ALJ/BDP/sid

Mailed 10/21/99

Decision 99-10-046 October 21, 1999

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Southern California Edison Company (U 338-E) to Report on the Valuation Process for Certain Generation-Related Assets Pursuant to D.97-11-074.	Application 98-05-014 (Filed May 1, 1998)
Application of PACIFIC GAS AND ELECTRIC COMPANY to Report Assessments of Inventory Balances and to Address Appraisal of Retained Generation Assets. (U 39 E)	Application 98-05-022 (Filed May 1, 1998)

OPINION ON THE MARKET VALUATION OF POST-1997 CAPITAL ADDITIONS

Summary

The Commission decides that the reasonableness and recovery of the undepreciated balance for post-1997 capital additions[1] to the utilities' remaining non-nuclear generation facilities should be addressed by the utilities in their Pub. Util. Code § 377[2] applications to be filed at the time of market valuation of the respective facilities.

[1] Post-1997 capital additions are those capital additions to retained non-nuclear generating facilities after March 31, 1998, the implementation date for the Independent System Operator (ISO) and the Power Exchange (PX) market structure (see Decision (D.) 98-03-054).

[2] All statutory references are to the Public Utilities Code unless otherwise stated.

Background

In D.97-09-048, we established the approach we would take to review past and future expenditures for non-nuclear capital additions put into service by Pacific Gas and Electric Company, Southern California Edison Company (Edison), and San Diego Gas and Electric Company. In that decision, we also approved a reasonableness review of the cost of capital additions placed in operation in 1996 and 1997, and capital additions for plants divested by March 31, 1998. (D.97-09-048, pp. 18-20.) For capital additions placed in operation in 1998 and beyond, we adopted, with some refinements, the market control approach. We determined that this approach would provide the utilities with a reasonable opportunity to recover post-1997 capital additions costs from either the ISO or the PX. (D.97-09-048, pp. 7, 11-18.)

While D.97-09-048 did address recovery by the utilities of the annualized cost of post-1997 capital additions, the decision did not address recovery of the undepreciated balance at the time of market valuation. We address that issue in this decision.

Procedural Matters

In D.99-03-061, which denied rehearing of D.97-09-048, the Commission ordered:

> "2. The Scoping Memo and Ruling of Assigned Commissioner, dated February 1, 1999, for the market valuation applications (A.98-05-014 & A.98-05-022) is modified to include the issue relating to how the utilities will recover post-1997 capital additions costs through the market for the generation plants they retain, and permit the parties to file comments and reply comments on this issue. Comments will be due April 19, 1999, and reply comments will be due May 3, 1999. The Executive Director shall serve a copy of today's decision to all parties on the service list for A.98-05-014 & A.98-05-022." (D.99-03-061, Ordering Paragraph 2.)

Opening comments were filed on April 19, 1999, by Edison and the Office of Ratepayer Advocates (ORA). Reply comments were filed on May 3, 1999, by Edison, Enron Corporation (Enron), and ORA.

In Resolution ALJ 176-2993 dated May 21, 1998, the Commission preliminary categorized these applications as ratesetting, and preliminarily determined that hearings were necessary. However, for this phase of the proceedings, no prehearing conference or evidentiary hearing was deemed necessary. This matter was submitted for decision on the comments filed by the parties.

ORA argues that the process the Commission chose to solicit comments was seriously flawed and may have had the effect of denying parties to this proceeding an effective opportunity to make their views known. ORA contends that the inclusion of this filing requirement at page 13 of a decision (D.99-03-061) in a different docket entitled "Order Modifying Decision (D.) 97-09-048 to Correct a Typographical Error, and Denying Rehearing of the Decision, as Modified" was not reasonably designed to provide parties notice of the need to file comments. ORA believes that the dearth of comments filed in this matter is indicative of the lack of sufficient notification to the parties.

Also, ORA points out that the Commission decision (D.99-03-061) calling for these rounds of comments was issued prior to the deferral of hearings in this docket and the beginning of the ongoing legislative overview of all the issues surrounding market valuation of the utilities' hydro assets. Given those two events, ORA suggests that this issue be put aside until there is more clarity on how the Legislature and Commission want the parties to proceed with the market valuation of the hydro resources.

