PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

ID #6258

ENERGY DIVISION **RESOLUTION E-4054**

January 25, 2007

R E S O L U T I O N

Resolution E-4054. Pacific Gas & Electric (PG&E) requests approval of increase in capital cost and resulting revenue requirement for Contra Costa 8. This request is conditionally approved as discussed in the body of this Resolution.

By Advice Letter (AL) 2928-E Filed on November 8. 2006.

SUMMARY

This Resolution conditionally approves PG&E's request for approval of an increase of $75.5 million in the capital costs and resulting revenue requirement increase of $13.2 million for Contra Costa 8 (CC8).[1] Approval of this request is conditioned upon PGE&E obtaining a final CEC license to construct and operate the CC8 facility.

The protest of the Division of Ratepayer Advocates (DRA) is granted in part, as discussed below.

The protest of Merced Irrigation District (Merced ID) and Modesto Irrigation District (Modesto ID) (collectively, the Districts) is denied, as discussed below.

[1] In its response, dated December 5, 2006, PG&E stated that on November 30, 2006 it completed the acquisition of CC8 from Mirant, and that the facility will be renamed the Gateway Generating Station. For continuity here, it will continue to be referred to as CC8.

BACKGROUND

PG&E filed AL 2928-E for review and approval of a request to increase by $75.5 million the reasonable and prudent estimate of the initial capital cost of completing CC8 for commercial operation and the associated dollar thresholds in Sections 4.1, 4.2 and 4.3 of Attachment A to Decision ("D.") 06-06-035. PG&E is requesting this increase in order to convert the facility from fresh water cooling to dry cooling, as necessitated by changes in the project's permitting environment. PG&E also requests authorization to increase the resulting revenue requirement by $13.2 million.

In D.06-06-035, issued June 15, 2006, the Commission approved PG&E's acquisition of CC8 via an Asset Transfer Agreement (ATA) between Mirant Delta LLC and Mirant Special Procurement (Mirant) and PG&E. The decision also adopted $295 million as the reasonable and prudent estimate of the initial capital cost of completing CC8. This cost of completion was developed based on Mirant's original design and permits obtained for CC8, which included the use of fresh water from the San Joaquin River for cooling.

The original ATA with Mirant assigned permitting duties and responsibilities to Mirant, including securing a final California Energy Commission (CEC) license to construct and operate the facility. The ATA also stipulated that all biological issues associated with constructing and operating the facility must be resolved with the appropriate federal and state resources agencies. The CEC license obtained in 2001 included a biological section with conditions which required the federal and state resource agencies' approval for mitigation and monitoring plans related to marine impacts of CC8, as well as the existing Contra Costa units 6 and 7. Mirant will continue to own and operate units 6 and 7.

Since the CEC issued the license in 2001, state agencies have intensified their focus on a number of larger Delta habitat issues including the Delta smelt habitat decline, the salmon and steelhead populations and overall water quality. Earlier this year, the State Lands Commission evaluated the water quality and marine life impact issues. Since May of 2006, the State Water Resources Control Board has been examining further regulation and water use reduction of all power plants in California which rely on the Delta and Pacific Ocean water to operate.

Further, the Ocean Protection Council passed a resolution in 2006 to study the impacts of power plants on the marine environment.

After significant review and consultation, and after researching and analyzing the changes in various permitting requirements, PG&E determined a need to clarify next steps with the CEC. In May 2006, PG&E and Mirant representatives met with CEC commissioners and senior staff to determine the feasibility of resolving the biological issues in a timeframe which would allow for successful construction and operation of CC8 by 2009. After these meetings, it was apparent that the use of fresh water for once-through cooling was contrary to both current CEC policy and the goals of the State's Energy Action Plan. The CEC Commissioners, siting division staff and siting committee only allowed progress on the CEC license with the condition that alternatives to the use of fresh water for cooling would be pursued by PG&E. In a July 19, 2006 order amending its prior decision in order to add PG&E as an owner of CC8, the CEC adopted the following staff recommendations:

> "1) PG&E and Mirant will obtain Energy Commission approval of an amendment reflecting a new mitigation program which mitigates the cooling system impacts to a less than significant level and is acceptable to the federal and state resource agencies and obtain all required permits prior to the start of operation. (The previously drafted Biological Opinions from the USFWS and the National Marine Fisheries Service would not satisfy this requirement.)
> 2) If such a mitigation program is not developed and/or the federal permits are not obtained prior to the start of operation, PG&E and Mirant will obtain approval of an amendment switching to an alternative cooling method (such as reclaimed water) prior to beginning operation.
> 3) Until the resource agency permits are obtained, Unit 8 will be designed and constructed in such a manner that will not preclude the switch to an alternative cooling technology."

PG&E states that, in order to stay on schedule to have the facility online in the 2008-2009 timeframe when it is needed, alternatives to using water from the Delta for plant operation must be pursued.

