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Decision 98-02-112 February 19, 1998

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Southern California Edison Company (U 338-E) for Order Approving Termination Agreement for Termination of ISO4 Power Purchase Agreements Between Southern California Edison Company and Geo Mesa, L.P.	Application 97-09-038 (Filed September 19, 1997)

ORIGINAL

OPINION

Summary

Southern California Edison Company (Edison) seeks ex parte approval of a proposed buyout of two Interim Standard Offer No. 4 (ISO4) Power Purchase Contracts between Edison and Geo East Mesa, L.P. (GEMLP) executed in 1984.[1] Under the contracts, Edison purchases energy and 38.5 megawatts (MW) of firm capacity from the GEM 2 and GEM 3 geothermal generating facilities, located on the East Mesa Geothermal Reservoir, 25 miles east of El Centro, California.

Edison asserts that the termination agreement will result in total expected benefits to Edison's customers of $19.8 million (January 1, 1997 net present value (NPV) @ 10% discount rate). These savings result from the replacement of GEMLP's expensive energy and capacity with lower-priced energy and capacity from alternate sources, and takes into account the termination payments provided for in the termination agreement.

The Office of Ratepayer Advocates (ORA) disputes the amount of savings estimated by Edison. Nevertheless, ORA agrees that termination of the contracts will provide significant benefits to ratepayers.

[1] Both contracts are contained in exhibit SCE-1. The original parties to the contracts were Edison and Magma Electric Company. GEMLP became a party to each of the contracts through a series of assignments to which Edison consented.

The application is granted subject to the assumed level of ratepayer savings being capped at $10 million for purposes of the calculation of Edison's contract restructuring incentive.

Procedural Summary

Edison filed this application on September 19, 1997. Notice of the application appeared in the Daily Calendar on September 26, 1997. On December 23, 1997, ORA filed a limited protest. Edison filed a reply on January 9, 1998. Aside from ORA's, no protests to the application have been received.

Motion for Protective Order

Edison moved to have the termination agreement and much of the supporting analyses received under seal. Edison argued that if other qualifying facilities (QFs) examined the details of the termination agreement and the financial analysis, Edison would be at a disadvantage in negotiating future buyouts. The motion to seal was unopposed. We will grant Edison's motion for a protective order. The redacted portions of the Edison application and exhibits are placed under seal through December 31, 1998, subject to renewal of the request for protection.

Likewise, ORA requested that its analysis of ratepayer benefits be received under seal. ORA's request is granted. And for reasons cited by Edison, ORA's entire protest shall remain under seal along with its analysis through December 31, 1998, subject to renewal of the request for protection. Accordingly, we will be circumspect in our discussion of the termination agreement and its analysis.

Background

The 30-year ISO4 contracts pursuant to which Edison purchases energy and 38.5 MW of firm capacity from the generating facilities were executed on November 30, 1984. The generating facilities achieved firm operation on June 30, 1989, for GEM 2, and June 2, 1989, for GEM 3. At the time of contract execution, the developer selected energy payment Option No. 1, Forecast of Annual Marginal Cost of Energy, for the first ten-year period, ending on June 29, 1999 for GEM 2, and June 1, 1999 for GEM 3. Under this option, the first period price paid for energy deliveries is based upon a

Commission-approved forecast of Edison's avoided energy costs. Energy purchases for the second 10-year period June 30, 1999 through June 30, 2019 for GEM 2, and June 2, 1999 through June 1, 2019 for GEM 3 will be at a price equal to Edison's posted short-run avoided cost of energy.[2]

The contracts provide that GEMLP is to receive levelized capacity payments based upon a Commission-approved forecast at the time of contract execution of Edison's avoided capacity costs over the 30-year terms. Specifically, GEM 2 is to be paid $198/kilowatt-year (kW-yr) for its 18.5 MW of firm capacity and GEM 3 is to be paid $198/kW-yr for its 20.0 MW of firm capacity. Under specified conditions, GEM 2 and GEM 3 are also entitled to capacity bonus payments and as-available capacity payments.

Edison states that the generating facilities have maintained high capacity factors since their first full years of production. The average annual capacity factors have been stable at a rate of 86% or greater since 1992, reaching 96% and 90% in 1995 and 1996, respectively. During the summers of 1994 and 1995, the generating facilities achieved monthly average capacity factors of nearly 100%. In light of this stable operating history and the conclusions reached by its independent expert consultants, Edison believes that the generating facilities are technically capable of maintaining similarly high levels of output for the remainder of the first periods of the contracts. Edison has also determined that GEM 2 and GEM 3 are financially sound and would operate viably at least through October 1, 1999, in the absence of a buyout.

