

**STATE OF CALIFORNIA  
DEPARTMENT OF WATER RESOURCES**

**RESPONSE TO REQUESTS FOR RECONSIDERATION  
OF JULY 1, 2003 SUPPLEMENTAL DETERMINATION OF  
REVENUE REQUIREMENTS**

California Code of Regulations Title 23, Section 516 (b)



December 4, 2003

## **Introduction and Summary of Response**

On February 1, 2001, the Governor signed into law Assembly Bill 1 from the First Extraordinary Session of 2001 ("AB 1X"). In AB 1X, the Legislature responded to the inability of the state's investor owned electric utilities to buy the power needed to serve their customers.

AB 1X authorizes the California Department of Water Resources ("the Department") to purchase electric power to sell directly to the electric utilities' customers. AB 1X also authorizes the Department to enter into a Rate Agreement with the California Public Utilities Commission ("the Commission"). On March 8, 2002, the Department and the Commission entered into a Rate Agreement. 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 recover a portion of the costs of the Department's power purchase program. AB 1X also authorizes the Department to promulgate emergency regulations for purposes of implementing its power supply program.

On June 7, 2002, the Department promulgated emergency regulations for purposes of establishing a process to reach a determination of revenue requirements, as well as to examine whether such revenue requirements are just and reasonable. (*See*, California Code of Regulations, Title 23, Sections 510–517 (the "Regulations"). The Regulations were approved by the Department's Water Commission and the State's Office of Administrative Law. The Department renewed its emergency regulations with the approval of the Office of Administrative Law. This approval was provided on December 5, 2002. On March 7, 2003, the Department issued a Notice of Proposed Rulemaking Action to adopt the Regulations as permanent regulations. On May 9, 2003, the Water Commission approved the Regulations and on June 4, 2003, the Department submitted the Regulations and Final Statement of Reasons to the Office of Administrative Law in accordance with the Notice of Proposed Rulemaking Action. The Regulations are now permanent.

Pursuant to the Regulations, the Department issued a notice of its proposed supplemental determination of revenue requirements ("Proposed Determination") on June 2, 2003 to the persons or entities that provided comments or requested notice of the prior 2003 determination of revenue requirements dated August 16, 2002, and to other persons or entities who had received notice of the August 16, 2002 Determination (collectively, "interested persons"). The notice was also made available on the Department's web site. The deadline for submitting comments

was June 23, 2003. On June 23, 2003, San Diego Gas & Electric Company ("SDG&E"), Southern California Edison Company ("SCE") and Pacific Gas and Electric Company (PG&E") submitted comments on the Proposed Supplemental Determination. On July 1, 2003, after considering the comments submitted by interested persons, the Department issued a Supplemental Determination of Revenue Requirements for 2003. The Department provided interested persons notice that it would accept requests for reconsideration of the Supplemental Determination of Revenue Requirements for 2003 up to and including July 10, 2003. On July 1, 2003, the Department also advised and notified the Commission of its Supplemental Determination of Revenue Requirements for 2003 pursuant to Water Code Sections 80110 and 80134 and the Rate Agreement.

On July 10, 2003, SDG&E and PG&E submitted requests for reconsideration. The Department did not receive any other requests. The Regulations state that requests for reconsideration shall be considered by the Department if timely submitted. The Department has considered all the arguments presented by SDG&E and PG&E and has determined that no grounds for reconsideration have been demonstrated.

### **Request of San Diego Gas & Electric Company for Reconsideration**

#### **The administrative record provides substantial evidence for the Department 's Determination of Revenue Requirements**

In its request for reconsideration, SDG&E claims that DWR has overstated SDG&E's electricity load. SDG&E contends that DWR has included excessive SDG&E transmission losses in SDG&E's load requirement. SDG&E states that SDG&E Utility Retained Generation is a primarily fixed energy resource and changes in load requirements tend to be served by dispatchable energy from DWR's long-term contracts. SDG&E also asserts that DWR dispatchable contract energy is likewise overstated by the amount of service area transmission losses. SDG&E requests that if its concerns are not addressed in the 2003 Supplemental Revenue Requirement that they be addressed in the Department's 2004 Revenue Requirement. The Department's administrative record underlying the Supplemental Determination Revenue Requirements supports its assumptions regarding SDG&E's load. The Department agrees that the inclusion of transmission losses in the calculation of SDG&E load requirements could overstate SDG&E's load. However, any potential overstatement would have a minimal effect on the Department's revenue requirements and does not support granting

reconsideration of the 2003 Supplemental Determination. The Department intends to continue to review its load assumptions and confer with SDG&E regarding load forecasts for SDG&E's service territory.

