UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION

Before Commissioners: Pat Wood, III, Chairman;
Nora Mead Brownell, and Joseph T. Kelliher.

Southern California Edison Company,
On behalf of Mountainview Power
Company, LLC

Docket No. ER04-316-000

ORDER CONDITIONALLY ACCEPTING PROPOSED RATE SCHEDULE
AND REVISING AFFILIATE POLICY

(Issued February 25, 2004)

1. In this order, we are conditionally accepting for filing a Power Purchase Agreement (PPA) between Southern California Edison Company (Edison) and Mountainview Power Company, LLC (Mountainview), an exempt wholesale generator (EWG). We will condition our acceptance, among other things, on Mountainview submitting a compliance filing reflecting ordered changes to the PPA, committing to filing a FERC Form 1 annually, maintaining its books and records in accordance with the Uniform System of Accounts, and limiting its market activity to cost-based sales to Edison. This action benefits customers by accommodating the construction of new generation in California while ensuring that Mountainview's rates are just and reasonable.

BACKGROUND

2. On December 19, 2003, Edison filed, on behalf of Mountainview, its to-be-acquired subsidiary, a proposed PPA between itself and Mountainview. Mountainview owns a yet-to-be completed 1054 MW state-of-the-art generating plant.[1] Edison seeks to exercise an option to purchase the project by purchasing Mountainview from its current owner, Sequoia Generating LLC (Sequoia).[2] Edison claims that its purchase of

---

[1] The plant will consist of two units. Unit 1 will be completed before Unit 2; both units are estimated to be completed in March 2006 (Full Commercial Operation Date).

[2] Sequoia bought the project from AES Corporation in March 2003. Construction was suspended in March 2002 when AES Corporation experienced financial difficulties. Prior to that, AES acquired it from Thermo-Ecotek in 2001.

Mountainview will restore stability to the marketplace, enhance reliability and provide substantial benefits to Edison's ratepayers, but Edison requests Commission approval of the PPA before it will exercise its option. The PPA is not a market-based contract; instead, it is a cost-based rate schedule which includes ratemaking features that give Mountainview incentives to control discretionary costs that it will incur and pass on to Edison. The PPA is structured as a tolling agreement, giving Edison the responsibility for gas procurement, hedging, and plant dispatch.

3. Edison states that it has elected to use this subsidiary-PPA structure because it is just beginning to return to financial health, and because significant unresolved policy issues in California "demand the increased assurance of cost recovery that a FERC-filed, cost-based PPA provides."[3] In other words, Edison "requires greater security of investment recovery than is available under traditional state-jurisdictional ratemaking."[4] The utility asserts that this is a unique request, unlikely ever to be repeated, because of the urgent need for new generating capacity in California. Edison notes that the Public Utilities Commission of the State of California (CPUC) has found that this transaction is in the public interest.[5] In summary, the CPUC ruled that ratepayers will be better off with Mountainview than without it.[6]

4. The Energy Policy Act of 1992 amended the Public Utility Holding Company Act of 1935 (PUHCA) to allow an EWG to sell power to an affiliated utility only if the state regulatory authority makes certain findings, described in Section 32(k) of PUHCA (Protection Against Abusive Affiliate Transactions).[7] The CPUC has made the requisite PUHCA findings, noting among other things that: (1) the PPA does not violate any state law; (2) the PPA does not confer any unfair competitive advantage; and (3) the CPUC

[3] Edison transmittal letter at 3.

[4] Id. at 5.

[5] Specifically, the CPUC found that the proposed transaction will benefit consumers and that Edison has established an immediate need for dispatchable peaking and intermediate capacity. See id. at 20-28.

[6] CPUC Decision 03-12-059 at 40-41, attached to CPUC comments (CPUC Decision).

[7] 15 U.S.C. § 79z-5a(k) (2000).

has sufficient regulatory authority, resources, and access to books and records of both Edison and Mountainview.[8]

5. Applicants request that the PPA be made effective upon execution, which is expected to be at the financial closing. Because the closing may not occur within 120 days from the date of the filing, Applicants seek waiver of the 120-day advance notice requirement.

NOTICE, INTERVENTIONS AND COMMENTS

6. Notice of Edison's filing was published in the Federal Register, 69 Fed. Reg. 63 (2004), with motions to intervene and protests due on or before January 9, 2004. The CPUC filed a notice of intervention and comments in support of the proposal. Timely motions to intervene raising no substantive issues were filed by AES Corporation, Constellation Power Source, Inc. and Constellation New Energy, Inc., and Pacific Gas and Electric Company. Timely motions to intervene and comments in support of the filing were filed by California Small Business Roundtable and California Small Business Association (CSBR/CSBA), Consumers First, Electric Consumer Alliance, Sequoia Generating LLC (Sequoia), and The Utility Reform Network (TURN). The following filed timely motions to intervene and protests: California Manufacturers and Technology Association (CMTA), Calpine Corporation (Calpine), Cogeneration Association of California (CAC), Electric Power Supply Association and Western Power Trading Forum (jointly, Competitive Suppliers), Energy Producers and Users Coalition (EPUC), FPL Energy, LLC (FPL), Independent Energy Producers Association (Independent Producers), Reliant Resources, Inc. (Reliant), and the Silicon Valley Manufacturing Group (SVMG).