Position of Edison

Edison states that it is only addressing recovery of post-1997 capital additions for retained assets prior to and at market valuation. Edison is not addressing recovery of capital additions to non-nuclear generation facilities that are retained by the utility after market valuation. To the extent Edison elects to retain generation assets within the utility distribution company (UDC), it will address recovery of post-market valuation of capital additions in its § 377 applications.

Edison believes that the Commission should continue its reliance on the market control approach adopted in D.97-09-048 prior to market valuation. In other words, the annualized costs of the capital additions would be recovered from ISO and PX revenues. To the extent that PX and ISO revenues would not cover the annualized cost of the capital additions, the utilities would not recover them.

Edison recommends that at the time of market valuation of any non-nuclear generating facilities retained by the utilities, the remaining net book value of the post-1997 capital additions should be added to the net book value of the plants. Then, the combined net book value should be compared to market value and any unrecovered net book value would then be recovered through the Competition Transition Charge (CTC). According to Edison, this would provide full recovery of the undepreciated balance of the cost of post-1997 capital additions at market valuation.

Edison contends that its proposal is consistent with D.97-09-048. It confines additions costs[3] to amounts recovered through ISO and PX revenues

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[3] Edison is referring to the annualized revenue requirement.

prior to market valuation, and it is consistent with § 367, which provides for recovery of reasonable capital additions incurred after December 20, 1995 that are necessary to maintain the facilities through December 31, 2001.

Position of ORA

ORA states that it is addressing recovery of post-1997 capital additions to generation assets retained by the UDC. It is ORA's understanding that any discussion of how to value capital additions for assets that will be valued as part of a process of divestiture is beyond the scope of this proceeding.[4]

ORA notes that the market control approach adopted in D.97-09-048 and D.98-03-054, for post-1997 capital additions uses the discipline of market forces to control the utility's level of capital additions rather than regulatory review in advance. The premise of this approach is that a utility would not make unreasonable investments, because revenues might be insufficient to cover the annual depreciation, return, and taxes (revenue requirement) associated with the capital addition. Under this approach, the book value of the capital addition is excluded form the Transition Cost Balancing Account (TCBA) and the utility recovers the current revenue requirement associated with the capital addition through market revenues or not at all. ORA agrees that this ratemaking treatment works well until the plant is market valued.

ORA acknowledges that capital additions may increase the market value of the plant substantially. However, if the capital additions are explicitly excluded from the book value in the TCBA, but included in any market valuation

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[4] ORA's understanding is based on the Scoping Memo and Ruling of Assigned Commissioner issued on February 1, 1999, and Assigned Commissioner's Response to Motion for Clarification or Modification of Scoping Memo and Ruling issued on March 15, 1999.

sales or appraisal, then an adjustment needs to be made to avoid an "apples and oranges" comparison. Therefore, ORA contends that either the book value of the underlying asset or the market value would need to be adjusted to remove the effects of the capital addition.

ORA believes that in theory, the market value of the plant with the capital addition should be adjusted to subtract the incremental change in market value of the asset which results from the capital addition. However, ORA acknowledges that the problem with this approach is that it may be exceptionally difficult to measure accurately the incremental change in value of the underlying asset associated with the capital addition.

ORA contends that the utilities' proposal that the undepreciated balance of the capital addition simply be added to the book value of the asset in the TCBA, assumes that a capital addition is cost effective and adds value to the project at least equivalent to its cost. ORA believes that such an assumption would be an abrogation of the Commission's mandate to oversee the reasonableness of all transition costs.

ORA recommends that the present market control approach be continued if a generation plant is retained and remains under cost-of-service ratemaking. ORA contends that this market-oriented approach to capital additions could be continued through the life of the capital addition. This makes an adjustment to the market or book value to reflect the capital addition unnecessary.

Since the future ratemaking arrangement for generation plants being retained is very uncertain at this time, and may be affected by legislative events, ORA recommends that no adjustment to market or book value to reflect post-1997 capital additions be developed at this time. Rather, it is ORA's recommendation that the status quo of booking capital additions to the memoranda accounts which track revenues and going forward costs should be

continued. ORA suggests that this issue be revisited in subsequent § 377 proceedings.