SDG&E also requests that the Department provide an explanation concerning a decrease in expected remittances due to load and dispatch changes. For purposes of estimating a decrease in expected remittances due to load and dispatch changes, the Department relied upon PROSYM modeling as well as the Department's financial model. These models are part of the administrative record supporting the 2003 Supplemental Determination. SDG&E's request for an additional explanation does not support granting reconsideration of the Department's Supplemental Determination of Revenue Requirements.

**SDG&E's modeling recommendation does not seek reconsideration of the Department's 2003 Supplemental Determination of Revenue Requirements**

In its request for reconsideration, SDG&E recommends that DWR model long-term contract energy deliveries to serve the requirements of individual utilities as opposed to statewide load. SDG&E requests DWR consider this approach in future revenue requirements starting in 2005. This request, by its own terms, does not impact the Department's 2003 Supplemental Determination of Revenue Requirements.

**Request of Pacific Gas and Electric Company for Reconsideration**

**The Department's Supplemental 2003 Determination of Revenue Requirements is based upon the administrative record consistent with the Regulations**

In its request for reconsideration, PG&E sets forth five grounds for reconsideration of the Department's Supplemental 2003 Determination of Revenue Requirements. First, PG&E argues that DWR needs to respond to PG&E data requests. PG&E argues that without this information, it cannot assess whether DWR's supplemental revenue requirements contains the maximum reasonable reduction that can be achieved for 2003 or includes off-setting cost increases that are reasonable or inaccurately forecasted. The Regulations governing DWR's administrative process do not provide for interested persons to submit data

requests to DWR. However, as described in its Notice of a Proposed Supplemental 2003 Determination of Revenue Requirements provided to the public, including PG&E, DWR made the administrative record supporting the Supplemental Determination of Revenue requirements available for inspection and copying. To date, PG&E has not requested to inspect or copy the Department's administrative record. Moreover, at the request of interested persons, including PG&E, the Department held several conference calls to answer questions concerning its Supplemental Determination of Revenue Requirements for 2003. PG&E and members of the public have had sufficient notice and opportunity to examine and question the assumptions supporting the reduction on the Department's 2003 Revenue Requirements.

PG&E also argues that DWR has not provided an explanation of how natural gas prices have increased DWR's power costs for 2003 or provided any information to permit interested persons to determine whether its gas contracting and hedging activities have prudently mitigated the impact of natural gas prices. PG&E is mistaken. The Supplemental 2003 Determination of Revenue Requirements specifically addressed increases in forecasted fuel costs and the impact those increases would have on DWR's revenue requirements.<sup>1</sup> As described therein, increased prices for natural gas result in increased costs under those contracts that have variable fuel costs.<sup>2</sup> In addition, the Department provided its modeling assumptions pertaining to increased fuel costs to interested parties subject to applicable nondisclosure requirements. PG&E received this information and had the opportunity to question any assumptions regarding increased fuel costs during conference calls held by DWR with interested persons, including PG&E, during the Department's administrative proceeding. The administrative record supporting the Supplemental 2003 Revenue Requirements Determination contains materials supporting the Department's analysis.<sup>3</sup>

Pursuant to Decision 02-12-069 of the California Public Utilities Commission ("the CPUC" or "Commission") and the consent of the Department, the Department's gas contracting and hedging activities have been undertaken by the investor owned utilities on behalf of DWR. Decision 02-12-069 required the utilities to

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<sup>1</sup> See, Supplemental Determination of Revenue Requirements for the Period January 1, 2003, through December 31, 2003 dated July 1, 2003 at pp. 18-19.

<sup>2</sup> *Id.*

<sup>3</sup> See, PROSYM - price forecasting and market simulation tool. See also, Input from the investor owned utilities received on February 24, 2003 and United States Energy Information Administration's Report of 2002 production.