PG&E investigated permitting, construction, and operational costs as well as schedule delays and risks of using either reclaimed water or dry cooling as an alternative to the use of fresh water. Neither of these alternative cooling methods would rely on the use of river water. After a thorough investigation, PG&E determined that changing the plant's design to incorporate dry cooling is the preferred option. Dry cooling uses air-cooled radiators to minimize the plant's use of water.

In addition to eliminating the use of river water for cooling, the change to dry cooling will provide additional environmental benefits:

- Approximately 97% less water is used.
- The visual plume of an evaporative cooling tower is eliminated.
- PM10 air emissions associated with cooling tower drift are eliminated.
- Chemical additives are not needed to treat cooling water.

NOTICE

Notice of AL 2928-E was made by publication in the Commission's Daily Calendar. PG&E states that a copy of the Advice Letter was mailed and distributed in accordance with Section III-G of General Order 96-A.

PROTESTS

AL 2928-E was timely protested by DRA and by the Districts on November 28, 2006. PG&E responded to the protests on December 5, 2006.

DRA states that, in the Advice Letter, PG&E has failed to provide any evidence of CEC approval of an amendment that requires switching to an alternative cooling method at this time. Therefore, DRA believes that PG&E's request to increase the reasonable and prudent initial capital cost estimate of CC8 by $75.5 million is premature. DRA argues that the Commission should reject PG&E's Advice Letter request because it fails to comply with the conditions as set forth in Section 6 of the Settlement Agreement adopted by D.06-06-035. DRA further states that the Commission should only approve the Advice Letter request

contingent on PG&E's actually implementing dry cooling at CC8 pursuant to PG&E obtaining such approvals.

According to the Districts, the Commission should order that PG&E may not obtain any uneconomic cost recovery for the increased capital cost of $75.5 million from any customers, whether bundled, direct access, or departing load. The Districts further state that if the Commission declines to so order, then rather than approve the increase requested by PG&E pursuant to Paragraph 6 of the Settlement Agreement, the Commission should treat this as a request for an increase under Section 4.3 of the Settlement Agreement, which would result in after-the-fact reasonableness review of about $29.5 million of the $75.5 million capital cost increase.

The Districts are concerned as to what effects a decision authorizing PG&E to proceed with its acquisition and completion of CC8 will have upon customers. This concern is especially heightened when by PG&E's own admission it had information about the likelihood that such an increase would be necessary but apparently did not share it with the Commission or parties before D.06-06-035 issued. The Districts state that they do not know whether this 25% increase will automatically transform the project from economic to uneconomic, but it does elevate the risk that the plant may someday become uneconomic.

The Districts suggest that if PG&E is going to be allowed a $75.5 million capital cost increase based on a brief advice letter that is sorely lacking in any facts to support the claim that the capital cost increase is "reasonable and prudent," then PG&E should have to take some risk along with receiving that increase. They believe this is especially so since PG&E knew of the issue leading to this increase before the Commission issued D.06-06-035, but apparently did nothing to bring that issue to the attention of the Commission or parties.

The Districts argue that an appropriate risk allocation would be to deny PG&E any recovery for uneconomic costs to the extent of the $75.5 million dollar increase, should the plant ever become uneconomic. Thus, PG&E could not obtain any uneconomic cost recovery for the increased capital cost of $75.5 million from *any* customer, whether bundled, direct access, municipal departing load, or customer generation departing load. This is an appropriate result especially because neither the parties nor the Commission have had any opportunity to examine the costs for reasonableness and prudence.

The Districts urge the Commission to follow their recommendation above. However, if the Commission does not do so, then the Districts suggest the Commission address PG&E's request under Section 4.3 of the Settlement Agreement, rather than under Section 6 as requested by PG&E.

The Districts believe that the Commission cannot adopt PG&E's request as presented in the AL because PG&E simply fails to demonstrate that its proposed increases in capital cost and revenue requirement are just and reasonable.

Instead, the Districts suggest the Commission examine PG&E's request as if it were made under Section 4.3 of the Settlement Agreement. Under the currently-existing threshold set in Section 4.3, the $75.5 million dollar capital cost increase requested by PG&E would be treated as follows: The $75.5 million would be added to $295 million to yield an initial capital cost of $370.5 million. PG&E would be entitled to include in rate base and recover through rates $341 million ($305 million plus $36 million). However, the remaining $29.5 million would be subject to an after-the-fact reasonableness review. If it were found to be just and reasonable, PG&E could, after such a review, include that sum in rate base and recover it through rates. If it or any portion of it were not found to be just and reasonable, recovery would be limited or perhaps denied.