Termination Agreement

Edison considered GEM 2 and GEM 3 to be attractive candidates for buyouts because the fixed, first period ISO4 energy and capacity payment terms under the contracts were considerably higher than currently prevailing and projected market rates. Accordingly, in late 1994, Edison approached GEMLP about the possibility of

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[2] Public Utilities Code § 390, enacted as part of Assembly Bill 1890 (Stats. 1996, ch. 854), establishes formulas for calculating short-run avoided costs.

restructuring or terminating the contracts. GEMLP indicated its willingness to discuss a buyout of the contracts and the parties began negotiating. On December 15, 1995, Edison and GEMLP entered into a confidentiality agreement to protect the confidentiality of the negotiations and other aspects of the contract buyouts, including the terms of the termination agreement.

EMP, Inc., one of the partners of GEMLP, is a wholly owned subsidiary of Edison Mission Energy. Edison Mission Energy is a wholly owned subsidiary of the Mission Group which, in turn, is a wholly owned subsidiary of Edison International, Edison's parent company. Due to the affiliate nature of the GEM 2 and GEM 3 projects, Edison took steps to ensure there would be no question that the terms of the contract buyout were negotiated on an arms-length basis. To this end, Edison retained Coopers & Lybrand L.L.P. to observe the negotiations with GEMLP and verify that GEMLP received no preferential treatment as a result of its Edison-affiliated nature. As set forth in his prepared testimony, Jeremy L. Sacks of Cooper & Lybrand L.L.P. concluded that Edison's approach to the negotiations with GEMLP was consistent with previously negotiated transactions between Edison and other QFs, and that GEMLP did not receive any favorable or partial treatment.

On December 26, 1996, the parties exchanged correspondence outlining the terms of the contract termination agreement and the present application. On May 6, 1997, Edison made a presentation to ORA regarding the proposed buyout of the contracts.

Subsequent to this initial presentation to ORA, an issue arose regarding the ability of GEMLP to secure the consent of one of the project creditors to the terms of the proposed termination agreement. Edison and GEMLP agreed that implementation of the termination agreement requires the consent of all project creditors who would be affected by the buyout of the contracts, or an effective substitute for such consents. To that end, as set forth more fully in the prepared testimony of W. Joseph Dryer, GEMLP continued to negotiate with the creditor in an effort to secure the necessary consent. As of the date of this application, GEMLP reached a preliminary understanding with the creditor; if finalized, the agreement would result in GEMLP obtaining the creditor's consent to the termination agreement.

In the event the consent is not forthcoming, GEMLP has informed Edison that it intends to file a petition for relief under Chapter 11 of the United States Bankruptcy Code and seek a final order of a bankruptcy court that would be binding upon the creditor and that would authorize GEMLP to perform the terms and conditions of the termination agreement. GEMLP believes that securing approval of the termination agreement from a bankruptcy court would be more expeditious than other methods of obtaining the creditor's involuntary consent, such as the initiation of litigation. Such a bankruptcy filing, moreover, would not impair the project's viability or impact its operations. Accordingly, the termination agreement permits GEMLP to substitute a final order of a bankruptcy court, containing specified terms, for the creditor consents otherwise required for the termination agreement to become effective.

On July 27, 1997, Edison made another presentation to ORA regarding these developments since the May meeting. The parties executed the termination agreement on August 20, 1997. (Exhibit SCE-3.)

The effectiveness of the termination agreement, including Edison's obligation to make termination payments, and the termination of the contracts are subject to the condition precedent of obtaining unconditional approval of the termination agreement by the Commission, in the form of a decision that becomes final and nonappealable no later than December 31, 1997.

Commission approval is defined in the termination agreement as a decision that approves the termination agreement in full and in the form presented, that finds the termination agreement to be reasonable and prudent, and that expressly finds that all payments to be made by Edison under the termination agreement will, to the same extent as power purchase payments to qualifying facilities, be deemed reasonable and recoverable in full by Edison though rates or such other cost recovery mechanism as may be authorized by the Commission, subject only to Edison's reasonable administration of the termination agreement. In the event of a favorable Commission decision, Edison may, in its sole discretion and upon notice to GEMLP, waive the requirement that the decision become final before the termination agreement can go

into effect. In such a case, the termination agreement will take effect on the last day of the month in which Edison so notifies GEMLP.

Along with the termination agreement itself, Edison also filed the testimony of its employees who negotiated the buyout and the consultants who evaluated ratepayer benefits and the viability of the GEM 2 and GEM 3 generating facilities. (Exhibits SCE-2, SCE-4, SCE-5, and SCE-6.)

