

**STATE OF CALIFORNIA
DEPARTMENT OF WATER RESOURCES**

**RESPONSE TO REQUEST FOR RECONSIDERATION
OF SEPTEMBER 18, 2003 DETERMINATION OF REVENUE
REQUIREMENTS**

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



December 4, 2003

Introduction

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" or "DWR") to purchase electric power to sell directly to retail 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. 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 Determination of Revenue Requirements for 2004 ("Proposed Determination") on July 17, 2003 to the persons or entities that provided comments or requested notice of the 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. On August 4, 2003, DWR provided notice of an extension of time for interested persons to submit comments on the

Proposed Determination up to and including August 14, 2003. On August 6, 2003, DWR noticed significant additional material upon which it intended to rely in reaching a determination of revenue requirements. On August 14, 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 Determination. On September 18, 2003, after considering the comments submitted by interested persons, the Department issued a Determination of Revenue Requirements for 2004 (“2004 Determination”). The Department provided interested persons notice that it would accept requests for reconsideration of the 2004 Determination up to and including September 29, 2003. On September 18, 2003, the Department also advised and notified the Commission of its Determination of Revenue Requirements for 2004 pursuant to Water Code Sections 80110 and 80134 and the Rate Agreement.

On September 29, 2003, PG&E submitted a request 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 PG&E and has determined that no grounds for reconsideration have been demonstrated.¹

The Department’s 2004 Determination is not a regulation and is not subject to the Administrative Procedures Act.

In its request for reconsideration, PG&E argues that DWR’s 2004 Determination fails to meet minimal standards of due process and commits violations of law.² PG&E first argues that DWR’s 2004 Determination is a regulation subject to the procedural requirements of the California Administrative Procedure Act (“APA”).³ This claim has been the subject of litigation between DWR and PG&E and was most recently addressed by the California Court of Appeal for the Third Appellate District, which stated:

We conclude DWR’s revenue requirement is not a “regulation” within the meaning of Government Code

¹ Concurrent with this determination, the Department is also denying PG&E’s Request for Reconsideration of DWR’s 2003 Supplemental Determination of Revenue Requirements.

² PG&E’s Request for Reconsideration at p. 1

³ *Id.* at pp. 2-5.

section 11342(g), and is therefore not subject to APA procedures.⁴

The Court of Appeal also stated:

[W]e see no basis for concluding, as urged by PG&E, that the revenue requirement is subject to APA procedures as a “quasi-legislative act”⁵

For the reasons set forth in the Court of Appeal’s Decision, the Department rejects PG&E’s request for reconsideration of the 2004 Determination on the grounds that DWR failed to comply with the APA.

The Department relied on the administrative record supporting the 2004 Determination to reach a just and reasonable determination.

In its request for reconsideration, PG&E asserts that DWR has relied on extra-record material to support its just and reasonable determination. Specifically, PG&E asserts that DWR is relying on net present value analyses of renegotiated power purchase agreements to determine that the 2004 Determination is just and reasonable. Although DWR conducted net present value analyses in connection with renegotiation efforts associated with DWR’s power purchase contracts, there is a more than adequate basis in the record (without those analyses) for DWR to make its just and reasonable determination, and it is upon that basis (again, without those analyses) that the just and reasonable determination was made. The record includes, among other evidence, the fact that DWR renegotiated long-term energy contracts with input and approval from the Commission, the Office of the Governor, the Attorney General’s Office, and the Electricity Oversight Board (“EOB”), all of whom were representing in one way or another ratepayers’ interests.⁶ Copies of the renegotiated contracts are contained within the administrative record supporting the 2004 Determination as are Settlement Agreements resolving related litigation as well as press releases describing the benefits of the renegotiated contracts.⁷ The Department’s 2004 Determination also

⁴ *Pacific Gas and Electric Company v. State Department of Water Resources et al.*, Case No. 041864, slip op. at p. 50 (Cal. Ct App. 3rd Dist. Oct. 2, 2003).

⁵ *Id.* at p. 42.

⁶ Determination of Revenue Requirements for the Period January 1, 2004 Through December 31, 2004 dated September 18, 2003 at p. 27.

⁷ *Id.* at p. 73.

explains the impact of these negotiations on DWR's 2004 power costs.⁸ The Department has relied only on these and the other sources within the administrative record to make its just and reasonable determination.

The Department is not required to conduct a hearing to provide clear and convincing evidence that its Determination of Revenue Requirements is just and reasonable.

In its request for reconsideration, PG&E argues that the Department's 2004 Determination violates Water Code §§ 80100, 80110 and Section 451 of the Public Utilities Code.⁹ The thrust of PG&E's argument appears to be that DWR was required to meet a clear and convincing burden of proof in connection with any just and reasonable review. PG&E contends this burden of proof is required under hearing procedures mandated by the Water Code and Public Utilities Code for just and reasonable reviews.¹⁰ There is no requirement for DWR to conduct a hearing in reaching a determination of revenue requirements or a just and reasonable determination.¹¹ Nevertheless, the Department has promulgated regulations to establish a process for determining a revenue requirement and conducting any just and reasonable review. Under the Regulations, the standard for review is whether the administrative record contains substantial evidence supporting the Department's determination.¹² Moreover, the Regulations set forth standards for the Department to evaluate whether its revenue requirements are just and reasonable.¹³ The standards reflect the legislative goals of Water Code § 80110, which the Department took into account when making procurement decisions pursuant to AB 1X.¹⁴

⁸ *Id.* at pp. 27-33.