The Districts suggest this is an appropriate result for three reasons. First, as noted, PG&E truly has not shown that its increases in the estimates for the capital cost and annual revenue requirement of the CC8 project are actually "reasonable and prudent." This solution allows later reasonableness review of not quite 40% of the extra cost while permitting the other 60% to be recovered without reasonableness review, thus not requiring the Commission to really put PG&E to its proof, as the Commission certainly could under Rule 4.2(5).

Second, according to the Districts, it provides a modicum of protection to those concerned about a future NBC due to CC8 becoming uneconomic, again by reserving for reasonableness review about 40% of the new cost. Such interested parties have not yet had a chance to challenge the new costs. PG&E apparently allowed its application to go to decision without disclosing that it knew an increase in estimated costs would likely be required due to the cooling issue. This approach would provide parties interested in the NBC issues to challenge 40% of the costs if they chose at a later date.

Third, this approach provides incentive to PG&E to complete the CC8 project at a cost that is truly just and reasonable. It allows PG&E to proceed with plant completion forthwith, without a detour to assess in hearing the reasonableness of the cost increase, while subjecting to reasonableness review only 8% of the total new plant cost estimate. Putting that 8% at risk will provide PG&E with a strong impetus to spend and work wisely. If PG&E does that, it seems unlikely the 8% would actually be at risk at all.

In its response, PG&E notes that neither of the protesting parties opposes the completion of CC8 as a dry cooled facility. PG&E states that the issues raised could affect customer reliability and cost, to the extent that granting the relief requested by protesting parties could lead to delays in completion of the facility and threaten adequate cost recovery. PG&E argues that it is important for the Commission to dismiss these protests without further proceedings and endorse the completion of CC8 as a dry-cooled facility with a greatly reduced impact on fresh water consumption.

PG&E states that D.06-06-035 (and the approved Settlement Agreement) is clear that further modifications to the CC8 design - and potential increases to the resulting costs - might be required due to other agency actions. The settling parties dealt in good faith with this possibility in Sections 5 and 6 to the Settlement Agreement. PG&E points to a July 19, 2006 CEC order which approved the addition of PG&E on the license but also imposed additional requirements related to cooling.

PG&E notes that the Settling Parties were fully aware, and made the Commission aware, that other regulatory agencies might modify CC8's environmental permits in a way which could lead to an increase in costs either because of a change in design or delay in construction. This has been the case with the recent restrictions on the use of fresh water for cooling. PG&E states that it has determined that dry cooling is the least cost alternative cooling technology and posed the least risk of delay. PG&E argues that, contrary to what the Districts imply, PG&E never failed in its efforts to keep the Commission fully informed.

PG&E believes that there is no need for further hearings, and it would be wholly inappropriate to revise the Settlement Agreement to provide either for more review of the project, less cost recovery, or less recovery of that cost from any class of customers. PG&E believes that it has provided compelling evidence to

the Commission's Energy Division that dry cooling is the most reasonable and cost-effective way to proceed with the completion of Contra Costa 8.

In addressing DRA's concerns, PG&E states that while the Energy Commission has not directly ordered the project to use dry cooling technology, it has clearly ordered alternative cooling technology in the absence of resource agency permits which are either unobtainable or unobtainable in time to support PG&E's resource needs. Therefore, PG&E asserts that dry cooling and reclaimed water are the only alternative cooling technologies. PG&E believes that dry cooling is the least cost and lowest risk approach.

PG&E believes that making this choice now enables it to have CC8 on-line in early 2009. PG&E further argues that not making this choice now, and continuing to explore fresh water alternatives that satisfy USFWS and National Marine Fisheries Service Biological Opinions, has no chance of succeeding and will result in a more expensive facility and a delayed online date.

DISCUSSION

We acknowledge the fact that neither of the protesting parties opposes the completion of CC8 as a dry cooled facility. We further acknowledge that, given state policy preference, the design of this facility is either modified to allow for dry cooling or it does not get built. We believe that not constructing this unit could have significant adverse reliability and cost implications.

We find that D.06-06-035, and the approved Settlement Agreement, is clear that further modifications to the CC8 design might be required due to other agency actions and that this might lead to potential increases in costs. Based on the record here, and in D.06-06-035, we find no reason to believe that any Party has done anything less than deal in good faith. At the time the Settlement was reached it was known that modifications to the plant's design might be necessary – as explicitly acknowledged in the Settlement Agreement itself – but the extent of the changes could not possibly be known. PG&E is now presenting those changes to the Commission for approval. Therefore, we find that the Districts assertions that PG&E failed to deal in good faith in executing the Settlement Agreement have no merit.

