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Decision 97-12-042 December 3, 1997

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Joint application of Pacific Gas and Electric Company, San Diego Gas and Electric Company, and Southern California Edison Company for Ex Parte Interim Approval of a Loan Guarantee and Trust Mechanism to Fund the Development of an Independent System Operator (ISO) and a Power Exchange (PX) Pursuant to Decision 95-12-063 et al.

ORIGINAL

Application 96-07-001
(Filed July 9, 1996)

O P I N I O N

Summary of Decision

In this decision, we address the request presented in a petition for modification filed by Pacific Gas and Electric Company, San Diego Gas & Electric Company, and Southern California Edison Company (Petitioners) by determining the eligibility for recovery under Public Utilities (PU) Code § 376[1] of the costs of implementing the Power Exchange (PX) and Independent System Operator (ISO).

Background

On October 17, 1997, Pacific Gas and Electric Company, San Diego Gas & Electric Company, and Southern California Edison Company filed their "Petition to Modify Decision No. 96-08-038 in Compliance with D.96-10-044: ISO and PX Funding."

Responses were submitted on November 3 by the Office of Ratepayer Advocates (ORA); by The Utility Reform Network (TURN); jointly by the Energy Producers and Users Coalition, the Cogeneration Association of California, the California Farm Bureau Federation, and the California Industrial Users (EPUC *et al.*); jointly by Automated Power Exchange, Avista, Eastern Pacific Energy, Electric Clearinghouse, Inc., Enron,

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

New Energy Ventures, Illinova Energy Partners, Montana Power, Vitol, and California Retailers Association (APX *et al.*);[2] separately by Automated Power Exchange (Automated Power); and jointly by the California Large Energy Consumers Association and the California Manufacturers Association (CLECA/CMA). Petitioners replied on November 13.

In Decision (D.) 97-11-077, we granted part of the petition and authorized a $50 million increase in the loan guarantees Petitioners provide to the ISO and PX Restructuring Trusts for development and startup of the ISO and PX. We also authorized the requested memorandum account treatment of this increase. We deferred, however, our resolution of the request for a determination that ISO and PX implementation costs would be eligible for recovery under the provisions of § 376.

Recovery Under Section 376

Petitioners ask for authority to record in their transition cost balancing accounts and to recover under § 376: 1) any initial charges or restructuring implementation fees, whether assessed as one-time charges or not, that the Federal Energy Regulatory Commission (FERC) authorizes the PX or ISO to charge for development and startup costs, 2) development and startup costs incurred by the ISO or PX but not included in FERC-approved rates, and 3) any ISO or PX implementation costs incurred by Petitioners under their loan guarantees. (Petition, pp. 4, 11, 13.)[3]

The impetus for Petitioners' request is an October 17 filing in which the PX asked FERC for authority to assess Petitioners a one-time initial charge of $85 million to cover the PX's implementation costs. Petitioners ask the Commission to find that payment of the initial charge, if authorized by FERC, and other costs of implementing the PX and

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[2] Southern Energy Trading and Marketing, Inc. (Southern) was listed as one of the parties joining in the response of APX *et al.* In a letter dated November 6, 1997, an officer of Southern stated that Southern had been included in the filing in error, and that it did not support the response of APX *et al.*

[3] Petitioners' specific request is not clearly stated. This summary reflects what we and most of the responding parties understand the request to be.

ISO may be recovered under § 376 from all retail customers on a nonbypassable basis, without any review of the reasonableness of incurring them. Under § 376, recovery of certain costs may extend beyond the end of the transition period on December 31, 2001.

Petitioners assert that we must now decide the question whether payment of the proposed initial charge may be recovered under § 376, so that FERC can rule on the PX's rate proposal by January 1, 1998. Without a favorable decision from this Commission, Petitioners "may be unable to support these charges before the FERC or to undertake the additional loan guarantees." (Petition at 9.)

Discussion

When we ordered Petitioners to provide loan guarantees to the ISO and PX Restructuring Trusts in D.96-08-038, we took the unusual step of offering an advisory opinion on the utilities' risks associated with providing the initial loan guarantees to fund the ISO's and PX's development costs. We began by stating our expectation that development costs for the PX and ISO would be recovered in federal rates set by FERC. But if it should turn out that there were development costs that were unrecoverable in federal rates, we concluded that Petitioners' shareholders should not bear these risks (except for costs resulting from unlawful acts or unauthorized expenditures). Petitioners "should not bear the risk of development costs so long as they make good faith efforts to develop and obtain FERC approval to the ISO and PX, including full recovery of ISO and PX development costs in federally set rates." (D.96-08-038, slip op. at 32.) We further stated that "no development costs that may subsequently come before the Commission should be excluded from state rates on the basis that the development cost was incurred unreasonably (i.e., through a lack of prudence on behalf of any of [Petitioners'] management) or that it violates the rule against retroactive ratemaking," although we acknowledged that the actions of the Legislature or the courts could affect our determination. (*Id.* at 34.)

