

Decision 99-05-049 May 27, 1999

**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

Application of Southern California Edison Company (U 338-E) for Order Approving Termination Agreement for Termination of a Negotiated Power Purchase Agreement Between Southern California Edison Company and O'Brien California Cogen Limited.

Application 98-12-021  
(Filed December 18, 1998)

**O P I N I O N****Summary**

By this decision, we approve Southern California Edison Company's (SCE) proposed buyout and termination of a 1985 power purchase agreement with O'Brien California Cogen Limited (O'Brien). Expected customer benefits from the buyout are \$13.7 million in net present value (NPV). We also find the settlement embodied in the agreement to be reasonable.

**Background**

O'Brien is a qualifying facility (QF).<sup>1</sup> It operates a 35 megawatt (MW) cogeneration facility located in Artesia, California. The facility is designed to operate 24 hours per day. O'Brien sells electricity to SCE and steam from the waste heat to the California Milk Producers Association facility, also located in Artesia. The steam is used to process milk products such as dry milk, cheese,

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<sup>1</sup> A QF is a small power producer or cogenerator that meets federal guidelines and thereby qualifies to supply generating capacity and electric energy to electric utilities. Utilities are required to purchase this power at prices approved by state regulatory agencies.

sour cream, and the ice cream base for such companies as Dreyers, Breyers and Thrifty.

On June 14, 1985, SCE executed a negotiated power purchase agreement, modeled after the Standard Offer 2 contract in effect at that time. Standard Offer 2 was one of the boilerplate long-term contracts between electric utilities and QFs. O'Brien commenced construction of the facility in 1988 and achieved firm operation on March 6, 1990.

Under the terms of the contract, SCE purchases 30.4 MWs of firm capacity and associated energy from the O'Brien cogeneration facility. The contract provides for O'Brien to sell energy to SCE at avoided cost prices and earn capacity payments at fixed prices until March 6, 2020. The capacity payments under the contract are \$187/kilowatt-year, and are subject to the firm capacity performance requirements and obligations defined in the contract.

On December 18, 1998, SCE filed an application for approval of the buyout and termination agreement. The termination agreement also resolves an outstanding dispute between SCE and O'Brien regarding whether the O'Brien facility met QF efficiency standards in 1996. SCE also presented its proposal to retain 10% of the ratepayer benefits resulting from the buyout, pursuant to the Commission's authorization in Decision (D.) 95-12-063, as modified by D.96-01-009.

The Office of Ratepayer Advocates (ORA) filed comments in support of the application, but raised concerns over the calculation of expected ratepayer benefits.

In Resolution ALJ 176-3007, the Commission preliminarily categorized this proceeding as ratesetting and determined that hearings will be necessary. A prehearing conference (PHC) was held on March 16, 1999. At the PHC, SCE proposed filing an amendment to the application addressing ORA's concerns.

On March 22, 1999, SCE filed a letter indicating agreement with ORA's proposal to adjust the expected ratepayer savings.

On April 16, 1999, the Assigned Commissioner issued a scoping memo determining that evidentiary hearings would not be needed in this matter. By a separate order issued today, the Commission ratified the Assigned Commissioner's determination.

### **Project Viability and Ratepayer Benefits**

There is no contention over the facts presented in this case on the viability issue. SCE internally evaluated the project's economic and technical viability and retained Energy Options, a third-party consultant with expertise in energy plants, to verify O'Brien's viability. Frequent site visits have confirmed that the facility is a well-designed, built, operated and maintained plant. O'Brien's production has been stable, with an average capacity factor of 65.7% from 1993 through 1997. Although there is an existing dispute over O'Brien's performance in 1996, audits have verified that the facility complied with QF efficiency standards for 1994 and 1995, and that the facility's performance greatly improved in 1997 and the first two months of 1998.

SCE's analysis of the project's economic viability used data from Energy Options' report as the basis to develop a cost model for appraising the project's cost of electric generation. This data included information on expected plant performance, capital cost, operation and maintenance, and thermal sales. SCE derived estimates of future revenues using O'Brien's historic kilowatt-hour production, firm capacity payments and bonus payments. This data establishes that, since its inception in 1990, the project has enjoyed strong revenue streams and has otherwise been financially viable. The data also establishes that this viability should continue for the remainder of the contract term.

In addition, O'Brien has a steam sales agreement with its host, California Milk Producers, that lasts the life of the contract. Energy Options has estimated that, under this arrangement, O'Brien may obtain incremental yearly revenues, which should contribute to O'Brien's continued financial viability.

ORA agrees with SCE's conclusion that there is no foreseeable impediment to the successful operation of the facility throughout the remainder of the ISO4 agreement's term.

ORA and SCE also agree that a reasonable estimate of the benefits of the buyout from the perspective of cost savings is \$13.7 million in NPV. These cost savings result from the replacement of O'Brien's high energy and capacity prices under the existing contract with lower-priced energy and capacity based on SCE's projected replacement costs, net of termination payments. SCE performed sensitivity analyses that examined how the forecast market prices during the remaining years of the contract would affect these cost savings. SCE's analyses produce savings that range from \$8.7 million to \$26.0 million in NPV, taking into account varying assumptions concerning energy prices, performance and the impact of the pending dispute on ratepayer savings.<sup>2</sup> In response to ORA's comments, SCE also incorporated into its analysis the probability that the O'Brien facility could fail QF efficiency requirements in the remaining years of the contract.