7. In addition, members of Congress submitted comments supporting the proposal stressing the need for new generation capacity in California. One Congressman opposed the filing. Several California Assemblymen also commented, requesting a full evidentiary hearing.

8. On January 14, 2004, Water and Energy Consulting filed a late motion to intervene on behalf of Black Mesa Trust and To' Nizhoni Ani' (WEC).

9. On January 26, 2004, Edison, Sequoia, and TURN filed answers responding to the protests. Independent Producers, Calpine, and CMTA subsequently filed replies.

---

[8] CPUC Decision at 40-46.

POSITIONS OF THE PARTIES

10. Supporters of the filing, including several organizations representing consumer interests,[9] claim that the Mountainview project is needed so that Edison can meet its immediate requirements for dispatchable peaking and intermediate capacity and its long-term need for baseload resources. Supporters also state that the PPA will not have an adverse effect on competition. The CPUC concludes that Mountainview is "a very good deal for Edison's customers"[10] and that the plant's location in Edison's load center makes the plant an efficient addition to its system. The CPUC also notes that the Mountainview project has already received a license for the project and an environmental review has been concluded. Consumers First and the Electric Consumer Alliance state that the PPA will promote reliability of California's energy supply and foster a more cost-effective, consumer-responsive energy market. Finally, while the CPUC and TURN both would prefer that the development of the Mountainview project be completed as a traditional utility-owned rate-based investment, they support the proposed PPA since it is cost-based and in many respects mirrors the cost recovery treatment of a rate-based investment.

11. Opponents of the filing argue that Edison has not shown that the Mountainview project is either needed or in the public interest. Additionally, opponents argue that Edison has failed to have an open and fair competitive bidding process prior to completing the Mountainview transaction and that the absence of competitive procurement will strike a blow to competitive markets in California. Specifically, Calpine and FPL argue that, had a request for proposals been available, they would have participated. Opponents also argue that Edison should be required to satisfy the Commission's Edgar standard[11] regarding affiliate transactions as well as affiliate abuse concerns. The Independent Producers raise numerous concerns regarding the PPA. For example, they argue that the terms and conditions are unjust, unreasonable and unduly discriminatory or preferential. They also raise issues regarding the development of the PPA's rates and charges such as its use of incentives, escalation indices, and other cost-of-service concerns. SVMG argues that the approval of the Mountainview PPA will

---

[9] These groups include Consumers First, TURN, CSBR/CSBA, and the Electric Consumer Alliance.

[10] CPUC comments at 5.

[11] See Boston Edison Co. Re: Edgar Electric Energy Co., 55 FERC ¶ 61,382 (1991) (Edgar) (requiring a showing that a sale of power at market-based rates to a franchised utility from an affiliate is reasonably priced compared to alternatives in the market).

initiate re-regulation in California. CAC and EPUC argue that the Mountainview project must not displace the need for existing and future qualifying facility (QF) needs and must comply with the provisions of the Public Utility Regulatory Policies Act of 1978 (PURPA).

DISCUSSION

Procedural Matters

12. Pursuant to Rule 214 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.214 (2003), the CPUC's notice of intervention and the timely, unopposed motions to intervene of the entities that filed them make them parties to this proceeding. We will grant WEC's late motion to intervene, given its interest in the proceeding, the early stage of the proceeding, and the absence of any undue prejudice or delay.

13. Rule 213(a)(2) of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.213(a)(2) (2003), prohibits an answer to a protest unless otherwise ordered by the decisional authority. We are not persuaded to accept Edison's, Sequoia's and TURN's answers and Independent Producers', Calpine's, and CMTA's replies, and will, therefore, reject them.

Cost of Service Issues

14. The PPA, as well as the rulings of the CPUC, provide that certain cost items and terms of service are subject to the CPUC's regulatory review. We note that the Commission is the ultimate arbiter of the rates, terms and conditions of service of a power purchase agreement that is subject to our jurisdiction.

Description of the Proposed Charges

15. As noted above, the proposed PPA is a cost-based rate schedule which includes ratemaking features that give Mountainview incentives to control discretionary costs that it will incur and pass on to Edison. Edison will buy the natural gas for the unit. The primary set of charges in the PPA include formula rates for the recovery of capital costs and certain specified other costs, stated operation and maintenance charges (O&M) and incentive rates for plant availability and heat rate.

16. The PPA has a Capital Recovery Charge that will be billed monthly on a formula rate basis and is intended to recover the Return on Investment, Book Depreciation, and Federal and State Income Taxes based on the original cost of the plant. Beginning on the Full Commercial Operation Date, Edison will pay the Monthly Capital Recovery Charge. However, between the time Unit 1 enters service and the full Commercial Operation Date, Edison will pay an Initial Monthly Charge which is calculated in the same manner

as the Monthly Capital Recovery Charge, but is based on only the investment associated with the first unit that is placed into service. The initial investment reflects the purchase price to Sequoia plus the costs incurred by Mountainview to complete the construction of the project including amounts associated with Allowance for Funds Used During Construction (AFUDC).

