes that an owner should have the right to withhold payment in the event of a good-faith dispute. This is an inappropriate provision for what amounts to a relatively minor performance obligation of a very large counterparty whose credit is rated investment grade. The possibility that the owner would obtain negotiating leverage over PG&E and the risk that PG&E would be unable to refund any overpayment are both so slight that they can be dismissed without further discussion.

Spare Parts

The O&M Agreement obligates the owner to procure, pay for, and keep on hand all required spare parts, tools, equipment, consumables, and supplies required for the operation and maintenance of the plant. To avoid disputes, AES believes that the scope of this responsibility should be spelled out through a schedule to the O&M Agreement. That suggestion ignores the fact that PG&E is to be operating the plant for the owner's benefit, not PG&E's benefit. The owner may take a very conservative view of certain spare parts, and be careful always to have on hand those whose lack will prevent operation of the plant. Or it may be anxious to minimize its carrying costs by using just-in-time inventory techniques. But the fact of the matter is that if a generator is down for lack of collector ring brushes, there is nothing that PG&E can do to bring it back on line without them. Should PG&E be in default of its obligations if the owner has failed to provide an adequate supply of collector ring brushes? No, it should not, and it should make no difference whether the owner thought to put collector ring brushes on a schedule or not.

Letter of Credit

AES suggests that PG&E should be required to provide a letter of credit to secure the performance of its duties. Letters of credit secure the performance of payment obligations solely. They facilitate commerce by permitting the substitution of the credit of a bank or other creditworthy party for that of a purchaser whose credit is suspect. If anyone should provide a letter of credit in connection with the O&M Agreement, it should be the owner, who has payment obligations, rather than PG&E, who does not.

Non-environmental Indemnities

AES wants us to expand PG&E's non-environmental indemnification obligations in respect of third-party claims arising from PG&E's breach of the O&M Agreement to include negligence and willful misconduct in the performance of PG&E's duties. AES proposes this change so that the owner's non-environmental indemnification obligations to PG&E under Section 9.2.1 of the O&M Agreement would exclude responsibility in the event that a PG&E action were the result of negligence or willful misconduct. That section requires the owner to indemnify PG&E against losses arising from third-party claims relating to (1) operation and maintenance activities by PG&E at the direction of owner or (2) any suspension of termination of performance by PG&E as permitted or required under the O&M Agreement. In each case, however, owner's obligations to indemnify PG&E exclude any loss for which PG&E is obligated to indemnify the owner under Section 9.1.1 of the O&M Agreement which governs its indemnification responsibilities. AES's stated concern, that it not be liable to indemnify PG&E against PG&E's own negligence or willful misconduct, is thus satisfied by the terms of the O&M Agreement as drafted.

Environmental Indemnities

AES complains that the owner's environmental indemnification obligations in Section 9.2.2 of the O&M Agreement are too broad. That section requires the owner to indemnify PG&E for losses from third-party claims that arise from hazardous wastes introduced to the plant site after the transfer from PG&E or that migrate there from an offsite source, unless caused by the gross negligence or intentional misconduct of PG&E (in which case the indemnification obligation runs the other way).

The purchase and sale agreement (Purchase and Sale Agreement, in the form attached to PG&E's application) deals with the migration of pre-existing hazardous substances onto the plant site following the closing. As provided in Section 10.3 of the O&M Agreement, the Purchase and Sale Agreement governs in the event of any conflict. Therefore, we are concerned only with environmental contamination caused by some act of PG&E after the transfer, whether it be a spill on the plant site or a discharge adjacent to the plant that migrates to the plant site.