undertake operation, administration and dispatch responsibilities for DWR's contracts and established fuel management protocols in connection with the utilities administration of DWR's contracts. These fuel protocols address among other things review of fuel plans for DWR contracts, development of fuel management strategies, identifying gas suppliers for fuel purchases, identifying appropriate gas transportation facilities and scheduling gas deliveries.<sup>4</sup> The fuel management protocols also address gas storage plans, managing deliveries and using gas imbalance and reviewing invoices. Decision 02-12-069 is part of the administrative record supporting the Department's Supplemental 2003 Revenue Requirements Determination. Since the issuance of Decision 02-12-069, the Commission has issued Resolutions adopting Gas Supply Plans for the period in time March 2003 through September 2003. These Resolutions were adopted on July 10, 2003 after the Department submitted its Supplemental 2003 Revenue Requirement to the CPUC consistent with Water Code §§ 80110 and 80134.<sup>5</sup> On August 15 and 22, 2003, the utilities have submitted Gas Supply Plans for the remainder of 2003 and the first quarter of 2004 to the CPUC for approval.<sup>6</sup> These Advice Letters were approved on November 16, 2003.<sup>7</sup> The Department is preparing additional fuel management protocols in consultation with the utilities, including PG&E. PG&E's position that there is insufficient information to determine whether DWR's gas contracting and hedging activities have prudently mitigated the impact of natural gas prices cannot be sustained. The Department has also formed a Fuel Management Working Group to develop and implemented a strategy for managing gas procurement.<sup>8</sup> Given the supporting materials included within the administrative record, reconsideration of the 2003 Supplemental Determination of Revenue Requirements is not appropriate.

PG&E also alleges that DWR has not revised its hydroelectric power forecasts to account for higher hydroelectric availability for 2003, and that DWR has refused to update its forecast for new 2003 projections. The Supplemental 2003

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<sup>4</sup> CPUC Decision 02-12-069, Exhibit B to attached Operating Order.

<sup>5</sup> CPUC Resolution E-3825 applicable to PG&E; CPUC Resolution E-3838 applicable to SDG&E; and CPUC Resolution E-3833 applicable to Southern California Edison Company ("SCE").

<sup>6</sup> Advice Letter 2410-E submitted by PG&E to the CPUC on August 15, 2003; Advice Letter 1518-E submitted by SDG&E to the CPUC on August 15, 2003; and Advice Letter 1738-E submitted by SCE to the CPUC on August 22, 2003.

<sup>7</sup> CPUC Resolution E-3845 applicable to PG&E; CPUC Resolution E-3854 applicable to SDG&E; and Resolution E-3846 applicable to SCE.

<sup>8</sup> State Auditor's Report, April 3, 2003, *California Energy Markets: The State's Position Has Improved, Due To Efforts By The Department Of Water Resources, But Cost Issues And Legal Challenges Continue.* ("State Auditor's Report") at pp. 37-39.

Determination of Revenue Requirements specifically addresses the Department's assumptions regarding hydroelectric conditions in California and the Pacific Northwest. For purposes of the Supplemental Determination of Revenue Requirements the Department updated its forecast to reflect expected hydroelectric conditions in these geographic regions. The Department's updated forecast does reflect higher hydro availability for 2003 than the assumptions underlying the Department's earlier Determination of Revenue Requirements for 2003. PG&E's contentions are wrong. Moreover, the administrative record underlying the Department's Supplemental 2003 Determination of Revenue Requirements supports DWR's hydroelectric assumptions.<sup>9</sup> The Department will continue to review its hydroelectric power forecasts and update those forecasts as appropriate.

PG&E further argues that DWR has not provided information demonstrating that DWR has evaluated all financing alternatives for funding cash reserves required by its bond indenture. In its comments on the Proposed Supplemental 2003 Determination of Revenue Requirements, PG&E also asserted that DWR did not provide sufficient information to demonstrate that it has fully evaluated and considered all viable alternatives to the level of these cash reserves, including alternative financing mechanisms that would be less expensive to DWR's customers than requiring those customers to fund the reserves through immediate cash remittances.<sup>10</sup> PG&E requested that DWR explain whether and to what extent alternative financing mechanisms are available which would require lower up-front cash remittances from customers to fund and maintain the Operating Account balance. The methodology for funding cash reserves is the same as the method set forth in the Department's earlier 2003 Determination of Revenue Requirements, which the Department determined was just and reasonable.<sup>11</sup>

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<sup>9</sup> See, DWR's California Water Supply Outlook runoff forecast, dated February 1, 2003; see also, National Weather Services Northwest River Forecast Center runoff forecast for The Dalles, March 3, 2003 Early Bird Forecast. In its comments, PG&E asserted that DWR underestimated the availability of hydroelectric power for 2003 but did not provide any supporting materials to allow DWR to assess the reasonableness of PG&E's assertion.

<sup>10</sup> PG&E Comments dated June 23, 2003 at p. 7.

