

**STATE OF CALIFORNIA**  
**DEPARTMENT OF WATER RESOURCES**

**RESPONSE TO REQUEST FOR RECONSIDERATION**  
**OF NOVEMBER 4, 2004 DETERMINATION OF REVENUE REQUIREMENTS**  
**California Code of Regulations Title 23, Section 516 (b)**



**March 16, 2005**

## **I. Introduction and Background**

On February 1, 2001, Assembly Bill 1 from the First Extraordinary Session of 2001-2002 (AB 1X) was signed into law.<sup>1</sup> AB 1X authorizes the California Department of Water Resources (“the Department” or “DWR”) to purchase electric power to sell directly to retail end-use customers in the investor owned utilities’ service territories. This legislation was necessary because of the temporary inability of investor owned utilities such as Pacific Gas & Electric Company (“PG&E”) to buy the power needed to serve their own customers. AB 1X also authorizes the Department to enter into an “agreement with respect to charges” with the California Public Utilities Commission (“the Commission” or “CPUC”). On March 8, 2002, the Department and the Commission entered into the Rate Agreement.<sup>2</sup> Both AB 1X and the Rate Agreement require the Department to calculate its revenue requirements at least annually and submit them to the Commission. AB 1X authorizes the Department to issue bonds to pay costs resulting from the Department’s power purchase program. AB 1X also authorizes the Department to promulgate regulations for purposes of its power supply program.

The Department has promulgated regulations for purposes of establishing a process to reach a determination of its revenue requirements as well as to examine whether its revenue requirements are just and reasonable. (See, California Code of Regulations, Title 23, Sections

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<sup>1</sup> California Water Code Sections 80000 *et seq.*

<sup>2</sup> Rate Agreement between State of California Department of Water Resources and State of California Public Utilities Commission dated March 8, 2002.

510–517 (the “Regulations”).<sup>3</sup> On November 4, 2004, pursuant to AB 1X and the Regulations, the Department issued its Determination of Revenue Requirements for the period January 1, 2005 through December 31, 2005 (the “2005 Determination”). The Department determined that the 2005 Determination was just and reasonable. On November 4, 2004, the Department also advised and notified the Commission of its revenue requirements pursuant to Water Code Sections 80110 and 80134 and the Rate Agreement. On November 16, 2004, PG&E submitted a request for reconsideration of the 2005 Determination.

## **II. PG&E Request for Relief**

In its Request for Reconsideration, PG&E asserts DWR’s 2005 Determination is not supported by substantial evidence in the record and is arbitrary, capricious and an abuse of DWR's discretion. PG&E argues that major components of DWR’s revenue requirement are unjust and unreasonable because DWR entered into above-market long-term power purchase contracts. PG&E also asserts that the Department’s contract with Kings River Conservation District (“KRCD”) contains above-market costs. PG&E also asserts that the contract essentially allows KRCD to recover the entire financing costs of the KRCD project. PG&E requests that DWR renegotiate its contract with KRCD or remove any “unjust and unreasonable” costs associated with the KRCD contract from the 2005 Determination. Finally, PG&E argues that DWR has not reduced its 2005 Determination to reflect a lower Minimum Operating Expense

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<sup>3</sup> The California Court of Appeal for the Third District ruled that DWR is not required to hold a hearing pursuant to the California Administrative Procedures Act or California Public Utilities Code in determining whether its revenue requirements are just and reasonable under Section 80110 of the Water Code. 112 Cal. App. 4th 477, 501-502.

Available Balance (“MOEAB”)<sup>4</sup> during calendar year 2005.

The Department has reviewed PG&E’s arguments and hereby denies reconsideration of the 2005 Determination.

**III. Response**

**A. DWR’s determination that costs associated with long-term power purchase contracts are just and reasonable under AB 1X and the Regulations is supported by substantial evidence on the record and is not arbitrary, capricious or an abuse of discretion**

In its Request for Reconsideration, PG&E argues that DWR has not granted relief to ratepayers or specifically responded to PG&E’s assertion that the 2005 Determination contains above-market costs associated with long-term power purchase contracts.