17. In addition to the Capital Recovery Charge, the PPA provides for recovery of O&M charges. Edison states that the O&M charges under the PPA are divided into two categories: (1) Pre-Authorized Charges and (2) Fixed and Variable O&M Charges.[12] Edison states that the Pre-Authorized charges are recovered on a formulary basis and a majority of these expenses are effectively pre-committed at the outset. Edison will also pay Mountainview a monthly stated Fixed O&M Charge and a monthly stated Variable O&M Charge, which are intended to recover all O&M costs not recovered through the Pre-Authorized charges and which will remain constant, except for an escalation factor for inflation, during the intervals between Overhaul Cycles.[13] Additionally, by being stated rates, the Fixed and Variable O&M rates are intended to act as an incentive to Mountainview to control the amount of costs incurred for the types of expenses recovered by these charges.

18. The PPA also includes two separate incentive rate mechanisms: (1) an availability incentive and (2) a heat rate incentive. The availability incentive provides bonus or penalty payments for performance by Mountainview above or below an availability standard, with the purpose of providing an incentive to Mountainview to maintain plant availability. The heat rate incentive is designed to provide financial rewards and/or penalties to Mountainview to maintain the plant in a reasonable condition so that the heat rate does not unreasonably degrade and the plant functions at an efficient heat rate.

---

[12] The Commission's Uniform System of Accounts would not include all items that will be recovered under these charges as O&M expenses. For example, property taxes would be booked to Account 408 of the Uniform System of Accounts.

[13] An Overhaul Cycle is defined as the period which begins on the Full Commercial Operation Date and ending on the last day of the month in which all four combustion turbines at the Facility have completed a Hot Gas Path Inspection and have been released for dispatch. Each Overhaul Cycle is expected to occur every 3-4 years.

Capital Costs

19. Edison has projected a total initial rate base for Mountainview of approximately $703 million which includes $84 million for AFUDC.[14] The CPUC ruled that if Mountainview's actual plant-in-service amount (excluding AFUDC) exceeded $624 million, Mountainview cannot include such amounts in its rate base without first receiving CPUC approval.[15] As an initial matter, we note that this Commission is the ultimate arbiter of the reasonableness of costs included in a rate subject to our jurisdiction, such as the PPA. In any event, our review indicates that the Independent Producers' concerns regarding the 5 percent contingency in excess of the $595 million capital cost limit is misplaced in a cost-based ratemaking environment. Under the Commission's regulations, the amounts associated with plant-in-service are those prudently incurred costs and only those costs that are found to be imprudently incurred are disallowed. Therefore, to the extent that any costs are found by the Commission to be imprudently incurred, they will be excluded from the capital recovery charge. We further note that preliminary estimates of the initial facility investment will be trued-up within twelve months following the date of Full Commercial Operation.[16]

Rate of Return

20. The formula rate specifies that the return on rate base will be the CPUC-approved annual return, including the CPUC cost factor for long-term debt and the CPUC current return on common equity for Edison. Mountainview's cost support indicates a rate of return of 9.75 percent, including a return on equity (ROE) of 11.6 percent.

21. The Independent Producers argue that this 11.6 percent ROE warrants further review, stating that it was previously approved for only transmission facilities, and therefore should not be used to justify the to-be-acquired generation asset. We note that Edison has committed that Mountainview will make a Section 205 filing prior to commercial operation and a filing with the Commission each January 1 coincident with or subsequent to CPUC changes in Edison's return on utility assets that will support the

---

[14] Edison states that AFUDC will be calculated monthly in accordance with electric plant instructions included in FERC's Uniform System of Accounts. See, Attachment 1 to Schedule 7.01 of the PPA (Original Sheet No. 49).

[15] The $624 million was developed using an original cost of $595 million plus a 5 percent contingency ($29 million).

[16] See Article VIII, Section 8.01 and Schedule 7.01 Original Sheet No. 44.

then applicable cost of capital regardless of whether the current return has been modified. The Commission in that filing will determine the just and reasonable capitalization and return components. At that time, we will address Independent Producers' concerns as to the basis for the ROE, including whether it is appropriate for the ROE to be based on the regulated utility assets. Furthermore, the future filing commitment ensures that the actual return utilized for billing purposes, whether it be the current return or a different return, will be subject to further Commission review, under Federal Power Act (FPA) Section 205. We will direct Edison, on behalf of Mountainview, to revise the PPA to reflect this commitment.

Phase-in of Monthly Charges

22. Edison notes that the Mountainview project consists of two units that will be placed into service with the expectation that Unit 1 will enter into service before Unit 2. Accordingly, the PPA is structured to include an Initial Monthly Capital Recovery Charge that will reflect recovery of costs associated with Unit 1 and a full Monthly Capital Recovery Charge that will recover the costs associated with both Units 1 and 2. The Independent Producers raised a concern that, based on their reading of the PPA, Mountainview would charge for the costs associated with both Units even though only Unit 1 would be in service.

23. Schedule 7.01 of the PPA requires clarification. The Initial Monthly Charge should allow for recovery of the initial unit that is in service. Schedule 7.01 states: ". . . Plant-In-Service will be equal to the Initial Facility Investment associated with the each Unit that becomes operational." The phrase "the each Unit" should read "the Unit" so as to remove any confusion. Therefore, we will condition our acceptance of the PPA on Edison, on behalf of Mountainview, submitting a compliance filing correcting Schedule 7.01.

