Decision 98-11-067 November 19, 1998

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of PACIFIC GAS AND ELECTRIC COMPANY to Modify Diablo Canyon Pricing and Adopt a Customer Electric Rate Freeze in Compliance with D.95-12-063.	Application 96-03-054 (Filed March 29, 1996)

ORIGINAL

ORDER CLARIFYING D.97-05-088 AND DENYING REHEARING

I. SUMMARY

This order disposes of several applications for rehearing of the "Pricing Modification Decision," Re Pacific Gas & Electric Company (Pricing Modification) [D.97-05-088] (1997) __ Cal.P.U.C.2d __. Certain parties withdrew issues from the application for rehearing process and those matters are dismissed. This order discusses the Commission's approach to fixing Diablo Canyon sunk costs and explains why this approach is both proper and properly supported. This order also concludes that allegations of error regarding the rule against retroactive ratemaking, the ability to modify past decisions, operations and maintenance expenses, rate reduction bonds and the Diabalo Canyon Independent Safety Committee do not demonstrate error. Therefore, after making a modification to the Pricing Modification Decision, this order denies rehearing of D.97-05-088.

II. BACKGROUND

The Pricing Modification Decision modifies the pricing mechanism for the Diablo Canyon Nuclear Power Plant (Diablo Canyon), in light of

California's electric restructuring. The history of the construction of Diablo Canyon is related and analyzed in Re Pacific Gas and Electric Company (Diablo Canyon Rate Case) [D.88-12-083] (1988) 30 Cal.P.U.C.2d 189, which is referred to as the "Rate Case Decision." In brief, when Diablo Canyon entered commercial operation, PG&E sought to have approximately $5.5 billion of its Diablo Canyon capital expenditures included in rate base. In proceedings before the Commission a number of parties vigorously opposed PG&E. The then-named Division of Ratepayer Advocates (DRA), for example, argued that $4.4 billion of Diablo Canyon capital expenditures should be disallowed. However, the Diablo Canyon rate case was never litigated. After four years of case preparation, most parties agreed to a settlement. Under that settlement, none of Diablo Canyon's costs were to be included in PG&E's rate base. Instead, Diablo Canyon was to be subject to a unique "performance based pricing" methodology over a 28 year period. The Rate Case Decision approved that settlement, which was later revised.[1]

In December, 1995 the Commission's "Preferred Policy Decision" announced the restructuring of the regulation of electric utilities. (Re Proposed Policies Governing Restructuring, etc. (Preferred Policy) [D.95-12-063] (1995) 64 Cal.P.U.C.2d 1.) Under the Commission's proposed "preferred policy," electricity prices were to be determined through market mechanisms instead of being set by the Commission. A transition cost recovery mechanism was provided to account for generation plants that produced electricity at above-market prices. In addition,

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1 In 1994, DRA petitioned to reopen the Diablo Canyon settlement. As a result, DRA, PG&E and other parties agreed revise the terms of the settlement. The revised settlement continued to exclude Diablo Canyon from rate base and to apply the unique Diablo Canyon performance based pricing methodology. However, the 1995 settlement reduced the price of Diablo Canyon over a three year period. The Commission adopted the revised settlement in Re Pacific Gas and Electric Company (Revised Diablo Canyon Settlement) [D.95-05-043] (1995) 60 Cal.P.U.C.2d 1.

the preferred policy indicated a desire that all CPUC-regulated nuclear facilities conform their rate structures to the model adopted in the SONGS settlement.[2] In 1996, California enacted comprehensive electric restructuring legislation, Assembly Bill (AB) 1890. (Stats. 1996, ch. 854.) This legislation confirmed the broad outlines of the Commission's preferred policy. It also set out a number of specific mandates, most relating to the recovery of transition costs.

Under AB 1890 and our preferred policy, if a generation plant produces electricity at above-market prices it is considered to be "uneconomic." In simplistic terms, an uneconomic price reflects two elements: operational costs associated with running the plant and the "fixed" cost of building the plant, which—under traditional ratemaking principles—was paid off over time with revenue generated by the plant. The electric restructuring transition period provides an opportunity for making a plant "economic," i.e. capable of selling electricity at market prices. This is achieved by writing down the plant's fixed cost until it is low enough to allow the plant to generate electricity at a market price. At the very least the transition period provides utilities with the opportunity to recover fixed costs—capital expenditures they actually incurred—and transition period operating costs, even if they cannot make the plant economic. Since electricity is now sold at its market price, amounts written off, called transition costs, are recovered through the non-bypassable competitive transition charge (CTC) that applies to all electricity customers during the transition period. (Cf., Pub. Util. Code, §367.) However, the collection of CTC does not alter a customer's rates. Rates have been frozen throughout the transition period, with some customers receiving a 10% rate reduction. (Cf., Pub. Util. Code, §368, subd. (a).)

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2 In 1996, ORA, Southern California Edison Company and San Diego Gas and Electric Company settled issues relating to units two and three of the San Onofre Nuclear Generating Station (SONGS). (Re Southern California Edison (SONGS Settlement) [D.96-01-011] (1996) 64 Cal.P.U.C.2d. 241.)

The Pricing Modification Decision alters Diablo Canyon ratemaking to accommodate electric restructuring and to conform to the SONGS model. Following the SONGS model, we determined to adopt accelerated depreciation of Diablo Canyon fixed costs, called "sunk costs," during the transition period and to use an "incremental cost incentive price" (ICIP) to recover operating costs. The Pricing Modification Decision determined the dollar amount of both Diablo Canyon sunk costs and the ICIP price. It then established a Diablo Canyon "revenue requirement" consisting of the amortization needed to pay off sunk costs plus the amount of ICIP needed to pay operating costs. This revenue requirement is the starting point for making transition cost calculations. To the extent the Diablo Canyon revenue requirement is higher than the market price for electricity, the above-market amount will be considered a transition cost, which PG&E has the opportunity to recover through CTC. The Pricing Modification Decision also resolved other matters such as questions of continued safety and local tax impacts.

III. DISCUSSION

Four applications for rehearing of the Pricing Modification Decision were filed. The parties filing were: PG&E; The Utility Reform Network (TURN); San Luis Obispo County and the San Luis Coastal Unified School District (County & District); and San Luis Obispo Mothers for Peace, Rochelle Becker and Life on Planet Earth (Mothers for Peace Group). Responses to the applications for rehearing were filed by: PG&E; TURN; DRA's successor the Office of Ratepayer Advocates (ORA); the California Energy Commission (CEC); and the Independent Safety Committee (Safety Committee).