<sup>11</sup> See, Determination of Revenue Requirements for the Period January 1, 2003, through December 31, 2003 dated August 16, 2002. As the Department explained at p. 21 of its Supplemental Determination of Revenue Requirements dated July 1, 2003:

Cash reserves are maintained by the Department to protect the Power Charge Accounts and the bondholders against reasonable levels of measured volatility in expenses and revenues from foreseeable and quantifiable risks. The Operating

Moreover, this methodology is supported by various materials in the administrative record, including a declaration reflecting discussions with Rating Agencies as well as financing documents.<sup>12</sup> The Department's determination of just and reasonableness does not require an analysis of all alternatives to the sizing of operating reserves. Neither Division 27 of the Water Code nor the Regulations require such an analysis prior to the Department reaching a just and reasonable determination.<sup>13</sup>

**DWR has determined that its renegotiated long term contracts are just and reasonable based on objective evidence within the administrative record**

PG&E contends that DWR has not provided a "net present value analysis" or other objective evidence to support the reasonableness of costs of the renegotiated contracts. PG&E also asserts that DWR has relied on confidential, undisclosed information in order to support a finding of reasonableness, which is arbitrary, capricious and violates DWR's own rules. As part of the Supplemental 2003 Determination of Revenue Requirements, DWR explained that it has renegotiated long term energy contracts with input and acceptance from the Commission, the Office of the Governor, the Attorney General's Office, and the Electricity Oversight Board, with specific goals in mind. These goals included, but

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Reserve Account is required by the Bond Indenture to be maintained at a level determined by the Department as described in the August 16, 2002 Determination and incorporated herein by reference. In the August 16, 2002 Determination, the Operating Reserve Account Requirement was determined to be \$777 million, based on the then applicable test. Now that the Department is no longer acquiring the residual net short, the Operating Reserve Account Requirement is "the greater of (i) the largest aggregate amount projected by the Department by which Operating Expenses exceed Power Charge Revenues during any consecutive seven (7) calendar months commencing in [the] Revenue Requirement Period, and (ii) 12% of the Department's projected annual Operating Expenses for [the] Revenue Requirement Period [but] not less than [12%] of the Department's Operating Expenses for the most recent twelve (12) calendar month period", taking into account a range of possible future outcomes. Based on the sensitivity analysis described later in this section, the Operating Reserve Account Requirement is now determined by the Department to be \$630 million.

<sup>12</sup> See, Declaration of Douglas Montague dated August 9, 2002 at ¶ 22; see also, documentation of California Department of Water Resources Power Revenue Bonds, Volumes 1-7 dated October 30, 2002 and Volumes 1-4 dated November 14, 2002.

<sup>13</sup> Water Code § 80000 *et seq.*, Title 23 California Code of Regulations § 517.

were not limited to: “(1) reduction of nondispatchable energy to shape supply to match energy demand, (2) shortening of contract terms to avoid purchases that sellers required but that were not vital to the state, (3) reduction of contract prices to just and reasonable levels and reduce overall portfolio costs, (4) reduction of volumes of purchases in later years of contracts, (5) enhancement of the reliability of energy by improving contract terms, (6) positioning of contracts for possible assignment to other parties, (7) facilitation of contract administration by improving the Department’s contractual rights and (8) targeting of projected customer savings of at least 20 percent.”<sup>14</sup> Copies of the renegotiated contracts are contained within the administrative record supporting the Supplemental Determination. The Supplemental Determination of Revenue Requirements also explains the impact of these negotiations of DWR’s 2003 power costs.

PG&E’s contention that DWR relied on confidential, undisclosed information to support its just and reasonable determination reached in connection with the Supplemental 2003 Revenue Requirement is incorrect. PG&E argues that other state agencies have information relevant to the Department’s assessment of the renegotiated contracts. Although this may be true, the Department relied on the materials within the administrative record in reaching its just and reasonable determination.<sup>15</sup> Consistent with the above-described goals, DWR assessed various factors associated with the renegotiated contracts, including reducing must-take energy requirements under the contracts to more closely match demand projections. The Department’s approach, which relies on several factors, is consistent with the CPUC’s assessment of renegotiated power purchase agreements that examine a variety of mechanisms to increase ratepayer benefits.<sup>16</sup>

For the reasons set forth above and in the Department’s Supplemental Determination, the Requests for Reconsideration submitted by SDG&E and PG&E do not state sufficient grounds for reconsideration. Therefore, they are denied.

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<sup>14</sup> See, Supplemental Determination of Revenue Requirements for the Period January 1, 2003, through December 31, 2003 dated July 1, 2003 at pp. 17-18.

<sup>15</sup> See, PG&E request for Reconsideration at p. 2; see also, Comments of PG&E dated June 23, 2003 at pp. 7-8; State Auditor’s Report at pp. 67-90.

<sup>16</sup> See e.g. *Re Biennial Resource Plan Update*, Decision 93-01-048, 47 CPUC 2d, 772; see also e.g., *Re Power Purchase Project Contracts Between Electric Utilities and Qualifying Facilities*, Decision 88-10-032, 29 CPUC 2d 415.