State Income Tax Treatment

24. The Independent Producers note that the recovery of State Income Taxes is calculated using flow through of book and tax depreciation differences in accordance with CPUC regulations, rather than the FERC required full normalization of such timing differences. The Independent Producers argue that this is inappropriate and inconsistent with the Commission's regulations regarding tax normalization. We agree with the intervenor that the use of flow through is inconsistent with our regulations, however, due to the characteristics of the PPA a waiver is appropriate in this case. Inasmuch as Mountainview is a single asset entity whose output will be purchased by Edison over its entire useful life, the use of flow through in calculating state income taxes will not result in excess revenues over the life of the plant. As such, it is unnecessary to record tax timing differences between state tax and book basis differences. Based on these facts, we

find Edison's proposal to be reasonable in these specific circumstances and will grant waiver of Section 35.24 of the Commission's regulations regarding normalization of state income taxes.

Decommissioning Costs

25. Finally, the PPA includes as a line item expense, decommissioning costs. However, Mountainview has not included any decommissioning costs at this time. The Independent Producers note that no decommissioning costs seem to be reflected in the charges, and therefore state that further review and discovery is necessary to determine the potential impact of decommissioning costs on the Capital Recovery Charge.

26. Our review indicates that salvage cost associated with this unit may be an appropriate cost item. However, inasmuch as Mountainview has not included any support for such cost at this time, we will require Mountainview to make a filing, with appropriate workpapers and justification, pursuant to Section 205 of the Federal Power Act when it seeks to include the recovery of decommissioning costs under the PPA. This filing requirement will ensure that all parties will have an opportunity to review and comment on the proposed level of such costs.

27. In conclusion, our review of the proposed formula rate for the recovery of capital costs, return, depreciation and associated income taxes for Mountainview indicates that it is generally reasonable. This finding is predicated on Mountainview including only the actual purchase cost with no premium or acquisition adjustment thereto for inclusion in capital costs. However, we will require that Edison, on behalf of Mountainview, make a compliance filing that modifies the formula rate for the recovery of these capital costs which includes more specificity by including the specific FERC Account numbers in the Capital Cost section of the PPA, e.g., the PPA should specifically reference amounts booked to Account 101, Plant-in-Service, amounts booked to Accounts 282-283, Accumulated Deferred Federal Income Taxes, amounts booked to Account 403, Depreciation expense, etc. The use of the FERC Uniform System of Accounts will ensure that the Commission and all interested parties will be able to track all changes to Capital Recovery Charge under the proposed formula rate.

O&M Charges

Pre-Authorization Charges

28. As noted previously, the PPA includes a collection for Pre-Authorization Charges. These charges include twelve specific costs which include, among other things, property taxes, government charges, insurance, A&G and General Plant expenses related to Edison's corporate center and costs associated with a third party service agreement – the Contractual Services Agreement (CSA) – for Mountainview's combustion and steam

turbine generators. Edison states that these costs are beyond Mountainview's control, and will be passed on through a formula rate as incurred. The estimated charges for first year of operation are approximately $20.7 million.

29. Our review indicates that the collection of these types of expenses on a formula basis that essentially flow through the actual costs incurred is generally reasonable. However, we will require some modifications to the PPA to ensure that it will result in just and reasonable rates. First, the A&G and General Plant expenses related to Edison's corporate center, designated in the PPA as Buyer Overhead Costs, are proposed to be recovered as a Pre-Authorized Charge and allocated to Mountainview by SCE. However, the method of allocation is not included in the PPA. We will require the PPA to be modified to include a description of the method to be utilized to allocate these Buyer Overhead Costs to Mountainview on a non-discriminatory basis. Additionally, another one of the twelve categories of Pre-Authorized charges are costs associated with Betterment Work,[17] Compliance Work, Facility Refurbishment Work or Major Equipment Repair or Replacement Work. Section 8.09 permits the Seller to include costs associated with such work in either the Capital Recovery Charge or as a Pre-Authorized Charge. We find that the decisions by Mountainview to either expense or capitalize any of these listed work items must be in accordance with the requirements of the Commission's Uniform System of Accounts.

30. Regarding the collection of Pre-Authorized costs as provided for in section 7.02 of the PPA, we note that section 8.08 of the PPA permits the reclassification of Pre-Authorized costs to Fixed and Variable O&M expenses or alternatively, the reclassification of Fixed and Variable O&M costs to Pre-Authorized Costs. Furthermore, the PPA provides that SCE, as the buyer, may seek CPUC regulatory review of any reclassification of Pre-Authorized costs by Mountainview. The Independent Producers raise concerns regarding any possible reclassifications. Our review indicates that both the discretion and the delegation of review of any reclassifications are inappropriate. Any reclassification of Pre-Authorized costs or Fixed and Variable O&M expenses must be filed with the Commission for its review and approval.

---

[17] Betterment Work means improvements or additions undertaken by or on behalf of Seller with respect to the Facility or any Unit for the purpose of increasing or improving the electrical output or operating efficiency of the Facility or Unit, or extending the life thereof, but excluding any maintenance work performed in the ordinary course of operations.

