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Decision 99-02-073 February 18, 1999

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ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of San Diego Gas & Electric Company (U 902-E) for Authority to Sell Electrical Generation Facilities and Power Contracts.

Application 97-12-039
(Filed December 19, 1997;
Compliance Filing Filed
December 23, 1998)

O P I N I O N

Pursuant to Decision (D.) 98-10-055, San Diego Gas & Electric Company (SDG&E) submits its Compliance Filing regarding the proposed divestiture of its Encina Power Plant (Encina) and its 17 combustion turbines (Combustion Turbines). The filing requests that the Commission authorize SDG&E to sell Encina and the Combustion Turbines to a consortium comprised of Dynegy Power Corp. (Dynegy) and NRG Energy, Inc. (NRG).

The transaction documents for these proposed sales are attachments to the filing, and the volume of these attachments is significant. Accordingly, pursuant to Rule 2.3(c) of the Commission's Rules of Practice and Procedure, SDG&E served the filing without attachments on parties other than the Office of Ratepayer Advocates, and SDG&E served a notice of availability with respect to the attachments. There are no objections.

I. Procedural Background

SDG&E filed this application on December 19, 1997. We issued our first interim opinion in D.98-10-055 on October 22, 1998, in which we permitted SDG&E to commence an auction of Encina, the Combustion Turbines, and the South Bay Power Plant (South Bay), subject to certain conditions, approved of the

proposed operations and maintenance (O&M) agreement for subsequent operation of the plants by SDG&E for the purchasers, and approved the accounting and ratemaking treatment described in SDG&E's application, subject to certain conditions.¹ In D.98-10-055, we determined that SDG&E's sale of its fossil plant assets does not create market power concerns, and we authorized SDG&E to permit bids on any combination of its fossil plant assets, and to sell all of its assets to a single bidder if such a sale would maximize auction proceeds.

On December 3, 1998, we adopted D.98-12-012 which approved a mitigated negative declaration for the project represented by the application, and approved a related mitigation, monitoring, and reporting program. This decision enabled SDG&E to accept final binding bids for Encina and the Combustion Turbines. This Compliance Filing: (i) describes the auction process and the results of the auction; (ii) provides the definitive sales agreements; (iii) provides certain estimates, including book values, transaction costs, and plant-related environmental remediation costs, for accounting and ratemaking adjustments necessary to reflect the sales; and (iv) asks the Commission to make specific findings and to grant final approval of the sales.

II. Auction of the Plants

SDG&E conducted an auction of Encina and the Combustion Turbines. Together with South Bay, these plants represent all of SDG&E's fossil-fueled generation capacity. The real and personal property included in the proposed

¹ In D.98-10-055, we noted that SDG&E was temporarily suspending the auction of South Bay in order to facilitate a possible purchase of the plant by the San Diego Unified Port District (Port of San Diego). SDG&E has since agreed, subject to Commission approval, to sell South Bay to the Port of San Diego. This proposed sale will be the subject of a separate amendment to SDG&E's application.

sale are described, in general, in D.98-10-055, and in detail in the agreements which are attached to the filing.

In the initial stage of the auction, SDG&E and its investment banker, Morgan Stanley Dean Witter (Morgan Stanley), prepared an informational brochure describing the California electricity marketplace, the plants to be sold, and the auction process. Morgan Stanley distributed this brochure to more than 200 potential purchasers, including domestic and international utilities, energy companies, independent power producers, and financial buyers. SDG&E also ran an advertisement in *The Wall Street Journal*, and publicized the auction in the trade press and on its internet site.

Morgan Stanley thereafter distributed a five-volume confidential information memorandum containing detailed information about the plants and the proposed auction to approximately 45 potential bidders who executed the required confidentiality agreement. Each of these potential bidders was also permitted to inspect plant-related documents and other relevant information at the data room established by SDG&E. On September 24, 1998, bidders submitted statements of interest and qualification and a non-binding initial bid. Each bidder also executed an auction protocols agreement which, together with the previously executed confidentiality agreement, established the rights and responsibilities of auction participants. Based on an evaluation of the financial and operational background of the bidders and the amounts of the initial bids, SDG&E selected bidders to participate in the second stage of the auction.