Two distinct situations should be addressed in connection with the owner's indemnification obligations. One is when PG&E is performing its duties under the O&M Agreement, and the other is when PG&E is not. It should be clear that the owner should have no obligation to indemnify PG&E in the latter situation, as when a PG&E crew is hauling hazardous waste from another plant site, happens to be passing the owner's site, and suffers an accident that results in discharge of contaminants to the owner's site. In that situation, it should not matter whether PG&E's crew was blameless, merely negligent, grossly negligent or an intentional miscreant. This result is implemented in the drafting of Section 9.2.1 of the O&M Agreement, which limits the owner's indemnification obligations to losses "arising out of or relating to" the O&M Agreement.

In the other situation, PG&E is assumed to be acting under the O&M Agreement. Hypothetically, its employees might be engaged in preparing hazardous waste for transport when a discharge to the plant site occurs. The owner is not obligated to indemnify PG&E if the discharge is grossly negligent or the result of intentional misconduct, and PG&E is not obligated to indemnify the owner if the conduct is negligent. Who should indemnify whom if PG&E is not at fault or has acted with simple negligence?

Competing policy options present themselves. One sound policy is that the party in the best position to guard against the risk should be the party to whom it is allocated. That would suggest PG&E should be required to indemnify the owner in all cases. Another sound policy is that the party who would bear the risk in the absence of an agreement should retain that risk unless the agreement is a contract for insurance.

This would suggest that the owner should be required to indemnify PG&E in the cases not provided for by the carve-out for gross negligence and intentional misconduct. A third sound policy is that the party who reaps the economic benefit that gives rise to the risk should bear that risk. This, again, suggests the owner, as the hazardous substances involved are those which are required to carry out the owner's business of generating electricity. However, when one party to an agreement is compelled to accept performance duties by operation of law, as is the case for PG&E, it is fair to relieve that party from exposure to risks that are disproportionate to compensation. Therefore, Section 9.2.1 of the O&M Agreement should not be changed.

Limitation of Liability

AES objects to the limitation on liability provisions of the O&M Agreement contained in its Article 10. Section 10.1 of the O&M Agreement excludes punitive, incidental, indirect, special or consequential loss or damages, including loss of revenues, income or profits, cost of capital, loss of goodwill or increased operating costs, whether in contract, equity, tort or otherwise, regardless of the fault, negligence (in whole or part), strict liability, breach of contract or breach of warranty of the defaulting party. AES believes there should be no exclusion of consequential losses or damages.

The ordinary damages in contract are those that "may fairly and reasonably be considered [as] arising naturally, i.e., according to the usual course of things, from such breach of contract itself." (*Hadley v. Baxendale* (1854) Ex. 341, 354, 156 Eng. Rep. 145, 151.) For example, if a builder contracts with a lumberyard to receive a carload of lumber of a given grade and the lumberyard defaults, the builder is entitled to the difference between the contract price and the cost of "cover" (*i.e.*, buying a carload from another supplier). This remedy vindicates the reliance interest of the builder in the contract, and holds the defaulting lumberyard to account for its nonperformance.

Not every breach of a contract can be covered, however, and the builder forlornly awaiting delivery of lumber from the only supplier on a remote island cannot pick up the phone and obtain an alternative source of supply quickly. From this, a chain of events may unfold with economically disastrous consequences to the builder. For lack of lumber, the carpenters must be sent home for lack of work, and the carpenters fly back to the mainland. For lack of patronage, the musicians also leave, and the bar owner cancels the project with the builder for an addition. Without the profits from the addition project, the builder is unable to make the payments on a backhoe, which the bank repossesses. Without the backhoe, the builder cannot lay the water line to the school and becomes liable to the district for breach of contract. Crushed by misfortune, the builder loses the opportunity to bid for the new school gym, which would have yielded extraordinarily high profits that could have been invested in a new subdivision project. The lost profits from the barroom, the liability to the school district, the lost profits from the gym, and the golden opportunity represented by the subdivision are potential consequential damages for which the lumberyard might be liable.

