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Decision 98-06-020 June 4, 1998

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

| Application of PACIFIC GAS AND ELECTRIC COMPANY for Authorization to Sell Electric Distribution and Transmission Facilities Serving the Cities of Ripon, Escalon, Riverbank and Oakdale and Surrounding Rural Areas to the Modesto Irrigation District Pursuant to the Public Utilities Code Section 851 and for Approval of Service Area Agreement Under Public Utilities Code Section 8101. (Electric) (U 39 E) | Application 97-07-030 (Filed July 24, 1997) ORIGINAL |
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# OPINION

## Summary

This decision denies the application of Pacific Gas and Electric Company (PG&E) for approval of an agreement to sell a portion of its distribution and transmission system to Modesto Irrigation District (MID). We find the agreement conflicts with our policies favoring competition in the electric industry.

## Procedural Background

PG&E filed this application on July 24, 1997 seeking Commission approval of an agreement between it and MID. The Office of Ratepayer Advocates (ORA) and The Utility Reform Network (TURN) filed protests to the application. The Commission held a prehearing conference on September 26, 1997 at which the parties discussed the issues raised by the application. Subsequently, TURN, ORA, PG&E and MID submitted testimony. At a second prehearing conference held on December 17, 1997, the parties stipulated that hearings were not

required. Although the parties' views differ on several matters of policy and law, the application does not raise factual disputes.

Following the second prehearing conference, the assigned administrative law judge (ALJ) issued a ruling on December 30, 1997 entering into the record MID's testimony, a procedural matter which had been overlooked during the prehearing conference. The ruling was tentative to provide an opportunity for a party to object to the entry of the document into the record. Subsequently, Hunt Foods, Inc. (Hunt) objected to the entry of the testimony on the basis that since the time of the second prehearing conference, MID had adopted a direct access program which Hunt alleges is unlawful and contrary to public policy. We deny Hunt's request. By offering no more than unsupported statements regarding its objections to MID's direct access program, Hunt provides no justification for excluding MID's testimony from the record. We herein enter into the record of the proceeding MID's testimony, making final the ALJ's December 30, 1997 ruling. We deny MID's motion to strike on the basis that the allegations in Hunt's pleading are not included in the record as evidence and striking them would therefore serve no purpose.

In its opening brief, Hunt again addresses its concerns regarding MID's direct access program. Like Hunt's response to the ALJ's ruling, Hunt's brief alleges MID's direct access program is unlawful and anticompetitive. On the basis of these allegations, Hunt proposes that the Commission either deny the request for approval of the sale or exempt Hunt from the exclusivity provisions of the proposed sale of facilities. The brief also asks the Commission to delay the issuance of a final order to April, 1998 to provide Hunt an opportunity to negotiate its differences with MID. We deny Hunt's procedural motions to delay the proceeding. We also decline to consider here the factual allegations Hunt presents in its brief which are not included as part of the evidentiary record.

Hunt declined an invitation by the assigned ALJ to move for the Commission to reopen the record to take new evidence on matters related to those allegations. Controversial factual matters which are not included in the evidentiary record, may not, as a matter of law, be considered in our deliberations here. We proceed to consider disputes which are the subjects of record evidence.

### Background to PG&E's Application

MID is a California irrigation district whose powers include the authority to acquire and operate electric facilities and to sell electricity to municipalities, public utility districts or individuals. MID currently serves about 90,000 customers in Central California. In recent years, MID has sought to reduce electric rates to its customers by reducing its costs and competing with PG&E for electric customers. MID now offers service to certain large customers in PG&E's territory, a circumstance which has motivated PG&E to pursue legal and legislative remedies in several forums, including the Federal Energy Regulatory Commission, Superior Court and the California State Legislature. In 1996, MID and PG&E undertook to negotiate their differences. The outcome of their negotiations is the agreement which is the subject of this proceeding.

### PG&E's Application

PG&E's application requests that the Commission approve an agreement with MID for MID's purchase of certain distribution and transmission facilities. The sale would permit MID to own and operate its own distribution system in the cities of Ripon, Escalon, Riverbank, and Oakdale and surrounding rural areas. The agreement, which is composed of several subordinate agreements, is summarized as follows:

1. *Master Agreement.* The Master Agreement establishes the general framework of the transaction. It provides for a payment by MID of $89.8 million for the transfer of assets and property rights; the payment by MID of $54.3 million to satisfy the competition transition charge (CTC) obligations [1]

2. *Asset Sale Agreement.* The Asset Sale Agreement provides for the sale and transfer by PG&E to MID of the electric substations, distribution lines, transmission lines and associated land rights required to serve the retail electric service customers in the purchase zone. The Asset Sale Agreement also requires MID to wheel to PG&E at no charge the power produced by Qualifying Facilities (QFs) under contract with PG&E in the purchase zone. The Asset Sale Agreement also grants MID an option to buy PG&E's Oakdale office.