Project Viability

In past applications similar to this one, the Commission has required a persuasive showing that a buyout will benefit ratepayers more than keeping the contract in place, and that the generating facility is a viable one that would not be likely to shut down prior to completing the contract.[3]

As part of the buyout negotiation process, Edison performed analyses of the GEMLP project's economic, resource and technical viability. Edison also engaged GeothermEx and Boswell, independent outside consultants, to prepare reports evaluating the generating facilities and the Geo East Mesa geothermal reservoir.[4]

In performing their analyses the consultants reviewed the contracts and performance data supplied by Edison and information provided by GEMLP during a January 30, 1997 visit by Boswell to the generating facilities. Boswell assessed the generating facilities on the basis of technical information found in reports for similar

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[3] See San Diego Gas & Electric Company, Decision (D.) 94-12-038, 58 CPUC2d 104 (1994); Southern California Edison Company, D. 95-10-041, 62 CPUC2d 142 (1995); Southern California Edison Company, D.95-11-058, 62 CPUC2d 472 (1995). See, generally, Power Purchase Contracts, D.88-10-032, 29 CPUC2d 415 (1988); Opinion on Guidelines for Year 11-Related Restructuring, D.94-05-018, 54 CPUC2d 383 (1994).

[4] See Exhibit SCE-5 and 6. In June 1995, Edison also did an internal analysis of the generating facilities and the geothermal resource. This analysis found that the generating facilities themselves were well-designed and maintained and technically viable, but raised concerns about GEMLP's ability to perform under the contracts due to the declining temperature of the production brine. Because of the concerns raised by the internal report, Edison retained GeothermEx and Boswell as outside, independent experts to reevaluate the project and resource.

facilities. For the geothermal resource analysis, GeothermEx used industry-wide information, as well as historical data from the Geo East Mesa geothermal resource.

The outside consultants concluded that GEMLP is a viable project that will operate at or near full contract capacity for the remainder of the first period, in the absence of a successful buyout. While the data suggests that the generating facilities will be technically capable of operating well into the second period, according to Edison, with respect to economic viability, GEM 2 and GEM 3 are not expected to continue operating much past the end of the first period in June 1999, due to the change in energy pricing to Edison's short-run avoided cost of energy during the second period of the ISO4 contracts, unless significant operating cost reductions occur or short-run avoided energy prices are much higher than forecast. The only exception to this last conclusion involves the first summer season of the second period, when Edison expects that the generating facilities would continue to operate in order to earn the high peak season capacity payments and bonuses. Edison accordingly analyzed the contract terminations with the expectation that both generating facilities would cease operations shortly after October 1, 1999, when the summer season ends.

Protest of ORA

ORA agrees that the contract terminations will provide significant benefits to ratepayers. However, ORA believes that some of the input assumptions underlying Edison's analyses are not sufficiently conservative. According to ORA, Edison makes at least two assumptions which may overstate the benefits of the terminations. ORA's ratepayer benefit analyses show reduced benefits to ratepayers.

ORA protests for the limited purposes of opposing the payment of an incentive reward in this case and challenging the benefit analyses. The incentive award ORA refers to was adopted in D.93-12-063, as modified by D.96-01-09, slip, op. at 132, where we stated that we would allow the utility's shareholders to retain 10% of the net ratepayer profits resulting from renegotiations of QF contracts. ORA states that if the Commission chooses to apply the incentive reward to this buyout, ORA recommends that the Commission adopt its analyses, submitted under seal. ORA also recommends

that the Commission apply the incentive based upon actual savings relative to future replacement cost, based upon ORA's model.[5] ORA argues that if the incentive is adopted based on a forecast, ORA's forecast should be used. According to ORA, if Edison's analyses are adopted, there may be an excessive incentive reward to Edison relative to the savings to be received by ratepayers from the termination.

ORA protests the payment of a reward for this contract restructuring. According to ORA, all the savings from the terminations are within the rate freeze period, and thereby may accrue solely to Edison's shareholders. ORA believes that even in the absence of an incentive reward, Edison's shareholders will benefit from both sides of this transaction, through an increase in "headroom" for recovery of transition costs, and through its affiliate, Mission Energy, which has an ownership interest in the GEM projects. ORA submits that for these reasons, it is inappropriate to pay an additional incentive reward in this case.

Response of Edison

Edison states that the only issues raised by the protest are whether it should receive an incentive payment and, if an incentive is paid, whether it should be based upon actual savings relative to future replacement costs or ORA's forecast of future costs, rather than Edison's forecast.

