

Decision 97-12-102 December 16, 1997

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.

ORIGINAL

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 Requirement 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
HYDROELECTRIC GENERATION REVENUE REQUIREMENT OPINION**

1. Summary

As an alternative to performance-based ratemaking (PBR), the Commission adopts a mechanism for determining Southern California Edison Company's (Edison) hydroelectric revenue requirement beginning in 1998 and for the duration of the electric industry restructuring transition period, or until market valuation of the generating facilities. The mechanism relies largely upon Edison's 1995 general rate case (GRC) and recent industry restructuring decisions, including decisions in the unbundling (or ratesetting) proceeding (Application (A.) 96-12-009, et al.) and the transition cost proceeding (A.96-08-001, et al.).

2. Background

This consolidated proceeding was initiated by Edison and Pacific Gas and Electric Company (PG&E) in response to a directive in Decision (D.) 95-12-063, as modified by D.96-01-009 (the Preferred Policy Decision) to file applications for PBR for generation. The early background and procedural history of this proceeding is

described in D.97-07-042, which addressed the respective roles of the Commission, the Federal Energy Regulatory Commission (FERC), and the Independent System Operator (ISO) with respect to transmission system reliability and related market power issues.

3. Procedural History

On June 11, 1997, Edison submitted an updated PBR proposal focusing on its hydroelectric generation. A prehearing conference was held on June 23, 1997, at which the Assigned Commissioner and Administrative Law Judge (ALJ) heard oral argument on the question of deferring or terminating the proceeding as a non-critical path electric industry restructuring activity. Among other things, Edison took the position that the revenue requirement determined by D.96-01-011 in its 1995 GRC could provide the basis for establishing the hydroelectric revenue requirement that needs to be in place on January 1, 1998. (Tr. PHC-3, p. 123.)

A *Joint Ruling of Assigned Commissioner and Administrative Law Judge* issued on June 25, 1997, determined that the various proposals of PG&E and Edison for the development of PBR/incentive mechanisms for generation were not on a critical path for implementation in 1998, and would not be considered for the time being. The ruling adopted Edison's procedural recommendation that, in lieu of its PBR proposals for hydroelectric generation, it submit a "compliance filing" detailing its proposal for using its existing hydroelectric revenue requirement. The ruling also provided for comments on Edison's proposal.¹

Pursuant to the June 25 ruling, Edison submitted its *Compliance Filing to Establish the Level of Edison's Currently Authorized Hydroelectric Revenue Requirement as the Basis for Future Hydroelectric Ratemaking (Compliance Filing)* on July 1, 1997. On July 14, 1997, the Office of Ratepayer Advocates (ORA) and The Utility Reform Network (TURN) filed comments on Edison's proposal. By joint letter dated August 5, 1997, Edison and

¹ The June 25 ruling also established a parallel procedure for determining PG&E's hydroelectric and geothermal revenue requirement. Evidentiary hearings were held in the PG&E sub-proceeding, and we are considering a decision in that sub-proceeding today.

ORA advised the ALJ that they had held discussions and agreed on most issues pertaining to Edison's hydroelectric revenue requirement and related ratemaking, and that nearly all of the issues upon which they had remaining differences were being resolved in other proceedings.

By ruling issued on September 23, 1997, the ALJ provided for comments on the procedural recommendations of Edison and ORA as well as the remaining substantive issues. In response, comments were filed by Edison, ORA, TURN, and Enron on October 7, 1997. By ruling issued on October 10, 1997, parties were permitted to file replies to the October 7 comments. Reply comments were filed by Edison, Enron, and James Weil.

4. Discussion

Parties have had the opportunity to comment on Edison's July 1, 1997 Compliance Filing, which sets forth Edison's proposal for establishing its hydroelectric generation revenue requirement. In addition, parties have had the opportunity to comment on the substantive and procedural agreements reached by Edison and ORA as set forth in their August 5, 1997 joint letter, and to reply to the comments of other parties. There are no factual issues requiring evidentiary hearings, and no party requests that hearings be held. With respect to the determination of Edison's hydroelectric revenue requirement beginning in 1998, the record is complete, and the matter is ready for decision.