On September 16, 1998 counsel for the County & District wrote to the Executive Director requesting the withdrawal of their application for rehearing. The County & District's letter stated that the issues underlying the application had been resolved through settlement and legislation. In light of this communication we will dismiss the County & District's application for rehearing. A copy of the County & District's letter is attached to this order as Appendix A.

On November 4, 1997 PG&E filed a letter in the correspondence file stating that if Advice Letter 1679-E was approved, we should consider section D of its application for rehearing (addressing the must-take status of Diablo Canyon) to be withdrawn. Advice Letter 1679-E was approved in Resolution E-3508. In light of this communication we will dismiss Section D of PG&E's application for rehearing. A copy of PG&E's letter is attached as Appendix B.

Of the rehearing issues that remain, the question of what methodology we should use to establish sunk costs is the most disputed. This question is discussed in Section A, below. The other issues (treatment of equipment and supply costs, issues relating to rate reduction bonds and the continuation of the Safety Committee) are discussed together in Section B.

A. <u>Sunk Costs.</u>

In order to establish the Diablo Canyon revenue requirement, the Pricing Modification Decision determined the dollar amount of Diablo Canyon sunk costs. The proper method for making this determination was hotly contested in this proceeding. The advocated various methods for determining sunk costs, each claiming its approach was mandated by applicable law.

PG&E proposed that sunk costs be established at an amount equaling its Diablo Canyon capital expenditures minus only depreciation that accrued during the settlement. The utility claimed this approach was warranted because it would forgo collecting revenue under the revised settlement agreement. On the other hand, TURN insisted that PG&E's Diablo Canyon capital expenditures be adjusted significantly before they were classified as sunk costs. TURN proposed two mechanisms to do this, claiming that sunk costs must be established at a level comparable to the amount of Diablo Canyon capital expenditures we would have entered into rate base had we conducted a reasonableness review in 1988.

The Pricing Modification Decision analyzed this question in a discussion of the applicability of Public Utilities Code section 463[3] and the merits of TURN's proposals. This discussion covered a number of points. We reviewed our responsibilities under section 463 and noted that care must be taken in establishing Diablo Canyon sunk costs because the ratemaking scheme resulting from the settlement agreement placed Diablo Canyon in a unique situation. Thus we implicitly rejected PG&E's claim that it was entitled to sunk cost treatment for all its capital expenditures in exchange for having given up the opportunity to collect revenue under the revised settlement agreement.

We also made the important observation that establishing Diablo Canyon sunk costs was part of our electric restructuring mandate. We were not engaged in traditional ratemaking for Diablo Canyon. Rather we were establishing "costs and categories of costs for generation related assets" that would be "recovered from all ratepayers on a nonbypassable basis" under section 367. By establishing the level of sunk costs, we would begin the accelerated recovery of those costs in the context of the transition to competition. In this context, we noted that two statutes pertained to the task of establishing sunk costs: section 463 and section 367.

Thus, although the Pricing Modification Decision concluded that some level of review of PG&E's capital expenditures was required before they could be established as sunk costs, it rejected the idea that this review should be accomplished by bringing the 1988 Diablo Canyon rate case back to life. Implicitly relying on the fact that this notoriously complex case had settled over ten years previously–in part because of the impracticality associated with litigating

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3 Section references indicate the Public Utilities Code unless otherwise specified.

it--we determined not to conduct a traditional reasonableness review of PG&E's Diablo Canyon capital expenditures before establishing sunk costs in the context of electric restructuring. By reaching this conclusion we rejected TURN's contention that sunk costs must be established now at a level comparable to the amount of Diablo Canyon capital expenditures we would have entered into rate base had we conducted a reasonableness review in 1988.

The Pricing Modification Decision then set out the standard it would use to establish sunk costs for Diablon Canyon in the context of the electric restructuring transition cost recovery mechanism. Considering both sections 463 and 367, the Pricing Modification Decision found that in order to establish Diablo Canyon sunk costs we "must disallow known and admitted errors or omissions above $50,000,000."[4] After reviewing the Rate Case Decision, the Pricing Modification Decision found that the mirror image error was just such an error. The Rate Case Decision found there was "no dispute that an error was made by PG&E and its contractors. The dispute is over the consequences of the error." (Re Pacific Gas & Electric Company (Diablo Canyon Rate Case) [D.88-12-083], supra, 30 Cal.P.U.C.2d at p. 269.) We noted that PG&E admitted the cost of the error was no more than $100 million and disallowed that amount from sunk costs.

The Pricing Modification Decision explained why this result was preferable to the proposals TURN had advocated. The Pricing Modification Decision found TURN's proxy "bore no relationship" to the question of which Diablo Canyon expenditures should be recovered as transition costs. We rejected TURN's approach because we had determined not to establish sunk costs by

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4 Elsewhere in the Pricing Modification Decision we concluded that PG&E's capital expenditures should be audited and any accounting irregularities reviewed for possible exclusion from sunk costs. (Re Pacific Gas and Electric Company (Pricing Modification) [D.97-05-088], supra, at p. 35 (mimeo.).) A report prepared for the Energy Division was released on September 3, 1998. We also excluded approximately $78 million in materials and supply costs from sunk costs, as discussed in Section B of this order.

referring to the amount of Diablo Canyon capital expenditures we would have entered into rate base had we conducted a reasonableness review in 1988. (Re Pacific Gas & Electric Company (Pricing Modification) [D.97-05-088], supra, at p. 32 (mimeo.).)

Both TURN and PG&E claim this result is error. Each party's application for rehearing again asserts that the law requires us to determine sunk costs using the methodology that party favors. We discuss the particulars of these claims individually, below. Overall, however, we believe they do not demonstrate legal error for one simple reason. The law makes it clear that agencies like this Commission have discretion to exercise expert judgment as they determine what a proper rate structure should be under a particular set of circumstances. Yet, both applications allege that unless we adopt a particular method or rate philosophy our decision will be in error. Nothing could be further from the truth. As the United States Supreme Court held in FPC v. Wisconsin (1963) 373 U.S. 294, 309, and later reaffirmed in Duquesne Light Co. v. Barasch (1988) 488 U.S. 299, 316:

> [T]o declare that a particular method of rate regulation is so sanctified as to make it highly unlikely that any other method could be sustained would be wholly out of keeping with this Court's consistent and clearly articulated approach to the question of the [Federal Power] Commission's power to regulate rates. It has repeatedly been stated that no single method need be followed by the Commission in considering the justness and reasonableness of rates.