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[5] ORA submitted a petition for modification of D.96-12-077 recommending the Commission base the incentive reward on actual savings. The petition is still pending. This petition will determine the exact amount Edison may recover under this restructuring, subject to the cap set in today's decision. This issue and related QF issues are being considered in the electric restructuring proceeding, Rulemaking (R.) 94-04-031, Investigation (I.) 94-04-032.

Edison disagrees with ORA's contention that no shareholder incentive should be paid to encourage utilities to restructure QF contracts. However, Edison states that it will not address the propriety of the shareholder incentive in this proceeding.[6]

Edison also disagrees with ORA's contention regarding how the shareholder incentive should be calculated in this case. Nonetheless, for purposes of this case only, and solely for the purpose of avoiding further delay in the consideration of this Application due to concerns about the appropriate amount of a shareholder incentive, Edison stipulates that the assumed level of ratepayer savings for purposes of calculating Edison's contract restructuring incentive may be deemed capped at the $10 million level suggested by ORA. Edison expressly reserves its right to dispute any similar position taken by ORA in other pending or future cases.

Discussion

The Commission scrutinizes the reasonableness of buyouts on a case-by-case basis. We realize that the fixed prices paid to a QF for the first 10 years of an ISO4 contract generally have been higher than the short-run avoided cost prices that will be paid after the initial 10 years. We look closely, therefore, at whether ratepayer benefits of a buyout exceed the lower energy prices that can be expected to be paid over the life of the power purchase agreement. We look closely, as well, at whether the QF project is likely to continue in operation, since it would make no sense to make buyout payments to an energy supplier that was not likely to stay in business. We believe that Edison has adequately demonstrated that the GEM 2 and GEM 3 geothermal facilities meet the Commission's viability criteria.

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[6] That issue has been extensively addressed in the electric restructuring proceeding, including in D.96-12-077 and ORA's pending Petition to Modify same. See, e.g., "Response of Pacific Gas and Electric Company (U 39 E), Southern California Edison Company (U 338 E), and San Diego Gas and Electric Company (U 90 E) in opposition to the Office of Ratepayer Advocates' Petition for Modification of Decision 96-12-077.")

Findings of Fact

1. The GEMLP power purchase agreement is technically and economically viable.

2. Edison states that the termination agreement will result in total expected benefits to Edison's customers of $19.8 million (January 1, 1997 net present value (NPV) @ 10% discount rate).

3. ORA states that its analyses show benefits to ratepayers which are less than estimated by Edison.

4. Other than a limited protest filed by ORA, no protests have been received, and no hearing is necessary.

5. In similar proceedings, the Commission has conditioned permanent recovery of expenses incurred under the approved agreements upon reasonable contract administration by the utility.

Conclusions of Law

1. The termination agreement will yield substantial ratepayer benefits.

2. The termination agreement should be approved as reasonable, subject to the assumed level of ratepayer savings, for purposes of calculation of the contract restructuring incentive, being capped at a level of $10 million.

3. Edison's request for recovery of expenses incurred under the termination agreement should be conditioned on Edison's reasonable performance of its obligations and exercise of its rights under the terms of the agreement.

4. The application should be granted as provided in the following order.

5. In order that benefits of the termination agreement may be realized promptly, this order should be effective immediately.

O R D E R

IT IS ORDERED that:

1. The application of Southern California Edison Company (Edison) for approval of the contract termination agreement between Edison and Geo East Mesa, L.P., as set forth in exhibit SCE-3 of the application, is granted, and the Termination Agreement is

approved, subject to the assumed level of ratepayer savings being capped at a level of $10 million for purposes of calculation of the contract restructuring incentive.

2. The Termination Agreement is found to be reasonable, and Edison's actions in entering into the agreement were prudent.

3. Edison is authorized to recover in rates all payments under the Termination Agreement through its Energy Cost Adjustment Clause, or any other mechanism authorized by the Commission, to the same extent as any other cost associated with a qualifying facility is reasonable, subject only to Edison's prudent administration of the Termination Agreement.

4. The motion of Edison for a protective order is granted. The economic analyses and other settlement information redacted from the application and exhibits which documents in unredacted form have been submitted as a sealed attachment to the motion for protective order, shall remain under seal for a period to and including December 31, 1998, and during such period shall not be made accessible or disclosed to anyone other than Commission staff except on the further order or ruling of the Commission, the Assigned Commissioner, the assigned Administrative Law Judge (ALJ) or the ALJ then designated as Law and Motion Judge.

5. Likewise, the limited protest of Office of Ratepayer Advocates, including the economic analyses attached to the protest, shall remain under seal for a period to and including December 31, 1998.

This order is effective today.

Dated February 19, 1998, at San Francisco, California.

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