4.1 Revenue Requirement Mechanism

There is general agreement that, even in the absence of PBR, it is necessary to establish a separate revenue requirement for Edison's hydroelectric generation operations in order to calculate costs eligible for recovery through the Competition Transition Charge (CTC) on an ongoing basis. In its Compliance Filing, Edison proposed to use off-the-shelf data adopted in its 1995 GRC, with adjustments for the cost of capital, Edison's revised cost separation methodology, the transfer of generation-related expenditures from the transmission function to the generation function, and the exclusion of revenue credits. Edison had previously submitted this revenue

requirement development in the unbundling proceeding. Edison calculated an annual base revenue requirement (exclusive of the cost of energy used for pumped storage) of \$120,279,000, but stated that it would file a revised calculation when the Commission resolved allocation issues in the unbundling proceeding and the rate of return issue in the transition cost proceeding. Edison proposed that the resulting base revenue requirement be fixed until market valuation of the underlying assets occurs.

In its comments on the Compliance Filing, ORA generally agreed with most of the principles underlying Edison's proposal, including basing the revenue requirement on Edison's 1995 GRC. ORA objected to freezing the base revenue requirement until market valuation of the hydroelectric units. ORA recommended that Operation and Maintenance (O&M) expenses be determined in this proceeding, and that the remaining cost elements be based on the resolution of other restructuring proceedings. ORA noted that under its proposal, the hydroelectric revenue requirement would not be frozen over time as it would under Edison's proposal.

TURN expressed concern that, with a declining rate base for hydroelectric facilities, freezing the hydroelectric revenue requirement for an extended period until market valuation would lead to a windfall for the utility. TURN recommended that Edison's proposal be adopted as an interim measure for 1998 only, and that provision be made for determining a more accurate revenue requirement for the post-1998 period.

In their August 5 joint letter, Edison and ORA proposed that the O&M expense-related revenue requirement, including administrative and general expenses and revenue credits, be based on the Commission's decision in the unbundling proceeding. They further proposed that the capital-related revenue requirement, including depreciation, taxes, and return on rate base, be based on the results of other proceedings. Specifically, sunk capital-related costs would be determined in the transition cost proceeding; capital additions, including relicensing costs, would be addressed in the capital additions proceeding; and taxes and franchise fees would be

determined from formulas adopted in Edison's 1995 GRC.² Edison and ORA noted that the issue of what rate of return to apply to various assets or portions thereof was being addressed in the transition cost proceeding.

The September 23 ruling asked parties to comment on whether the joint proposal of Edison and ORA for the treatment of capital-related costs or any other aspects of the Edison/ORa approach mitigated TURN's concerns regarding the need for a more accurate revenue requirement for the post-1998 period. Edison noted that the provisions for using recorded costs and the results of the capital additions proceeding directly addressed the concern. Similarly, ORA pointed out that the proposal's provisions for capital-related costs as well as O&M expenses should alleviate TURN's concern. TURN confirmed that the joint proposal sufficiently mitigated its concerns.

We find that the joint Edison/ORa proposal is reasonable for purposes of setting Edison's hydroelectric revenue requirement for 1998, and that it should be adopted. It uses existing data and principles found reasonable in Edison's 1995 GRC and in recent decisions in related industry restructuring proceedings, including the unbundling proceeding (D.97-08-056), the capital additions proceeding (D.97-09-048), and the transition cost proceeding (D.97-11-074). Accordingly, it minimizes the need for extensive litigation and avoids duplication of effort in multiple proceedings while developing a reasonable hydroelectric revenue requirement for purposes of the transition cost recovery mechanism. The proposal addresses the concerns which were raised in the comments on the Compliance Filing. With the exception of issues which are addressed in the following sections of this opinion, the proposal is uncontested.

² After Edison and ORA made their joint proposal, the Commission determined in D.97-09-048 that capital additions to hydroelectric plants made in 1998 and beyond would be subject to the modified market control approach adopted by that decision. The market control approach provides for recovery of capital additions costs through market revenues. Recorded expenditures for 1996 and 1997 additions are to be included in utility applications for *ex post facto* review.