31. The Independent Producers also raise concerns about potential lack of future review of these costs. We believe that such concerns are best addressed by imposing additional requirements on Mountainview. Accordingly, we find that in order to ensure that the collection of costs included in the PPA as Pre-Authorized costs are just and reasonable, Mountainview will be required to modify section 7.02 of the PPA to include FERC account numbers for these specifically identified cost categories. This requirement is consistent with our requirement regarding the recovery of Capital Costs under the PPA and will work to ensure that there will be no double recovery of costs. Additionally, in order to allow all parties adequate review of the operation of this formula rate and to prevent the collection of costs that are not specifically identified by current cost categories and associated account numbers, we will require Mountainview to make an annual informational filing and an annual filing of a FERC Form No. 1.[18]

Fixed and Variable O&M Charges

32. Edison will pay a Fixed O&M charge to Mountainview of $636,000/month following the Full Commercial Operation Date, subject to annual escalation and adjustment following each Overhaul Cycle.[19] Edison's estimate of $636,000/month for Fixed O&M is derived based on projected administrative costs incurred in connection with the operation of the Facility and includes staff and labor costs, routine maintenance costs, periodic maintenance costs, and SCE provided support services costs. The $636,000/month rate will not be subject to increase during the course of an Overhaul Cycle, except for escalation. Edison states that these charges are subject to escalation to reflect cost increases due solely to inflation. The charges will then be reset to reflect recorded costs once the Overhaul Cycle is completed. Edison's derivation of the initial costs used to derive the monthly rate of $636,000 was based on costs incurred by similar units. Additionally, this cost estimate was reviewed and found reasonable by Stone & Webster consulting firm.

33. The Variable O&M Charge that Edison will pay to Mountainview shall be based on the Net Electrical Output delivered in such month at the rate of $0.44/MWh, subject to

[18] The annual informational filing and the filing of FERC Form No. 1 should be made by May 1 of each year.

[19] However, beginning at the end of the month in which the first Unit Commercial Operation Date occurs and continuing each month until the end of the month in which the Full Commercial Operation Date occurs, Edison will pay Mountainview a prorated share of the $636,000/month Fixed O&M Charge based on the number of Units in Commercial Operation in such month.

annual escalation and adjustment following each Overhaul Cycle. These costs are classified as consumables, disposal of waste and other major maintenance costs and are intended to recover monthly water and wastewater costs, chemical costs, feed water pumping costs, and heat recovery boiler costs and other variable costs not recovered under the Pre-Authorized costs. Again, the $0.44/MWh rate was based on Edison's review of such costs for similar units and was reviewed and found reasonable by Stone & Webster consulting firm.

34. Regarding the proposed Fixed and Variable O&M Charges, the Independent Producers note that while the charges are based on estimates that were reviewed and found to be reasonable by Stone & Webster, it does not appear that the Stone & Webster comparison was included in the filing. Additionally, the Independent Producers raise concerns regarding double recovery of costs in this category as well as costs under the Pre-Authorized charge.

35. These stated rates for Fixed and Variable O&M costs are intended to serve as a mechanism to control Fixed and Variable O&M costs during each overhaul cycle, except for inflation.

36. Our review of the proposed Fixed and Variable O&M stated rates indicates that such rates have not been shown to be just and reasonable and may result in unjust and unreasonable rates. Accordingly, we will reject these stated rates for Fixed and Variable O&M and require Mountainview to bill out, as part of this cost-based formula rate, the actual costs incurred, by FERC account number, for fixed and variable O&M expenses. We are not persuaded that the purported incentive to control these cost types with stated rates in intervals between Overhaul cycles is necessary or desirable. Mountainview has an obligation to operate the planned facilities in a prudent and least-cost manner. As such, the recovery of actual costs incurred for Fixed and Variable O&M expenses is appropriate. Accordingly, Mountainview must amend the PPA to reflect this finding and include the specific FERC Account Nos. for Fixed and Variable O&M expenses.

Incentive Components

37. There are two performance measurements in the PPA. The availability measurement which has both a Summer Availability and Winter Availability provision and a heat rate measurement. Regarding the availability incentive, the maximum combined payment from Mountainview or to Mountainview is $1.56 million annually, subject to escalation. In order to determine the Availability Payments, actual winter or summer availability is measured against the contract's availability target, which is 97

percent for summer periods and 92 percent for winter periods.[20] The Summer Availability Payment is calculated by multiplying $360,000 by the summer availability achieved minus the summer target availability. Similarly, the Winter Availability Payment is calculated by multiplying $60,000 by the winter availability achieved by the facility minus the winter target availability.[21]

38. Additionally, the PPA includes a target heat rate incentive for the Mountainview Project of 7000 Btu/kWh. Section 12.03 of the PPA adjusts payments under the PPA based on a comparison of the actual facility heat rate, as determined by twice-annual testing, against the Contract Heat Rate. As long as the test results are within 3 percent of the Contract Heat Rate, no incentives or penalties are assessed. Performance above or below the 6 percent deadband results in either incentive payments to Mountainview or payments by Mountainview to Edison for failure to meet these targets.