The Department has assessed whether the costs associated with DWR’s long-term contracts are just and reasonable in light of the circumstances faced by the Department at the time the various decisions implementing DWR’s power purchase program were made.<sup>5</sup> As

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<sup>4</sup> Under the Trust Indenture, the MOEAB is defined as “at the time Revenue Requirements are submitted to the Commission . . . (i) for so long as the Department is procuring all or a portion of the Residual Net Short, \$1 billion, and, (ii) thereafter, the maximum amount projected by the Department by which Operating Expenses exceed Power Charge revenues during any one calendar month during that Revenue Requirement Period. Such projections shall be based on such assumptions the Department deems to be appropriate after consultation with the Commission and may take into account a range of possible future outcomes.” (Trust Indenture at p. 11)

<sup>5</sup> California Code of Regulations Section 517.

explained in DWR's August 16, 2002 Determination of Revenue Requirements, and in the Department's Reconsideration of the August 16, 2002 Determination, issued on August 19, 2004, DWR does not believe that the Legislature intended that the Department conduct an after-the-fact reasonableness review.<sup>6</sup> By law, the Department is not permitted to realize a profit from its activities, nor does it have any shareholder capital from which to pay for costs that cannot be included in rates or charges. Any just and reasonable review and determination undertaken by the Department, must be consistent with the mandate of Section 80134 of the Water Code that the Department establish and revise revenue requirements sufficient, together with other moneys, to provide for all of the Department's costs.

The Department's Regulations require the application of the following standards in determining whether its revenue requirements are just and reasonable:

To protect ratepayer interests, the record of the determination must demonstrate by substantial evidence that the revenue requirement is just and reasonable, considering the circumstances existing or projected to exist at the respective times of the department's decisions concerning whether to incur the costs comprising such revenue requirement, and the factors which under the Act [AB 1X] are relevant to such determination and such decisions, including but not limited to the following:

- (1) The development and operation of the program as provided in the Act is in all respects for the welfare and the benefit of the people of the state, to protect the public peace, health, and safety, and constitutes an essential governmental purpose;
- (2) The department must do those things necessary and authorized under chapter 2 of the Act to make power available directly or indirectly to

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<sup>6</sup> Both DWR's August 16, 2002 Determination of Revenue Requirements and the Department's Reconsideration of the August 16, 2002 Determination are included in the administrative record supporting the 2005 Determination.

electric consumers in California; provided that except as otherwise stated, nothing in the Act authorizes the department to take ownership of the transmission, generation, or distribution assets of any electrical corporation in the State of California;

(3) Upon those terms, limitations, and conditions as it prescribes, the department may contract with any person, local publicly owned electric utility, or other entity for the purchase of power on such terms and for such periods as the department determines and at such prices the department deems appropriate taking into account all of the factors listed in section 80100 of the Water Code;

(4) The department may sell any power acquired by the department pursuant to the Act to retail end use customers, and to local publicly owned electric utilities, at not more than the department's acquisition costs, including transmission, scheduling, and other related costs, plus other costs as provided in section 80200 of the Water Code;

(5) The department must, at least annually, and more frequently as required, establish and revise revenue requirements sufficient, together with any moneys on deposit in the Electric Power Fund, to provide for all of the amounts listed in section 80134(a) of the Water Code, including but not limited to the repayment to the General Fund of appropriations made to the Electric Power Fund for purposes of the Act; and

(6) Obligations of the department authorized by the Act shall be payable solely from the Electric Power Fund.<sup>7</sup>

Pursuant to the Regulations, the Department must rely on the standards set forth above to determine whether the 2005 Determination is just and reasonable. The various factors set forth in the above standards in large part mirror the statutory directives of AB 1X. These directives were part of the circumstances facing the Department at the time it made various procurement decisions underlying the 2005 Determination.

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<sup>7</sup> 23 California Code of Regulations § 517.

Importantly, a comparison to market price is not the sole consideration with respect to whether DWR's energy costs are just and reasonable under AB 1X. The Legislature intended that the Department's power supply program achieve an overall portfolio of contracts for energy resulting in *reliable service at the lowest possible price*.<sup>8</sup> The Department's objectives were to meet this two-part directive: reliability and cost-effectiveness. Accordingly, the Department's core strategy was to emphasize longer-term contracts as a means to secure new generation capacity for greater reliability and long-term price stability. This strategy underwent periodic review and modification as the power supply program progressed and market conditions changed.<sup>9</sup> DWR's long-term power purchase contracts must be assessed in part based on whether they contributed to the achievement of the goal of increased reliability at lower prices, by shifting supply from the spot market to a long-term supply.

There is substantial evidence in the administrative record, which explains the condition of California's energy market, DWR's procurement objectives and its portfolio planning efforts.<sup>10</sup> This evidence supports a just and reasonableness determination of the long-term contract costs included within the 2005 Determination.

When compared to the alternative of continuing to purchase large volumes of energy at excessive prices in the spot market during 2001, the long-term contract costs included within the

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<sup>8</sup> Water Code Section 80100 (a).