We explain in detail below why the Pricing Modification Decision adopted a proper approach to determining sunk costs. We will also explain that our decision is appropriately supported and complies with relevant procedural standards, such as the rule against retroactive ratemaking and section 1709.

1. Section 463 Does Not Require Adoption of Another Method of Determining Sunk Costs.

TURN argues that the Pricing Modification Decision's approach to sunk costs is insufficient because section 463 requires the Commission to conduct a traditional reasonableness review before it establishes sunk costs. More generally, TURN's application argues that section 463 requires us to set sunk costs at a level comparable to the amount of Diablo Canyon capital expenditures we would have entered into rate base had we conducted a reasonableness review in 1988.

Section 463, subdivision (a) provides, in relevant part,[5] with emphasis added:

> For purposes of establishing rates for any electrical or gas corporation, the commission shall disallow expenses reflecting the direct or indirect costs resulting from any unreasonable error or omission relating to the planning, construction, or operation of any portion of the corporation's plant which cost, or is estimated to have cost, more than fifty million dollars ($50,000, 000), including any expenses resulting from delays caused by any unreasonable error or omission. . . . . This subdivision is a clarification of the existing authority of the commission, is not intended to limit or restrict any power or authority of the commission conferred by any other provision of law, and applies to all matters pending before the commission.

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5 The uncodified section 2 of Stats 1986, chapter 1212, which enacted section 463 discusses our responsibilities in our:

> . . . . final order and decision in the application of Pacific Gas and Electric Company for an increase in rates reflecting expenses related to the construction of that project known as the Diablo Canyon Nuclear Power Plant, if the commission determines that the company shall be allowed to earn a return on undepreciated capital costs related to the project. . . .

This language does not require us to conduct a traditional reasonableness review before establishing Diablo Canyon sunk costs. The application takes an overly doctrinaire approach to our responsibilities. Section 463 specifies the end result the Commission must achieve and leaves the selection of a means to that end to the Commission. The specific language of section 463 indicates that costs resulting from certain errors should be disallowed if they are unreasonable. We believe the inclusion of the word "unreasonable" indicates we may use our judgment in determining which costs should be disallowed and are not required to adopt any particular approach (such as the traditional reasonableness review) in order to make that determination. Indeed, section 463 states it "is a clarification of the existing authority of the commission, [and] is not intended to limit or restrict any power or authority of the commission conferred by any other provision of law . . . ."

Under our "existing authority," we may make rate determinations based on the criteria we find to be relevant in the circumstances. As the California Supreme Court has held, this Commission "may choose its own criteria or method of arriving at its decision, even if irregular, provided unreasonableness is not clearly established." (Pacific Tel. & Tel. Co. v. Public Utilities Com. (1971) 62 Cal.2d 624, 647.) In City of Long Beach v. Unocal California Pipeline Company [D.96-04-061] 66 Cal.P.U.C.2d 28, we defended our ability to depart from traditional ratemaking mechanisms and specifically rejected a claim that we were required to hold a general rate case before establishing oil pipeline rates, finding at 66 Cal.P.U.C.2d 31:

> . . . Cost-of-service ratemaking is an important—perhaps even the preeminent—ratemaking technique. However there is no single yardstick by sole reference to which rates may be judged reasonable. A number of different standards exist to judge the reasonableness of rates, just as a number of different standards exist to judge a building, a computer program, or any other

> complex object. [¶] We believe we may choose our own criteria or method of determining reasonableness, as appropriate to the specific situation with which we are presented.

Consistent with that approach, we must disagree that a full-blown reasonableness review is required in order for the Pricing Modification Decision to avoid error. So long as the Commission properly establishes sunk costs based on factors appropriate to the current circumstances, a full-blown reasonableness review is not a material factor in making disallowances. The mere fact that a reasonableness review did not occur in 1988 is insufficient to support the conclusion that sunk costs can only now be established by undertaking such a review. Similarly, we are not required to ensure that Diablo Canyon sunk costs are now set at a level generally comparable to the amount of capital expenditures PG&E would have been allowed to enter into rate base had the Commission decided the 1988 rate case. Just as the reasonableness review methodology is not required, section 463 does not require this Commission to make disallowances applicable during the transition period in a way that mimics the approach that would have been taken in 1988 had the case not settled.

In this respect, it is worth emphasizing that the Pricing Modification Decision considered a number of approaches to sunk costs and adopted the one we believed best fit current circumstances. That decision contemplated reviving the 1988 reasonableness review proceeding and determined that it was neither possible nor desirable under these circumstances. The claim that section 463's use of the phrase "any unreasonable error" requires such a thorough examination of PG&E's capital expenditures that the use of the "known and admitted" approach constitutes legal error essentially argues that reasonableness must be established by using traditional mechanisms. As discussed above, this claim fails to demonstrate error because this Commission has the ability to select its own criteria for adjudging reasonableness, in light of the circumstances. Since the Pricing Modification

Decision based its approach on the determination that it was impossible to revive the 1988 rate case, it was proper for it to decline to establish sunk costs at a comparable level or to seek a "proxy" for the 1988 cases' result.

Moreover, the Pricing Modification Decision noted the circumstances we faced in setting sunk costs in the context of electric restructuring. The 1988 rate case was designed to determine what amount of Diablo Canyon capital expenditures could properly be included in rate base and recovered through a traditional cost-plus-return rate mechanism over the anticipated life of Diablo Canyon. This proceeding is designed to establish the amount of Diablo Canyon sunk costs that should be amortized over the electric restructuring transtion period in order to move away from such traditional schemes and provide ratepayers with the benefits of competition. Because rates are frozen, customers will not experience any rate changes as a result of this proceeding. In this proceeding we also faced PG&E's claims that it was entirely proper to include <u>all</u> of its capital expenditures in sunk costs because it would forego settlement revenue.