During the second stage of the auction, bidders received a significant amount of additional documentary information relevant to the proposed sales. In addition, SDG&E invited all bidders to plant tours, management presentations, and due-diligence interviews with company personnel. Visits to

the data room, plant tours, management presentations, and interviews with company personnel were all conducted with a view toward preserving the confidentiality of bidder identity.

Bidders in the second stage of the auction were given the opportunity to propose changes to the relevant transactional documents on an anonymous basis. SDG&E considered two rounds of proposed changes from bidders, and revised the transaction documents to reflect proposals that it believed to be acceptable and consistent with the intention behind the documents. SDG&E circulated the revised transaction documents to bidders before final bids were due, and all bidders in the second stage of the auction submitted bids on the basis of identical transaction documents. As discussed below in more detail, these revisions did not substantially change the documents from the forms that the Commission previously reviewed.

As required by D.98-10-055, SDG&E notified all auction participants that its existing right to locate four of the Combustion Turbines on Navy property may terminate on September 29, 1998. In addition, SDG&E notified all second-round auction participants when it reached an agreement with the Navy which extended those rights through March 31, 2001.

III. Outcome of the Auction

On December 10, 1998, SDG&E received final, price-only, binding bids. A consortium comprised of Dynegy and NRG submitted the highest bid, \$356 million for Encina and the Combustion Turbines as a package. No other bid or combination of bids yielded proceeds as high as the bid of Dynegy and NRG. On December 11, 1998, SDG&E's board of directors met and approved the sale, and SDG&E executed Asset Sale Agreements with Dynegy and NRG for both Encina and the Combustion Turbines.

SDG&E asserts that Dynegy is an independent energy producer, with interests in 20 power generating facilities in the United States. Dynegy is a wholly owned subsidiary of Dynegy Inc., formerly NGC Corporation. Dynegy Inc. is one of the leading marketers of energy products and services in North America. NRG is a wholly owned subsidiary of Northern States Power Company, a publicly held Midwestern utility company. NRG is one of the world's leading independent power producers, and is involved in over 10,500 megawatt of projects throughout the United States, Europe, the Pacific Rim, and Latin America. Dynegy and NRG will make the acquisition of Encina and the Combustion Turbines through two special-purpose Delaware limited liability companies: Cabrillo Power I LLC (Encina), and Cabrillo Power II LLC (Combustion Turbines). Dynegy and NRG will guarantee the obligations of the two limited liability companies under the agreements.

Encina and the Combustion Turbines have a combined net book value, as of December 31, 1997, of approximately \$94.8 million. Accordingly, the sale of these assets will result in approximately a \$261.2 million, or 363 percent, premium over book value. In D.98-10-055, we stated that "[i]n the absence of significant irregularity in the auction process, the fair market value for the fossil plant assets will be determined by the auction process." (D.98-10-055, mimeo., at 16.) SDG&E has conducted an auction process without significant irregularity. Therefore, SDG&E requests that the Commission determine that the market value of Encina and the Combustion Turbines is \$356 million.

The sale of Encina and the Combustion Turbines to Dynegy and NRG is in the public interest, and the measures described in the mitigated negative declaration adopted in D.98-12-012 are sufficient to avoid or mitigate the reasonably foreseeable adverse environmental impacts of the project represented by SDG&E's divestiture application. Accordingly, we will approve the sale of

Encina and the Combustion Turbines to Dynegy and NRG, subject to the measures adopted in D.98-12-012 to avoid or mitigate the reasonably foreseeable adverse environmental effects of the project.

IV. The Transaction Documents

Attachment A to the filing contains copies of the transaction documents associated with the proposed sales. These documents include the Asset Sale Agreement, O&M Agreement, and Facilities Services Agreement previously presented to the Commission, as well as several subsidiary agreements. These documents are consistent with our directives in D.98-10-055. In particular, the sale of Encina and the Combustion Turbines is subject to the O&M Agreement substantially in the form presented in SDG&E's application, and the sale of these assets is subject to an assignment of SDG&E's Must-Run Agreements for the assets with the Independent System Operator.