<sup>9</sup> See, Declaration of Ronald O. Nichols dated August 8, 2002 at paragraphs 38 through 88. See also, Declaration of Peter S. Garris dated August 9, 2002.

<sup>10</sup> See e.g., Declaration of Ronald O. Nichols dated August 8, 2002 at paragraphs 4 through 43 and exhibits thereto — *History of DWR's Net Short Energy Procurement Process Under Long-Term Contract*.

2005 Determination are just and reasonable. The following facts provide substantial evidence to support a determination that the Department's costs were just and reasonable pursuant to Section 80110 of the Water Code and the Regulations: the dramatic reduction in spot market prices during 2001 following DWR's contracting efforts,<sup>11</sup> the reduction in total costs as compared to prices that were experienced prior to contracting efforts undertaken by the Department,<sup>12</sup> and projected prices and energy shortages absent actions taken by the Department.<sup>13</sup> To maintain a reliable power supply, achieve lower prices in the market and halt the unsupportable continued drain on the State General Fund, the Department reasonably determined to move expeditiously to convert spot market purchases in an explosive market into longer-term bilateral contracts.<sup>14</sup> Based on the information provided above, the Department has demonstrated that the long-term power contract costs contained in its 2005 Determination meet the criteria established to determine that those costs are just and reasonable.<sup>15</sup>

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<sup>11</sup> See e.g., Declaration of Ronald O. Nichols dated August 8, 2002 at paragraphs 71 through 72. See also e.g., California Department of Water Resources Activities and Expenditures Report Quarter Ended June 30, 2001.

<sup>12</sup> Memorandum dated December 10, 2001 from the Department of Water Resources to Mary D. Nichols regarding Department of Water Resources' Response to the State Auditor's Draft Report. Declaration of Ronald O. Nichols dated August 8, 2002 at paragraph 39 and Exhibit 12 thereto—*History of DWR's Net Short Energy Procurement Process Under Long-Term Contract*.

<sup>13</sup> See e.g., Declaration of Ronald O. Nichols dated August 8, 2002 at paragraph 7.

<sup>14</sup> Memorandum dated December 10, 2001 from the Department of Water Resources to Mary D. Nichols regarding Department of Water Resources' Response to the State Auditor's Draft Report.

<sup>15</sup> In its Request for Reconsideration, PG&E specifically references the contract between DWR and Sempra Energy Resources ("Sempra"). PG&E argues that DWR has asserted that it entered into this contract based on fraudulent misrepresentations citing page 54 of the 2005 Determination. The 2005 Determination does not make this statement. DWR notes that the DWR-Sempra contract is currently subject to an arbitration proceeding before the American Arbitration Association.

The Department has also demonstrated that contract related savings are utilized to reduce the Department's revenue requirement thereby providing the Commission with the opportunity to pass these savings on to ratepayers. In the 2005 Determination, the Department explained its efforts to incorporate amounts received and amounts projected to be received as a result of contract renegotiations and settlements of disputes involving DWR's long-term power contracts and other energy crisis litigation.<sup>16</sup> The 2005 Determination reflects amounts received and projected to be received from settlements with El Paso Energy, Williams Energy Marketing and Trading and Dynegy Power Marketing. These receipts in part account for a 2005 Determination that is less than DWR's 2004 Supplemental Revenue Requirement.

**B. The administrative record supports a finding that the costs associated with Kings River Conservation District contract that are included within the 2005 Determination are just and reasonable.**

In its Request for Reconsideration, PG&E argues that DWR has not adequately addressed PG&E's criticisms concerning the reasonableness of the KRCD power purchase contract. Specifically, PG&E argues that it estimates the cost of power from the KRCD contract to be above market.<sup>17</sup> PG&E requests that DWR either renegotiate the KRCD contract to "market-

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<sup>16</sup> 2005 Determination at pp. 33-34.

<sup>17</sup> In its request for reconsideration, PG&E also argues that costs that may be paid to KRCD for power in years beyond 2005 may allow KRCD to recover its project financing costs at the end of the contractual period. The 2005

responsive levels”, or remove from the 2005 Determination the costs attributable to the allegedly unjust and unreasonable terms and conditions of the contract.

The administrative record supporting the 2005 Determination contains various documents concerning the KRCD contract. These documents include an Amended and Restated Power Purchase Agreement between DWR and KRCD, a letter agreement between DWR and KRCD related to implementation of the Amended and Restated Power Purchase Agreement, cost analyses of the KRCD contract, a fact sheet concerning the KRCD project and the official statement issued by KRCD in connection with its bond issuance. Based on these materials, DWR determined that the costs associated with KRCD that are included in the 2005 Determination (approximately \$2.7 million) were just and reasonable.