⁹ PG&E Request for Reconsideration at pp. 6-9. PG&E argues that DWR did not hold evidentiary hearings or permit the cross-examination of witnesses. PG&E also argues that DWR has not met its burden of proof in connection with such a hearing. PG&E asserts that DWR must demonstrate by "clear and convincing evidence" that its costs are just and reasonable under Public Utilities Code § 451.

¹⁰ *Id.* at pp. 1 and 7-8.

¹¹ *Pacific Gas and Electric Company v. State Department of Water Resources et al.*, Case No. 041864, slip op. at pp. 36-39 (Cal. Ct App. 3rd Dist. Oct. 2, 2003).

¹² Title 23 California Code of Regulations Section 517.

¹³ *Id.*

¹⁴ *Id.*

The Department's 2004 Determination and DWR's finding of just and reasonableness is based on substantial evidence in the record.

In its request for reconsideration, PG&E asserts that the Department's just and reasonable determination is not supported by substantial evidence in the record.¹⁵ In large part, PG&E reiterates its comments on the Proposed Determination, to which the Department responded in the 2004 Determination. PG&E references, among other things, conclusions of the First and Second State Audit Reports, complaints brought by the State of California before the Federal Energy Regulatory Commission ("FERC"), and the Declaration of Eugene Meehan submitted with PG&E's comments. PG&E's request does not raise any new facts that the Department has not already considered in connection with its 2004 Determination. The Department has already assessed that the administrative record supporting the 2004 Determination contains substantial evidence to support a determination that DWR's revenue requirement is just and reasonable. Consistent with title 23 of the California Code of Regulation § 517, DWR examined its power purchase costs for 2004 in compliance with the criteria set forth in AB 1X. The Department's just and reasonable determination is based on these standards.

Although the Legislature instructed the Bureau of State Audits to conduct a financial and performance audit of the Department's implementation of Division 27 of the Water Code,¹⁶ the Legislature did not ask the Bureau of State Audits to assess whether the Department's implementation of Division 27 was just and reasonable. Indeed, the Legislature expressly reserved any such determination to the Department.¹⁷ The purpose of the audit was to provide the Legislature and Executive Branch of government with an independent assessment of the Department's power purchase program in order for government to make appropriate decisions concerning energy matters facing the State of California.

¹⁵ PG&E Request for Reconsideration at pp. 9-16.

¹⁶ Water Code § 80270.

¹⁷ *Id.* at § 80110.

The Department's just and reasonable determination reached in connection with its 2004 Determination is not undermined by litigation brought by the State of California before the FERC.

PG&E also argues that proceedings initiated by certain California state agencies before the FERC effectively preclude DWR from finding that power costs associated with its long term contracts are just and reasonable. The Department has expressly recognized the efforts of these California state agencies to pursue refunds, lower prices or changes to the terms and conditions of DWR's long-term power purchase contracts through litigation before FERC.¹⁸ In the event that the Department's long-term contracts are modified by order or through renegotiation, these modifications and corresponding cost reductions will be incorporated into future Determinations. However, under the Regulations, the Department must consider whether its revenue requirements are just and reasonable within the legal framework established by AB 1X and under the circumstances that existed at the time from the Department's perspective. The litigation before FERC, which was initiated by the Commission and the EOB, alleges that under Section 206 of the Federal Power Act, the prices and terms required by suppliers under the Department's long-term contracts are not just and reasonable due to the market power that suppliers exercised at the time that the Department was placed in the position of obtaining contracts to assure reliable service and reduce the cost of energy within California. As the California Court of Appeal for the Third Appellate District has noted, this contention is not inconsistent with a determination that power costs incurred by the Department and included within a determination of revenue requirements are just and reasonable.¹⁹ This point has also been explained by the Commission in Decision 02-03-062, in which the CPUC itself explained that PG&E's contention has no merit:

The challenge currently before the FERC relates to the justness and reasonableness of a FERC-filed rate. As long as DWR is required to pay the current rate in those long-term contracts, AB 1X permits DWR to recover those costs from customers. Consequently, PG&E's challenge is not valid.²⁰

Litigation brought by the State of California before FERC does not create estoppel or preclude DWR from reaching a reasonableness determination concerning the Department's market mitigation and portfolio development strategy. The CPUC

¹⁸ August 16, 2002 Determination of Revenue Requirements at p. 66.

¹⁹ *Pacific Gas and Electric Company v. State Department of Water Resources et al.*, Case No. 041864, slip op. at p. 3 (Cal. Ct App. 3rd Dist. Oct. 2, 2003).

²⁰ Decision 02-03-062, 2000 Cal. PUC LEXIS 1103 (March 21, 2002).

and EOB are different state agencies than DWR, with different mandates. Prices paid by DWR during the energy crisis must be assessed against the facts and circumstances facing DWR at the time of contracting, even though the prices demanded by generators may have resulted from improper market practices. Accordingly, the litigation before FERC does not preclude a finding by DWR that costs incurred pursuant to a legislative directive in a dysfunctional market were prudent.

The Department's just and reasonable determination is not arbitrary and capricious or an abuse of discretion.

PG&E charges that DWR's just and reasonable determination is arbitrary and capricious and an abuse of discretion. Here, PG&E reargues its earlier positions, referencing litigation brought by the State of California before FERC, the findings of the Bureau of State Audits and the declaration of Eugene Meehan. PG&E also argues that DWR has not evaluated other components of its 2004 Determination such as administrative costs, energy prices under the renegotiated contract prices or bond interest costs. PG&E is wrong. The Department has considered these matters in its determinations pursuant to AB 1X and the Regulations, which are supported by substantial evidence in the administrative record.

For the reasons set forth above and in the Department's 2004 Determination, PG&E has failed to state sufficient grounds for reconsideration of the 2004 Determination. Therefore PG&E's request for reconsideration is denied.