After we issued D.96-08-038, the Legislature passed Assembly Bill (AB) 1890 (stats. 1996, ch. 854), the Legislature's comprehensive approach to electric industry restructuring, which Governor Wilson signed into law. In AB 1890, the Legislature also

addressed the issue of the utilities' risk for recovery of the ISO's and PX's implementation costs when it added § 376 to the PU Code. Section 376 provides:

> To the extent that the costs of programs to accommodate implementation of direct access, the Power Exchange, and the Independent System Operator, that have been funded by an electrical corporation and have been found by the commission or the Federal Energy Regulatory Commission to be recoverable from the utility's customers, reduce an electrical corporation's opportunity to recover its utility generation-related plant and regulatory assets by the end of the year 2001, the electrical corporation may recover unrecovered utility generation-related plant and regulatory assets after December 31, 2001, in an amount equal to the utility's cost of commission-approved or Federal Energy Regulatory Commission approved restructuring-related implementation programs. An electrical corporation's ability to collect the amounts from retail customers after the year 2001 shall be reduced to the extent the Independent System Operator or the Power Exchange reimburses the electrical corporation for the costs of any of these programs.

As an initial matter, it is important to understand that § 376 does not directly authorize recovery of PX and ISO implementation costs.[4] Rather, it extends the period for recovery of "generation-related plant and regulatory assets"[5] to the extent that the opportunity to recover them has been reduced by the collection of specified implementation costs. Thus, § 376 by itself does not authorize recovery of any costs; rather, it permits utilities to recover uneconomic generation-related costs (*see* § 367) beyond the December 31, 2001 deadline set in § 367(a), to the extent the opportunity to recover these costs is reduced by FERC- or Commission-authorized recovery of unreimbursed implementation costs incurred by the utilities.

The Legislature's intent in making this exception to the four-year recovery period for uneconomic generation costs becomes clear when seen in the broader context of AB 1890. A key element of that legislation is a freeze of electric rates at the levels in

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[4] In this regard the Petition appears to misread § 376.

[5] This term is undefined. For purposes of this decision, we take it to be equivalent to the "generation-related assets and obligations" described in § 367.

effect on June 10, 1996 (subject to a reduction of no less than 10% for residential and small commercial customers beginning January 1, 1998) (§ 368(a)). Further, rates are to be unbundled, with separate charges identified for energy, transmission, distribution, public benefit programs, and recovery of uneconomic costs (§ 368(b)). Because the overall rate level was frozen and because of the nature of the other components, the charge for recovery of uneconomic costs, called the competition transition charge (CTC), had to be set residually, after all the other rate components had been subtracted from the total rate.

The Legislature was aware of the residual nature of the CTC and recognized that the size of the CTC would be affected by the levels of the other rate components. Because the total rate is frozen, the portion of the rate available to offset transition costs, the CTC, decreases as other components increase. The consequence of a lower CTC is a slower pace of recovery of the utilities' uneconomic costs.

Seen in this light, it becomes clear why the Legislature provided for special treatment for the "costs of programs to accommodate implementation of direct access, the Power Exchange, and the Independent System Operator." These are three new major programs that we created to carry out our plan for industry restructuring, described in our Preferred Policy Decision (D.95-12-063, as modified by D.96-01-009). The Commission required the utilities to bear actual or potential additional costs to implement these new programs. None of these additional costs were reflected in the frozen rates, and recovery of these costs during the transition period would necessarily displace other cost recovery. The residual nature of the CTC meant that recovery of these implementation costs jeopardized the Legislative plan for offsetting the utilities' uneconomic costs.

The solution codified in § 376 is to allow the utilities to recover the implementation costs they incur but in effect to extend the period for recovery of uneconomic costs to the extent necessary to restore the balance of risks of the initial concept of cost recovery. Utilities remain at risk for recovering their uneconomic costs during the transition period, but that risk is not increased by FERC- or Commission-authorized recovery of implementation costs.

With this understanding of the Legislative scheme in mind, we turn to the question of the eligibility for § 376 treatment of the three specific types of costs mentioned in the Petition.