For the foregoing reasons, we adopt the Edison/ORA proposal. We intend that Edison may continue to use this mechanism until the end of the restructuring transition period, i.e., until December 31, 2001, or until market valuation, whichever occurs first.³ In the parallel sub-proceeding for PG&E's hydroelectric and geothermal revenue requirement, we are establishing a procedure to review the appropriateness of PBR for PG&E's hydroelectric and geothermal generation. We do not believe that it is necessary to establish a similar procedure for Edison's hydroelectric generation. Nevertheless, we reserve the right to make modifications to the approach that we adopt today to become effective in the 1999-2001 period. We therefore make today's order subject to further order of the Commission.

4.2 Procedural Recommendation

Edison and ORA agree that a decision in this proceeding should direct Edison to file an advice letter detailing its hydroelectric revenue requirement within 30 days of the Commission's decision in the transition cost proceeding, and that Edison should provide the advice letter along with workpapers used to derive the revenue requirement to all parties to this proceeding. The September 23 ruling invited parties to comment on this proposal, which is uncontested.

We will direct Edison to file an advice letter consistent with the joint recommendation. D.97-11-074, the then-anticipated transition cost decision referenced by Edison and ORA, was signed on November 19, 1997. Edison should file the advice

³ In his reply comments, James Weil took the position that we should adopt the recommended revenue requirement mechanism for 1998 only, and that we should pursue PBR for 1999 and beyond. Edison's Compliance Filing proposed that the revenue requirement mechanism be used until market valuation, and the September 23 ruling asked for comments on TURN's initial proposal to fix a revenue requirement for 1998 only. Thus, parties had notice of this issue and opportunity to make alternative proposals in comments on the Compliance Filing and in comments in response to the September 23 ruling. Reply comments are not the appropriate vehicle for making such proposals. We note that Edison and other parties have not had the opportunity to respond to the recommendation for PBR.

letter within five days of the date of this decision. The resulting revenue requirement should become effective no sooner than January 1, 1998.

4.3 Recording of Pumped Storage Costs

Edison's hydroelectric pumped storage facility at Balsam Meadow consumes electric energy during low-cost hours in order to pump water uphill so that it can be released to produce power in high-value hours. Edison has estimated that it will incur approximately \$2 million in pumped storage energy costs in 1998. Up to now, Edison has recovered pumped storage energy costs under the Energy Cost Adjustment Clause (ECAC), subject to reasonableness review.

As the parties have anticipated, the ECAC mechanism is being eliminated effective January 1, 1998, pursuant to D.97-10-057 (the Streamlining Decision). In its Compliance Filing, Edison proposed that pumped storage energy costs be recovered through a Miscellaneous Adjustment Mechanism (MAM) account which it had proposed in the unbundling proceeding. ORA generally agreed with Edison's proposed treatment of pumped storage energy costs, and recommended that such costs be determined by using Power Exchange (PX) hourly prices.

D.97-08-056 denied Edison's MAM proposal. The September 23 ruling asked parties to comment on any impacts of recent decisions, and particularly on whether the disposition of the MAM proposal in D.97-08-056 affected Edison's proposal in this proceeding for recording pumped storage energy costs. In response, Edison proposed that pumped storage energy costs be recovered through the Transition Cost Balancing Account (TCBA) as a component of its authorized revenue requirement. Edison noted that its proposed Hydro Generation Subaccount would need to be changed accordingly. ORA noted that while D.97-08-056 denied Edison's MAM proposal, it provided that pumped storage costs are generation-related and should be recovered through the generation function.

No party stated any opposition to Edison's modified proposal for recording pumped storage costs. We agree that, prior to market valuation, it is appropriate to flow these costs through to ratepayers. The modified proposal is consistent with the

streamlining decision as well as the Phase II transition cost decision. We will therefore adopt it.

As proposed by ORA, pumping costs should be determined by using actual PX hourly prices. Also, we authorize Edison to make changes in its TCBA or related subaccounts which are necessary to reflect our intent that pumped storage energy costs be included in the authorized revenue requirement. In the following section we address Edison's proposal to eliminate review of the reasonableness of recorded pumped storage energy costs.

4.4 Reasonableness Reviews

Edison believes that the rate freeze/transition cost recovery mechanism, under which eligible transition costs may be recovered only within a limited period, provides it with incentives to ensure that pumped storage costs booked to the balancing account are reasonable. Edison also notes that elimination of reasonableness reviews would simplify ratemaking.