The details of some of the documents and their schedules may change between now and the closing of the sales, as is customary in complex asset transactions of this type. SDG&E therefore asks the Commission to approve the sale of Encina and the Combustion Turbines under the form of the agreements submitted with this filing, with the understanding that the precise content of the documents and their schedules may be somewhat different in some respects at closing, and that SDG&E may be executing additional documents and agreements necessary to effectuate the substance of the transactions.

As noted above, the Asset Sale Agreement, O&M Agreement, and Facilities Services Agreement previously presented to the Commission have been revised in response to bidder comments, but these revisions did not substantially change the documents from the form that we previously reviewed. Set forth below is a brief description of the primary changes to these three documents, as well as a

short description of the additional ancillary agreements included in Attachment A. Note, however, that the discussions below are summary in nature. The transaction documents themselves control the parties' rights and should be consulted for a more precise and complete treatment of the issues.

A. Asset Sale Agreement

The revisions to the Encina and Combustion Turbine Asset Sale Agreements include changes to the requirements for assignment of the Must-Run Agreements, clarifications to the environmental responsibilities upon decommissioning, the addition of certain real estate documents in order to transfer the appropriate real property rights, and the elimination of a deposit.

Sections 1.1(l), 1.1(o), and 2.5(c) contain modifications to the Must-Run Agreement assignment provisions which spell out the parties' rights and responsibility in the event of changes to SDG&E's Must-Run Agreement between signing and closing. The definition of "Plant Decommissioning Costs" in Section 1.1(n) has been modified to clarify certain issues involving the allocation of environmental responsibilities. In addition, Section 2.5 of the Encina agreement outlines the real estate documents that the parties are entering into. Some of these documents are necessary in order to effectuate the transaction without the lot line adjustment originally contemplated by SDG&E.

Under the Encina Asset Sale Agreement and the related real estate documents, certain real property that SDG&E was originally transferring (the inner Agua Hedionda lagoon as well approximately seven acres to the north of the outer lagoon) will be retained by SDG&E, and certain SDG&E property south of the plant (approximately 32 acres) that SDG&E was originally retaining will be transferred to the new owner, until the lot line adjustment originally contemplated by SDG&E's application is approved.

The parties will receive easements or a license, as the case may be, to conduct the activities originally contemplated by SDG&E's application over the relevant property, and the parties will have options, exercisable upon completion of the lot line adjustment, to acquire or re-acquire, as the case may be, the property in question. Upon exercise of the parties' options, the real property owned by each party will be the same as originally contemplated by SDG&E's application. This revised approach has been necessitated by SDG&E's inability to obtain a lot line adjustment in a timely manner, and such an approach is expressly contemplated by Section 2.11 of the Asset Sale Agreement previously presented by SDG&E in this proceeding. In addition, this revised approach has been incorporated in the mitigated negative declaration adopted in D.98-12-012.

Finally, Section 2.6(a) has been modified to eliminate a deposit. In light of the fact that the deposit was never intended to represent liquidated damages, and based on the financial strength of the bidders, a deposit was considered unnecessary.

B. O&M Agreement

In the O&M Agreements, the definition of "Owner Subsidiary" has been removed, as in the Facilities Services Agreements, because the actual party entering into these agreements is already a subsidiary of the winning bidders. Accordingly, these agreements will not need to be assigned from the winning bidders to a subsidiary, as was anticipated in the original form. In addition, changes in Sections 6.1, 8.1, and 11.1 give the new owner a somewhat greater ability to direct the overall management of certain activities at the facilities during the contract term.

C. Facilities Services Agreement

In the Facilities Services Agreements, the definition of "Owner Subsidiary" has been removed, just as it was for the O&M Agreements. Section 2.3 contains modifications to the parties' relocation obligations. Pursuant to this revised section, the new owner is no longer obligated to relocate all of the Subject Equipment and Services (as such term is defined in the Facilities Services Agreement) upon the decommissioning or other earlier termination of the Facilities Services Agreement by the new owner. Rather, the new owner will only be required to relocate Subject Equipment and Services that (i) are used by SDG&E at the time of such decommissioning or earlier termination, and (ii) are required in accordance with good industry practice. Finally, Section 5.5 has been added to coordinate the scheduling and payment obligations for capital improvements. Either party may propose a capital improvement and both parties will cooperate to establish the schedule and cost allocation for such improvements.