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<sup>2</sup> Specifically, SCE assigned probabilities to the outcome of the dispute and its related repayment of contract payments by O'Brien to SCE. SCE then subtracted these amounts from net savings under the various scenarios to arrive at estimates of ratepayer benefits.

## Discussion

The Commission scrutinizes the reasonableness of buyouts on a case-by-case basis. We look closely, therefore, at whether the buyout produces a reasonable level of cost savings to ratepayers, taking into account the buyout payment terms and the expected reduction in energy payments. We also look closely at whether the QF project is likely to continue in operation, since it would make no sense to make buyout payments to an energy supplier that was not likely to stay in business under the existing contract.

SCE has demonstrated to our satisfaction that O'Brien meets the Commission's viability criteria and that the buyout will produce significant and robust savings for its ratepayers under a range of economic and operational assumptions. Further, we find that the projected ratepayer benefits of \$13.7 million in NPV are reasonably commensurate with the projected benefit to O'Brien.

The termination agreement also resolves a dispute between SCE and O'Brien that all parties find reasonable. Our rules governing approval of settlements specify that the Commission will not approve a settlement unless it is "reasonable in light of the whole record, consistent with law, and in the public interest."<sup>3</sup> We described the applicable criteria in D.88-12-083 by referring to standards used in judicial review of class action settlements:

"In order to determine whether the settlement is fair, adequate and reasonable, the court will balance various factors which may include some or all of the following: the strength of the applicant's case; the

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<sup>3</sup> Rules of Practice and Procedure, Rule 51.1(e). (See D.93-03-058.)

risk, expense, complexity, and likely duration of further litigation; the amount offered in settlement; the extent to which discovery has been completed so that the opposing parties can gauge the strength and weakness of all parties; the stage of the proceedings; the experience and views of counsel; the presence of a governmental participant; and the reaction of the class members to the proposed settlement. [Citations omitted.]

"In addition, other factors to consider are whether the settlement negotiations are at arms' length and without collusion; whether the major issues are addressed in the settlement; and the adequacy of representation." [Citations omitted.] (D.88-12-083; 30 CPUC2d 189, 222.)

We have reviewed SCE's discussion of the settlement process and terms, and find that the settlement embedded in the termination agreement fully satisfies these criteria. We will not reveal the details of the settlement terms, except to say that it resulted in SCE negotiating for the best available buyout price after taking into account a ratepayer credit for the settlement value of the dispute. The assumed dispute value used, however, was not shared with O'Brien and remains confidential. We have evaluated SCE's calculations of the settlement value of the dispute, and find that it falls well within the range of possible outcomes.

In sum, we find SCE's application to be reasonable and will approve it, subject to the modification in the calculation of ratepayer benefits, and associated shareholder incentives, agreed to by SCE and ORA.

#### **Waiver of Comment Period**

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

### **Findings of Fact**

1. Frequent site visits have confirmed that the O'Brien cogeneration facility is a well-designed, built, operated and maintained plant. Its production has been stable, with an average capacity factor of 65.7% from 1993 through 1997.

Although there is an existing dispute over O'Brien's performance in 1996, audits have verified that the facility complied with efficiency standards for 1994 and 1995, and that the facility's performance greatly improved in 1997 and the first two months of 1998.

2. All parties agree that O'Brien will continue to earn reasonable profits under the existing contract.

3. The benefits of the buyout from the perspective of cost savings is expected to be \$13.7 million in NPV. These cost savings result from the replacement of O'Brien's high energy and capacity prices under the existing contract with lower-priced energy and capacity based on SCE's projected replacement costs, net of termination payments. These estimates account for the settlement value associated with a pending dispute between SCE and O'Brien, and include risk adjustments for future facility performance. They are reasonably commensurate with the expected benefit to O'Brien.

4. The settlement embodied in the termination agreement fully satisfies the criteria set forth by this Commission regarding all party settlements.

### **Conclusions of Law**

1. SCE's December 18, 1998 application, as modified by SCE's letter dated March 22, 1999, is reasonable and should be approved.

2. SCE's request for recovery of expenses incurred under the termination agreement should be conditioned on SCE's reasonable performance of its obligations and exercise of its rights under the agreement. Rate recovery should also be subject to the rate freeze provisions of Pub. Util. Code § 330 et al.

3. Because all issues have been addressed by this decision, this proceeding should be closed.

4. In order to proceed expeditiously with the proposed buyout, this decision should be effective today.

**O R D E R**

**IT IS ORDERED** that:

1. The December 18, 1998 application of Southern California Edison Company (SCE) for approval of the contract termination and settlement agreement between SCE and O'Brien California Cogen Limited (O'Brien), as modified by SCE's March 22, 1999 letter, is approved.

2. The termination agreement as set forth in Exhibit SCE 2 of the application is reasonable, and SCE's actions in entering into the agreement were prudent.

3. SCE is authorized to recover in rates all payments under the termination agreement, to the same extent as any other cost associated with a qualifying facility is recoverable, subject only to SCE's prudent administration of the termination agreement and the rate freeze provisions of Pub. Util. Code § 330 et al.

4. This proceeding is closed.

This order is effective today.

Dated May 27, 1999, at San Francisco, California.

RICHARD A. BILAS  
President

JOSIAH L. NEEPER  
Commissioner

Commissioner Henry M. Duque, being necessarily absent, did not participate.