3. *Partial Termination and Second Service Area Agreements.* The Partial Termination Agreement terminates an agreement reached in 1940 between PG&E and MID restricting competition between them and replaces it with the Second Service Area Agreement which includes a provision prohibiting competition for distribution and transmission services between MID and PG&E for a period of 25 years. The Second Service Area Agreement permits direct access transactions between MID and PG&E and does not affect competition by other parties. The Second Service Area Agreement requires the Commission to oversee the agreement.

4. *Release, Praxair Release and Tolling Agreement.* MID and PG&E agree to release each other from liability. PG&E has obtained a release of liability from Praxair, Inc., originally a PG&E customer who has obtained service from MID and who was involved in litigation with PG&E. MID and PG&E also agree to toll all unexpired statutes of limitation as to causes of action which either party may have against the other relating to MID's proposed service outside its traditional electric service area.

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[1] "CTC" as it is used here refers to the utility charge for recovering uneconomic electric investments. The charge was authorized by Assembly Bill (AB) 1890 (Stats. 1996, Ch. 854) and has been implemented by several decisions issued in Rulemaking (R.) 94-04-031/Investigation (I.) 94-04-032.

To effectuate the agreements, PG&E herein seeks a Commission order which:

1. Authorizes PG&E to sell to MID certain electric distribution and transmission facilities for $89.8 million;

2. Approves PG&E's proposed accounting and ratemaking treatment of the sale, including holding that the before-tax gain on sale of $37.8 million should accrue to PG&E's shareholders;

3. Approves the Partial Termination Agreement and the 25-year Second Service Area Agreement that would define exclusive geographic zones within which MID and PG&E would own or control electric distribution facilities and provide electric distribution services to customers and hold that such agreement is in the public interest;

4. Adopts a plan for the Commission's continuing oversight of the new service area agreement;

5. Finds that PG&E's obligation to serve customers in the purchase zone ceases with the closing of the sale;

6. Finds that the responsibility for the CTC and other non-bypassable surcharges imposed by PG&E on retail customers is fully satisfied by MID's lump-sum payment of $54.3 million and that PG&E and its shareholders will not be required to assume any liability for further CTC obligations associated with the customers that will, as a result of the sale, be served by MID;

7. Authorizes PG&E to provide certain customer information to MID prior to the closing date in the asset sale agreement in order to facilitate a smooth transition in billing customers who will be served by MID as a result of the sale;

8. Authorizes PG&E's release of customers in the purchase zone from any obligations to repay electric energy efficiency grants or rebates that may arise solely from those customers' termination of PG&E's electric service as a result of the sale to MID; and

9. Approves a notice of determination to be prepared by the Commission staff stating that the Commission has reviewed and considered the information contained in the negative declaration prepared by MID in approving this application.

PG&E's application states the agreements between PG&E and MID to sell the facilities will be good for PG&E's shareholders and ratepayers, including those who will become MID's customers and those who will remain on PG&E's system.

MID supports PG&E's application in all respects, arguing that the transaction is beneficial to all affected parties.

### Protests to PG&E's Application

ORA and TURN protested PG&E's application. TURN and ORA propose that the application be approved only under certain conditions, proposing that the Commission:

1. Allocate the gain on sale from the transaction to offset PG&E's CTC;
2. Order PG&E to collect the grants and rebates over $500 owed by leaving customers, with the funds flowing to remaining customers and to refund to ratepayers a portion of the profits it earned on related programs; and
3. Adjust PG&E's revenue requirement to reflect the reduction in PG&E's operating costs which result from the sale.

ORA also proposes that the Commission reject the 25-year exclusive Second Service Area Agreement or at least require a modification to it which would permit the Commission to terminate the agreement if circumstances warrant.

### Is the Second Service Area Agreement Consistent with Law and Commission Policy?

PG&E asks the Commission to approve the Second Service Area Agreement with MID. The main purpose of the agreement is to identify those

geographic areas served by the respective utilities. The Second Service Area Agreement would eliminate competition between PG&E and MID for 25 years. It settles lawsuits between PG&E and MID which would have addressed MID's efforts to bypass PG&E's distribution system. For these provisions, PG&E agrees to pay MID $34 million. MID agrees to repay $24 million to PG&E if the anticompetitive provisions of the agreement are terminated.

ORA objects to portions of the agreement which would restrict competition between PG&E and MID with regard to transmission and distribution for a period of 25 years. ORA argues that the provision is contrary to Commission policy and will foreclose potential benefits of competition by preventing both uneconomic and economic bypass of the transmission and distribution system. ORA also objects to provisions which it interprets as requiring PG&E's ratepayers to assume the cost of related provisions, up to $34 million. Hunt also objects to portions of the overall agreement which would limit its ability to choose its utility.