D. Other Ancillary Agreements

Dynegy and NRG have delivered guaranties of the obligations of Cabrillo I and Cabrillo II under the agreements to which they are parties. In addition, as discussed above, the parties are also entering into various real estate transactions.

For the Encina transaction, SDG&E and the new owner are entering into an Easement and Covenant Agreement, a License Agreement, an Option Agreement, and a Plant Owner Option Agreement. The Easement and Covenant Agreement creates reciprocal easements over the new owner's land and SDG&E's land in order to facilitate the use, operation, and access to each party's facilities. The License Agreement grants a license to SDG&E for the use of certain land being sold to the new owner. Finally, the Option Agreement and the Plant

Owner Option Agreement grant options to certain land which may be exercised when the appropriate lot line adjustments are complete.

For the Combustion Turbines transaction, SDG&E and the new owner are entering into a License Agreement. The License Agreement grants the new owner rights to certain SDG&E land where the Combustion Turbines are located.

In addition, SDG&E and the new owner will execute other agreements which may be required to effectuate the transactions. Such agreements may include (i) a Participating Generator Agreement, (ii) a Meter Service Agreement for Independent System Operator (ISO) Metered Entities, (iii) agreements required in connection with the provision of reserve or auxiliary power by SDG&E to the new owner, (iv) agreements necessary to effectuate the delivery of electrical energy to SDG&E at the facilities, (v) agreements required by SDG&E to access certain of the revenue or ISO meters included in the Assets, and (vi) various assignment and assumption agreements needed to transfer the assets.

V. Accounting and Ratemaking Adjustments

In D.98-10-055, we established the accounting and ratemaking treatment for SDG&E's fossil generation sales. In particular, sale proceeds for Encina and the Combustion Turbines are to be adjusted for the costs of the auction, tax consequences of the sales, and forecasted environmental cleanup costs. The amount by which these net sale proceeds exceed SDG&E's sunk costs for the plants is then to be credited by SDG&E to its transition cost balancing account (TCBA) within 30 days after the sales are concluded. (D.98-10-055, mimeo., at 17 and 19.) SDG&E will make its TCBA adjustments consistent with the Commission's directives.

A. Transaction Costs

Based upon costs incurred to date and its projections for additional work that will be required to complete the sales, SDG&E estimates that its transaction costs to sell Encina and the Combustion Turbines will approximate the figures set forth below. These costs are estimates, and will be adjusted to reflect actual costs before they are netted against auction proceeds.

<u>Description</u>	<u>Estimated Amount</u>
Investment Banker	\$ 4.06 million
Outside Legal	\$ 2.70 million
Outside Document Support	\$ 0.13 million
SDG&E Environmental Consultant	\$ 1.89 million
California Public Utilities Commission California Environmental Quality Act ²	\$ 1.20 million
Outside Survey Costs	\$ 0.22 million
Title Insurance and Escrow Costs	\$ 0.18 million
Advertising	\$ 0.02 million
Other Miscellaneous Sale-Related Costs	\$ 0.03 million
Total Estimated Transaction Costs	<u>\$10.43 million</u>

B. Tax Effect

The sale of Encina and the Combustion Turbines will create certain Financial Accounting Standard (FAS) 109 deferred tax liability. This deferred tax liability resulting from plant sales was recognized and authorized by the Commission for recovery in D.97-11-074, our Phase Two Competitive Transition Charge decision. (D.97-11-074, mimeo., at 161.) SDG&E estimates that the total

² This estimate was provided by Andrew Barnsdale of the Commission's Energy Division.

FAS 109 deferred tax liability resulting from the sale of Encina and the Combustion Turbines will be approximately \$43.6 million. As with transaction costs, this tax figure is an estimate, and it will be adjusted to reflect actual costs before it is netted against auction proceeds.