Implementation Costs Included in FERC Rates

If costs are properly classified as the costs of programs to accommodate implementation of the PX or ISO, and FERC authorizes the recovery of such costs in FERC rates, then these costs are eligible for § 376 treatment, provided other statutory requirements are met. This general conclusion requires a few words of explanation.

First, we assume here that FERC's approval includes a conclusion that such costs are "recoverable from the utility's customers" in FERC-approved rates or charges for the ISO, including transmission rates, or for the PX. FERC could authorize collection on a volumetric (*e.g.*, per kilowatt-hour) basis from all ISO and PX participants, as a one-time charge to the utilities, or through some combination of these two approaches. If the costs are recovered through a volumetric FERC rate, then some of the charges might be borne by other entities using the PX or ISO, and not just by the utility's customers. Recovery under § 376 would be limited to the costs paid by each utility's customers, because only that portion would reduce the utility's opportunity to collect its full uneconomic costs. If the costs are recovered through a one-time charge to the utilities, as the PX proposes, the entire amount assessed to the utility would have the potential to reduce the opportunity to collect uneconomic costs.

If these implementation costs are assessed only to the utilities through a one-time charge or similar device, the question arises whether such costs are "recoverable from the utility's *customers*." We conclude that they are. When a utility incurs costs as a result of paying a FERC-approved charge, state authorities must allow the affected utilities to recover those costs from their customers. (*See Nantahala Power & Light Co. v. Thornburg*, 476 U.S. 953, 965-966 (1986).) The rate freeze presents a unique situation in which we cannot raise rates and we do not need to change rate components to allow this recovery; we have the option of allocating the amount required to offset these costs from the "extra" revenues the frozen rates produce, without designating a specific rate

amount for this recovery. The effect of such an allocation would be to reduce the headroom available to offset uneconomic costs, the precise result the Legislature accounted for in enacting § 376. Thus, even though customers may not incur these costs in higher rates, they still would effectively pay these costs through the revenues collected by means of the frozen rates. In any event, the result is that the utility's customers would directly or indirectly bear the costs assessed to the utility, and we find that this statutory condition would be met in these circumstances.

A different question arises if FERC assesses these implementation costs through a volumetric rate. The question raised in that case is whether the utilities have "funded" these programs, as required by § 376.[6] We conclude that they have. D.96-08-038, which set up the ISO and PX Trusts and required Petitioners to provide loan guarantees for the money borrowed by the Trusts, was entitled "ISO and PX Funding." The Legislature was aware of this decision when it drafted AB 1890; Section 361 refers to the restructuring trusts set up by that decision, and directs the Commission to ensure that the funds secured by the trusts are turned over to the ISO and PX.[7] The Legislature was thus also aware that we had funded the ISO and PX Trusts by requiring the Petitioners to guarantee loans taken out by the Trusts to cover the costs of development and startup of the ISO and PX. In this context, we conclude that the purpose of the words "have been funded by an electrical corporation" is to identify the implementation programs that are the subjects of § 376, and not to impose a condition precedent of direct financial contribution by the utilities.

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[6] An initial question is whether "funded" in the statute modifies "costs" or "programs." In normal usage, programs are funded, and the resulting funds allow the program sponsors to incur costs to carry out the intended program. We will follow this usage and interpret "funded" to refer to the "programs to accommodate implementation."

[7] Petitioners find significance in the use of the words "funds" in § 361 and "funded" in § 367. While similar wording lends some weight to the argument that utilities have funded the ISO and PX implementation programs, we find the overall logic of § 376 to be more instructive of the Legislative intent.

In light of the purpose of § 376, whether the Petitioners finance the PX's and ISO's development costs directly or indirectly is irrelevant. The pertinent question is whether the amount of implementation costs to be recovered from the utilities' ratepayers would differ, depending on whether the initial utility funding had been direct or indirect. The utilities could have directly financed the development costs and then sought recover of those costs from ratepayers. Or, as is the actual case, they could have guaranteed loans to the ISO and PX, and those two entities in turn could have sought recovery in rates. The effect on ratepayers and headroom would be exactly the same in either case.

Implementation Costs Not Recovered in FERC Rates

Petitioners also seek § 376 treatment for implementation costs incurred by the ISO and PX that are not included in FERC-approved rates. The advisory opinion included in D.96-08-038 addresses this possibility. In D.96-08-038, we stated our expectation that ISO and PX development costs would be recoverable in FERC rates. "Nevertheless," we continued, "decisions made by legislators, federal or state courts, FERC or this Commission, are not entirely within [Petitioners'] control and may cause the ISO or PX to fail to develop, or to develop in ways that render some portion of the development costs unrecoverable in federal rates. Shareholders should not bear these risks, and [Petitioners] should rely on this statement in entering the loan guarantees." (D.96-08-038 at 31-32.)