In light of these factors, we determined to disallow $100 million associated with the mirror image error because that error was "known and admitted." This determination was proper for a number of reasons. Since the 1988 reasonableness review could not be revived, and since approaches based on the hypothetical results of that proceeding could not be relied upon, we chose a standard that was clearly implementable. We sought to catch obvious errors about which there was a minimum of disagreement. We were also mindful of the fact that we were establishing sunk costs that would undergo accelerated recovery under the transition cost recovery mechanism. PG&E was having its rate structure altered in a way it claimed produced harm and merited setting sunk costs at a high level. Finally, as discussed in detail below, fixing the actual amount of the disallowance at $100 million under this approach was proper. Although $100 million falls at the low end of the range, it allowed us to have confidence that our disallowance was supportable, unlike the other options we rejected.

However, the Pricing Modification Decision does not contain an explicit finding that this amount should reasonably be excluded from sunk costs. While we believe this determination is implicit in our decision to make a disallowance, we will modify Finding of Fact 6 to make it clear. We are concerned that part of the application's difficulty with the Pricing Modification Decision results from the lack of an explicit finding. We believe this modification and our discussion here will clarify our reasoning.

2. General Principles of Ratemaking Do Not Require the Commission to Adopt Another Approach to Determining Sunk Costs.

As discussed above, the Pricing Modification Decision represents an exercise of judgement in which we attempted to balance a number of different factors in reaching its determination on sunk costs. In Duquesne Light Co. v. Barasch, (1988) 488 U.S. 299 (hereinafter, "Duquesne"), the United States Supreme Court commented that states are "free to decide what ratesetting methodology best meets their needs in balancing the interests of the utility and the public." (Duquesne Light Co. v. Barasch, supra, 488 U.S. at p. 316.) Duquesne establishes the constitutional minimum below which rates may not fall without illegally confiscating utility property. TURN's application states the Pricing Modification Decision contravenes Duquesne by analogy because it allegedly adopts a practice that the Court speculated might damage utility interests. The application also asserts the Pricing Modification Decision contravenes section 451's general requirement that we set "just and reasonable" rates.

However, general principles of ratemaking do not require sunk costs to be established differently. The U.S. Supreme Court's decision in Duquesne establishes standards that protect utilities from having their property effectively confiscated by excessively harsh regulation. This approach focuses on the net financial effect of a rate order on shareholders, asserting that the theory behind a rate order is not relevant to the legal analysis. In fact, the Court casts aspersions on those who advocate overly strict reliance on a particular methodology or regulatory outcome. Thus, Duquesne cannot be said to stand for the principle that any particular ratesetting methodology is legally inadequate.

The application's specific discussion of changes to rate methods also misreads Duquesne. In dicta, the U.S. Supreme Court noted that "a State's decision to arbitrarily switch back and forth between methodologies in a way which required investors to bear the risk of bad investments at some times while denying them the benefit of good investments at others would raise serious constitutional questions." (Duquesne Light Co. v. Barasch, supra, 488 U.S. at p. 315.) Here, the Commission has changed methodologies only once, and there is little indication that it will change again. Moreover, the change in methodology is far from arbitrary. It is part of the Commission's broad attempts to restructure electric utility regulation. The Court also states only that such action would be questionable, not per se illegal.

Finally, it is to be noted that TURN's taking claim refers to law that is not applicable here. The position of ratepayers is not constitutionally analogous to that of a utility that has dedicated its facilities to the public use. Taking law also does not seem to be implicated because rates have been frozen during the transition period and the amount customers pay is unaffected by the Pricing Modification Decision.

In this respect, we must also reject the claim that the Pricing Modification Decision's sunk cost determinations are "unreasonable" in contravention of section 451. As explained above, the fixing of sunk costs is the result of considered judgment, based on current circumstances. The overall electric restructuring scheme is designed to bring the benefits of competition to ratepayers.

The effect of the Pricing Modification Decision is that Diablo Canyon will not operate at the expensive settlement price for a lengthy time period. Instead, it will either sell market-priced electricity or shut down, relieving ratepayers of their previous obligation to buy high-priced power. We believe we have properly balanced the relevant concerns in a decision that moves forward to achieve competition.

3. The Rate Case Decision Supports a $100 Million Disallowance.

As explained above, the Pricing Modification Decision chose to disallow $100 million relating to the mirror image error because such a disallowance could be made on the basis of information contained in the published Rate Case Decision. The Pricing Modification Decision specifically did not attempt to make a disallowance based on what the result of the 1988 reasonableness review might have been. Despite PG&E's contentions, the Rate Case Decision contains ample information supporting this disallowance. In the Rate Case Decision, the Commission found that there was no dispute that PG&E and its contractors made the mirror image error. (Re Pacific Gas and Electric Company (Diablo Canyon Rate Case) [D.88-12-083], supra, 30 Cal.P.U.C.2d at p. 269.) The Rate Case Decision stated that the only dispute was about the cost of the error. DRA alleged that the error had costs $2.4 billion. PG&E "admitted to an error of no more than $100,000,000." (Ibid.)

Nevertheless, PG&E's application claims the Pricing Modification Decision is not supported by evidence. We find the analysis provided by ORA in its response to PG&E's application to be persuasive on this point. ORA correctly explains that the question here is whether there is enough evidence to support making the $100 million disallowance in the context of a proceeding that establishes sunk costs that may be recovered through the transition cost recovery mechanism. ORA points out that testimony it submitted—and testimony TURN submitted—in this proceeding advocated reducing sunk costs to account for the effects of the unique Diablo Canyon performance based pricing mechanism. As ORA points out, the $100 million disallowance is conservative based on this evidence.

Moreover, Finding of Fact 5 in the Rate Case Decision provides sufficient support for the Pricing Modification Decision's disallowance. Finding of Fact 5 indicates that PG&E admitted it made the mirror image error. Finding of Fact 5 describes the possible disallowance relating to the mirror image error in this blunt language: "The stakes attributable to the mirror image error are approximately $2.4 billion . . . . There is substantial evidence which would sustain a decision for either PG&E or the DRA . . . ." (Re Pacific Gas and Electric Company (Diablo Canyon Rate Case) [D.88-12-083], supra, 30 Cal.P.U.C.2d at p. 281.) This language indicates that evidence supported the conclusion PG&E acted imprudently and that evidence supported DRA's proposed $2.4 billion disallowance. The fact that PG&E's first line of defense was to deny any wrongdoing does not negate the fact that Finding of Fact 5 states evidence supported a $2.4 billion disallowance, implicit in which is the conclusion that evidence existed indicating PG&E was at fault for the error. Similarly, the claim that PG&E never fully conceded a $100 million cost attributable to this error ignores the effect of Finding 5. The finding that PG&E, when pressed, was willing to concede an amount of $100 million attributable to the mirror image error provides sufficient support for our choosing that number as a conservative disallowance amount. In the circumstances we thought it was proper to adopt the highest amount PG&E was willing to concede as an appropriate disallowance.

