From: Cherry, Brian K

Sent: 9/23/2010 11:32:06 AM

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Cc:

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Subject:

On another of our favorite topics. I pasted this from another email. Please don't circulate but this might be a way to resolve our problem. I haven't been briefed on it but it is the only thing that looks promising at this point. Let me know if you think this might work.

You asked for an opinion on whether PG&E could recover in rates the AFUDC costs associated with a $300 million pre-payment to GE, if PG&E were to restructure the Oakley PSA. PG&E is contemplating agreeing to provide a $300 million pre-payment at the time the project initiates commercial operations (after passing applicable performance testing) and pay the remainder of the purchase price on the acquisition date (which we are assuming will be around January 1, 2016). My understanding is that the result of the pre-payment would be to increase project costs by approximately $35 million which is attributable to 1) the AFUDC costs on the pre-payment and 2) the AFUDC costs applicable to the delay in recovery of PG&E's project development labor costs.

Short Answer: I believe the AFUDC costs are recoverable in rates under the ratemaking settlement approved by the CPUC in the LTRFO Decision, D.10-07-045. The ratemaking settlement in its entirety (including the Oakley provisions) was approved by the CPUC in D.10-07-045, subject to the CPUC finding that Oakley was needed. If PG&E's petition to modify is approved and the Commission approves the Oakley project based on a January 1, 2016 delivery date, the condition in the ratemaking settlement would be satisfied and it would apply to the project. The ratemaking settlement contains a "sharing band" applicable to the project's capital costs. Under the settlement, an initial capital target price of $1.143 billion is adopted and there are three additional $20 million sharing bands that are applicable if project costs exceed the target. The first $20 million is subject to 100% recovery, the second $20 million is subject to 90% recovery and the third $20 million is subject to 80% recovery. If costs exceed the target by more than $60 million, recovery of the excess costs would be subject to reasonableness review.

Thus, to the extent the additional AFUDC costs cause PG&E to exceed the target, the sharing bands would apply. DRA and TURN might argue the settlement does not apply because the prepayment and change in delivery date changes the commercial deal that the settlement was premised upon. Our response would be that DRA and TURN agreed to a reasonable target price plus sharing bands for customers to bear for Oakley in the settlement and PG&E would continue to fully honor all the elements of the ratemaking settlement.

It is expected that the CPUC would condition approval of the petition to modify on PG&E agreeing to not take delivery of Oakley sooner than January 1, 2016, causing the need for a second amendment to the PSA. I strongly recommend that such second amendment explicitly include the pre-payment provision and that it be submitted to the CPUC with any compliance filing. This way the Commission and the settling parties will be on notice that PG&E agreed to the pre-payment as part of the third amendment and that PG&E intends to fully apply and honor the ratemaking settlement to Oakley. If the Commission approves such a compliance filing, that would provide added assurance that the settlement ratemaking would remain applicable.

Key Provisions of the Ratemaking Settlement:

*D.10-07-045 states that "with regard to the Oakley Project, the Joint Parties agreed that the cost recovery and ratemaking proposals applicable to the Oakley Project, as modified by the Partial Settlement Agreement, are reasonable and should be approved by the Commission, if Oakley is selected to meet the LTRFO need." (p. 44) "We agree that the Partial Settlement Agreement is just, reasonable, and in the public interest. We therefore,

approve the Partial Settlement Agreement (as shown in Appendix A)." (p. 50; Ordering Paragraph 7, p. 56) If D.10-07-045 is modified to approve Oakley based on a later delivery date, the Partial Settlement Agreement would thus apply to Oakley.

*The Settlement Agreement adopts an initial capital cost of $1,143,714, 000. Section 4.1 says 'PG&E is entitled to include in rate base and recovery in rates the actual costs of the CCGS Project up to the Initial Capital Cost Estimate without the need for an after the fact reasonableness review." Section 4.2 contains the three $20 million recovery bands if project costs exceed the initial capital cost estimate -- 100% of the first $20 million, 90% of the second $20 million and 80% of the third $20 million. If costs exceed the target by more than $60 million, the excess costs are subject to a separate application and reasonableness review.

*The settlement fixes O&M until January 1, 2022 (with very limited opportunities for revisions prior to this date). Settling parties assumed that O&M would be fixed for 8 years. The delay in the project would effectively shorten this period to 5 years. While not required by the terms of the settlement, PG&E might want to consider voluntarily extending the period of fixed O&M by two years to preserve the intent of the parties. However, we would need to be very careful how we do this to avoid a general reopening of the ratemaking settlement.

*There are also limits the recovery in rates of capital additions prior to January 1, 2022. But, in this case, there is a chart that ties the limit on capital additions to the first 8 years of operation. TURN and DRA would likely assert that the limit on recovery of capital additions would run for the first 8 years of operations and would not sunset on January 1, 2022.

Additional Considerations:

*I understand that PG&E is contemplating providing O&M services to GE during start-up and for the initial period prior to PG&E taking delivery of the project on January 1, 2016. If PG&E provides such services, the CPUC's non-tariffed products and services rules would apply. Such services are authorized under "category 10" and, thus, pre-approval would not be required. However, the O&M contract would need to conform to CPUC requirements, charge market rates, and be subject to CPUC reporting requirements and audit.