We again assure Petitioners that we will allow recovery in state rates or from state revenues of costs that they incur to implement the ISO and PX that are not recovered in FERC-approved rates, with the exceptions noted in D.96-08-038 of costs resulting from unlawful acts or unauthorized expenditures. We note, however, that our previous assurance was given in what was clearly and necessarily designated as an advisory opinion, because we did not have a concrete request for recovery before us. The Petition now before us is no more concrete, because it seeks our opinion on the eligibility for § 376 treatment of a category of costs that does not yet exist. That is, FERC has not yet rejected recovery of implementation costs for the ISO and PX. Accordingly,

we can add to the previous advisory opinion only our view that § 376 provides a defined way to treat such costs if and when they arise.

Costs Incurred Under the Loan Guarantees

Costs that Petitioners incur under the loan guarantees were also addressed in the advisory opinion rendered as part of D.96-08-038 and reiterated above. If the loan guarantees are called upon because the ISO or PX fails to make scheduled payments on time or is in default, we assume that the ISO or PX would first seek a remedy from FERC. If FERC responds by raising relevant rates or imposing additional charges, then the analysis outlined above would apply. If FERC fails to respond, requiring the Petitioners to pay out funds under the loan guarantee, Petitioners are entitled to rely on the assurance of D.96-08-038 and this decision. We clarify that any such costs would be eligible for § 376 treatment.

Recording Implementation Costs in the Transition Cost Balancing Account

Petitioners also ask us to authorize them to record implementation costs in their transition cost balancing accounts. This request must be denied. Transition costs are the "uneconomic generation-related assets and obligations" listed in §§ 367 and 840(f), reasonable and necessary capital additions (§§ 367, 840(f)), and certain employee-related costs (§ 375; *see* § 367(a)(1)). (*See* §§ 330 (s)-(u), 368.) Implementation costs are not included in the statutory descriptions of transition costs. This distinction is reinforced by the scheme outlined in § 376: If implementation costs are incurred and authorized for recovery, and if recovery of these costs results in the utility not recovering its full transition costs before the statutory deadline, then an extension of period for collecting transition costs is granted.

Because implementation costs are not transition costs, it would be conceptually confusing to record them in the transition cost balancing account, and we will deny this portion of the Petition.

Conclusion

We have concluded that ISO and PX implementation costs recovered through FERC rates, ISO and PX development costs not recovered through FERC rates, and ISO

and PX implementation costs Petitioners incur under their loan guarantees are eligible for the treatment described in § 376.

We emphasize that § 376 has an important additional requirement: the eligible costs must be shown to reduce the utility's opportunity to recover generation-related plant and regulatory assets after 2001. As a practical matter, the precise amount of costs that meet this standard will not be known until after 2001. Obviously, it would be unfair to wait until that time to take action on utility requests for § 376 treatment. In our decision on Phase 2 of the Transition Cost proceeding, D.97-11-074, we directed Petitioners to file applications to define the types of costs that are eligible for § 376 treatment. When eligible costs are recovered (*i.e.*, when collected revenues are allocated to offset eligible costs), the affected utility should record the amount recovered in a tracking account. When we approach the end of the transition period, we will determine whether and to what extent collection of the CTC should be continued past December 31, 2001 to compensate for the reduced opportunity to recover uneconomic costs.[8] Obviously, § 376 comes into play only if uneconomic costs are not fully recovered by December 31, 2001.

In addition, we note that our conclusion that implementation costs are eligible for § 376 treatment is limited to those costs that are incremental, *i.e.*, costs that are not being recovered in current rates. (*See* D.97-03-069, slip op. at 30.) Similarly, if the ISO or PX takes over certain functions from the utilities, then the utility may avoid incurring certain costs. Costs that the utility avoids or that are not incremental would not reduce the utility's opportunity to recover uneconomic costs and should not be eligible for § 376 treatment. When the utilities request recovery of specific implementation costs, or

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[8] Although § 376 appears to be self-executing, as a practical matter the mechanism for such recovery would be the CTC, which we have established to fulfill our responsibilities under § 369. We have not yet decided how the CTC will be calculated after the end of the rate freeze, but it seems likely that the Commission will be involved in setting the level of the CTC during the extended recovery period authorized by § 376.

when implementation costs are considered more generally in the applications required by D.97-11-074, the utilities should show that the costs requested for recovery are incremental and are not avoided.