ORA recommends that reasonableness reviews be continued for pumped storage costs. Edison would retain the burden to prove that its decisions and actions regarding pumped storage were reasonable and benefited ratepayers. ORA agrees that reasonableness reviews would be unnecessary if Edison's pumped storage units are placed under must-run agreements with the ISO, and the corresponding revenue requirement is excluded from the total hydroelectric revenue requirement so that Edison is placed at risk for the recovery of the corresponding expenses. Enron and James Weil support ORA's position on the need for reasonableness review. A similar issue is under consideration in the PG&E sub-proceeding, and the September 23 ruling invited comments on whether the Commission should pursue a uniform policy with respect to reasonableness reviews for pumped storage costs for the two utilities. ORA and TURN indicate that they support a uniform policy.

Consistent with our adopted cost recovery treatment for PG&E's pumped storage expenses, we will adopt ORA's recommendations for reviewing the reasonableness of Edison's pumped storage. We provided in D.96-12-088 (the updated

Roadmap decision) that as long as fuel procurement practices are undertaken in a regulated regime, reasonableness reviews would be the *quid pro quo* of balancing account treatment. (D.96-12-088, p. 23.) While we are hopeful that market incentives can begin to take the place of reasonableness reviews once the PX is functioning (*Id.*), we do not believe that the rate freeze/transition cost recovery mechanism alone provides cost control incentives sufficient to justify elimination of reasonableness reviews. Since pumped energy costs will be passed on to ratepayers through the TCBA, reasonableness reviews properly remain the *quid pro quo* of such balancing account treatment. Consistent with our provision for reasonableness reviews in Ordering Paragraph 13 of D.97-10-057, such reviews will take place in Edison's annual transition cost or revenue adjustment proceedings pursuant to Commission orders or rulings.

4.5 Must-Run Units

ORA recommends that Edison be required to exclude certain must-run units from the calculation of the revenue requirement used to determine entries into the TCBA.⁴ ORA has made the same recommendations for PG&E's hydroelectric and geothermal generating units in the parallel sub-proceeding for PG&E. ORA believes that including the revenue requirement of must-run units which rely upon the ISO for full cost recovery misallocates risk between ratepayers and shareholders, and would inhibit competition for must-run services.

There is no opposition to ORA's proposal, and we believe it is reasonable to pursue an approach which is consistent with that adopted for PG&E's must-run hydroelectric and geothermal generation. For simplicity, we will provide as a default that Edison shall exclude the revenue requirement of any unit designated by the ISO as a must-run unit. Should Edison seek to record the revenue requirement associated with any must-run units, it should file an advice letter reflecting the treatment of must-run units adopted in the PG&E sub-proceeding.

⁴ ORA notes that Edison has not identified any of its hydroelectric units as must-run, and that the proposal may not be relevant.

4.6 Treatment of Individual Units and Generating Sub-categories

ORA has proposed that Edison be required to provide separate revenue requirement data for each hydroelectric unit. ORA's recommendation is based on the expectation that individual units will be decommissioned, market-valued, or made subject to a must-run contract with the ISO, and that as these events occur, the total level of revenue requirement will be impacted accordingly. ORA also recommends that two subaccounts be established to track conventional and pumped storage hydroelectric generation separately in order to minimize potential cross-subsidy of these types of generation.

Edison opposes both of these recommendations. Edison notes that it has 81 main generating units at 37 hydroelectric plants. Edison contends that it would be difficult to allocate common costs to each separate unit, and that doing so is not a critical path task that should be undertaken at this time. Edison also believes that creating separate subaccounts for conventional and pumped storage units is impractical in the case of its Big Creek Project, which includes the Eastwood pumped storage facility and eight conventional plants. This is because the Big Creek Project units are hydraulically linked, share O&M costs, and are operated to maximize the benefits of the entire Big Creek system. Edison contends that it is necessary to take the operation of the linked units into consideration as a whole.

ORA's proposals would require Edison to perform new cost studies, and they do not appear to take into account the actual operations of linked units. We are not persuaded that it is necessary at this time to establish individual revenue requirements or subaccounts as proposed by ORA. However, we reserve the right to consider these and similar proposals further in an appropriate forum. We are concerned that, with aggregate accounting, uneconomic units could in effect be subsidized by economic units. In any event, we note that when a unit is market valued, decommissioned, or designated as a must-run unit, the revenue requirement impact can (and, by advice letter filing, should) be determined at that time.