39. The Independent Producers argue that the type of incentive ratemaking contained in the PPA is inconsistent with Commission precedent and not appropriate for use when a competitive wholesale electric market exists. The Independent Producers further argue that in both the availability and heat rate incentive proposals, the potential payment/penalty is unsupported and does not appear to include a provision for Commission review. This sale under the PPA is a cost-of-service contract and not a sale at market-based rates. We therefore find the use of incentives appropriate in this instance. Regarding the Independent Producers' claim that there is no provision for Commission review, the Commission has at this time reviewed these incentive provisions and found them reasonable.

40. Our review indicates that the heat rate incentive is reasonable. Mountainview and Edison have agreed that amounts above or below the target heat rate will result either in additional payments by Mountainview to Edison that will be used to offset the additional gas costs incurred or payments by Edison to Mountainview to reflect savings as a result of maintaining the target heat rate. The target heat rate is reasonable in that it is representative of a base line expectation for this type of unit, and the additional payments

---

[20] Conversely, the PPA provides for the incentives to be measured with a minimum Summer Target Availability of 94 percent and a Winter Target Availability of 84 percent so as to limit the potential payment by Mountainview to not exceed $1,560,000.

[21] Edison states that the winter availability target of 92 percent is reduced in years where a maintenance overhaul is scheduled.

or savings are done on a 50/50 sharing basis. As such, the incentives are consistent with prior sharing of incentive rates.[22]

41. With respect to the incentive for availability targets, our review indicates that this incentive payment, roughly 1 percent of the total projected annual non-fuel revenue requirement, was developed using a base line availability that was based on similar units with the same plant characteristics. We find that the target availability relied upon is a valid comparable measure. If in the future, based on the required annual informational filings, parties believe these incentives are not just and reasonable, they are free to file a complaint with the Commission detailing their concerns.

Cost to Supply Gas

42. The PPA is structured as a tolling agreement, giving Edison the responsibility for gas procurement and hedging for the life of the unit. Edison states that it will recover the fuel costs through the CPUC's Energy Resource Recovery Account (ERRA), which is a CPUC-approved balancing account in which Edison records fuel costs relating to Edison-owned generation stations.

43. SVMG[23] argues that since the fuel cost comprises roughly two-thirds of the total cost of electricity, the Commission's focus should be on whether or not the gas supply is cost-effective. SVMG concludes that if the proposal is approved, then the risk associated with the volatility of natural gas will be borne entirely by the ratepayers.

44. The issue raised by SVMG appears to be largely a matter that will be subject to state oversight and regulation. The CPUC decision found that it is in the interest of the Edison ratepayers to have Edison recover the costs of operating Mountainview through the ERRA. The CPUC can exercise regulatory control by reviewing Edison's fuel acquisition practices in a manner similar to a utility-owned generating plant. With regard to the concern raised by SVMG, the Commission acknowledges that cost-based regulation may not always provide the clearest incentives to the utility to minimize costs for the end-use customer.

[22] See Pacific Gas and Electric Company, 90 FERC ¶ 61,314 (1999), sharing of secondary uses of jurisdictional assets on a 50/50 basis.

[23] SVMG is a voluntary association of industrial customers of PG&E and Edison.

Other Miscellaneous Issues

45. As previously noted, the summer and winter availability incentives are subject to annual escalation. Our review indicates that these annual escalations are reasonable. With respect to the remaining two PPA items that are subject to escalation (allowance for SCR catalyst replacement and a minimum cost requirement for major equipment repair), we believe that these escalations have no direct impact on customer costs. The escalation of the equipment cost threshold only changes the limit on which costs are considered major, and the escalation of the SCR catalyst replacement simply addresses how much of these costs are to be recovered through the Pre-Authorized and Variable O&M charges.

46. The Commission finds good cause to grant waiver of Section 35.3(a) of its regulations to allow the PPA to be filed more than 120 days in advance of the proposed effective date. Accordingly, the Commission accepts the PPA for filing and allows it to go into effect without suspension or hearing on the date the parties execute the PPA. Edison should inform the Commission promptly of the effective date and the date when service commences, and file an executed version of the PPA with the Commission.

Affiliate Transaction Issues

47. Edison asserts that the Commission's rules regulating affiliate transactions made at market-based rates are not applicable to the instant proposal. First, Edison notes that the PPA itself is a cost-based rate schedule and argues that rates based on costs of service (so long as they provide a return on investment that reflects a reasonable balance of consumer and investor interests) are held to be just and reasonable whether or not they are between affiliates. Second, Edison states that its purchase of Mountainview was negotiated at arm's length between non-affiliated companies, and the Commission's affiliate abuse standards apply only to market-based rates. Third, Edison observes that the PPA dedicates all of the output of the project solely to Edison for the project's life (30 years). Edison concludes that, from a competition standpoint, the PPA is equivalent to Edison purchasing Mountainview from Sequoia at arms' length and passing through the costs to its ratepayers at cost-based rates.

48. Even if the Commission were to apply its affiliate standards to this transaction, Edison contends that it would meet them. Edison presents a benchmark analysis that it asserts demonstrates that the rates, terms and conditions of the PPA are low-cost and reasonable when compared to comparable alternatives selected by buyers in the competitive market.[24]

[24] See Edison transmittal letter at 63-67 and Attachment F.