Findings of Fact

1. On October 17, 1997, Pacific Gas and Electric Company, San Diego Gas & Electric Company, and Southern California Edison Company filed their "Petition to Modify Decision No. 96-08-038 in Compliance with D.96-10-044: ISO and PX Funding."

2. Responses were submitted on November 3 by ORA, TURN, EPUC *et al.*, APX *et al.*, Automated Power, and CLECA/CMA. Petitioners replied on November 13.

3. The size of the CTC is affected by the levels of the other rate components. Because the total rate is frozen, the portion of the rate available to offset transition costs, the CTC, decreases as other components increase.

4. Direct access, the Power Exchange, and the Independent System Operator are three new major programs that we created to carry out our plan for industry restructuring.

5. The Commission required the utilities to bear actual or potential additional costs to implement direct access, the ISO, and the PX. None of these additional costs were reflected in the frozen rates.

6. Recovery of implementation costs during the transition period would necessarily displace other cost recovery and might jeopardize the Legislative plan for offsetting the utilities' uneconomic costs.

7. D.96-08-038, which set up the ISO and PX Trusts and required Petitioners to provide loan guarantees for the money borrowed by the Trusts, was entitled "ISO and PX Funding."

8. When it enacted § 376, the Legislature was aware that we had funded the ISO and PX Trusts by requiring the Petitioners to guarantee loans taken out by the Trusts to cover the costs of development and startup of the ISO and PX.

Conclusions of Law

1. Section 376 does not directly authorize the recovery of PX and ISO implementation costs. Rather, it extends the period for recovery of uneconomic generation-related costs beyond the deadline of December 31, 2001, to the extent the utility's opportunity to recover these costs is reduced by FERC- or Commission-authorized recovery of unreimbursed implementation costs incurred by the utilities.

2. Section 376 allows the utilities to recover the implementation costs they incur but in effect extends the period for recovery of uneconomic costs to the extent necessary to restore the balance of risks of the initial concept of cost recovery.

3. Under § 376, utilities remain at risk for recovering their uneconomic costs during the transition period, but that risk is not increased by FERC- or Commission-authorized recovery of implementation costs.

4. If costs are properly classified as the costs of programs to accommodate implementation of the PX or ISO, and FERC authorizes the recovery of such costs in FERC rates, then these costs are eligible for § 376 treatment, provided other statutory requirements are met.

5. Recovery under § 376 is limited to the costs paid by each utility's customers, because only that portion would reduce the utility's opportunity to collect its full uneconomic costs.

6. Implementation costs assessed only to the utilities through a one-time charge or similar device are "recoverable from the utility's customers" under § 376.

7. When a utility incurs costs as a result of paying a FERC-approved charge, state authorities must allow the affected utilities to recover those costs from their customers.

8. The purpose of the words "have been funded by an electrical corporation" is to identify the implementation programs that are the subjects of § 376, and not to impose a condition precedent of direct financial contribution by the utilities.

9. Utilities may recover in state rates or from state revenues costs that they incur to implement the ISO and PX and costs they incur under the loan guarantees that are not recovered in FERC-approved rates, with the exception of costs resulting from unlawful acts or unauthorized expenditures.

10. Implementation costs are not included in the statutory descriptions of transition costs.

11. ISO and PX implementation costs recovered through FERC rates, ISO and PX development costs not recovered through FERC rates, and ISO and PX implementation costs Petitioners incur under their loan guarantees are eligible for the treatment described in § 376.

O R D E R

IT IS ORDERED that:

1. Independent System Operator (ISO) and Power Exchange (PX) implementation costs recovered through rates approved by the Federal Energy Regulatory Commission (FERC); ISO and PX development costs not recovered through FERC rates; and ISO and PX implementation costs Pacific Gas and Electric Company, San Diego Gas & Electric Company, and Southern California Edison Company incur under their loan guarantees are eligible for the treatment described in Public Utilities Code § 376.

2. Except as granted in Decision (D.) 97-11-077 and in this decision, the "Petition to Modify Decision No. 96-08-038 in Compliance with D.96-10-044: ISO and PX Funding," filed by Pacific Gas and Electric Company, San Diego Gas & Electric Company, and Southern California Edison Company on October 17, 1997, is denied.

This order is effective today.

Dated December 3, 1997, at San Francisco, California.

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