Further, ORA notes that numerous parties have called for more environmentally friendly regulation of the utilities' vast hydroelectric systems. Some of the proposals for enhancing environmental conditions on several of the river systems serving the hydro plants call for the construction of new structures to modify the physical characteristics of the flows in the river (temperature, oxygen, etc.), or even the decommissioning of certain facilities which may involve capital costs. ORA anticipates that consideration of capital additions designed to enhance environmental and recreational values, rather than simply to mitigate further adverse impacts, may require a modification of the Commission's market control approach. However, because the Commission has deferred consideration of most environmental issues until the utilities' subsequent applications, ORA believes it is premature at this time to speculate on these changes.

Position of Enron

Enron's understanding is that under the market control approach adopted in D.97-09-048, the costs of post-1997 capital additions should be recovered from market revenues, rather than through transition cost treatment. Limited ex post facto reasonableness review of certain capital additions expenditures for transition cost recovery was recognized only if four conditions are met: (1) the capital additions were made to ISO-designated must-run units and were necessary to continue operating the must-run unit during the transition (through December 31, 2001); (2) the capital additions were cost effective compared to other options for maintaining plant operations through the transition and compared to other resources available to the ISO for system reliability; (3) the

final ISO contracting options approved by the Federal Energy Regulatory Commission (FERC) did not include provisions that would allow utilities to negotiate recovery of these costs; and (4) the costs of capital additions could not be recovered in market prices for energy or ancillary services." (See D.97-11-074, p. 53.)

Also, it is Enron's understanding that the status quo, established in D.97-09-048, and subsequently reiterated in D.99-03-061, has not been altered and that the recovery of post-1997 capital additions is still subject to the parameters set forth in D.97-09-048.

Therefore, Enron contends that to the extent that recovery of the cost of capital additions is through the market under the market control approach (as it will be, with the limited exceptions identified in the decisions), the determination of the market value of a retained asset should exclude the separate value of the capital addition to the asset. In that way, the capital addition will not implicitly receive transition cost treatment. Enron acknowledges that how those values are determined will no doubt be the subject of tremendous controversy. Thus, Enron urges the Commission not to take any action at this time that will prematurely decide this issue. Specifically, Enron is concerned that a decision absent adequate review poses a risk of implicitly allowing for stranded cost recovery of certain capital additions costs through market valuation where none was intended by prior Commission decisions.[5]

Enron supports ORA's first three recommendations. First, Enron agrees that its premature and unnecessary at this time to "develop a scheme to adjust either the book or market value of retained power plants to reflect the presence

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[5] Enron cites D.97-09-048, D.97-11-074 and D.99-03-061.

of post-1997 capital additions." Second, Enron likewise agrees that the Commission should make no change to the current arrangement for recovering capital additions costs from market revenues through memoranda accounts which track revenues and going forward costs. Third, Enron supports ORA's recommendation that "[i]f subsequent ratemaking treatments established for retained plants seem to warrant a future adjustment to market value and transition costs, this issue should be revisited in future § 377 proceedings." Enron notes that its support for this latter recommendation should not be understood as agreement that a future adjustment will in fact be necessary. Rather, in the event that circumstances do warrant a consideration of a change, Enron agrees that such a change should be considered in a later proceeding.

Discussion

We note that prior to year-end 2001, the market value of all utility-owned generation-related assets must be established for transition cost purposes.[6] In the instant proceeding, comments were limited to "how the utilities will recover post-1997 capital additions costs through the market for the generation plants they retain."