Findings of Fact

1. With respect to determining Edison's hydroelectric revenue requirement, there are no factual issues requiring evidentiary hearings, and no party requests that hearings be held.

2. It is necessary to establish a separate revenue requirement for Edison's hydroelectric generation operations in order to calculate transition costs eligible for recovery through the CTC on an ongoing basis.

3. Establishing a revenue requirement by using existing data and principles found reasonable in Edison's 1995 GRC, and in D.97-08-056, D.97-09-048, and D.97-11-074, minimizes the need for litigation and avoids duplication of effort in multiple proceedings.

4. The joint Edison/ORR proposal addresses the concerns which were raised in the comments on the Compliance Filing.

5. The joint Edison/ORR proposal is reasonable for purposes of setting Edison's hydroelectric revenue requirement until December 31, 2001, or until market valuation, whichever occurs first. However, we reserve the right to make modifications to the approach that we adopt today for application in the 1999-2001 period.

6. The recommendation that Edison be directed to file an advice letter detailing its hydroelectric revenue requirement, and that Edison provide the advice letter along with workpapers used to derive the revenue requirement to all parties to this proceeding, is uncontested.

7. It is reasonable and appropriate to pass on to ratepayers, through the TCBA, pumped storage energy costs determined by using actual PX hourly prices.

8. Our policy is that as long as fuel procurement practices are undertaken in a regulated regime, traditional reasonableness reviews are the *quid pro quo* of balancing account treatment.

9. In the parallel sub-proceeding for PG&E, we found that including the revenue requirement of must-run units which rely upon the ISO for full cost recovery in the total revenue requirements that are debited to the TCBA misallocates risk between

ratepayers and shareholders, and could inhibit competition for must-run services and cause unwarranted cost-shifting.

10. While there is no showing that Edison's hydroelectric units have been designated by the ISO as must-run, it is reasonable to adopt an approach which is consistent with that adopted for PG&E's must-run hydroelectric and geothermal generation.

11. It is not necessary at this time to establish individual unit revenue requirements or subaccounts for categories of hydroelectric generation as proposed by ORA.

Conclusions of Law

1. The revenue requirement mechanism proposed by Edison and ORA for determining Edison's hydroelectric revenue requirement should be adopted for 1998 and should be continued in effect through 2001, subject to further order of the Commission.

2. Edison should be directed to file an advice letter detailing its hydroelectric revenue requirement within five days of the date of this decision, to become effective no sooner than January 1, 1998. Edison should serve the advice letter and underlying workpapers on parties to this proceeding.

3. Consistent with our adopted cost recovery treatment for PG&E's pumped storage, we should adopt ORA's recommendations for reasonableness review for Edison's pumped storage.

4. Edison should exclude from the TCBA the revenue requirement of any unit designated by the ISO as a must-run unit, provided that if Edison seeks to record the revenue requirement associated with a must-run unit, it should file an advice letter reflecting the treatment of must-run units adopted in the PG&E sub-proceeding.

O R D E R

IT IS ORDERED that:

1. The joint proposal of Southern California Edison Company (Edison) and the Office of Ratepayer Advocates for determining the revenue requirement for Edison's

A.96-07-009, A.96-07-018 ALJ/MSW/sid

hydroelectric generation facilities is adopted with the modifications discussed in the opinion and set forth in the foregoing findings and conclusions. The mechanism will continue in effect until December 31, 2001, or until market valuation, whichever occurs first, unless it is discontinued, modified, or replaced before then by further order of the Commission.

2. Edison shall modify its tariffs to implement the foregoing ordering paragraph by filing an advice letter within five days of the effective date of this order. The tariffs shall become effective no earlier than January 1, 1998, after they have been reviewed for compliance with this order by the Energy Division.

This order is effective today.

Dated December 16, 1997, at San Francisco, California.

P. GREGORY CONLON

President

JESSIE J. KNIGHT, JR.

HENRY M. DUQUE

JOSIAH L. NEEPER

RICHARD A. BILAS

Commissioners