On November 9, 2006 the Energy Division issued a data request to PG&E concerning the magnitude of PG&E's $75 million increase in capital cost request,

citing an Energy Commission April 2006 Report which states that dry cooling has an "Increased plant capital cost of approximately $8 million to $27 million."[2] In the data request the Energy Division asked for a reconciliation of the capital cost difference. PG&E supplied the requested information and Energy Division released the response to the Service List in A.05-06-029. Based on this additional information, the estimates provided by PG&E of $75.5 million to convert CC8 to dry cooling appear reasonable. Further, construction has not begun on CC8 because PG&E has yet to obtain the all the final permits. Based on this aspect we find it reasonable to include the additional cost of construction in the initial capital cost of completing CC8 for commercial operation.[3]

In its protest, DRA states that PG&E has failed to provide any evidence of CEC approval of an amendment that requires switching to an alternative cooling method at this time. Therefore, DRA believes that PG&E's request to increase the reasonable and prudent initial capital cost estimate of CC8 by $75.5 million is premature. DRA further states that the Commission should only approve the AL request contingent on PG&E actually implementing dry cooling at CC8 and obtaining the appropriate approvals. We agree with DRA in part. We agree that PG&E has not shown anywhere in its request that the CEC has given final approval of an amendment requiring the Company to switch to dry cooling. However, as noted above, given state policy preference, it is abundantly clear that the facility will not be able to operate if it continues to be constructed in a manner that requires the use of fresh water for cooling.

Additionally, we realize that further delay in the construction and operation of CC8 could have adverse reliability impacts in the near future. Therefore, we approve PG&E's request contingent upon PG&E obtaining the appropriate permitting approvals in order to implement dry cooling at CC8. We urge PG&E to work expeditiously with the CEC and other relevant permitting agencies in order to obtain the necessary approvals as quickly as possible.

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[2] (CEC-500-2006-034)

[3] Along with the associated dollar thresholds in Section 4.1, 4.2, and 4.3 of the Settlement Agreement.

COMMENTS

"Public Utilities Code section 311(g)(1) provides that this resolution must be served on all parties and subject to at least 30 days public review and comment prior to a vote of the Commission. Section 311(g)(2) provides that this 30-day period may be reduced or waived upon the stipulation of all parties in the proceeding.

"The 30-day comment period for the draft of this resolution was neither waived nor reduced. Accordingly, this draft resolution was mailed to parties for comments, and will be placed on the Commission's agenda no earlier than 30 days from today."

FINDINGS

1. Commission Decision 06-06-035 directed PG&E to file an Advice Letter to seek an increase in the estimate and the associated dollar thresholds in Sections 4.1, 4.2 and 4.3, and the revenue requirement, if the costs of CC8 are increased as a result of any material changes to the project that are required to implement or comply with any permits, approvals, or conditions thereof, or the issuance of any order, judgment, award, or decree which affects the project.

2. PG&E filed Advice Letter AL 2928-E on November 8, 2006.

3. Advice Letter 2928-E seeks Commission review and approval of a request to increase by $75.5 million the reasonable and prudent estimate of the initial capital cost of completing CC8 for commercial operation and the associated dollar thresholds in sections 4.1, 4.2 and 4.3 of Attachment A to D.06-06-035.

4. PG&E is requesting this increase to convert CC8 from fresh water cooling to dry cooling, as necessitated by changes in the project's permitting environment.

5. PG&E also requests authorization to increase the resulting revenue requirement by $13.2 million.

6. The Commission's Energy Division issued a data request to PG&E on November 9, 2006.

7. PG&E responded to Energy Division's data request on November 23, 2006.

8. DRA timely protested the Advice Letter filing on November 28, 2006.

9. The Districts timely protested the Advice Letter filing on November 28, 2006.

10. PG&E responded to protests on December 5, 2006.

11. Energy Division posted PG&E's data request answers to the Service List for A. 05-06-029 on December 7, 2006.

12. PG&E's request should be conditionally approved pending PG&E obtaining final approval to construct and operate CC8 as a dry cooled facility.

13. PG&E will file an amended Advice Letter seeking final Commission approval within 30 days of obtaining final permits to construct and operate CC8 as a dry cooled facility.

THEREFORE IT IS ORDERED THAT:

1. The request of PG&E to increase by $75.5 million the reasonable and prudent estimate of the initial capital cost of completing CC8 for commercial operation and the associated dollar thresholds in sections 4.1, 4.2 and 4.3 of Attachment A to D.06-06-035, as requested in Advice Letter AL 2928-E, is conditionally approved as discussed in the body of this resolution.

2. The request of PG&E to increase the resulting revenue requirement by $13.2 million, as requested in Advice Letter AL 2928-E is conditionally approved as discussed in the body of this resolution.

3. Within 30 days of PG&E receiving final CEC permitting approval to construct and operate CC8 as a dry cooled facility, PG&E shall file a supplemental advice letter seeking final Commission approval of the requested increases.

This Resolution is effective today.

I certify that the foregoing resolution was duly introduced, passed and adopted at a conference of the Public Utilities Commission of the State of California held on January 25, 2007; the following Commissioners voting favorably thereon:

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STEVE LARSON
Executive Director