The market control approach adopted in D.97-09-048 provides the utilities with an opportunity to recover the annualized revenue requirement for

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[6] Section 367(b), in pertinent part, states that transition costs "shall be recovered from all customers ... on a nonbypassable basis and shall ... be based on a calculation mechanism that nets the negative value of all above market utility-owned generation-related assets against the positive value of all below market utility-owned generation related assets. For those assets subject to valuation, the valuations used for the calculation of the uneconomic portion of the net book value shall be determined not later than December 31, 2001, and shall be based on appraisal, sale, or other divestiture."

depreciation expense, earnings, and taxes related to post-1997 capital additions through ISO and PX revenues. However, the market control approach does not address recovery by the utilities of the remaining reasonable undepreciated cost of post-1997 capital additions at the time of market valuation.[7]

Enron recommends that any determination of market value of retained assets should exclude the separate value of the capital addition to the asset. According to Enron, in that way, the capital addition will not implicitly receive transition cost treatment. Apparently, Enron would deny the utilities recovery of the remaining undepreciated portion of post-1997 capital additions not recovered through the market control approach. Contrary to Enron's preference, § 367 does not foreclose recovery by the utilities of "appropriate" and "reasonable" costs of additions at market valuation, as determined by the Commission.

Edison's proposal assumes that the capital additions in fact would increase the market value of the underlying plant amount by the cost of the capital addition. In the 1996 and 1997-98 capital addition cases, ORA and other parties challenged just that conclusion, presenting testimony that some of the capital additions were not cost effective and thus were likely to raise the market value of the project by less than the cost of the capital addition. If the Commission were to allow the utility to recover the full cost of capital additions in such circumstances, it would cause ratepayers to subsidize a portion of the capital addition. In the 1996 and 1997-98 dockets, the Commission had to resort to a

[7] Section 367 allows recovery by the utilities of "appropriate costs incurred after December 20, 1995, for capital additions to generating facilities existing as of December 20, 1995, that the commission determines are reasonable and should be recovered, provided that these additions are necessary to maintain the facilities through December 31, 2001."

reasonableness review to determine the cost effectiveness of the capital additions.

ORA points out that theoretically the market value of the plant with capital additions should be adjusted by subtracting out the incremental change in market value of the asset resulting from the capital addition. We agree with ORA that this approach is simply not feasible and a reasonableness review of post-1997 capital additions is most likely unavoidable.

ORA recommends that the current arrangement for recovering the revenue requirement related to the cost of capital additions be continued. ORA suggests that if subsequent ratemaking treatments established for plants retained by the UDC require a future adjustment to market value and transition costs, this issue should be revisited in future § 377 proceedings. We agree with ORA's recommendation for plants retained by the UDC.

Comments on Draft Decision

The draft decision of the ALJ in this matter was mailed to the parties in accordance with Pub. Util. Code § 311(g) and Rule 77.1 of the Rules of Practice and Procedure. Comments were filed on October 4, 1999, by ORA. No reply comments were filed. We have reviewed the comments and made changes to the draft decision where appropriate.

Findings of Fact

1. The utilities currently have the opportunity through the market control approach adopted in D.97-09-048 to recover the revenue requirement related to annual depreciation, return and taxes associated with post-1997 capital additions to the utilities' retained generation-related assets through the year 2001.

2. D.97-09-048 does not address how the utilities may recover post–1997 capital additions costs: (1) at the time of market valuation of the utilities'

generation-related assets, or (2) when generation-related assets are retained by the UDC after the year 2001.

Conclusions of Law

1. At the time of market valuation, it would not be appropriate to allow the utilities to simply add the remaining undepreciated balance of the capital additions to the book value of the asset in the TCBA, because this approach assumes that all post-1997 capital additions are cost effective.

2. To ensure that post-1997 capital additions are cost effective and ratepayers are not paying to upgrade the utilities' retained assets to make them more competitive in the new electric market, recovery of the undepreciated balance related to post-1997 capital additions costs should be subject to adjustment in future § 377 proceedings.

3. Ratemaking treatment of post-1997 capital additions should be accomplished in future § 377 proceedings related to the retention of such assets within the UDC after the year 2001.

ORDER

IT IS ORDERED that Pacific Gas and Electric Company and Southern California Edison Company shall address the ratemaking treatment of post-1997 capital additions in future Public Utilities Code Section 377 applications requesting Commission approval of retention within the utility distribution company of any generation-related asset after year-end 2001.

This order is effective today.

Dated October 21, 1999, at San Francisco, California.

RICHARD A. BILAS
President
HENRY M. DUQUE
JOSIAH L. NEEPER
JOEL Z. HYATT
CARL W. WOOD
Commissioners