Finally, we note that the $100 million disallowance was initially suggested in the Proposed Decision of the assigned administrative law judge. (Cf. Pub. Util. Code, § 311(d).) This Proposed Decision was circulated on February 28, 1997 and commented on by the parties. Subsequently, an alternate Order of Commissioner Knight was circulated on May 2, 1997. (Cf. Pub. Util. Code, §311(e).) This alternate order concluded that section 463 was inapplicable and that no disallowance should be made. The parties commented on the alternate as well.

The Commission may take notice of such facts as may be judicially noticed by the State of California. (Rule 73 of the Commission's Rules of Practice and Procedure, Cal. Code Regs, tit. 20, §73.) In applying this rule, we have in the past officially noticed prior orders. Here, PG&E was provided two opportunities to file written comments on these matters. The application's claim that the rules for official notice were contravened has no merit. The claim that PG&E was denied administrative due process also lacks merit. As noted earlier, parties raised the question of a disallowance at the outset of this proceeding. The claim that we must provide PG&E further opportunities to litigate this matter finds no basis in the Public Utilities Code and does not recognize the legislative nature of this rate proceeding.

In this context we must comment that the Pricing Modification Decision is not "unfair" or "arbitrary" or "punitive" as PG&E's application alleges. We wish to remind PG&E that the Pricing Modification Decision balances a number of interests. TURN, at least, believes that PG&E's interests have been given too much weight. We believe that our determination the level of sunk costs properly balances the relevant interests.

In addition, the specific facts PG&E relies upon are not accurately presented. The scope of alleged harm to PG&E does not require the Commission to exercise its discretion by reinstating the amount disallowed. In this respect, the application re-argues an issue that the Commission has already decided. The claim that PG&E deserves a pass-through of sunk costs with no adjustment in return for its abandoning the settlement simply rehashes a decided policy question. Similarly, the application's discussion of the Rate Case Decision and the decision conforming Palo Verde pricing with AB 1890 do not accurately reflect the Commission's holdings. Decisions made with regard to Palo Verde are inapposite, since that facility underwent reasonableness review. The issues addressed in the Pricing Modification decision arise specifically because Diablo Canyon did not undergo a reasonableness review.

4. No Legal Rule Requires the Commission to Disregard Section 463 and Establish Sunk Costs Without Any Disallowance.

PG&E asserts that we must disregard section 463 and may not make any disallowance of Diablo Canyon capital expenditures when we establish sunk costs. As a general matter the application's claims are based on a faulty premise. As PG&E itself admits, we have discretion to establish sunk costs at the level we believe is proper. As discussed with respect to TURN's application, section 463 does not limit that discretion. Thus, even if section 463 were inapplicable, the application would not demonstrate error.

In any event, the Pricing Modification Decision properly took section 463 into account when making a disallowance. Section 367[6] does not supersede section 463 and the application's interpretation of these two code sections finds no support in either section's actual language. Section 367 requires the Commission to "identify and determine those costs and categories of costs for generation assets" that should be paid by consumers as transition costs. Clearly, this requirement implies that we should determine which costs should be classified as transition costs and which should not. Section 463's clarification of our authority to disallow certain costs is easily harmonized with this directive.

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6 The application refers to section 367, subdivision (a), although that subdivision contains only the rate freeze and the requirement that transition cost recovery end on December 31, 2001. Section 367 contains the relevant language.

The application is also incorrect when it interprets section 367's use of the phrase "nuclear settlements" to create a requirement that the entire "value of the existing Diablo Canyon performance based settlement" be recovered in CTC. This claim reads the Commission's role out of section 367 and requires the conclusion that section 463 be repealed by implication. It also does not comply with the requirement that only uneconomic costs should be recovered in CTC. It is unclear whether the value of a settlement agreement that allows a utility to charge an above-market price unrelated to the plant's fixed and operational costs is an amount that can be considered "uneconomic," especially since the settlement may not have been valid at the time.

Section 368, subdivision (g),[7] also does not supersede section 463. Subdivision (g) indicates the Restructuring Rate Settlement is example of a rate reduction plan. Section 368 requires the Commission to approve a utility's rate reduction plan if it meets the criteria set out in subdivisions (a) through (f). None of those criteria require the Commission to avoid adjusting PG&E's capital expenditures before establishing Diablo Canyon sunk costs. In Re Proposed Policies Regarding Electric Restructuring etc. (Cost Recovery Plans) [D.96-12-077] (1996) __ Cal.P.U.C.2d __ the Commission explained, at p. 4 (mimeo.):

> The criteria specified in § 368, with some exceptions, provide only the broad framework for cost recovery. The utilities' plans provide more detail, filling in some of the gaps in the statutory framework and adding desired elements. Our role includes, among other functions, coordinating the legislative requirements without existing proceedings that are considering the issues implicated by § 368, and critically reviewing the utilities' additional proposals for consistency with the goals expressed in AB 1890 and in our Policy

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7 The material enacted as subdivision (h) of section 368 in AB 1890 now appears at section 368, subdivision (g). (Cf., Stats. 1996, ch. 856, § 2.)

> Decision. Our general role is to approve the overall framework for recovery of transition costs and to provide necessary guidance on some of the details of this cost recovery.

As this language makes clear, the Commission does not "violate[] AB 1890" when it reaches a result different from the Restructuring Rate Settlement in this one aspect. The Restructuring Rate Settlement was not enacted as law and we cannot be required to disregard an existing statute on that basis.