We concur with ORA's evaluation of the Second Service Area Agreement which would restrict competition. While we have not undertaken an investigation into transmission and distribution competition, in general the Commission's policy is to promote competition in all markets where competition may be economic. Apparently, competition in transmission and distribution markets may be possible in some areas of the state. We recently addressed the issue in PG&E's "rate design window" proceeding in which PG&E sought discretion to discount its distribution rates in order to foreclose uneconomic bypass in distribution markets. We granted PG&E's request with the view that PG&E should be able to "compete for distribution customers who would otherwise uneconomically bypass its system." In reaching that result, we considered PG&E's arguments to the effect that its rate flexibility proposal was

consistent with the general objectives of AB 1890 and Commission policy to promote competition. [2] (See D. 97-09-047.) Here, PG&E argues that the provision in the Second Service Area Agreement with MID that restricts competition is not contrary to Commission policy or AB 1890 because their related objectives are limited to promoting competition in generation markets, not distribution and transmission markets.

PG&E appears to interpret the objectives of AB 1890 and Commission policy narrowly. Our interpretation, however, is clear. Where economic competition is possible, and where other public policy goals are not unduly compromised, our policies will promote competition in utility markets. AB 1890 refers to generation only but certainly does not anticipate a policy to discourage competition in other electric markets. As a practical matter, we do not know whether competition in distribution markets is imminent. We nevertheless decline to approve any agreement which would prohibit it absent a demonstration that such a provision is the only reasonable way to prevent specified harm.

Notwithstanding our policy and AB 1890, state law creates some confusion over the matters at issue here. As evidence that the Second Service Area Agreement's provisions are consistent with state policy, MID and PG&E rely on Section 8101, enacted in 1951, which provides in pertinent part that,

> "Under certain conditions the sale and distribution of electric power and energy in the same geographical area both by an electrical utility and by an irrigation distribution, results in duplication of service...and is detrimental to the efficiency and best interests of

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[2] Recently, we also provided an Advisory Opinion to the Stanislaus County LAFCO expressing our view that a reorganization by the Patterson Water District would not have a significant adverse impact on the rest of PG&E's ratepayers. Patterson Water District proposed to provide electrical service to new and existing customers within its boundaries (Res. E-3528).

> such districts. ... It is the policy of this State to induce such utilities and irrigation districts to prevent or remove such economic waste and to adopt more efficient and economic methods of distribution of electric power and energy, and to that end encourage the definition of areas to be served or not be served by each."

MID states its commitment to serving the cities which are the subject of the Second Service Area Agreement and observes that if the Commission does not approve the transaction, it intends to build duplicative distribution facilities. It believes such an outcome is contrary to Legislative intent.

We agree that state policy enunciated in Section 8101 discourages duplication of the distribution system in recognition that a single system is likely to be more efficient. Our approval of PG&E's proposal to discount distribution rates to cost recognizes that setting rates above cost may encourage the construction of duplicative facilities, facilities which are not more efficient than those on the existing system but whose construction is motivated by artificially high utility rates. This is one of the conditions under which Section 8101 would anticipate economic waste. However, once PG&E's distribution rates are set at cost, discouraging construction of new facilities is also inefficient. This is because the cost of those facilities is presumably less than the cost of the utility facilities. To the extent that Section 8101 is concerned with economic efficiency, we believe that state policy does not discourage new construction of distribution facilities where the competing utility's distribution rates are set at cost. Where, as here, the utility's distribution rates are set at or may be negotiated to the cost of the facilities, duplication of facilities would not necessarily be uneconomic and would therefore not conflict with state policy.

We interpret Section 8101 in conjunction with our reading of Section 8104, which permits us to grant applications limiting utility service areas upon a finding that "it is for the best interests of the State and of the utility, and not incompatible with any public interest that the petition be granted..." We have

already stated on numerous occasions that the policy of the Commission is to promote competition where it is economic and would not unduly compromise other public policy objectives. In light of current circumstances and the State Legislature's recent commitments to promote competition in the electric industry, we cannot find that an agreement to restrict competition for many years would best serve the interests of the state. The agreement is in that way incompatible with the public interest.

Overall, the agreement would have three separate elements which may restrict competition. First, the customers who are currently in PG&E's territory, but who would become MID customers under the agreement, would no longer have the potential of choosing between MID and PG&E for their distribution service. As skirmishes over service to these customers were at the root of this application, this element of choice is not academic. Second, these same customers would be denied opportunities to choose their generation providers until as late as 2002 because, unlike PG&E, MID is not required to provide customers the same direct access opportunities as PG&E until that date and has indicated that it will not do so. Third, PG&E customers outside of the expanded MID territory would lose any opportunities for competition from MID in distribution markets for at least five years due to MID's agreement not to compete.