From the perspective of the lumberyard, it simply promised to deliver a load of lumber. What the builder intended to do with the lumber was not its concern. Now it finds itself defending a claim for $1 million in damages on a sale that it stood to make a profit of only $100. Its defense will be that the consequential damages were not foreseeable. For all the lumberyard knew, the builder was stockpiling the lumber for next year. Had the builder disclosed these contingencies to the lumberyard, so that they were foreseeable, moreover, the lumberyard would have charged much more for the sale, knowing it would have to cover a risk of liability for nonperformance that was greatly disproportionate to the amount involved in the sale.

It is to keep the risks of nonperformance in proper proportion to the rewards for performance that sellers often bargain for exclusion of consequential damages, especially when it is foreseeable that they will arise. With respect to the O&M Agreement, it is highly likely that the owner will suffer consequential damages in the event of a breach by PG&E, especially in light of the provision in the O&M Agreement that prohibits the owner from arranging for the operation and maintenance of the plant with its own personnel or third-party personnel, even should PG&E be unable to provide required personnel. If we were to assign to PG&E the burden of bearing owner's consequential damages, it should be entitled to a commensurate increase in its compensation under the O&M Agreement. To know what increase is justified, we would have to know much about the owner, its business, its prospects, and future contingencies. On the other hand, however, if we permit PG&E to escape liability for consequential damages, the owner, who has the best information on the subject, is free to make its own assessment, and to adjust its bid for the plant accordingly. That is what we consider the better course, and we will not require the exclusion of consequential damages to be changed in the O&M Agreement.

Time to Assert Claim against PG&E

AES believes that the one-year limitation in the O&M Agreement for asserting claims against PG&E should be removed, so that the statute of limitations would apply, which would give the owner up to four years to make its claim. AES presented nothing concrete to support its belief that it requires longer than a year to determine whether it should assert any rights under the O&M Agreement, and nothing in the nature of the O&M Agreement suggests that more than a year should be required.

Limitation of Liability for Damage to the Plant

AES objects to a limitation on PG&E's liability with respect to damage to the plant or its equipment arising from causes other than PG&E's gross negligence or intentional misconduct. Section 10.2 of the O&M Agreement requires the owner to look solely to its own insurance coverage for such losses. The provision is reasonable because in the absence of the O&M Agreement, the owner would either bear the loss or be required to carry insurance.

Reliance on Owner's Instructions

AES objects to a limitation on PG&E's liability for good-faith reliance on instructions by the owner's agent. AES believes that only objectively reasonable reliance should limit PG&E's liability. The owner should be sufficiently in control of its own agents to prevent any of them from giving instructions to PG&E that could give rise to a mistaken good-faith belief that such instructions were given under authority of the owner. It would not be reasonable to task PG&E with determining when an agent of the owner had the authority purported. The limitation on liability for good faith reliance should remain unchanged.

Aggregate Liability

AES objects to the $1 million limitation on total liability of PG&E, and recommends that it be set on a case-by-case basis considering the value of the plant. To do so, however, would reasonably require adjusting PG&E's compensation on a plant-by-plant basis. It better suits administrative convenience to fix the aggregate liability and permit owners to reflect that fact in the bids for the plants. The aggregate liability amount should remain unchanged.

Whether O&M Agreement Should be Performed by a Subsidiary

AES wants to require PG&E to form a separate legal entity for purposes of performing the O&M Agreement, and to prohibit that entity from disclosing any information relating to the operation of the plants to PG&E. Section 13.16.3 of the O&M Agreement contains a "Code of Conduct" that adequately protects what we expect to be commercially significant information concerning the plant from disclosure, and we will not require the further step of forming a distinct legal entity.