Moreover, we are not required to disregard section 463 simply because the transition cost recovery mechanism differs from traditional ratemaking. Section 463 does not limit its applicability to any particular ratemaking paradigm. The Pricing Modification Decision may have overstated the effect of section 463, subdivision (a)'s reference to ratemaking involving an allowed rate of return on undepreciated capital costs. Nevertheless, the Pricing Modification Decision reached the correct conclusion. The statute's indication that rate schemes such as the unique Diablo Canyon settlement fall outside its scope supports the determination that PG&E's proposed cost recovery mechanism (which we found provides an allowed rate of return in undepreciated capital costs) is "squarely . . . within the boundary of section 463." (Re Pacific Gas and Electric Company (Pricing Modification) [D.97-05-088], supra, at p. 31 (mimeo.).)

In the same vein, the Pricing Modification Decision correctly found that PG&E's exposure to the risk of incomplete transition cost recovery was not dispositive. A utility is always exposed to some risk, even under the most traditional ratemaking schemes.[8] The assertion that PG&E will sustain such a great

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8 Under traditional ratemaking, the price of Diablo Canyon electricity would have been fixed at a level allowing PG&E to recover reasonable capital costs and a reasonable profit. But the ability to earn that return would have been contingent on PG&E's having had electricity to sell. PG&E would have assumed the risk for shut-downs, and other events that prevented it from generating power.

amount of risk that the prudence concerns expressed in 463 are irrelevant is exaggerated. The type of risk PG&E assumes under transition cost recovery treatment of Diablo Canyon's sunk costs does not preclude us from engaging in a process to determine where the level of sunk costs properly should be established. We took the nature of transition cost recovery into account when determining what costs should be disallowed. This properly addressed PG&E's concern within the context of section 463.

The uncodified section two of this statute also does not create an exception that must be followed here. That part of the law refers to the Commission's "final order and decision in the application of [PG&E] for an increase in rates reflecting the expenses related to the construction of . . . Diablo Canyon . . . ." Since section two refers to the Rate Case Decision it does not create an exception that must be followed in applying the codified portion. The Pricing Modification Decision's reliance on language referring to rates established "on a basis other than an allowed rate of return on undepreciated capital costs[,]" does not invoke uncodified section two—similar language appears in the code as part of section 463. Similarly, the application's claim that we must look to legislative history and conclude that section 463 applies only to questions arising in the course of the original Diablo Canyon rate case has little merit. Although PG&E might argue that the circumstances surrounding the statute's passage imply that conclusion, we do not need to speculate as to the legislative concept behind the statute when it is clear on its face.

Finally, we note that the nature of our discretion supports, rather than detracts from, the Pricing Modification Decision. The application alleges error on the unusual grounds that since we have discretion over the $100 million disallowance we are required not to make it. Section 463 may not unduly restrict our ability to exercise discretion in matters of reasonableness. However, the application's conclusion of error does not follow from the premises it advances. If the Commission has discretion over the disallowance of the $100 million, it is not error to exercise that discretion by reducing sunk costs by that amount. PG&E attached to its application legal documents relating to the Rate Case Decision. In those documents, the Commission's Legal Division argued the Commission was not required to undertake a complete prudency review in order to legally determine what rate was reasonable. This position is entirely consistent with the position the Commission takes in this case.

5. The Pricing Modification Decision Does not Misapply Technical Rules.

a) Retroactive Ratemaking.

The rule against retroactive ratemaking is a principle of regulatory law derived from section 728. Section 728 grants the Commission the authority to "determine and fix, by order, the just, reasonable and sufficient rates . . . to be thereafter observed and in force." (Emphasis added.) The California Supreme Court has read this language, in conjunction with the principle that ratemaking is a legislative act, to grant to Commission "the power to fix rates prospectively only." (Southern Cal. Edison v. Public Utilities Com. (1978) 20 Cal.3d 813, 816 (emphasis added).) However, the California Supreme Court has also indicated that this apparently simple rule must "be properly understood" and must "not become a device to fetter the Commission in the exercise of its lawful discretion." (Ibid.) Here, the rule against retroactive ratemaking is not implicated by making the Diablo Canyon revenue requirement effective as of January 1, 1997. The Pricing Modification Decision does not constitute general ratemaking and a number of other factors support the determination to use the new revenue requirement as of January 1, 1997. For example, appropriate accounting methods were established and commencing the new revenue requirement as of January 1, 1997 conformed with AB 1890's transition cost approach.

Although it often refers to "rates," the Pricing Modification Decision only addresses Diablo Canyon. Establishing Diablo Canyon revenue requirement is not an act of "general ratemaking" and in this case may not even be ratemaking since it does not affect the ultimate retail rates that customers pay. Those rates were determined in Re Proposed Policies Governing Restructuring, etc. (Cost Recovery Plans) [D.96-12-077] (1996) __ Cal.P.U.C.2d __, which implements AB 1890's rate freeze. This rate freeze began on January 1, 1997 and is part of AB 1890's transition cost recovery mechanism

Moreover, our decisions implementing AB 1890 indicate that certain rate components were to be subject to adjustment during the first year of the transition period. For the most part the transition cost recovery mechanism came into play in 1998 when the ISO and PX commenced operation.[9] However, the 1997 rate structure was subject to the transition cost recovery mechanism at least in part. In 1997, utilities' rate revenue was determined by the rate freeze and not by their actual costs. In addition, when collected, rate revenue was allocated to one of two different categories. Utilities first collect their "adopted consolidated revenue requirement." Any rate revenue collected in excess of this amount (denominated "headroom") was tracked in an interim balancing account called an ITCBA and allocated for the payment of transition costs. (Re Proposed Policies Governing Restructuring, etc. (Cost Recovery Plans) [D.96-12-077], supra, at pp., 8, 12 (mimeo.).) We made provision for adjustment when establishing the ITCBA to track transition costs collected in 1997. Re Proposed Policies Governing

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9 In 1998, PG&E's revenue requirement was calculated by adding the PX price of electricity to revenue requirements for other aspects of service such as distribution and transmission. Rates were unbundled and the portion of revenue collected that was allocated to the various rate components became transparent. Any rate amounts not allocated as part of the various revenue requirements was allocated to transition cost recovery and billed to customers as CTC.

Restructuring, etc. (Cost Recovery Plans), D.96-12-077 at p. 12 (mimeo.) contains the following language:

> The interim nature of these [ITCBA] accounts will eventually be removed after we have considered refinements to these accounts in Application (A.) 96-08-001. In that proceeding we will resolve the issues related to tracking both the transition costs we authorize for recovery and the headroom revenues, i.e., the difference between revenues collected at frozen rates and the authorized revenue requirement.