49. Finally, Edison rebuts supplier arguments that they could have offered the same power at a better price noting that other suppliers failed to come forward either with evidence in the California Commission proceeding of a willingness to provide a proposal or with a commercial proposal directly to Edison.

50. Sequoia's comments in support mirror Edison's remarks, and in addition, Sequoia argues that because Edison will be a sole shareholder of Mountainview and Mountainview will sell power only to Edison under a PPA subject to this Commission's jurisdiction, the Commission need not worry about benefits being transferred improperly from ratepayers to shareholders of an unregulated affiliate. Further, Sequoia asserts that because sales will be exclusively to Edison, the Commission need not address impacts on other wholesale customers.

51. Protesters argue that the Commission must scrutinize this proposal closely because of the potential harm that could occur to competitive wholesale markets. California Manufacturers comment that because no other competitor is likely to secure the type of favorable arrangements that Edison accorded to Mountainview, the proposal is likely to further discourage private investment in new power plants. Similarly, SVMG asserts that removing 1054 MW from the pool of demand for which independent generators would otherwise compete will dampen suppliers' enthusiasm for doing business in California. EPUC notes that the issue of whether Mountainview will compete in the market is not what provides it with an unfair competitive advantage; rather, the advantage is the long term of the PPA plus the special terms and conditions and the lack of opportunity for others to seek to provide that power. EPUC continues that market participants cannot participate where a fair and level playing field does not exist. SVMG observes that everyone except Edison's shareholders will bear the risk of Mountainview being under-utilized or of volatile gas prices, and Independent Producers object that Edison drafted the PPA unilaterally so that there was not the "'natural tension' typical of contract negotiations between unaffiliated companies that disciplines prices, terms and conditions."[25]

52. Protesters cite several recent Commission orders addressing affiliate transactions and commenting on their potential impact on wholesale competition. These cases include two in which franchised utilities sought approval under FPA Section 203 to acquire generating facilities initially developed and marketed as merchant generation by a power

---

[25] Independent Producers at 47.

marketer affiliate[26] and two others where franchised utilities entered into market-based PPAs involving affiliated merchant generators.[27]

53. Thus, several protesters assert that the Commission should not approve the proposal without applying the Edgar[28] standard. Competitive Suppliers conclude that the Commission must ensure that a market test has been met to the extent necessary for Commission approval. Independent Producers argue that the PPA should be scrutinized as an affiliate transaction even though the initial purchase was negotiated at arm's length because the two transactions are inextricably linked. They contend further that review under Edgar is not limited to market-based agreements, but believe that the larger purpose underlying the review of affiliate transactions is "the protection of competitive wholesale markets from the distorting influence of self-dealing between a utility and its affiliate."[29]

54. Even if an Edgar review is not required, several protesters suggest other standards that should be met. California Manufacturers assert that the only way Edison can demonstrate that it procured the lowest cost, most reliable resources that are available is through an open and fair competitive bid process. Independent Producers contend that Edison must show that no reasonable alternatives from non-affiliated entities were available.

55. Independent Producers object to alleged monopsonistic behavior by Edison, charging that Edison's refusal to buy from non-affiliates is anti-competitive. Other concerns raised include that the record does not show that Edison needs the capacity Mountainview offers, and that the proposed PPA is not consistent with the Commission's Code of Conduct.

---

[26] See Cinergy Services, Inc., 102 FERC ¶ 61,128 (2003), reh'g pending (Cinergy); Ameren Energy Generating Co., et al., 103 FERC ¶ 61,128 (2003), reh'g pending (Ameren).

[27] See Entergy Services, Inc., 103 FERC ¶ 61,256, reh'g denied, 105 FERC ¶ 61,208 (2003) (Entergy); Southern Power Co., 104 FERC ¶ 61,041 (2003), reh'g pending (Southern).

[28] See infra note 12.

[29] Independent Producers at 11.

Commission Determination

56. The rate presented in the PPA is a cost-based rate, which, heretofore, has not triggered the type of analysis laid out in Edgar. The issue in this case is whether the proposed cost-based formula is a just and reasonable rate based on traditional cost-based principles. This is what is required under the Commission's current policy and precedent.

57. Protesters' concerns about whether Edison's need for the capacity has been established and whether the PPA is consistent with Edison's Code of Conduct are not relevant The Commission need not examine the need for power in a proceeding filed under FPA Section 205. Moreover, Edison's need for capacity is one to be decided by a state regulatory authority. Edison's Code of Conduct pertains to its market-based transactions, and the PPA is strictly cost-based.

58. While we are conditionally accepting the PPA on the basis that it is consistent with the Commission's current policy, we will henceforth require that all affiliate long-term (one year or longer) power purchase agreements, whether at cost or market, be subject to the conditions set forth in Edgar. There have been significant changes in electricity markets since the Edgar policy was announced more than twelve years ago. For a variety of reasons, including competitive supply entry, transmission open access, and other factors, in many regions of the country market prices are below cost-based rates. In Edgar, the Commission was concerned that the "buyer potentially may have unduly favored the rates offered by its affiliate seller over lower rates offered by other nonaffiliated sellers."[30] That concern remains. In order to protect wholesale power customers and guard against potential abuse of self-dealing in a market where cost-based rates may exceed market rates, the Commission will apply Edgar to all future power purchase agreements involving affiliates. This policy will be applied prospectively to avoid regulatory impact on transactions already filed for Commission approval, i.e., filed as of the date of issuance of this order.