It currently appears to SDG&E that the only tax effect of the sales will be the creation of FAS 109 deferred tax liability. This is because the net gain realized by SDG&E on the sales will be offset by the expense created by flowing through the net gain to the TCBA. If in fact there is any net tax effect resulting from the sales other than FAS 109 deferred tax liability, SDG&E will make the appropriate adjustment, and will apprise the Commission in the relevant annual proceeding relating to the TCBA balance.

C. Estimated Environmental Remediation Costs

SDG&E's estimated environmental remediation costs for Encina and the Combustion Turbines are \$0.882 million and \$1.952 million, respectively. These estimates are based upon detailed studies conducted by SDG&E's environmental consultant, Fluor Daniel GTI (Fluor). Attachment B to the filing is Fluor's remediation study for Encina. Attachment C to the filing is Fluor's remediation study for the Combustion Turbines. Both the estimates and the studies have previously been provided to the ORA.

The remediation estimates presented by SDG&E for Encina and the Combustion Turbines are reasonable and well-founded. Pursuant to the Commission's direction in D.98-10-055, SDG&E should net estimated environmental remediation costs against sale proceeds. Accordingly, SDG&E requests that the Commission authorize SDG&E to net a total of \$2.834 million in estimated environmental remediation costs against the sale proceeds for Encina and the Combustion Turbines.

D. Net Book Value

The net book value of Encina and the Combustion Turbines as of December 31, 1997, was \$90.436 million and \$4.406 million, respectively. To determine the sunk costs associated with these two assets as of the actual closing date, SDG&E will update these 1997 book value figures to reflect 1996 generation capital additions approved in D.98-05-059, 1997 and 1998 generation capital additions currently before the Commission in A.98-08-012, and accumulated depreciation from January of 1998 through closing. The updated book value figures will then be reflected in SDG&E's TCBA calculations.

E. Proposed Adjustments

The actual entries to SDG&E's TCBA to reflect the sale of Encina and the Combustion Turbines will consist of the \$356 million of total sale proceeds, less SDG&E's actual transaction costs, less SDG&E estimated environmental remediation costs, less the actual tax consequences of the sales, and less the actual net book value of Encina and Combustion Turbines as of the closing date. This net figure will be credited to the TCBA within 30 days after the sales are concluded. Using the estimates set forth above, the following table illustrates the calculation of the TCBA credit resulting from this sale.

Sale Proceeds	\$356 million
less: Transaction Costs	\$10.4 million
Deferred Taxes	\$43.6 million
Estimated Environmental Remediation Costs	\$2.834 million
Net Book Value	<u>\$94.8 million</u>
Estimated Net Credit to TCBA	<u>\$204.4 million</u>

SDG&E requests authorization to make each of the accounting and ratemaking adjustments described above.

VI. Request for Exempt Wholesale Generator Finding

Under the Federal Energy Policy Act of 1992 (the Act), it is possible for the buyers to qualify as "exempt wholesale generators" (EWGs) under the Act, which avoids federal regulation as a public utility holding company under the Public Utility Holding Company Act of 1935 (PUHCA). Buyers must apply to the Federal Energy Regulatory Commission for EWG status and, in the case of facilities that were formerly in a utility's ratebase, such as Encina and the Combustion Turbines, a finding is necessary that allowing such a facility to be an EWG "(1) will benefit consumers, (2) is in the public interest, and (3) does not violate state law." (15 U.S.C. § 79z-5a(c).) This determination must be made by this Commission, as the applicable state utility commission.

SDG&E requests that we include such a determination in our decision regarding the present filing. The transition of electrical generation from a regulated monopoly to a competitive marketplace is the policy of the State of California. (See, e.g., Public Utilities (Pub. Util.) Code § 330(d).) That policy is expressly intended to benefit consumers. (*Id.*) Subjecting the buyers to regulation under PUHCA would not advance that policy and is not required to prevent any violation of California law regulating utilities. Moreover, the determination requested by SDG&E is consistent with determinations already provided by us regarding previous fossil generation sales by Pacific Gas and Electric Company and Southern California Edison Company. (See D.97-12-107, mimeo., at 9; D.97-12-106, mimeo., at 8.)