This language indicated that amounts tracked in an ITCBA would be subject to adjustment based on "headroom issues," that is, determinations relating to the amount of revenue allocated to revenue requirements and the amount allocated to transition cost recovery. Later, in Re Pacific Gas & Electric (Phase 2 Transition Costs) (1997) [D.97-11-074] __ Cal.P.U.C.2d __, the Commission made the promised adjustments to the ITCBA and established that the 1997 revenue requirement for Diablo Canyon should be determined with reference to the Pricing Modification Decision. (Id. at p. 103 (mimeo.).) As PG&E points out we also made other indications that we might alter rate elements during the rate freeze.

TURN's application refers to cases where the proper use of accounting mechanisms has facilitated our making certain adjustments. These cases state that certain specific actions do not run counter to the rule against retroactive ratemaking. However, these cases do not describe the limits of our authority. A number of factors such as the use of balancing accounts or the fact that revenue is merely being passed through allow us to make certain adjustments without implicating the rule against retroactive ratemaking. Here we were faced with the need to take a proper approach under AB 1890 and the Preferred Policy Decision. AB 1890 requires transition cost recovery treatment for Diablo Canyon and establishes the rate freeze and the commencement of the transition period as of

January 1, 1997. Since transition period ratemaking addresses capital costs and Diablo Canyon sunk costs are established in the Pricing Modification Decision, it was appropriate to make the modification of Diablo Canyon rates effective congruent with the start of the transition period.

TURN's application seems most concerned with the possibility that we would adjust headroom retroactively at the end of the transition period. The Pricing Modification Decision only affects ITCBA amounts and this effect only occurred because of the unique circumstances surrounding Diablo Canyon. The adjustments TURN is concerned about would be contrary to the legislative program established in AB 1890. Here we rely on the fact that adjusments were only made to the ITCBA, which we indicated would be revised. Further, these adjustments were made to accommodate Diablo Canyon's unique situation to the beginning of transition period ratemaking on January 1, 1977.

b) Modification of the Rate Case Decision.

The Pricing Modification Decision made rate determinations that were designed to be applied on a going forward basis. The determinations made in the Rate Case Decision are not "final" nor are they "conclusive" with respect to how ratemaking should be accomplished under the transition cost recovery mechanism. Those determinations established Diablo Canyon rates for the first nine years of the settlement period. Changing Diablo Canyon's rate structure for the future does not undo or compound anything that occurred during the settlement's first nine years.

Moreover, the application is imprecise in its description of the law. The application appears to claim that once the Commission has established a rate structure it must adhere to that rate structure forever, since changing rate schemes would amount to a "collateral attack" on the first rate order. Section 1709 does not create such a limit on the Commission's authority. In fact, section 1709 must be read in conjunction with section 1708 which explicitly grants the Commission broad authority to modify or set aside its past orders. As a regulatory body the Commission has continuing jurisdiction over utilities. It is not bound even by its own past decisions so long as it meets certain procedural requirements before it acts. (Sale v. Railroad Com. (1940) 15 Cal.2d, 612, 616.) If the Commission can revise its decisions after they have become final there is no question that it can make a new order addressing issues on a going forward basis.

Finally, the application's account of the Rate Case Decision is somewhat fictionalized and does not demonstrate that the Pricing Modification Decision is in error. PG&E has not "already sustained" a full disallowance with respect to Diablo Canyon that cannot be augmented. Rather, the Rate Case Decision approved a pricing mechanism that, over the 28-year life of the settlement agreement, would have assigned to PG&E a certain amount of risk. One of those risks was that, at the end of 28 years, PG&E might have collected less that a full cost-of-service ratemaking return. However, the settlement was in effect for only nine of an anticipated 28 years. During those nine years PG&E did not in fact incur loss as resulting from that risk. Thus PG&E did not "sustain" the loss it claims prevents the Pricing Modification Decision from "augmenting."

B. Other Issues.

The Pricing Modification Decision addresses several other issues, which were also subject to applications for rehearing. PG&E contests the disposition of matters relating to material and supply costs. Although this question relates to sunk costs, it is discussed here because PG&E does not allege error involving fundamental questions about the method of calculating sunk costs. PG&E also makes a claim relating to the linking of rate restructuring bonds and the 10% rate reduction. Issues relating to the Safety Committee were raised by the

Mothers for Peace Group and commented on extensively in the responses to the applications for rehearing. Each of these matters is discussed in turn below.

1. Material and Supply Costs.

The Pricing Modification Decision determined to exclude $77.8 million in materials and supply (M&S) inventories from Diablo Canyon sunk costs. These costs were excluded for two reasons: PG&E would have received free O&M following the transition period and it would have received double recovery. (Re Pacific Gas & Electric Company (Pricing Modification) [D.97-05-088], supra, at p. 75 (mimeo.) (Finding of Fact 12).) These conclusions are based on PG&E's accounting methods. When an item of M&S is used, PG&E charges it as an operating cost and, if needed, replenishes the supply. If M&S is paid off over five years along with sunk costs, then PG&E will be able to use those supplies without incurring an operating expense when the transition period ends. Since PG&E also proposed to include in ICIP an estimate of the M&S that would be consumed during the transition period, PG&E would also recover for that amount of M&S twice: once through CTC and again in the ICIP.

The application does not demonstrate that these determinations are in error. The claim that there will be no double recovery is not supported. The application merely gainsays the Pricing Modification Decision's determination, stating, "there is no 'double recovery' of M&S inventory in sunk costs and ICIP prices." (PG&E Application, p.16.) Without more, such a claim cannot demonstrate error.

The claim that the Commission must include M&S in sunk costs also fails to demonstrate error. Neither section 367 nor the Preferred Policy Decision create a legal requirement that M&S be included in sunk costs. Section 367 requires the Commission to identify and determine costs that should be recovered through CTC. As discussed above, this mandate does not require specific amounts to be included in CTC. The Preferred Policy Decision's determination of what elements could be included in transition costs is also not dispositive since the Commission's responsibility was to make transition cost determinations under AB 1890. In addition, the Preferred Policy Decision does not guarantee that M&S costs be amortized as sunk costs. Rather, it refers to "unavoidable commitments directly related to generation." The application has made no showing that these M&S inventories are such expenses. On the contrary, the Pricing Modification Decision notes that M&S levels can be changed as conditions warrant. (Re Pacific Gas & Electric Company (Pricing Modification) [D.97-05-088], supra, at p. 40 (mimeo.).)