59. We are also concerned that granting undue preference to affiliates, whether through cost-based or market-based transactions, could cause long-term harm to the wholesale competitive market Affiliate preference could discourage non-affiliates from adding supply in the local area, harming wholesale competition and, ultimately, wholesale customers.

60. In addition, Edison makes several commitments regarding its transaction. Edison states that because the PPA is cost-based, it provides a hedge against market volatility

[30] Edgar at 62,167.

and eliminates the risk that Edison's shareholders could earn excess returns.[31] Edison states that the PPA does not confer any unfair competitive advantage because Mountainview will not compete in the competitive market and is prohibited from doing so for the 30-year term of the contract. Rather, Mountainview will dedicate its full output to Edison's customers at cost-based rates for the life of the contract. Edison goes on to explain that Mountainview will not receive compensation on a market basis. Moreover, Edison will need to purchase additional power from other resources and Mountainview will not be competing against those sources in the marketplace.[32]

61. We will accept these commitments. To ensure that these commitments are implemented, we will condition our approval on the applicants agreeing to the following. Mountainview will be created and formed solely for the purpose of owning the Mountainview project and selling the output of the facility to Edison at cost-based rates under the PPA. Mountainview will not be eligible to sell at market-based rates and will not be entitled to any waivers typically granted by the Commission under that program. As discussed earlier in this order, Mountainview will be required to follow all Commission regulations and reporting requirements (e.g., filing FERC Form 1, and maintaining its books and records in accordance with the Uniform System of Accounts) applicable to traditional public utilities.

62. Independent Producers argue that Edison is harming wholesale competition by exercising its monopsony power as the sole buyer in its territory. Independent Producers state that Edison, by choosing only to deal with an entity that would become its affiliate, has succeeded in removing 1000 MW of demand from the competitive wholesale market and has extended its market power to other markets through preferential affiliate transactions and effectively pre-empted the market. However, Independent Producers have cited no case in which the Commission made such a finding under the FPA; more importantly, Independent Producers have asserted, but not demonstrated, that Edison has exercised such power here. Independent Producers have not shown why the relevant market in this case is so constrained and why a seller in Edison's territory does not have the ability to sell to utilities in other parts of California or the West. This is particularly relevant when a utility's transmission facilities are operated by an ISO or RTO, as here.

63. Aside from Independent Producers' concerns about monopsony power, the Commission is concerned that there is nothing to prevent Edison from marketing its purchased power from Mountainview and receiving market-based compensation, an

---

[31] Id. at 6.

[32] Id. at 26-27.

action that is effectively contrary to the stated purpose of the PPA. Edison could change market outcomes by bidding any energy or capacity from the Mountainview project into the California Independent System Operator's market below its costs. Because Edison is assured full cost recovery of its cost from Mountainview, it could benefit from this bidding strategy if it depresses a clearing price and it is a net buyer in that market.[33] This example also demonstrates the ability of the two affiliates to gain an advantage over other competitors by engaging in both cost-based and market-based sales. For example, an independent power producer without the cost recovery assurances that Edison enjoys here could not sustain bidding below its marginal cost. Moreover, lowering a clearing price below a competitive outcome will serve to dampen competitive price signals. Restricting Edison's resale of the output from Mountainview to spot market sales bid at the marginal cost of each unit will address these potential concerns.[34]

PURPA Issues

64. CAC and EPUC argue that the Commission must enforce PURPA in this proceeding by either rejecting the PPA or by conditioning its acceptance in a way that would require continued purchase of QF power by Edison. Contrary to these assertions, the Commission is not required to make any findings here regarding Edison's obligations under PURPA since Mountainview will not be selling as a QF. The standard for evaluating a cost-based rate schedule is whether the rate is just and reasonable.

The Commission orders:

(A) The proposed PPA is hereby accepted, as conditioned in Paragraphs B and C, to become effective on the date Edison and Mountainview execute the PPA, as discussed in the body of this order.

(B) Edison, on behalf of Mountainview, is hereby directed to submit a compliance filing within 30 days of the date of this order reflecting the modifications discussed in the body of this order.

---

[33] Edison would have had this incentive when participating as a net buyer prior to entering into the PPA; the existence of the PPA could merely magnify the incentive.

[34] We note that section 5.05 of the PPA recognizes that any energy from the project that is available and not already dispatched for the buyer (Edison) may be subject to dispatch by CAISO in real-time or on a day-ahead basis.

(C) Mountainview is hereby directed to comply with applicable Commission regulations including complying with the Uniform System of Accounts, filing a FERC Form No. 1 on an annual basis, and making an annual informational filing by May 1 of each year detailing the prior calendar year's costs, as discussed in the body of this order.

By the Commission. Commissioner Kelly not participating.

(S E A L)

Magalie R. Salas,
Secretary.