This is an uncontested matter in which the decision grants the relief requested. Accordingly, pursuant to Pub. Util. Code Section 311(g)(2), the otherwise applicable 30-day period for public review and comment is being waived.

Findings of Fact

1. SDG&E has conducted an auction process without significant irregularity.
2. The measures described in the mitigated negative declaration adopted in D.98-12-012 are sufficient to avoid or mitigate the reasonably foreseeable adverse environmental impacts of the project.
3. The market value of Encina and the Combustion Turbines is \$356 million.
4. SDG&E estimates that its transaction costs to sell Encina and the Combustion Turbines will approximate \$10.43 million. These cost estimates should be adjusted to reflect actual costs before they are netted against auction proceeds.
5. The sale of Encina and the Combustion Turbines will create Financial Accounting Standard (FAS) 109 deferred tax liability. SDG&E estimates this liability will be approximately \$43.6 million. This cost estimate should be adjusted to reflect actual costs before they are netted against auction proceeds.
6. If there is any net tax effect resulting from the sales other than FAS 109 deferred tax liability, SDG&E should make the appropriate adjustment, and apprise the Commission in the relevant annual proceeding relating to the TCBA balance.
7. SDG&E's estimated environmental remediation costs for Encina and the Combustion Turbines are \$0.882 million and \$1.952 million, respectively, and are reasonable and well-founded. SDG&E should net a total of \$2.834 million in estimated environmental remediation costs against the sale proceeds for Encina and the Combustion Turbines.
8. The net book value of Encina and the Combustion Turbines as of December 31, 1997, was \$90.436 million and \$4.406 million, respectively.
9. To determine the sunk costs associated with Encina and the Combustion Turbines as of the actual closing date, SDG&E should update its December 31,

1997 book value figures to reflect 1996 generation capital additions approved in D.98-05-059, 1997 and 1998 generation capital additions currently before the Commission in A.98-08-012, and accumulated depreciation from January of 1998 through closing.

10. The entries to SDG&E's TCBA to reflect the sale of Encina and the Combustion Turbines should consist of the \$356 million of total sale proceeds, less SDG&E's actual transaction costs, less SDG&E estimated environmental remediation costs, less the actual tax consequences of the sales, and less the actual net book value of Encina and the Combustion Turbines as of the closing date. This net figure should be credited to the TCBA within 30 days after the sales are concluded.

11. The sale of Encina and the Combustion Turbines will not jeopardize electric system reliability. (See, Finding of Fact 9, D.98-10-055.)

12. The sale of Encina and the Combustion Turbines does not create market power concerns. (See, Finding of Fact 11, D.98-10-055.)

Conclusions of Law

1. The sale of Encina and the Combustion Turbines to Dynegy and NRG is in the public interest and should be approved, subject to the measures adopted in D.98-12-012 to avoid or mitigate the reasonably foreseeable adverse environmental effects of the project.

2. Allowing Encina and the Combustion Turbines to be exempt wholesale generators within the meaning of the Act would benefit consumers, be in the public interest, and would not violate California law.

3. The accounting and ratemaking adjustments described in SDG&E's December 23, 1998 filing should be approved.

O R D E R

IT IS ORDERED that:

1. Subject to the measures described in the mitigated negative declaration approved in Decision 98-12-012 to avoid or mitigate the reasonably foreseeable adverse environmental effects of the project, San Diego Gas & Electric Company (SDG&E) may transfer and sell Encina Power Plant and the Combustion Turbines to Dynegy Power Corp., and NRG Energy, Inc., or their permitted affiliates, in accordance with the forms of the documents in SDG&E's December 23, 1998 filing, together with customary ancillary documentation necessary to effectuate the transactions.
2. The accounting and ratemaking adjustments described in SDG&E's December 23, 1998 filing are approved.
3. This proceeding remains open to deal with the remaining assets to be divested.

This order is effective today.

Dated February 18, 1999, at San Francisco, California.

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