Similarly, the Commission's desire to achieve SONGS comparability does not mandate sunk cost treatment of M&S. The Pricing Modification Decision determined that SONGS comparability meant following the basic policy framework of the SONGS settlement: "the use of an ICIP mechanism for the recovery of incremental operating costs during [a] period of accelerated sunk cost recovery." The Pricing Modification Decision specifically found that because of the "material differences between the Diablo Canyon and Songs plants, the specifics of the ICIP mechanism and sunk cost recovery vary." (Re Pacific Gas & Electric Company (Pricing Modification) [D.97-05-088], supra, at p. 73 (mimeo.) (Finding of Fact 2).)

Finally, the claim that the Pricing Modification Decision's treatment of M&S is disadvantageous to PG&E does not demonstrate legal error. The application simply re-argues a policy question. The application refers to PG&E's testimony indicating that the failure to amortize this balance will leave PG&E vulnerable to losing these costs in the event of a shut-down. The Pricing Modification Decision based its determinations on the desirability of avoiding double recovery and giving PG&E free O&M. Although there may be disadvantages with this approach, we believe they are outweighed by the benefits.

2. Mandatory Nature of the 10% Rate Reduction.

PG&E's application asserts that the Pricing Modification Decision is in error because it concludes that the 10% rate reduction is not contingent on bond financing. In Re Proposed Policies Governing Restructuring, etc. (Cost Recovery Plans) [D.96-12-077] __ Cal.P.U.C.2d __ the Commission indicated that while the rate reduction was mandatory, bond financing was optional. (Id. at p. 9 (mimeo).) PG&E and Edison challenged this result by filing a petition to modify. The Commission concluded in Re Proposed Policies Governing Restructuring, etc. (Modification of D.96-12-077) [D.98-05-046] __ Cal.P.U.C.2d __:

> With the passage of time, PG&E's and Edison's petitions have become moot. The rate reduction bonds were approved in September 1997 (D.97-09-054, D.97-09-055, D.97-09-056, and D.97-09-057) and were successfully issued. The rate reductions began on January 1, 1998, as AB 1890 required. At this point, no benefit could be gained by our repeating the parties' arguments on this point and resolving this issue. We will therefore dismiss PG&E's and Edison's petitions as moot.

The claim PG&E raises here is identical. It, too, is moot and the application for rehearing should be denied in this respect.

3. Independent Safety Committee.

Both PG&E and the Mothers For Peace Group challenge the decision to continue the existence of the Safety Committee. According to PG&E, the need for the Safety Committee's input will end when the transition period ends and Commission regulation of Diablo Canyon will be significantly reduced. The Mothers For Peace Group alleges there is no evidence to support the finding that the Safety Committee "is a key element of monitoring the safe operation of Diablo Canyon." (Cf., Re Pacific Gas & Electric Company (Pricing Modification) [D.97-05-088], supra, at p. 78 (mimeo.).) The application asserts the record is inadequate to support findings on safety issues and requests rehearing to properly evaluate those concerns.

Several parties commented on these claims in their responses to the applications for rehearing. The Safety Committee filed a response justifying its continued operations and disputing the claim that AB 1890 changes the need for continued Safety Committee funding. The California Energy Commission (CEC) also entered the fray to indicate its support for continued funding. Neither the Safety Committee nor CEC addressed the claims made by the Mothers for Peace Group.

The contentions contained in PG&E's application for rehearing do not demonstrate legal error. For the most part, the application seems to make policy, not legal arguments, such as the claim that the Safety Committee will have outlived its usefulness when the transition period ends. The claim that the Commission will have "limited authority" over Diablo Canyon once the transition period ends, does not indicate that it has no jurisdiction to order the continuation of the Safety Committee. Similarly the statement that continued funding would be "discriminatory" does not demonstrate legal error. Rate discrimination, which is prohibited in section 453, is not at issue here.

The Mothers for Peace Group's claims also do not demonstrate error. The Pricing Modification Decision based its determination to continue the Safety Committee on the facts raised in the proceeding by the Safety Committee and the Energy Commission. In response to pleadings filed by these parties, the Pricing Modification Decision determined that the work of the Safety Committee, as described on the record, was valuable and should be continued. (Re Pacific Gas and Electric Company (Pricing Modification) [D.97-05-088], supra, at pp. 62-63 (mimeo.).)

The Mothers for Peace Group's second claim, that the Commission failed to give proper consideration to matters of safety, does not accurately reflect the Pricing Modification Decision. We reviewed safety matters and concluded that they had been adequately addressed through the combination of providing an adequate return to PG&E, federal regulation and the continuation of the Safety Committee. There is no basis to require a full rehearing on safety issues when those conclusions are adequately supported by the record underlying this decision.

IV. CONCLUSION

As this order explains in detail, the Pricing Modification Decision represents a considered exercise of the Commission's judgment in establishing the reasonable level of Diablo Canyon sunk costs in the context of electric restructuring's transition cost recovery mechanism. The Commission's finding that $100 million should be disallowed was supported by the Rate Case Decision, and the Pricing Modification Decision properly resolved the other issues challenged without contravening procedural rules such as section 1709 and the rule against retroactive ratemaking.

THEREFORE, GOOD CAUSE APPEARING, IT IS ORDERED that:

1. The application for rehearing of D.95-05-088 filed by San Luis Obispo County and the San Luis Coastal Unified School District is dismissed.

2. Section D of the application for rehearing of D.95-05-088 filed by Pacific Gas and Electric Company is dismissed.

3. Finding of Fact 6 of D.95-05-088 is modified to restate the last sentence of the finding, preceding the mathematical formula. The restated sentence shall read: "There should be disallowed from current sunk costs as a result of unreasonable expenditure the depreciated value of $100,000,000 under the formula:".

IT IS FURTHER ORDERED that:

5. In all other respects, rehearing of D.97-05-088 is denied.

This order is effective today.

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

RICHARD A. BILAS
President
P. GREGORY CONLON
HENRY M. DUQUE
JOSIAH L. NEEPER
Commissioners

I dissent.

/s/ JESSIE J. KNIGHT, JR.
Commissioner