The potential benefits from these three aspects of competition cannot be readily quantified. However, our policy judgment has been that true competition is preferable to even the most effective regulation. The benefits to ratepayers from allocating the gain on sale to CTC, as advocated by ORA and TURN, would produce a maximum benefit of about $37 million. The proposed decision by the assigned ALJ would lower this benefit to about $28 million, while PG&E's proposal would eliminate this benefit entirely. Aside from the potential gain-on-

sale benefits, there is little or nothing in the agreement to benefit PG&E ratepayers (with the exception of those customers who would receive lower rates by becoming MID customers, but would be required to forego certain distribution and generation competitive options). In contrast, the benefits to ratepayers from distribution and generation may be considerably more than $37 million, as competitive forces compel PG&E and MID to lower rates and improve service offerings.

Another provision of the Second Service Area Agreement which we find troubling is the requirement that the Commission exercise continuing oversight over the Second Service Area Agreement. MID and PG&E state the purpose of this provision is to provide them with protection against federal antitrust laws by creating a defense of "state action." The provision also prohibits the Commission from terminating the agreement if its provisions or parties' performance becomes unsupportable as a matter of policy or law. We could not accept the provisions in the Second Service Area Agreement which commit the Commission to certain actions. First, we would not agree to become a party to a private agreement which, by circumscribing our oversight for 25 years, the Second Service Area Agreement would require. Neither would we have the authority to bind future Commissions to the provisions of the order we issue today. In any event, we wonder what purpose our oversight would serve because the agreement prohibits us from terminating it even in the event we determine that its provisions are contrary to the public interest. Perhaps most importantly, we would decline to use this Commission's resources to protect two parties against federal law where they have agreed not to compete, contrary to our policy and without any demonstration that PG&E's customers are better off as a result.

## Conclusion

This application seeks approval of an agreement between a regulated utility and a governmental entity with powers of condemnation. As MID observes, this Commission may have little interest in such transactions under certain circumstances. This is not one of those circumstances. Here, PG&E seeks approval of an agreement which may have affect PG&E's rates and the structure of the electric system in various regions of the state.

We consider this application to be the first of its kind, and our conclusions should be viewed as applicable only to the circumstances in this case. For the first time since the Legislature and this Commission have stated their common goal to promote competition in the state's electric markets, we are asked to review an agreement guiding the sale of part of PG&E's distribution system to an entity that has sought to compete with PG&E for related distribution customers and services. We do not know whether to expect more applications such as this, although we expect that opening markets in electric generation may provide some impetus for competition in distribution markets.

Today's decision does not approve the agreement between MID and PG&E because of our concerns with the anti-competitive aspects of the Second Service Area Agreement. For that reason, we do not need to resolve the remaining controversies raised in this proceeding.

## Findings of Fact

1. It is reasonable to assume that PG&E may be subject to competition in some of its distribution markets in upcoming years.

2. The agreement presented for approval in this application results from MID's efforts to compete with PG&E in providing distribution services.

3. The Second Service Area Agreement presented for approval in this proceeding would restrict competition between PG&E and MID in their respective distribution and transmission markets for 25 years.

4. It is the Commission's policy to promote competition in markets where competition may be economic and where competition would not unduly compromise other public policy goals.

5. Section 8101 addresses circumstances where duplication of distribution facilities would create economic waste.

6. Section 8104 permits the Commission to restrict utility service areas upon a finding that such a restriction would service the public interest.

7. If PG&E's distribution rates are set above cost, the construction of new distribution facilities is likely to be economically inefficient, all other things being equal. If PG&E's distribution rates are set at cost or may be negotiated to cost, the construction of new distribution facilities is economically efficient, all other things being equal.

8. The Second Service Area Agreement specifies certain Commission oversight of its provisions in order to provide the parties with immunity from antitrust law.

9. The Second Service Area Agreement prohibits the Commission from terminating the agreement.

10. PG&E has not demonstrated that its agreement not to compete with MID is in the public interest.

## Conclusions of Law

1. The Commission should not approve this agreement between MID and PG&E that would restrict competition between them on the basis that the agreement is contrary to Commission policy and the public interest.

2. The Commission should not approve this agreement which binds this Commission to certain types of oversight or circumscribes its regulatory discretion for any purpose and specifically for the purpose of providing MID and PG&E immunity from antitrust laws.

## ORDER

**IT IS ORDERED** that:

1. The application of Pacific Gas and Electric Company for authorization to sell certain electric distribution and transmission facilities to Modesto Irrigation District is denied.

2. This proceeding is closed.

This order is effective today.

Dated June 4, 1998, at San Francisco, California.

JESSIE J. KNIGHT, JR.
HENRY M. DUQUE
JOSIAH L. NEEPER
Commissioners

I dissent.

/s/ P. GREGORY CONLON
Commissioner

I dissent.

/s/ RICHARD A. BILAS
President