Whether PG&E Should be Permitted to Retain Copies of Certain Documents

Section 11.1 of the O&M Agreement makes materials and documents prepared by PG&E in discharging its duties the property of the owner when prepared. However, PG&E is permitted to retain copies. AES wants such documents "available to the owner upon demand" rather than awaiting the delivery of the documents at the end of the O&M Agreement. However, because the documents are the property of the owner "when prepared," presumably the owner has the right to inspect them upon reasonable notice, whether or not spelled out in the O&M Agreement. Moreover, the O&M Agreement reasonably defers delivery of the documents into the custody of the owner until completion of PG&E's performance obligation because they are needed during that time. Furthermore, despite AES's assertion that there is no reasonable basis to permit PG&E to retain copies after the end of the O&M Agreement, these documents could be material to the defense of any claim against PG&E by the owner, and that is sufficient justification in our view to permit PG&E to retain copies.

Discretion of Owner to Communicate Certain Information to PG&E

Section 13.6.3 of the O&M Agreement prohibits the owner from communicating certain non-public market information about the plant to PG&E. AES wishes to be able to communicate such information to PG&E under protection of a duty by PG&E not to disclose. AES misapprehends the purpose of the restriction, which is not to protect the owner, but to protect PG&E. To the extent that PG&E participates in the electric generation market, it must guard against communications that could be construed as price fixing. This section of the O&M Agreement should not be changed.

Assignment of the O&M Agreement for Financing

AES asks us to restrict PG&E's control over assignment to permit assignment for the purposes of meeting an owner's obligations in financing the purchase of the plant. Section 13.13 of the O&M Agreement provides an adequate standard (no unreasonable delay or withholding of approval).

Extraneous Issues

Whether Transfer of the Plants Adequately Mitigates PG&E's Market Power

CCSF claims that PG&E has failed to demonstrate that the proposed transfer of the plants sufficiently mitigates PG&E's market power. Even assuming that the proposed transfer leaves PG&E with no less market power than it has already, it clearly does not confer any *more* market power upon PG&E than it already possesses. The only question we are deciding is whether to permit PG&E to transfer the plants and, if so, under what conditions. We are not deciding whether the transfer, if it occurs, thereby relieves PG&E of sufficient market power for any purpose. We will take up the question of any residual California market power issues for PG&E in another proceeding, now that the FERC has acted. And, as stated in the first interim decision, we will review market power issues in the final decision.

Potential Conflicts with Existing Third-Party Arrangements

AES asks us to make certain that the "ISO does not interfere with existing contractual obligations or create problems or competitive disadvantages for existing [standard-offer] contract holders" through the manner in which the ISO operates the transmission system. We agree with the reply briefs of ORA and PG&E that this is the wrong forum for that debate.

Findings of Fact

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

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

3. 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.

4. The Commission may require additional information from proposed transferees concerning other generation assets to compete its review under PU Code Section 362.

5. The form of O&M Agreement is reasonable to buyer and seller.

Conclusions of Law

1. The Moss Landing Power Plant and the Oakland Power Plant will remain available and operational consistent with maintaining open competition, if, as a condition of sale, PG&E requires that the successful bidder enter into an agreement with the ISO substantially in the form approved by the FERC Order or provide a certificate of the ISO to the effect that it has determined that the related plant is not required for the ISO's purposes.

2. PG&E should require the successful bidder to disclose to the Commission all other generation assets in California under common ownership or control with the bidder.

3. The form of O&M Agreement should be approved and should be required as a condition of sale under the Purchase and Sale Agreement.

INTERIM ORDER

THEREFORE, IT IS ORDERED that:

1. Pacific Gas and Electric Company (PG&E) shall require as a condition of sale of the Moss Landing Power Plant and Oakland Power Plant, that the successful bidder enter into an agreement with the Independent System Operator (ISO) substantially approved by the Federal Energy Regulatory Commission on October 30, 1997 or provide a certificate of the ISO to the effect that it has determined that the related plant is not required for the ISO's purposes.

2. PG&E shall require the successful bidder to disclose to the Commission all other generation assets in California under common ownership or control with the bidder.

3. PG&E shall require the successful bidder to enter into an Operation and Maintenance Agreement substantially in the form attached to its application.

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