The KRCD contract provides for the sale of dispatchable capacity. The cost analyses supporting DWR’s just and reasonable determination demonstrate an estimated annual capacity cost of \$83 per kW during the contract term. For 2005, DWR estimates an annualized estimated capacity price of \$83 per kW year for the KRCD contract. The \$83 per kW annual capacity price is significantly below other capacity prices obtained by DWR for dispatchable capacity from simple cycle turbines of the same general size and for a similar general duration.<sup>18</sup> PG&E has not presented any materials or analyses to DWR that support PG&E’s contention that the

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Determination relates only to costs included within DWR’s revenue requirements for 2005 and not future years. In any event, it is not clear that if KRCD is able to recover its financing costs at the end of the contractual term that such a result would not be just and reasonable under AB 1X and the Regulations. Under such an outcome, KRCD would presumably be able to operate a financially viable power plant located within California.

<sup>18</sup> The average DWR contract price for other peaker projects are follows: Wellhead (approximately \$110/kW-yr); Calpeak (approximately \$117/kW-yr); Calpine Contract 3 (approximately \$172/kW-yr); and GWF (approximately \$183/kW-yr.)

costs of the KRCD contract are above-market for capacity payments or are unjust or unreasonable.

While DWR intends to continue to look for opportunities to renegotiate its long-term power purchase contracts to obtain benefits for California ratepayers consistent with the statutory directives set forth in AB 1X, the Department has determined that the costs associated with the KRCD contract for 2005 are just and reasonable, consistent with AB 1X and the Regulations, and are appropriately included in the 2005 Determination.

**C. The Department's determination to model a target MOEAB in 2006 is just and reasonable.**

In its Request for Reconsideration, PG&E argues that DWR should reduce its 2005 Determination to reflect a reduced MOEAB in 2005. PG&E's argument echoes comments DWR received by the Energy Division of the CPUC during DWR's administrative process leading to the 2005 Determination. DWR responded to the comments of the CPUC's Energy Division as part of its 2005 Determination.<sup>19</sup>

As explained in the 2005 Determination, the Department has covenanted in the Bond Indenture to include in its revenue requirements amounts estimated to be sufficient to cause the amount on deposit in the Operating Account at all times during any calendar month to, at a minimum, equal the MOEAB. The Bond Indenture addresses the minimum requisite projected

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<sup>19</sup> 2005 Determination at pp. 59-61.

amount to be on deposit in the Operating Account and leaves to the Department the determination as to what total reserves are appropriate or required to fulfill its duties under AB 1X. The MOEAB is to be determined by the Department at the time of each revenue requirement determination and, when the Department is not procuring the residual net short, is to be an amount equal to the largest projected difference between the Department's projected operating expenses and the Department's projected Power Charge revenues during any one month period during the revenue requirement period, taking into account a range of possible future outcomes (i.e. stress cases).

For purposes of the 2005 Determination, DWR determined the MOEAB to be \$282 million. The Department projects to exceed the MOEAB at all times during 2005. As stated in the 2005 Determination, the Department determined that the amount projected to be on deposit in the Operating Account, including the amount therein that serves as a reserve for Operating Expenses, is just and reasonable, based in part on the following factors: (1) potential gas price volatility, (2) potential gas price escalation, (3) credit rating agency and credit and liquidity facility considerations, as well as other factors discussed in the 2005 Determination.<sup>20</sup> The Department adopted a similar modeling approach in connection with its 2004 Supplemental

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<sup>20</sup> 2005 Determination at pp. 39-39 "Sensitivity Analysis" and pp.40-41 "Key Uncertainties in the Revenue Requirement Determination". If 2005 Determination were calculated so that the Operating Account balance were to actually reach the MOEAB during calendar year 2005, the Department projects that it could not avoid falling below the MOEAB in February 2006, because charges implemented as of January 1, 2006 would not be reflected in cash flows until the second half of February. Assuming for the sake of argument that the Department was prepared to take this risk (which it is not), in order to meet the MOEAB during the balance of 2006, the 2006 revenue requirement would likely need to be higher than currently projected under this 2005 Determination. Based on current assumptions underlying the 2005 Determination, PG&E's argument essentially seeks a reduction in DWR's reserves now in exchange for a greater increase in 2006. DWR does not believe this outcome is consistent with the statutory directives of AB 1X.

Determination of Revenue Requirements, which was implemented by CPUC Decision 04-08-050.

**IV. Conclusion**

For the reasons stated herein, DWR denies PG&E's Request for Reconsideration of the 2005 Determination.